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TAX TOPICS

Accumulating and Transferring Wealth Through the Use of Life Insurance – Corporate Ownership

The Corporate Perspective

Often the profits or surplus cash of an operating company or an investment holding company are retained in the corporation and invested in GIC's or taxable investments, instead of being paid out to the shareholder. This may be because the shareholder does not need the income and/or because the distribution will trigger dividend tax. However, these taxable investments may not be the most advantageous way for the corporation to invest its retained profits. A tax efficient alternative is to reposition retained profits into an exempt life insurance policy. An exempt life insurance policy provides immediate life insurance protection and cash values can accumulate within the policy on a tax-deferred basis. Manulife refers to this strategy as the "*Corporate Estate Bond*" concept.

Protection and Savings Elements of Life Insurance

Life insurance is, by its nature, a hedge against the risk of death. It is a cost effective method of providing a tax-free lump sum at death to meet liabilities, or to compensate for the financial loss arising as a result of a person's death. This protection element is generally the main reason why life insurance is purchased.

The premium payable in respect of the protection element of a life insurance policy will generally take into account the insurer's estimate of expected mortality rates, investment earnings, policy lapses and terminations, as well as administrative expenses and profit margins.

However, life insurance can also be used as a tax-effective savings vehicle.

Conventional savings investments are exposed to tax, whether under the accrual rules on an annual basis or as income received by way of interest, dividends or as capital gains realized on dispositions of capital property. Exposure to tax reduces investment returns and ultimately, what is received at death by heirs.

As an alternative, a policy owner can deposit funds into an exempt life insurance policy in excess of what is needed to fund the current policy premiums. These extra funds can grow tax-deferred within the policy and be used to fund future policy costs, buy additional insurance coverage and/or accumulate as cash values that can be accessed during life or paid out as a death benefit. As a result, life insurance can be structured to provide pure protection, with no element of savings, or it can be structured to provide protection as well as a savings element or cash value.

The "*Corporate Estate Bond Concept*" compares the net estate value arising from a life insurance policy to an alternative corporate owned investment assuming the same amount of funding. Note that the tax-sheltered investment component should not be the only motivation for purchase of a life insurance policy. The need for the pure protection element and the costs thereof should be factored into the comparison to a taxable investment alternative.

When compared to taxable investment alternatives, an exempt life insurance policy is an effective wealth accumulation and transfer tool. The combination of both the protection and investment elements of life insurance can deliver higher estate values.

Income Tax Considerations

Exempt Policies and Treatment of Accumulating Income

A permanent life insurance policy that qualifies as an "exempt policy", allows for tax-deferred growth of the cash value of the policy and tax-free receipt of the proceeds at death. The cash value growth within an exempt policy is not subject to annual accrual taxation and is only subject to tax if there is a disposition (deemed or otherwise) of the policy. Significant cash value can accumulate on a tax-deferred basis if deposits in excess of the policy charges are deposited into the exempt policy. Provided that the deposits do not exceed the maximum permitted by the Income Tax Act (the "Act"), they can remain tax-sheltered within the contract and pay for the cost of insurance and expenses in future years. For detailed information on exempt policies refer to the Tax Topic *"The Exempt Test".* For further discussion regarding the treatment of accumulating income and policy dispositions refer to the Tax Topic "*Accumulating and Transferring Wealth Through the Use of Life Insurance".*

Using "Cheaper" Corporate Dollars to pay Insurance Premiums

Where the funds to pay insurance premiums are inside a corporation, an income tax savings will normally result if the corporation pays the premium directly rather than paying dividends or salary to the shareholder so that the shareholder can pay the premium. In the case of dividends, using corporate dollars avoids the dividend tax that would be payable by the shareholder on receiving the dividend. In the case of a salary paid to a shareholder, using corporate dollars will be cheaper if the corporation pays tax at a lower rate than the shareholder. This is because life insurance premiums are generally non-deductible and are therefore paid with after tax dollars. (For more details refer to the Tax Topic "*Ownership of Life Insurance – Planning Considerations*")

Tax Implications of a corporation owning a life insurance policy

When a corporation owns a life insurance policy, particularly a cash value life insurance policy, there may be implications for the taxation of the corporation and its shareholders. Most of these implications result from the fact that for tax purposes, a life insurance policy is considered a passive asset (i.e. not an asset used in an active business). Therefore, when considering a corporate purchase of a life insurance policy or any other passive asset, it is important to evaluate the impact the policy or asset may have on the following:

- Availability of the small business deduction for active business income
- Provincial capital tax liability
- Ontario corporate minimum tax
- Availability of the capital gains tax exemption for shareholders of the corporation
- Value of shares for purposes of the deemed disposition at death (under subsection 70(5) of the Act)
- Corporate attribution rules (subsection 74.4(2) of the Act)

For more details on these issues refer to the Tax Topics:

- "*Corporate Owned Life Insurance – Tax Considerations",*
- *"The Lifetime Capital Gains Exemption", and*
- *"Corporate - Owned Insurance — Valuation Issues Regarding The Deemed Disposition Rules At Death (Subsection 70(5))".*

Capital Dividend Account (CDA)

A life insurance policy owned by a corporation is treated for tax purposes in a manner similar to a policy owned by an individual. If the policy is held until the death of the life insured, the proceeds are received tax-free by a corporate beneficiary. In addition, private corporations are able to pass out some or all of the life insurance proceeds on a tax-free basis to their shareholders through the CDA mechanism. The CDA, as defined under subsection 89(1) of the Act, is a notional tax account that includes, among other things, life insurance proceeds received by a corporate beneficiary in excess of the adjusted cost basis (ACB) of the policy to the corporation. All private corporations resident in Canada qualify for a CDA, however public corporations do not qualify for a CDA, and non-residents receiving capital dividends will most likely pay tax on these dividends in their country of residence as well as Canadian withholding tax. For a full discussion of the CDA refer to the Tax Topic "*Capital Dividend Account*".

To the extent that there is a credit to the corporation's CDA (from the life insurance proceeds or other credited amounts), the corporation can declare that a dividend be treated as a capital dividend. In turn, the capital dividend is received by the shareholder on a tax-free basis.

Note that if a corporation is the beneficiary of a life insurance policy, but not the owner of the policy, the ACB of the policy to that corporation is nil. As a result, the CDA to the beneficiary corporation would equal the full amount of the death benefit. However, designating another corporation as beneficiary may have other tax consequences as discussed in the Tax Topic "*Corporate Owned Life Insurance – Tax Considerations*".

Issues to Consider in Comparing the Alternatives

In considering corporate owned life insurance as compared to an alternative investment it is important to consider many of the same issues as for personally held insurance including: the internal rate of return of life insurance as compared to an alternative investment; liquidity needs; and investment flexibility and mix. Refer to the Tax Topic "*Accumulating and Transferring Wealth Through the Use of Life Insurance*" for a discussion of these issues.

There are however some issues that are different when a cash value life insurance policy is corporately owned, and some additional issues that must be considered.

Creditor Protection

A personally held policy can receive enhanced creditor protection because the common law provinces have enacted legislation that provides protection for life insurance contracts where certain family members of the insured are designated as a beneficiary under the policy (in the province of Quebec, creditor protection is based on the relationship between the policyholder and the beneficiary). This protection applies to the cash values within the policy while the life insured is alive and also to any death benefit payable under the policy. This protection does not exist for a corporate owned policy because a corporation cannot designate family members as beneficiaries without giving rise to shareholder or employee benefit issues. As a result, a corporate owned life insurance policy – like any other investment – will be subject to the claims of the corporation's creditors. In some cases, use of a holding corporation can mitigate this issue for both life insurance and alternative investments.

Underwriting

As with personally held insurance, the issuance of a corporate owned insurance policy will require both medical and financial underwriting. As a result, to take advantage of this planning strategy, the individual who is insured under the policy will have to submit to medical underwriting, and the corporation will have to provide evidence of its financial need for the insurance, its insurable interest in the life insured, and its financial position. Depending on the amount of insurance, the corporation may have to provide financial statements, credit reports, information on shareholders and officers of the corporation, and information on its relationship to the insured etc.

Impact on Estate Value

When comparing different corporate owned investments, it is important to take into consideration not only the internal rate of return on the investment, but also the tax characteristics of the investment and the impact it has on the value of the shares at death. Depending on the type of shares the insured owns, a corporate owned life insurance policy will often result in a lower tax liability arising on the deemed disposition of the shares of the corporation at death and/or the subsequent distribution of the corporation's assets as compared to an alternative corporate owned investment with a similar value. In other words, if a corporately owned life insurance policy provides a death benefit equal to the pre-tax value of an alternative investment, the life insurance policy will usually provide higher after tax estate values than the alternative investment.

A simplistic approach to comparing the estate value arising from a corporate owned life insurance policy and an alternative corporate owned investment is to assume that at death the corporation pays the death benefit from the life insurance, or the proceeds from the sale of the alternative investment as a dividend to the estate. Under this assumption, since the life insurance death benefit typically generates a large CDA credit to the corporation, most of the life insurance proceeds are received by the estate tax-free. In contrast, a taxable investment will typically generate some CDA (from untaxed portion of capital gains arising on the taxable investment), but the rest of the dividend will be a taxable dividend. As a result, the tax arising on the distribution of the proceeds from the taxable investment will be considerably higher, and therefore the estate value will be much lower, even if the value of the investment is comparable to the life insurance death benefit. This approach is used in many presentations that do this comparison.

However, it is important to remember that taxes also arise on death as a result of the deemed disposition of the shares, and that often post-mortem planning procedures are used to minimize the taxes arising at death. As noted earlier, the cash value of a corporate owned life insurance policy (immediately before death) is generally included in the valuation of the participating common shares for purposes of the deemed disposition at death rules. So arguably, the capital gains tax arising on the value of the shares attributable to the cash value of the life insurance policy should reduce the net estate value said to arise from the policy. However, there is also post-mortem planning that can be done to reduce the tax burden on the shares, and stop-loss rules that should be taken into account.

If the main objective is to maximize estate value then instead of simply paying out the insurance proceeds as a dividend, a common planning approach is to wind up the company or redeem the shares within one year of the date of death, (assuming a spousal rollover is not available). If this is done, the windup or redemption will trigger a dividend equal to the assets distributed on the windup or redemption (including the insurance proceeds) and a capital loss equal to the capital gain at death (assuming the ACB and paid up capital of the shares is nominal). The capital loss can then be carried back to offset the capital gain at death utilizing subsection 164(6) of the Income Tax Act. In this way the capital gain arising as a result of the deemed disposition at death can be eliminated, and the overall result at death is a dividend to the estate equal to the value of the assets distributed (including the life insurance proceeds). To the extent that CDA is available, the dividend can be characterized as a capital dividend. However, unless the shares are grandfathered for purposes of the stop-loss rules in subsection 112(3.2) of the Act, the stop-loss rules may apply to limit the amount of the loss that can be carried back (see the Tax Topic "*Stop-Loss Provisions and Grandfathering Rules*" for more details).

If the shares are participating common shares (i.e. shares whose value depends on the underlying assets and liabilities of the corporation) that have a nominal adjusted cost base and paid up capital (which is often the case), and we assume that the life insurance policy is the only asset in the corporation, then assuming the shares are not grandfathered, typically the total tax cost at death will equal:

- the tax on any taxable portion of the dividend (typically equal to the ACB of the life insurance policy), plus
- tax on the capital gain after the allowable loss carryback (which equals 50% of the capital gain on the shares arising as a result of the cash value of the life insurance less the taxable dividend).

So for instance, assume Mr. A owns all the shares of a corporation. Assume that the only asset in the corporation is a life insurance policy with a death benefit of $2.7 million, a cash value of $1.7 million, and an ACB of $100,000. The shares are not grandfathered for the purposes of the stop-loss rules in subsection 112(3.2). When Mr. A dies, the life insurance policy pays the death benefit to the corporation resulting in a CDA credit equal to $2.6 million (proceeds of $2.7 million less the ACB of $100,000). Then assume the estate winds up the corporation and distributes the $2.7 million proceeds to the estate. The consequences to Mr. A and his estate for tax purposes are as follows: (assuming a 33% tax rate on dividends and a 25% tax rate on capital gains)

Capital gain at death	$1,700,000 (= cash value)
Deemed dividend	$2,700,000 (= death benefit)
Capital dividend	$2,600,000 (= CDA)
Taxable dividend	$100,000 (= ACB of the life policy)
Capital loss carryback	$950,000 (=50% x CV + taxable dividend)
Capital gain after loss carryback	$750,000 (= Capital gain – loss carryback)
Tax on taxable dividend	$33,000 (100,000 x 33%)
Tax on capital gain	$187,500 (750,000 x 25%)
Net to Estate	**$2,479,500** (2,700,000 – 33,000 – 187,500)

If the shares are frozen shares (i.e. shares whose value has been frozen at a fixed amount, often called "frozen preferred shares"), that have nominal adjusted cost base and paid up capital (which is often the case), and we assume that the life insurance proceeds are used to fully redeem those shares, the capital gain on the shares at death will equal the redemption value. Assuming the shares are not grandfathered, the loss arising on redemption that can be carried back to offset the capital gain will be limited by the stop loss rules. In this scenario, the tax arising on the deemed disposition at death and the redemption will equal:

- the tax on any taxable portion of the dividend (typically equal to the ACB of the life insurance policy), plus
- tax on the amount by which half of the redemption value of the shares (which equals the life insurance policy death benefit) exceeds the taxable amount of dividends (this is the tax on the capital gain remaining after the permitted loss carryback).

So for instance, assume Mr. A owns frozen shares of a corporation valued at $2.7 million. Assume that the shares are redeemed using a life insurance policy with a death benefit of $2.7 million a cash value of $1.7 million, and an ACB of $100,000. The shares are not grandfathered for the purposes of the stop-loss rules in subsection 112(3.2) of the Act. When Mr. A dies, the life insurance policy pays the death benefit to the corporation resulting in a CDA credit equal to $2.6 million (proceeds of $2.7 million less the ACB of $100,000). Then assume the shares are redeemed for $2.7 million proceeds to the estate. The consequences to Mr. A and his estate for tax purposes are as follows: (assuming a 33% tax rate on dividends and a 25% tax rate on capital gains)

Capital gain at death	$2,700,000 (= fixed share value)
Deemed dividend	$2,700,000 (= redemption amount)
Capital dividend	$2,600,000 (= CDA)
Taxable dividend	$100,000 (= ACB of the life policy)
Capital loss carryback	$1,450,000 (=2,700,000x50% + 100,000)
Capital gain after loss carryback	$1,250,000 (=$2,700,000 – 1,450,000)
Tax on taxable dividend	$33,000 (100,000 x 33%)
Tax on capital gain	$312,500 (1,250,000 x 25%)
Net to Estate	**$2,354,500** (2,700,000 – 33,000 – 312,500)

When comparing to an alternative investment, the CDA and RDTOH balances arising from that alternative investment as well as the impact on the capital gain arising on the shares at death and any post-mortem planning that may be done should similarly be taken into account. In a typical scenario this would mean that where the only asset in the corporation is the investment, after death a capital dividend would be paid out equal to the CDA balance, a taxable dividend would be paid out equal to three times the RDTOH balance, and the remainder would be structured to accomplish capital gains treatment. (Note that the dividends would be paid in the form of redemptions of shares in order to trigger a loss that can be carried back to offset the gain at death). The reasoning for this is that the CDA can be extracted tax free, so this is done first. To fully recover the RDTOH a taxable dividend equal to three times the RDTOH balance must be paid out. Capital gains treatment is accomplished using a post-mortem planning tool commonly referred to as the "pipeline" procedure. This involves transferring the remaining shares to a new corporation in exchange for a promissory note. The promissory note acts as a "pipeline" through which the assets can be flowed up to the estate tax-free, and the only tax paid is on the capital gain triggered at death that was not offset by the losses carried back.

So for instance, assume Mr. A owns all the shares of a corporation. Assume that the only asset in the corporation is an investment asset with an after tax (corporate tax) fair market value of $2,300,000, an RDTOH balance of $400,000 and a CDA balance of $700,000. If we assume that the above planning is undertaken to withdraw all of the value out of the corporation after Mr. A's death, the consequences to Mr. A and his estate for tax purposes are as follows: (assuming a 33% tax rate on dividends and a 25% tax rate on capital gains)

Capital gain at death	$2,700,000 (= investment value + RDTOH)
Capital dividend	$700,000 (= CDA)
Taxable dividend	$1,200,000 (= 3 x RDTOH balance)
Capital loss carryback	$1,900,000 (= shares redeemed)
Capital gain after loss carryback	$800,000 (=2,700,000 – 1,900,000)
Tax on taxable dividend	$396,000 (1,200,000 x 33%)
Tax on capital gain	$200,000 (800,000 x 25%)
Net to Estate	**$2,104,000** (2.7M – 396,000 – 200,000)

Refer to Appendix A for the detailed calculations in each of the above scenarios. Note also, that the planning discussed above and illustrated in the Appendix is just one of the planning strategies that could be used. Other planning strategies might result in a lower net estate value, but may preserve CDA or RDTOH to be utilized or recovered by continuing shareholders. Refer to the Tax Topic "*Dealing With Private Company Shares at Death – Post-Mortem and Insurance Planning*" for a more detailed discussion of post-mortem planning.

Summary

The "*Corporate Estate Bond*" concept can be an attractive alternative to taxable investments for a corporation which has excess liquid assets which are not set aside for a specific purpose or needed for operations.

An exempt life insurance policy can provide an attractive alternative to taxable investments in a corporation by providing:

- A large, immediate estate value,
- Tax sheltered growth of cash values,
- A tax-free death benefit, and
- Liquidity, if required.

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Appendix A - Detailed Calculations of Net Estate Value

	Participating Shares	Frozen Shares	Alternative Investment
Insurance			
Pure Death Benefit (DB)	1,000,000	1,000,000	-
Cash Value	1,700,000	1,700,000	-
Total Death Benefit at LE	2,700,000	2,700,000	-
Policy ACB at LE	100,000	100,000	
Investment Assets			
FMV of other assets	-	-	2,300,000
RDTOH balance	-	-	400,000
CDA balance at death	2,600,000	2,600,000	700,000

Post-Mortem Planning	Wind up and loss carry-back Maximum Capital Dividend	Redemption and loss carry-back Maximum Capital Dividend	Partial redemption and loss carry-back with Pipeline
Deemed Disposition at death at fmv	1,700,000	2,700,000	2,700,000
Redemption/Windup Dividend*			
Capital Dividend	2,600,000	2,600,000	700,000
Taxable Dividend	100,000	100,000	1,200,000
Redemption Dividend Paid	2,700,000	2,700,000	1,900,000
Loss on Redemption/Windup			
Proceeds	2,700,000	2,700,000	1,900,000
Deemed Dividend	(2,700,000)	(2,700,000)	(1,900,000)
Adjusted Proceeds	-	-	-
ACB	1,700,000	2,700,000	1,900,000
Loss	(1,700,000)	(2,700,000)	(1,900,000)
Tax on Dividend @ 33%	**33,000**	**33,000**	**396,000**
Pipeline			
Value of shares transferred to Holdco for promissory n	n/a	n/a	800,000
Capital Gain on shares at Death**			
Gain on deemed disposition at death**	1,700,000	2,700,000	2,700,000
Loss carryback	(950,000)	(1,450,000)	(1,900,000)
Net Gain	750,000	1,250,000	800,000
Tax on capital gain @ 25%	**187,500**	**312,500**	**200,000**
Total Tax	**220,500**	**345,500**	**596,000**
Net Estate Value	**2,479,500**	**2,354,500**	**2,104,000**

Stop Loss Calculation	750,000	1,250,000	-
lesser of:			
a) capital dividend	2,600,000	2,600,000	700,000
b) loss less taxable dividends	1,600,000	2,600,000	700,000
less 1/2 of lesser of:			
a) capital gain on deemed disposition	1,700,000	2,700,000	2,700,000
b) estate's capital loss	1,700,000	2,700,000	1,900,000
Loss Stopped	750,000	1,250,000	-
Actual Loss	(1,700,000)	(2,700,000)	(1,900,000)
Capital loss available to carry back	(950,000)	(1,450,000)	(1,900,000)

* Assumes paid up capital of shares is nominal
** Assumes adjusted cost base of shares is nominal