Collins Barrow
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TAX ALERT

Life insurance policies and your corporation

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When seeking to buy life insurance, a business owner has two primary options that will allow the insurance proceeds to be paid out tax free. It is well known that life insurance proceeds received personally are not subject to tax. In addition, however, where a corporation owns a policy and receives proceeds, there is a mechanism to pay those proceeds out tax free through the corporation's capital dividend account (CDA).

Though there are many factors that will affect the decision between these two options, the factor that is often most important to business owners is the cost of the policy premiums. Generally, premiums paid for a life insurance policy are not a deductible expense and are paid using "after-tax dollars." Thus, if a corporation's tax rate is lower than the personal tax rate – which it usually is – it would cost less to fund the premiums in the corporation rather than paying for them personally.

Suppose Betty owns a Canadian corporation and is considering the purchase of a life insurance policy with a monthly premium of $1,000. Betty's personal marginal tax rate is 46% and her corporation's tax rate is 25%. If Betty purchases the policy personally, she will have to earn $1,852 in order to have $1,000 after tax to pay the monthly premium. In contrast, if Betty's corporation owns and funds her life insurance policy, the corporation would have to earn only $1,333 before tax to fund the $1,000 monthly premium. The result is that Betty saves about $500 per month ($6,000 per year) when the premiums are paid with corporate dollars.

Because it is usually "cheaper" to fund life insurance premiums with corporate dollars, individuals often choose to have their corporations own their life insurance policies. However, if a business owner already owns a life insurance policy personally, should he or she transfer this policy to the corporation? As with most tax-planning questions, the answer will depend on each individual's facts and circumstances. In certain cases, a transfer of a personally owned policy can even result in tax-free funds owing to the shareholder.

Factors to consider on the transfer of a personally owned policy to a corporation

Generally, the transfer of a personally owned policy to a corporation is a disposition for tax purposes. When the transfer is between two parties not dealing at arm's length (a shareholder and his or her corporation, for example) the proceeds of disposition to the shareholder are deemed to be the policy's cash surrender value (CSV). If the CSV of the policy exceeds the policy's adjusted cost basis (ACB), there will be a policy gain on the transfer of the policy. Policy gains are fully taxable, like interest, in contrast to capital gains where only 50% of the gain is included in income. The corporation is also deemed to acquire the policy at its CSV.

Where an insurance policy has a fair market value (FMV) greater than its CSV, the shareholder may be able to receive consideration for the policy in excess of the CSV without any additional taxation. The FMV of a life insurance policy is difficult to determine as it is based on a number of factors, including the health of the insured, the number of years the policy has been in force, the CSV, the replacement value, etc. At Collins Barrow, we recommend using an experienced valuator of life insurance policies to determine the FMV of a policy. The cost for such a valuation typically ranges from $1,500 to $3,000.

This type of planning is best shown with an example. Consider Bob, who is 58 years old and the owner of a Canadian corporation. Bob has a $1 million term policy that he has owned personally for 15 years. He recently suffered a cardiac incident and is not as healthy as he used to be. Bob has contacted an actuary who specializes in the valuation of policies. The actuary has determined that the FMV of Bob's policy is approximately $300,000. If Bob was to transfer his term life insurance policy into his corporation, he could receive $300,000 in cash (or a note) from the corporation tax free. Bob will have a disposition of his policy for tax purposes, but the proceeds of disposition will be nil since the policy is a term policy with no CSV.

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Bob's corporation is also deemed to acquire the policy for its CSV (or nil), giving the policy an ACB of nil. When Bob dies, the corporation will receive the life insurance death benefit and an addition to its CDA equal to the life insurance death benefit less the policy's ACB. The lower the ACB, the higher the CDA value on death, so a transfer in which the ACB is nil could result in a higher CDA value. For example, if Bob died after the policy was transferred into the corporation, the corporation would receive an addition to its CDA for the full $1 million, which could then be distributed to the estate or other shareholders as a tax-free capital dividend.

Although this planning sounds attractive, there are some longer-term implications that should be considered.

- **Who is the ultimate beneficiary of the life insurance proceeds?** When a life insurance policy is owned by a corporation, the corporation should also be the beneficiary of the policy to avoid a taxable shareholder benefit. If the ultimate beneficiary is not a shareholder or not going to be a shareholder on death, it may be more difficult to get the life insurance proceeds to the intended beneficiary.
- **What are the future plans for the corporation?** If the plan is to sell or wind up the company in the future, there may be negative tax consequences on a future transfer of a life insurance policy out of the corporation. The positive tax consequences above are reversed when doing a transfer from a corporation to a shareholder. As above, the corporation will have a disposition of the policy and a policy gain if the CSV exceeds the ACB on transfer. Further, the FMV at the time of transfer will be a taxable shareholder benefit. If the shareholder is uninsurable or ill at the time of transfer, the taxable benefit could be substantial.
- **Is creditor protection important?** A corporate-owned life insurance policy is not afforded the same creditor-protection benefits as an individually owned policy with the proper beneficiary designation. A corporate-owned life insurance policy will be vulnerable to the corporation's creditors.

Consideration should also be given to how the Canada Revenue Agency (CRA) views this type of planning. In response to technical interpretation requests, the CRA has indicated that, while it agrees with the tax result, there is some question as to whether this was the intention of the legislation. The matter has been referred to the Ministry of Finance, though at the time of this writing there has been no change to the legislation.

Whether it is better for you to own your life insurance policy personally or in your corporation depends on the facts and circumstances in your situation. There may be short-term tax-planning opportunities available on the transfer of a personal policy to your corporation, but the longer-term tax implications must also be considered. Your Collins Barrow advisor can help you determine what is best for you. **§**