By Jeff Sniderman

Evaluating corporate-owned life insurance

There are good reasons to hold a life insurance policy in a corporation — one being the tax treatment

Corporate-owned life insurance is an effective tool for dealing with a multitude of tax and estate planning issues, at both the personal and corporate level. The array of products and the combinations of insured, owner and beneficiary, as well as the many funding and investment options, allow for great customization. They also make evaluating insurance proposals received by a client a challenge for accountants and other financial advisers.

Life insurance has two important and unique qualities that make it ideal for tax and estate planning: it provides a tax-free benefit on the death of the insured (death benefit), and it can be designed to have a growing cash surrender value (cash value), which is exempt from annual taxation (see Taxation, April). These features allow it to be used for a variety of personal and corporate objectives.

In the corporate context, the death benefit can be used for business continuation purposes, allowing a company to recover from the financial impact of a key employee's death (key man). This may take the form of providing capital to attract a skilled replacement, or dealing with the cash flow and going concern issues resulting from a death such as lost sales, difficulty in collecting receivables or the calling of a bank loan. Alternatively, the death benefit can be used for succession purposes by funding the redemption or purchase of the deceased's shares (buy/sell). An increasing death benefit is useful for buy/sell purposes when shares are increasing in value, and the associated cash value can be used as collateral for corporate or shareholder borrowing.

When the corporate perspective is expanded to include the tax issues and estate planning goals of the shareholders, corporate-owned life insurance becomes very attractive for clients wishing to fund capital gains tax triggered by the death of an insured; fund the lifestyle of a surviving spouse; fund a family trust or enhance the after-tax value of an estate. This is because the policy's cash value grows tax-free, and substantially all the death benefit flows out of the corporation as a tax-free capital dividend, increasing the tax-efficiency and value of life insurance compared with alternative taxable investments within a corporation.

RYAN SNOOK

When considering what type of insurance to use for a particular purpose it is important to distinguish between the temporary coverage provided by term insurance and the permanent coverage provided by whole life, universal life or term-to-100 policies. Term coverage has a much lower initial premium and is best suited for temporary needs because the guaranteed premiums increase on each renewal, dramatically at older ages, and the coverage generally ends at age 80 or 85 (though it is usually convertible to permanent insurance until ages 65 to 75). It is pure protection only and has no cash value. Accordingly it is suitable for corporate operating needs, including key-man coverage, insuring corporate debt or for buy/sell purposes where the shares have a relatively fixed value.

Permanent coverage, which is designed to stay in force for the entire life of the insured, is a better choice for holding company and personal estate purposes because of the longtime horizon, the potential requirement for a cash value or for an increasing death benefit, and the

long-term affordability of a level premium or a limited premium-paying period, which is only available with permanent products.

It is also important to ensure that there is a good match between when the death benefit is required for a particular purpose and when it will actually be paid. This is a function of who is insured and whether it is single life, multilife, joint first-to-die or joint last-to-die coverage. These options also have a material impact on the cost since the earlier a death benefit is expected to be paid, the higher the premium. Accordingly, joint first-to-die and multilife are the most expensive, followed by single life and finally joint last-to-die. The latter is often used for estate tax liabilities, since the benefit is paid on the second death of a couple, which is when large tax liabilities are typically triggered on appreciated capital property and registered capital.

Each client has unique facts and a particular insurance product may be better suited to those facts depending on factors such as the required duration of coverage, the age and health of the insured, the capital or cash flow available for funding the premium, and the desired level of flexibility, guarantees and liquidity. It takes an insurance expert to look at the full array of products and select the optimal one for a particular set of facts and objectives. Nonetheless, the client's accountant or financial adviser may be engaged to determine if the proposed insurance achieves the client's objectives and in a cost-effective, tax-efficient and low-risk manner.

The insurance proposals often contain many assumptions that can have a material impact on the projected future values. These assumptions, such as future investment returns and dividend rates, should be compared with appropriate historical rates and conservatively tested within ranges to create a high confidence level that the projected values will be realized or exceeded. In this connection it is important to identify which values or rates are guaranteed within the policy and which are not.

One popular insurance concept illustration compares the option of making premium deposits into a permanent policy within a holding company to the option of investing the same premium amounts in a fully taxable corporate-owned investment such as bonds. This comparison assumes that the deposits are not required for retirement income and would form part of the estate. Typically the illustration uses a higher than current yield for the bonds to allow for higher rates of inflation in the future.

Due to preferential tax treatment, the insurance option usually provides a much higher net estate value than the bond option at life expectancy, unless the rate assumed for the bonds is about twice the implicit yield of the insurance. The interest income earned by the bonds is taxed at the higher rates that apply to passive income and then subject to the top dividend rate that typically applies when the liquidated investments are paid out to the estate or a deemed dividend results from the windup of the corporation on the death of the shareholder. By contrast, the difference between the premiums paid and the eventual death benefit is exempt from tax, and by life expectancy the entire death benefit passes to the estate as a capital dividend. Simply put, premium deposits grow in and flow out of the corporation tax-free.

Another common illustration is based on the same analysis, except that the bonds and the life insurance policy are compared as vehicles for providing retirement cash flow. The bonds are sold as the principal is required to supplement the interest income, and both capital and interest are paid out of the corporation as taxable dividends. By contrast, the cash value of the policy is used as collateral by either the corporation or the shareholder, to obtain a series of third-party bank loans to create the cash flow. The interest is added to the outstanding loan balance (provided the loan does not exceed 75% to 85% of the cash value) and the entire loan amount is eventually paid off by the death benefit.

Where the borrower is the corporation, the loans are paid out to the shareholder as taxable dividends, whereas when the borrower is the shareholder, the borrowings are not taxable but could give rise to a shareholder benefit, which is typically mitigated by a guarantor fee paid by the shareholder to the corporation. Additionally, shareholder borrowing does complicate repayment of the loan since at the time of death, the policy, which is providing security for the loan, must be released before the death benefit is paid out. This requires the executor or surviving shareholder to substitute other collateral for the loan, until such time that the death benefit flows out to the estate or surviving shareholder, providing the funds to repay the loan.

It is important to ensure that there is a good match between when the death benefit is required for a particular purpose and when it will actually be paid

Though the policy and corporate bond options are modeled to provide identical after-tax retirement cash flow, the policy will typically have a larger residual net estate value. If having an estate is of little consequence, this may not be an appropriate strategy. Note that one of the key assumptions in this comparison is the cost of borrowing, which should not be underestimated. Lastly, an alternative corporate investment may be illustrated using a mix of interest, dividend and capital gains to provide a more relevant comparison depending on the risk tolerance of the client and the mix of investments within the policy.

These examples show how insurance proposals must be evaluated within the context of the client's goals and circumstances and with due consideration as to the assumptions used. Some concepts, which combine leveraging and interest deductibility to increase the tax benefits, can become quite complex. Make sure your client understands how they function and what the benefits and risks are. Care must also be taken to ensure that more aggressive arrangements are properly structured, documented and implemented to reduce the risk of a challenge by CRA.

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