By Jeff Sniderman

Corporate or personal?

There are a number of reasons to hold a life insurance policy in a corporation rather than personally — one being the tax treatment

The proposed changes to the exempt test for life insurance policies announced in the 2012 federal budget will likely create a flurry of insurance proposals aimed at grandfathering the old preferential tax treatment to be accorded policies issued by the end of 2013. Many of these proposals will pertain to corporate-owned life insurance, which provides substantial tax benefits that are sometimes overlooked or inadequately understood by accountants and other financial advisers.

A lack of familiarity with the tax treatment, alternate structures and the insurance product itself can impede their ability to provide professional advice to their clients. This is a review of the tax treatment of corporate-owned life insurance.

The most basic tax fact regarding life insurance is that the death benefit is always paid tax-free to the beneficiary. To maintain the integration concept — the notion that the tax system should be designed and tax rates set so a taxpayer pays the same amount of tax irrespective of whether a form of income is earned directly or via a corporation — a death benefit paid to a corporation creates a credit to the capital dividend account (CDA) equal to the death benefit less the adjusted cost basis (ACB) of the policy to the corporate beneficiary. Consequently the death benefit can flow out substantially tax-free as a capital dividend to the intended beneficiaries who may be direct sharehold-

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ers or beneficiaries of a trust or an estate that holds the shares.

The next basic tax fact is that an exempt policy is not subject to annual taxation on the increase in the cash value of the policy. This allows the corporation to tax-shelter capital paid into the policy as premiums. The growing cash value typically gives rise to a growing death benefit, allowing a larger sum to be paid tax-free to the corporation on the death of the insured, which then receives the capital dividend treatment described above. Even where the death benefit does not increase, there is an implicit sheltering in that the difference between the total premiums paid and the eventual death benefit is not treated as income or as a capital gain.

In the situation of a holding company, where a significant portion of the capital is expected to be passed on by the shareholders to their beneficiaries, the corporate-owned policy can serve as a tax-free conduit for this purpose. Simply put, dollars paid into the policy grow to a larger value tax free and then are paid out of the corporation to the beneficiaries tax free. Though this may seem too good to be true, it is in fact the way the tax rules are written and applied.

Using corporate cash to invest in life insurance premiums compares very favourably with the alternative of putting cash into taxable investments such as fixed income products, which accrue income that is subject to annual taxation. Further tax is payable when a dividend is paid to beneficiaries. Lastly, taxable investments contribute to the capital gains tax liability on the deemed disposition of the deceased shareholder's shares.

By contrast, the death benefit is not considered a corporate asset for the purpose of the share valuation, thus saving capital gains tax. (However, the cash surrender value [CSV] of the insurance policy, if any, is included in the fair market value [FMV] of the shares.) The result of this preferential tax treatment is the creation of a larger estate using life insurance than is generally created using alternative corporate investments of similar risk and funded with the same deposits.

The last basic tax fact is that life insurance is not a capital property for tax purposes, nor is it eligible property for the purposes of a Section 85 rollover. Rather, the transfer of an existing policy to a corporation is considered a disposition.

Ironically, the tax treatment of this transaction can be particularly beneficial where the existing policyholder is a shareholder because the proceeds of disposition are deemed to be equal to the CSV, which may be nil or less than the ACB, resulting in no taxable policy gain.

On the other hand, the transfer of the policy to the corporation gives the shareholder the right to receive, in exchange, a payment equal to the FMV of the policy, which may be tax free. The FMV, which is best established by an actuary, can be a very significant number, especially for a long-established policy or when the life expectancy of the insured is impaired.

As a final benefit, the ACB of the policy to the corporation is the CSV, not the FMV, which can result in a lower ACB to the corporation than the ACB was to the existing policyholder, thereby reducing the portion of the death benefit, which is distributed to the shareholder as a taxable dividend rather than a tax-free capital dividend.

There are several other reasons why one may want to hold a life insurance policy in the corporation rather than personally. First, the corporation may be in a better position to pay the premiums, especially where capital is effectively trapped in the corporation by the tax cost of getting it into the shareholder's hands.

Paying the premiums with after-tax corporate dollars is in virtually all cases cheaper than paying the same premiums personally. (The corporation must use after-tax dollars because premiums are nondeductible except to a limited extent if the coverage is required by a lender for a corporate loan.) More fundamentally, the death benefit may provide liquidity that can be used to redeem the shares of the deceased pursuant to a shareholders agreement or to meet operating requirements where the insured is a key employee whose death would cause a disruption to the operations and thereby the cash flow of the corporation.

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Notwithstanding the advantages, there may be reasons not to own the life insurance in a corporation, such as:

- the corporation may be an operating company where the death benefit and CSV could be subject to the claims of creditors (in contrast, if the policy is personally owned, the death benefit is protected from the owner's creditors as long as there is a named beneficiary and further where a beneficiary designation is made in favour of a member of the preferred family class, the policy itself, including the CSV, is protected from creditors under provincial insurance legislation);
- there is an intention to access the cash value of the policy for personal cash-flow purposes and corporate ownership could give rise to a shareholder benefit; or,
- there is a desire to sell or wind up the company before the death of the insured and the expected tax cost of transferring the policy at that time is considered prohibitive.

The second part of this article, in the next issue, will discuss some of the common corporate-owned insurance structures designed to achieve the retirement and estate objectives of shareholders in a tax-efficient manner.

Jeff Sniderman, MBA, CFP, TEP, EPC, CLU, CH.F.C., is an estate planning specialist and first vice-president at CIBC Wood Gundy Financial Services Inc.

Technical editor: Jay Hutchison, tax managing partner, Canada, E&Y