CIBC Wood Gundy

THE O'KEEFFE GROUP

INTEGRATED PLANNING. DISCIPLINED INVESTING.

Insurance Planning For Business Owners

Insurance Planning For Business Owners

Business owners face a unique set of challenges and opportunities when it comes to the management of their wealth. Whether you have a sole proprietorship or a corporation, protecting your business from a number of key risks is critical to your continued success. Insurance-based solutions have an important role to play in mitigating the financial impact of several of these, such as the loss of a key emInployee or shareholder, the loss of personal income and the high taxation of corporate investments.

Protecting your business from the loss of a key employee or shareholder

For some businesses, revenue is dependant upon the skills of a key employee, such as a manager, a top salesperson, or someone who maintains crucial customer relationships. Without the implementation of a sound contingency plan, the death, disability or illness of a key person could impair the growth or stability of your business. Having the right type of insurance in place can protect you from these potential risks.

Key person insurance is a term insurance policy on the life of a key employee. In the event of the employee's death, the business receives a lump sum, tax-free payment which can be used to hire an experienced replacement or to deal with cash flow issues caused by a disruption to the revenues or operations of the business.

Business overhead insurance is a disability policy to protect the business from the inability of a key employee to perform his or her essential duties. For the period of the disability, a monthly benefit would be received to help cover fixed expenses of operating the business such as salaries, rent, leases and utilities.

Buy-sell insurance is designed to fund the purchase or redemption of shares upon the death of a shareholder. This is done in conjunction with a buy/sell agreement that requires the surviving shareholder to purchase the shares of the deceased shareholder, usually at fair market value. Typically, a shareholders agreement will require that life insurance be purchased to provide the necessary funds for this buyout. This protects the surviving shareholder who does not have to pay out capital at a critical time of transition, or acquire an unwanted business partner. Importantly, along with the shareholders agreement, it ensures that the transfer of the shares at an agreed-upon value will take place immediately providing the needed capital for the deceased's family.

Protecting your family from a loss of income

Major life-changing events, such as an injury or illness, can happen without warning, potentially putting your business, and your financial well being, at risk. For business owners and self-employed individuals whose income is crucial to maintaining their family's financial security, protecting against a loss in income due to injury or sickness is of particular importance. One way to mitigate this financial impact is through individual disability insurance and critical illness insurance.

Disability insurance provides you with income for a specified period of time, if you are unable to work due to an injury or illness. Disability insurance plans offer a range of benefits and premium options to suit your occupation, income level and budget. Your coverage can be customized to include your choice of benefit periods (how long you can receive benefits), elimination periods (the number of days of disability that must pass before benefits are payable) and premium options. On some policies, you can purchase a rider that will periodically refund a portion of the premiums paid, if no claim is made.

Critical illness (CI) insurance can provide you with a tax-free lump sum benefit, if you are diagnosed with a covered critical illness. This can be used in any way you see fit, such as paying down debt, modifying your home or vehicle, or to get alternative medical treatment abroad, thus reducing the need to withdraw funds from your savings or investments. Some of the most common illnesses covered by CI policies include: stroke, heart attack, cancer, kidney failure, Alzheimer's, Parkinson's, etc.

Critical Illness as a complement to Disability Insurance

Critical illness insurance provides financial protection in ways that are different, yet complementary to disability. CI covers specific medical conditions without measuring their impact on your ability to earn income. An event covered by CI, such as a heart attack, may not give rise to a disability claim if recovery occurs within the elimination period. The inverse is also true: conditions that give rise to disability claims, such as a back injury, may not be covered by CI. Although some conditions may provide a benefit from both, such as blindness, many more will be covered by only one or the other, which is why they can be seen as complementary.

Protecting your family from the impact of taxation

Business owners rely on the equity in their business to provide income during retirement and build their personal wealth. Toward this end, retained earnings are often moved, tax-free, to a holding company and invested for the long-term. The income generated from these investments is subject to annual taxation close to the top personal marginal tax rate. Often times, this capital is effectively "trapped" in the holding company due to the high tax cost to the shareholder of receiving it as salary or a dividend. Further tax consequences arise upon death of the shareholder, when his or her shares are deemed to have been sold at fair market value and any resulting capital gains tax becomes payable. Lastly, when the holding company assets are liquidated, the dividends paid out will be taxable to your heirs or estate.

Tax-exempt life insurance is the only financial vehicle that allows for the sheltering of these otherwise taxable corporate assets and their eventual payout tax-free to the estate or surviving shareholders. It combines permanent insurance protection, the death benefit, with a savings component, the cash surrender value. These features provide an attractive opportunity to defer taxes during your lifetime, as capital grows tax-free within the policy. The tax-free payment of the death benefit to the corporation provides funds that are payable largely or entirely tax-free to the surviving shareholders who could be the estate or your heirs.

Who should consider tax-exempt life insurance?

Typically permanent life insurance policies work best for those who:

- Are in good health
- Currently maximize their RRSP and TFSA contributions or are able to do so,
- Have substantial non-registered savings subject to annual taxation,
- Have, or will likely accumulate, more capital in their lifetime than they will likely consume (redundant capital), and
- Are concerned about, and would like to proactively address the effect of taxation on their estate

What type and amount of insurance is appropriate?

A permanent insurance policy is a long-term planning strategy, whose early cancellation can be quite punitive. Accordingly, it is important to first carefully consider your personal and financial circumstances and goals.
Our process typically involves:

1. Creating a full financial plan: identifying assets and liabilities, expected spending and saving, major future outlays and all other considerations relevant to your financial affairs in order to project your future net worth.
2. Identifying the existence of, if any, capital that is likely destined for the estate
3. Recommending the type and amount of coverage to meet your objectives within the context of the financial plan, such as: funding your projected estate tax liabilities, enhancing your estate or your retirement income.

What are the benefits of corporate-owned life insurance?

Corporately-owned life insurance has some unique characteristics that make it particularly attractive for these assets. Some of these benefits include:

- Using corporate capital to pay for premiums, which is cheaper and more efficient than personal capital*
- Elimination of future taxation by transferring capital from a tax-exposed environment to a tax-free environment
- Tax-free growth of investments and income earned within the policy
- Creating a large credit to your capital dividend account when insurance proceeds are received, which allows funds to flow to your heirs tax-free
- Ensuring liquidity to pay capital gains taxes without selling assets
- Magnifying the value of the estate
- Using the policy to provide cash flow in retirement by leveraging the cash surrender value
- Significant tax savings to the estate as the death benefit is not included in the fair market value of the shares of the corporation for capital gains calculations

* In Ontario, the highest individual marginal tax rate is 46.41% vs.15.50% for small businesses. An annual $10,000 premium would require the individual to earn **$18,660.20** ($10,000/(1-.4641)) before tax to pay the $10,000 premium vs. only **$11,834.32** ($10,000/(1-.155)) if the small business pays the premium. *NOTE* the latter assumes the taxable income of the small business is under the $500,000 limit for the preferred rate.

CIBC Wood Gundy
The O'Keeffe Group

181 Bay Street
Suite # 600
Toronto, Ontario M5J 2T3

Tel: (416) 369-2224
Fax: (416) 369-7683

patrick.okeeffe@cibc.ca