CORPORATE OWNED INSURANCE

There are many reasons why insurance should be purchased on the life of the shareholder of a private corporation. Once the decision is made to acquire life insurance, the question of whether it is better for insurance to be held personally or within the corporation can arise. This article outlines some of the reasons why business owners buy life insurance, the potential tax benefits to owning the insurance within a corporation, and issues that may arise as consequence of doing so.

WHY HOLD LIFE INSURANCE?[1]

Business Continuity

Life insurance is often purchased on the life of a key employee or shareholder. This is commonly referred to as "key-person" life insurance. Should this individual pass away, the life insurance proceeds may provide liquidity to assist the business in continuing.

Buy-Sell Agreement Facilitation

There is often more than one shareholder of a corporation and those shareholders frequently have entered into an agreement specifying what will happen should one shareholder wish to exit the business or when a shareholder passes away. On the death of one shareholder, for example, the insurance proceeds could be used to purchase (or redeem) the shares of the deceased shareholder.

Business Loan Protection

Insurance may be obtained to permit corporate debt to be extinguished upon death.

Family Protection

Life insurance is often purchased for the simple reason of providing funds to support the business owner's surviving family members.

Capital Gains Tax

On death, most non-registered property held by the deceased (other than property transferred to a spouse or common-law partner) is deemed to have been disposed of at fair market value. Life insurance may be purchased to cover any tax arising, so that certain property (such as private company shares or vacation properties) will not need to be sold to cover the tax liability and may continue to be held by future generations.

TAX BENEFITS OF CORPORATE-OWNED INSURANCE

Reduced Cost of Premiums

Although life insurance premiums are not generally tax deductible, low corporate tax rates may result in savings on insurance premiums. When the life insurance policy is owned by the corporation, premiums are paid from corporate funds that have only been subject to tax at the corporate level. The corporate tax rate is generally lower than the personal tax rate. When life insurance premiums are paid with personal funds that were earned through a corporation, they are generally subject to tax at a higher rate as salary, or taxed at both the corporate and personal levels if received as dividends. So, corporate-paid premiums have a lower after-tax cost than premiums that were paid personally. For example, assume Sally is the sole shareholder and an employee of a private company, and her marginal tax rate is 50%. If Sally acquires life insurance with annual premiums of $2,000, she would need to withdraw $4,000 in salary to cover the annual premium; however, if the policy was held by the corporation, assuming it pays tax at a 25% tax rate, the pre-tax cost of the premiums would be only $2,666[2]. There would be an additional $1,334[3] in the corporation to distribute to Sally as salary. After tax, Sally would have $667[4] more than if she had paid the insurance premiums personally.

If, however, the corporation that pays the premiums is not the owner and beneficiary of the life insurance policy, then tax issues may arise. For instance, if the shareholder of the corporation is the owner or the beneficiary of the insurance policy, then the premiums paid may be taxable to the shareholder as a shareholder benefit. Similarly, if a different corporation is the owner or beneficiary (such as a holding company or operating company), adverse tax consequences may arise. As a result, it is generally advisable to make the corporation the beneficiary (and owner) of the policy if it's paying the premiums.

Tax-Free Life Insurance Proceeds

Just as life insurance premiums are generally not tax deductible, the death benefit associated with life insurance is generally received on a tax-free basis[5], whether such proceeds are received by an individual, or by a corporation. So, if the life insurance policy is held by a corporation, the proceeds on death will not be subject to tax within the corporation. As a result, how those proceeds will be paid out to the shareholder(s) of the corporation must be considered.

The Capital Dividend Account (CDA) is a notional account of a private corporation. An amount equal to the CDA balance at any point in time can be distributed to shareholders as tax-free capital dividends. Amounts added to the CDA include certain tax-free amounts received by the corporation, such as the non-taxable portion of capital gains, which is generally 50%, less the non-taxable portion of capital losses, at a rate of 50%, and the life insurance death benefit less the adjusted cost basis (ACB) of the policy.

WHAT IS THE ACB OF A LIFE INSURANCE POLICY?

Generally, the ACB of a life insurance policy is the total premiums paid, less the Net Cost of Pure Insurance (NCPI). The NCPI is the pure mortality cost, being the part of the premium paid for insurance, and not for any investment component. In other words, after deducting the NCPI from the premiums paid, the ACB is the portion of the premium paid relating to the investment component of the policy.

Usually the ACB will rise in the years shortly after the policy is issued, as initial premiums are paid, and then starts to decline, as the cost of pure insurance rises, until it declines to zero.

To calculate the ACB of a life insurance policy can be a very complex process and policyholders will not be able to determine the ACB on their own. The life insurance provider should supply this value when requested.

It is also important to note that under new tax rules, which come into effect in 2017, it will take longer for the ACB to decline to zero. Policies in effect prior to 2017 will have the ACB calculated under the existing tax rules; therefore, if a policy is being considered, a client may wish to finalize the purchase before the new tax rules take effect in 2017.

Amount added to the CDA

If the ACB is nil, then the entire proceeds of the policy would be added to the CDA. So long as there is not a negative balance in the CDA[6], 100% of the insurance proceeds can be paid out to the shareholder tax-free.

It is important to note that it is not safe to assume that the ACB of the policy will be always be nil. As set out above, the ACB of a policy may take years to decline to zero. Until that time, a portion of the life insurance proceeds will not be available to be added to the CDA, and will be subject to tax when ultimately distributed to the shareholder.

Collateral Insurance

If a life insurance policy is assigned as collateral for a loan, a portion of the premiums may be tax deductible. In addition, unless the arrangement constitutes a leveraged insured annuity, the assignment will not impact the portion of the proceeds on death that is added to the CDA.

TRANSFER OF A PERSONALLY-OWNED LIFE INSURANCE POLICY TO A CORPORATION

What happens if one already owns a life insurance policy? Should the policy be transferred to a private corporation so that the premiums have a lower after-tax cost? This is not a simple question to answer.

Because the transfer will be considered a disposition of the life insurance policy for tax purposes, there is the possibility that the shareholder could realize a policy gain on the transfer[7]. This policy gain would be equal to the proceeds received, minus the ACB. When a policy is transferred to a corporation where the owner is a majority shareholder, as it is a transfer between parties not dealing at arm's length, the proceeds are deemed to be the Cash Surrender Value (CSV). Therefore, if the CSV exceeds the ACB of the policy, the individual will realize a policy gain that is taxable as ordinary income, and not as a 50% taxable capital gain.

If the fair market value of the policy exceeds the CSV, perhaps because the policyholder's health has deteriorated and it would be more expensive to replace the same policy today, the shareholder may be able to extract non-taxable proceeds from the corporation. If the corporation were to pay the shareholder an amount equal to the fair market value, as determined by a professional valuator, the difference between the fair market value and the CSV could be received by the shareholder on a tax-free basis.

Let's assume Sally's policy has a CSV of $150,000 and an ACB of $100,000. If the policy is transferred to her corporation, she will realize a policy gain of $50,000[8]. This will occur no matter what she is paid by the corporation for the policy. In addition, the ACB of the policy to the corporation will be the CSV, no matter what the consideration paid; however, if it is established that the fair market value of the policy is $200,000, and the corporation pays that amount to Sally, she will continue to only be taxed on the policy gain of $50,000. Amounts paid in excess of the CSV of $150,000 and no more than the fair market value of $200,000 can be received on a tax-free basis[9]

ANCILLARY TAX ISSUES

Small Business Tax Rate

Certain corporations are entitled to a reduced tax rate, sometimes called the "small business tax rate", on up to $500,000 (federally) of active business income earned in Canada. This is only available when the corporation's capital for the year does not exceed certain thresholds. Access to the small business tax rate is limited for corporations with over $10 million of capital and is not available for corporations with over $15 million of capital. The ownership of a life insurance policy may impact the ability of a corporation to access this lower tax rate, as the policy could increase the corporation's capital base above the $10 million threshold.

Lifetime Capital Gains Exemption

Gains realized by an individual on the disposition of qualifying small business corporation shares (QSBC shares) are eligible to be sheltered from tax using the lifetime capital gains exemption (LCGE), currently $813,600 for QSBC shares and $1 million for farming and fishing property. There are, however, a number of criteria to be satisfied before the LCGE can be utilized. Two of these tests relate to the percentage of assets that must be used in an active business. The fair market value of an insurance policy will be included in the percentage of assets that are not used in an active business. Depending on the other property in the corporation, this could cause the shares to be ineligible for the LCGE.

Corporate Insured Annuities[10]

An "insured annuity" generally refers to an annuity contract where the annuitant has also purchased life insurance. The proceeds of the life insurance policy paid on the death of the insured annuitant will replace the capital that was previously invested in the annuity. Premiums for the insurance policy are generally paid out of the cash received from the annuity contract. Annuity contracts fall into two different categories for tax purposes: prescribed annuity contracts (PAC), for which payments are taxed more favorably, and accrual annuity contracts. When an annuity is held by a corporation, it cannot be a PAC, as one requirement of a PAC is that it be cannot be held by a corporation. So, at the death of the annuitant, there could be an income inclusion to the corporation in respect of the annuity contract. The death benefit on the insurance policy would be treated as any other insurance policy, with the appropriate allocation to the CDA account.

The value of the annuity and the life insurance policy at the time of death could have implications to the shareholder. The shareholder will be deemed to have disposed of his shares immediately before death, unless there is a transfer to a spouse/common-law partner, at their fair market value. The value of such shares is partially derived from the value of corporate assets, including the annuity and life insurance policy. The CSV of the life insurance policy is deemed to be its value for purposes of valuing the corporation shares. Because of this, it is common to hold term insurance, or a universal policy with a low cash value. What's unclear, however, is how the value of the annuity will be determined.

Is the rule deeming the CSV to be used for valuing an insurance policy immediately before death applicable to annuity contracts? Many take the position that such a rule is applicable, and the CSV would be nil since the policy can no longer be surrendered. This would result in the shares having a lower fair market value upon death than they would if a GIC was held. Also, one could argue that there is no value to an annuity immediately before death since payments do not continue afterwards.

CRA, however, may take the position that immediately before death there is a value to the annuity, as it is unclear at that moment in time how long payments will be received under the annuity. This could increase the value of the shares, and hence, the gain realized. In addition, the value of the annuity should be factored into the calculation of whether the shares will qualify for the LCGE on disposition.

One might consider holding the annuity personally, so that it can be treated as a PAC and its value does not impact the value/status of the corporation shares. The life insurance policy could continue to be held within the corporation.

Once the decision to purchase insurance on the life of a shareholder has been made, it must be kept in mind that advance planning is important in determining whether such insurance should be held within a corporation, or outside of the corporation.

[1] See http://w2.cibc.com/en/ke/advisor-articles/small-business/Pages/insurance.aspx for a more detailed discussion..
[2] Corporate tax on income of $2,666 would be $666 ($2,666 x 25%), leaving $2,000 ($2,666 – $666) after tax.
[3] $4,000 – $2,666.
[4] $1,334 less personal tax of $667.
[5] Proceeds from life insurance policies that do not qualify as "exempt policies" may be taxable. Exempt policies are insurance policies where the policyholder is not required under tax rules to include an accrual amount in income annually. These policies must satisfy tests in the Income Tax Act so that only policies with insurance protection as their primary purpose are excluded from annual tax. For the purposes of this discussion, it is assumed that the life insurance policies qualify as exempt policies, as most Canadian insurance policies so qualify.
[6] A negative balance in the CDA can occur, for example, when the non-allowable portion of capital losses exceeds the CDA balance at any point in time
[7] A life insurance policy does not qualify for the general tax-free corporate rollover in subsection 85(1) of the Income Tax Act.
[8] Policy gain is calculated as proceeds (deemed to be CSV of $150,000) less ACB of $100,000.
[9] CRA has confirmed this result from a technical perspective. However, this issue was referred to the Department of Finance for review to determine if this result should change. CRA has not commented on whether GAAR could apply. Any client considering this transaction must obtain independent tax advice.
[10] General information on Insured Annuities can be found at http://w2.cibc.com/en/km/wg/services/Documents/marketing/special-reports/insured-annuity.pdf

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