

# Financial Advisor

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## Beware the multi-life trap

One reason corporate-owned life insurance is attractive is the ability to create non-taxable dividends for the corporation's shareholders. Where multiple lives need to be insured, administrative simplicity may encourage use of a multi-life policy, but it could also reduce the amount of non-taxable dividends available through the Capital Dividend Account (CDA). This article will highlight some of the opportunities, issues and concerns that might arise from using a corporate owned multi-life policy vs. separate insurance policies.

## Introduction

One common issue facing clients planning for business insurance needs when considering insurance on several lives is whether to purchase separate policies or have one contract which insures multiple lives. This could occur, for example, when funding a shareholders agreement or obtaining key person coverage. From an administrative standpoint, one policy may be very appealing by offering simplicity and potential opportunities for paying the fund value on each death under the policy. However, there are disadvantages that advisors and clients need to be aware of when considering the use of a multiple life or multi-life policy. In addition, proposed changes related to updating the life insurance exempt test rules may also impact the use of this type of policy design in the future.

## The importance of a life insurance policy's adjusted cost basis

Before we can understand how a multi-life policy might impact a client's planning, we need to consider the importance of a life insurance policy's adjusted cost basis (ACB).

## The ACB calculation

Simplified, a policy's ACB is calculated as follows:

$$\text{ACB} = \text{aggregate premiums for all years} - \text{cumulative net cost of pure insurance (NCPI)}$$

The NCPI is the 'net amount at risk' times the probability of dying before the end of the year, as calculated from actuarial tables. The net amount at risk is the difference between the amount of the death benefit and the cash surrender value of the policy. For example, a life insurance policy with a \$1 million death benefit and a \$300,000 cash surrender value has a \$700,000 net amount at risk. Even term life insurance policies with no cash surrender value have an ACB.

As you might expect, the likelihood of dying increases each year as we grow older. Even if premiums remain level, and even if the net amount at risk remains the same, a policy's NCPI will increase each year because the probability of dying increases each year. In time, a policy's NCPI will increase until it's greater than the aggregate premiums paid over the years. When that happens, the cumulative NCPI will equal or exceed the aggregate premiums, and the ACB will equal zero.<sup>1</sup>

## The CDA credit

A corporation that owns a life insurance policy receives the entire death benefit tax-free. Since the Canadian tax system strives to achieve integration (i.e., money received by the corporation and distributed to the shareholder should be taxed the same as if that money were received directly by the shareholder), the Income Tax Act (ITA) provides that what's received tax-free by a corporation must retain the same tax characteristics when paid out to shareholders. Payment of a death benefit to the corporation will mean that at least some portion of the death benefit will be credited to the CDA. You need the ACB to calculate this credit.

$$\text{CDA credit} = \text{death benefit} - \text{ACB}$$

When the life insured under a corporate-owned policy dies, the corporation receives the entire death benefit tax-free. However, the policy's ACB determines how much of the death benefit may be paid out to the shareholders as a non-taxable dividend. If an insured dies before the ACB has declined to zero, only that part of the death benefit that exceeds the ACB may be credited to the CDA and distributed as a non-taxable dividend. Once the ACB has declined to zero, the entire death benefit may be credited to the CDA and distributed to shareholders as a non-taxable dividend.<sup>2</sup>

## Advantages of using a multi-life policy

Consider a corporation with four shareholders, each one looking at the most appropriate way to fund their obligation under a buy-sell agreement. Using a standard cross-purchase agreement, each shareholder must personally acquire insurance on the life of the three other shareholders, with the result that 12 single life policies would be needed. Instead, each shareholder may be interested in owning only one multi-life policy, requiring just four policies in total. If the buy-sell structure involves corporate-owned insurance, this could be reduced to only one multi-life policy, owned by the corporation, insuring all four lives.

The most obvious benefit from this arrangement is administrative. Accounting and bookkeeping work can be kept to a minimum with only one policy to keep track of, one cash surrender value (CSV) to record, and one premium to pay. With some insurers and policies, the arrangement could include cost savings as well, given that there would only be one policy fee.

Apart from these administrative benefits, advisors will often recommend a corporate-owned universal life insurance policy on multiple lives that offers a death benefit plus fund option. The policy can be set up so that at each death, the corporation would receive the death benefit attributed to the deceased plus any fund value in the policy. Each death benefit, which includes the fund value, is paid tax-free under existing rules.<sup>3</sup> This can occur upon each death, allowing tax-free access to the entire policy cash value at different points in time depending on how many lives are insured under the policy. As well, the total payment, including the death benefit attributable to the fund value, will result in a credit to the corporation's CDA to the extent the death benefit exceeds the ACB of the policy.<sup>4</sup>

## Issues with a corporate multi-life policy

Corporate owned multi-life insurance policies may sound like an excellent opportunity, but the use of these policies can come with some planning and tax complications. In particular, the potential for future changes to shareholder relationships needs to be considered. For example, what happens when one shareholder decides to retire?

<sup>1</sup> A life insurance policy ACB can't be negative. Section 257 of the Income Tax Act (ITA) deems a negative ACB to be nil.

<sup>2</sup> The policy's ACB isn't credited to the CDA on the grounds that if the life insurance policy had been owned by the shareholder, and if the corporation had paid the premiums (or distributed enough money to the shareholder to allow the shareholder to pay the premiums personally) the premiums paid by the corporation or the money distributed to the shareholder would have been taxed in the shareholder's hands.

<sup>3</sup> Canada Revenue Agency (CRA) TI 2000-003388 dated September 11, 2000 confirmed that the payment of a death benefit from the fund value of the policy will be considered a "death benefit" that's received tax-free by the corporation. However, CRA TI 2003-004286IE5 dated June 25, 2004 indicates that if the policyholder has discretion as to whether the death benefit would be paid, the payment may not be made "in consequence of death" and therefore wouldn't be treated as a tax-free death benefit.

<sup>4</sup> Definition of capital dividend account in subsection 89(1) of the ITA. A corporation can pay a capital dividend to shareholders on a tax-free basis by virtue of subsection 83(2) of the ITA.

Often times, shareholders will look to the cash value within their life insurance policies to help with retirement funding. Multi-life policies will create complications in achieving this; while still possible, it could require obtaining consent from the other shareholders, which may not be easily obtained in the absence of some sort of agreement related to ownership rights.

A retiring shareholder may also want to take control of their coverage under the multi-life policy. This would mean not only obtaining permission of the corporation but also, depending on the terms of the policy, the life insurance company since that coverage needs to be removed from the multi-life policy and reissued as a separate policy. This will be complicated if there are cash values that need to be allocated between the remaining multi-life policy and the newly created separate insurance policy.<sup>5</sup>

As the shareholders move on to other endeavors, there may be a desire to substitute or replace one of the lives under the policy with the life of a new shareholder.<sup>6</sup> Whether or not a taxable disposition arises in these circumstances is a question of fact, and hinges on whether the change is fundamental to the nature of the contract. While there may be a potential argument against this, the CRA appears to be of the view that a change in the life insured under a policy, regardless of contractual provisions allowing for it, is a disposition and triggers the corresponding tax consequences.<sup>7</sup> While this concern also exists with separate corporate owned policies, the triggering of a disposition could have significantly greater impact depending on the status of the multi-life policy at that time.

The factor that's most likely to impact the largest number of clients considering a multi-life policy has to do with the CDA credit upon receipt of life insurance proceeds. Despite insuring multiple lives, a multi-life policy has only one ACB.<sup>8</sup> Due to the factors described below, the CDA credit available at the second (and subsequent) death may be less than it would have been had the corporation owned single life policies.

In the situation where a corporation acquires separate single life policies, each policy has its own ACB. When an insured dies, the ACB is deducted from the death benefit to determine the amount that may be credited to the CDA and distributed to shareholders as a non-taxable capital dividend.

As noted, a multi-life policy has only one ACB, even though it covers more than one insured life. When the first insured on a multi-life policy dies, the policy pays the death benefit attributable to that life. Unlike a single-life policy, the policy remains in force and its ACB continues without any adjustment.<sup>9</sup> At the corporate level, the CDA credit is equal to the amount by which the death benefit exceeds the policy's ACB, and a non-taxable dividend may be paid to shareholders.<sup>10</sup> When the second insured dies, the policy's full ACB remains and is subtracted a second time when calculating the CDA credit for the second death benefit. As a result, the CDA credit available at the second death may be less than it would have been if the corporation had owned two single policies, each with its own ACB.

Consider a simple example. Steven and Greg, aged 45 and 50, are co-owners of XYZ Co. The company needs \$1 million in key-person life insurance protection on each. They're considering a multi-life policy with a \$2 million aggregate death benefit, with \$1 million payable on each death.

They think it seems simpler than two separate policies, and would prefer to pay a single annual policy fee rather than two.<sup>11</sup> However, their plan could result in a reduced capital dividend on death.

Assume that Steven dies in year 19, when the multi-life policy's ACB is \$190,297, and that Greg dies the following year, when the ACB is \$176,974.<sup>12</sup> On the first death, XYZ collects the death benefit on Steven's life.<sup>13</sup> The CDA credit is \$1 million minus \$190,297, or \$809,703. When Greg dies, the policy pays its second death benefit of \$1 million. XYZ collects the second death benefit, and again credits the CDA by \$1 million minus \$176,974, or \$823,026. The total amount in the CDA after the second death is \$1,632,729.<sup>14</sup>

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<sup>5</sup> The tax consequences are also complicated in terms of determining whether there's a disposition of the multi-life policy and the possible reporting of a shareholder benefit under subsection 15(1) of the ITA on the transfer of the policy to the departing shareholder.

<sup>6</sup> Assuming this is permitted by the terms of the policy or administrative practices of the applicable life insurance company.

<sup>7</sup> See CRA document 2000-0021175, dated January 26, 2001.

<sup>8</sup> The ACB of an insurance policy is defined in subsection 148(9) of the ITA and in general terms is equal to the total of all premiums paid less the "net cost of pure insurance," which is a notional insurance charge defined in Regulation 308 of the ITA.

<sup>9</sup> There's no adjustment as the payment of the death benefit isn't a disposition that would otherwise trigger a reduction in the ACB of the policy.

<sup>10</sup> Supra note 3.

<sup>11</sup> This isn't an issue for a SunUniversalLife insurance policy since it doesn't charge a policy fee.

<sup>12</sup> Values based on a SunUniversalLife insurance policy.

<sup>13</sup> Assume that premiums for Steven's coverage ended in year 19 when Steven died.

<sup>14</sup> This example assumes that the ACB on a multi-life policy is the same as the combined ACB on two single-life policies insuring the same insurers.

Let's assume instead that XYZ owned separate policies on the shareholders, each with a death benefit of \$1 million. When Steven dies in year 19, the ACB on his policy is \$111,068. When Greg dies in year 20, the ACB on his policy is \$65,906. The combined CDA credit following both death benefits is \$1,823,026, which is \$190,297 more than with the multi-life policy, but with the same death benefit and premiums. Assuming a 30% dividend tax rate and that the full \$2,000,000 is paid out of the company, the multi-life policy arrangement would have cost \$57,089 more in tax than it would have using two single life policies.

## Proposed changes to the tax treatment of multi-life policies

The proposed changes to the policyholder tax rules arising from the draft exempt test legislation<sup>15</sup> (the "proposed legislation") will address the tax issues related to corporate owned multi-life policies mentioned above. According to the proposed legislation, the fund value of the policy will be apportioned according to each of the individual coverages provided for under a multi-life policy, which will impact how much fund value can be paid on death as a tax-free death benefit. Only the fund value up to the fund value that would otherwise arise for that particular life under a single life policy will be available on a tax-free basis. Any excess amount that's paid would be treated as a partial withdrawal which may be taxable depending on the ACB of that interest in the policy.<sup>16</sup>

The double-counting of the ACB has been addressed though, as the proposed legislation allows for a reduction to the policy's ACB by the amount attributable to each death under the multi-life policy.<sup>17</sup> This will have a positive impact on the CDA calculation, which will in turn affect how much of the death benefit can be paid as a tax-free capital dividend.

## Conclusion

While the simplicity of a multi-life policy from an administrative standpoint may be appealing, clients should be made aware of the potential disincentives from a tax perspective and the lack of flexibility in altering certain arrangements down the road before putting in place this type of policy arrangement. These considerations will also be influenced by the proposed legislation which will generally apply to multi-life policies issued after 2016.

***Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.***

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<sup>15</sup> Released by the Department of Finance on August 29, 2014. These new rules will be effective for policies issued after 2016, and for policies issued before 2017 which lose their grandfathered status.

<sup>16</sup> Proposed subsection 148(2)(e) of the ITA.

<sup>17</sup> Proposed Variable N in the definition of adjusted cost basis contained in subsection 149(9) of the ITA.

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