Ownership of Life Insurance – Planning Considerations

There are many factors to consider when choosing the owner of a life insurance policy. The general focus of this article is to outline relevant considerations in deciding whether a policy should be owned personally or in a corporation, but many of the considerations also apply to other ownership decisions. Also included is a short discussion of Trust ownership and Shared Ownership.

Before making any decision regarding who should own the policy, the best place to start is to have a clear understanding of the facts of the situation. Specifically, three key questions should be answered:

1. What is the purpose of the life insurance?
2. When and where will the life insurance proceeds be needed?
3. Where are the funds available to pay the life insurance premiums?

Life insurance is typically purchased because of a need for capital on the insured person's death. Capital may be needed to fund a buy-sell agreement, pay off an outstanding bank loan, replace lost income, make a gift to a charity, pay capital gains tax or pay other estate liabilities.

Once the purpose of the insurance is determined, it should be evident where and when the life insurance proceeds are needed or desired. Are they needed inside a corporation, in the estate or in the hands of some other beneficiary? It is important that the ownership structure allows the life insurance proceeds to flow tax-effectively to the beneficiary at the time the proceeds are needed (discussed in more detail below).

In some cases, there may not be a particular need for capital, but the goal may be increasing the value of the estate and/or diversifying assets. In this case, a key consideration is where the funds are available to "invest" in a life insurance policy or pay for the policy. For example, if most of a client's liquid investments are currently inside a holding company, then it likely makes sense to have the holding company purchase the policy.

When these questions are answered, it's possible that several different alternatives will accomplish the desired goals. The next step is weighing the "pros" and "cons" of each ownership option by considering the issues outlined later on.

Cheaper After-Tax Dollars

Generally, premiums paid under a life insurance policy are considered capital outlays and not outlays or expenses made or incurred by a taxpayer for the purpose of gaining or producing income from a business or property. Therefore, a deduction is generally prohibited under the general limitation for payments on account of capital in paragraph 18(1)(b) of the Income Tax Act (the "Act"). As a result, life insurance premiums are usually paid with after tax dollars. Often it is desirable to fund a policy with the cheapest after-tax dollars available. The taxpayer with the lowest tax rate requires less pre-tax income to pay the premiums; their dollars are "cheaper".

For example, assume Mr. X is considering the purchase of a life insurance policy with a monthly premium of $1,000. Mr. X is subject to a personal tax rate of 50%; his corporation ("Xco") pays tax at a rate of 30%. If Mr. X pays the premium, he will have to earn $2,000 in order to pay the $1,000 premium. If Xco pays the premium, it will only have to earn $1,429 to pay the $1,000 premium.

Although this is a convenient way to think about this issue, and the relative tax rates will tell you which owner is preferable from a cost perspective, it is not an accurate way of calculating the actual cost. A more accurate analysis reflects the after-tax cost of paying the premiums, rather than the pre-tax cost. Put another way, ideally the analysis should take into account the tax savings to a corporation, if any, when it flows money to Mr. X as demonstrated in the example below.

Using the same facts outlined earlier, let's assume Mr. X wants to fund the policy out of cash currently held inside Xco. Mr. X has a personal tax rate of 50% on salary and 30% on dividends.

If Xco owns the policy and pays the premium directly, the after-tax cost to Xco is simply the premium amount, i.e., $1,000.

If Mr. X wants to pay the premium and own the policy personally, then Xco must pay him enough so that he keeps $1,000 after-tax to pay the insurance premium. Xco has two options:

1. Xco pays Mr. X a dividend of $1,429. Mr. X pays dividend tax of $429 ($1,429 x 30%) leaving $1,000 to pay the premium. This costs Xco $1,429 instead of just $1,000; or

2. Xco pays Mr. X salary of $2,000. Mr. X pays $1,000 of tax on the salary ($2,000 x 50%) leaving $1,000 to pay the premium. This costs Xco $1,400 ($2,000 less $600 in corporate tax savings generated by deducting $2,000 from its taxable income ($2,000 x 30%)).

To summarize, if the money to fund the premiums must come from Xco, there are three options:

1. Xco owns the policy and pays the premium directly. Xco after-tax cost: **$1,000**;
2. Xco pays a dividend to Mr. X; Mr. X pays the premium and owns the policy. Xco after tax cost: **$1,429**; and
3. Xco pays salary to Mr. X; Mr. X pays the premium and owns the policy. Xco after tax cost: **$1,400**.

The cheapest alternative is to simply have the corporation own and pay for the policy. Note however, that an inherent assumption in this analysis is that the premium payments must come from the corporation. If Mr. X has other personal funds from which he can pay the premiums and he does not expect to use these funds for personal expenditures during his lifetime, then it may not matter if he uses personal funds to pay the premiums since the tax has already been paid on these funds. In effect, the personal tax paid on the personal funds is a "sunk" cost; it has already been expended. As a result, it is no longer relevant to the decision about whether to use corporate dollars or personal dollars. In this case, the other considerations discussed later on may have a more significant impact on where the policy should be held.

Impact on Estate Value

Although it is true to say that the tax paid on personal dollars is a "sunk" cost, consideration must also be given to the impact that future taxes will have on the individual's estate value. There are two important characteristics of corporate owned life insurance that can reduce the taxes paid on the shares of a corporation at death and on the distribution of corporate assets. First, a life insurance death benefit received by a private corporation may give rise to a capital dividend account ("CDA")[1] credit. Second, the value of a corporate owned life insurance policy, for purposes of the deemed disposition of the shares at death, is generally limited to the cash surrender value of the policy.

When a private corporation receives a death benefit from an exempt life insurance policy, it receives a credit to its CDA equal to the excess of the proceeds over the corporation's adjusted cost basis ("ACB") of the policy immediately before death. To the extent that the corporation has a CDA balance, it can declare and pay capital dividends to Canadian resident shareholders. Capital dividends are not taxable to the shareholder; therefore, the proceeds from a life insurance death benefit in excess of the ACB of the policy can be distributed from a corporation tax- free. (Refer to the "Capital Dividend Account" Tax Topic for a more detailed discussion of the CDA and the ACB of a life insurance policy.)

On death, all corporate shares owned by an individual are deemed to be disposed of at fair market value. For this purpose, the value of a corporate owned life insurance policy on a shareholder is generally deemed to be the cash surrender value (refer to the Tax Topic, "Corporate-Owned Insurance — Valuation Issues Regarding the Deemed Disposition Rules at Death (Subsection 70(5))" for details). As a result, life insurance policies held in a corporation have the effect of reducing the value of the corporation for purposes of the deemed disposition at death (if the shareholder owns common/participating shares). Through the CDA, the corporate dollars held in a life insurance policy

[1] Any private corporation within the meaning of the Act – including a Canadian-controlled private corporation ("CCPC") – can accumulate a CDA.

can be sheltered from the personal tax that would otherwise arise at death and on the distribution of the corporation's assets. Because of these potential benefits, life insurance can be an attractive "investment" for private corporations and may increase a person's estate value more than a personally owned policy of the same size. In other words, while a policy may provide the same death benefit whether held in a corporation or personally, the corporately owned policy provides the additional benefit of potentially reducing the taxes payable on the shares of the corporation at death and on the distribution of the corporation's assets to the estate (assuming that the shareholder/life insured owns all of the shares of the corporation). If the shareholder/insured owns only some of the shares of the corporation, particularly if the shares are fixed value shares, owning the policy corporately (or transferring a policy into a corporation) may not be beneficial from an estate value perspective. For a detailed discussion regarding life insurance as a corporate investment, refer to the Tax Topics, "Accumulating and Transferring Wealth Through the Use of Life Insurance – Corporate Ownership".

Corporate Owned Life Insurance to Fund Personal Insurance Needs

Beneficiary Designation

A key consideration is whether the intended beneficiary of the life insurance death benefit is an individual. Generally speaking, to avoid taxable benefit issues, a corporate owned policy should name the corporation as the beneficiary. As noted earlier, when a corporation receives the death benefit from a life insurance policy, it receives a credit to its CDA. To the extent of the CDA, it can flow the death benefit to a shareholder by paying a tax-free capital dividend. However, there is no such mechanism to get the proceeds out of the corporation to a person who is not a shareholder of the corporation. Therefore, if the life insurance proceeds are intended to benefit someone other than a shareholder or a particular shareholder (or his/her estate) for a specified purpose, some additional steps may be necessary.

For example, if the policy is on the life of the sole shareholder of the corporation, the life insurance proceeds could be paid as a dividend to the estate of the shareholder after his/her death. The dividend will be non-taxable to the estate to the extent of the CDA balance. The estate will then pay the proceeds to the beneficiary as outlined in the deceased shareholder's Will. However, the proceeds will flow through the estate possibly subjecting the proceeds to probate, where applicable[2], and potential claims of the estate's creditors.

Documenting the Intentions of the Shareholder

Consideration should be given as to how the intentions of the sole shareholder are documented. The Will can provide direction and appropriate powers to the executor and enable the executor to direct the corporation to pay the life insurance proceeds out of the corporation as a dividend. The Will can also communicate the extent to which the CDA is intended to be utilized by the corporation.

However, there may be a conflict between the executor's role and responsibility as executor of the estate and the executor's role and responsibility as director of the corporation. The executor's role as executor of the estate requires him/her to act in the best interests of the estate beneficiaries while the executor's role as director of the corporation requires him/her to act in the best interest of the corporation. The decision that the executor makes regarding the payment of dividends and use of the CDA may not necessarily be the one that he/she would make in his/her capacity as an officer of the corporation. This conflict may be easier to understand in a situation where the majority shareholder does not own all the shares. For example, there may be a group of employees that own 35% of the voting shares. In this case, the executor, acting as an officer of the corporation, has a duty to the minority shareholders to ensure they are treated fairly. That is, if he/she allocates all of the CDA to the majority shareholder, he/she is not acting in the best interests of all the shareholders. Clear direction in a shareholder's agreement would relieve the executor of this potential conflict because it would obligate the corporation or the shareholder's executor to carry out the intended distribution of life insurance and CDA to the estate of the deceased shareholder. Alternatively, as discussed below, life insurance shares might be used to alleviate this conflict.

Life Insurance Shares

In some cases, "life insurance shares" may be used to direct insurance proceeds to a specific individual. Life insurance shares are shares that entitle the holder to the death benefit proceeds from a corporate owned life insurance policy, but otherwise have no control or value. Typically, shares are created that are non-voting, non-participating, redeemable for $1 at the discretion of the corporation, and entitling the holder to receive a dividend equal to the proceeds of the life insurance received by the corporation when the life insured dies. (The dividend could be paid as a non-taxable capital dividend to the extent of the CDA credit arising from the life insurance policy.) The intended beneficiary might purchase such shares for $1, usually prior to issuing the policy. The main tax issue with such shares is whether the $1 purchase price represents a reasonable value for the shares. If not, (i.e., if the shares are worth more than what the purchaser pays for them), then a taxable benefit may arise to either the common shareholder or

[2] In Quebec, probate fees do not apply.

the purchaser (refer to CRA technical interpretations 2005-013861C6 and 2008-028615C6 for CRA's views on valuation issues related to life insurance shares).

Life insurance shares issued to the sole shareholder can also be used to resolve the conflict of interest issue noted earlier with respect to the executor's role as director of the corporation and as executor of the estate of the deceased shareholder. If the intention is for the shareholder's estate to benefit from the life insurance proceeds, life insurance shares can be issued to the shareholder before purchasing the policy. When the shareholder dies, these shares enable the executor to force redemption of the shares and utilize the CDA to shelter the dividend as a right created by the attributes of the shares. Because the executor, as a director of the corporation, does not need to cause the corporation to redeem the shares and use the CDA balance, the conflict is avoided.

Financial Statement Impact of Corporate Owned Life Insurance

When a life insurance policy is owned by a corporation, it is an asset of that corporation and may have an impact on the corporation's financial statements.

For accounting purposes, typically a corporation will record a life insurance policy as an asset on its balance sheet at a value equal to the cash surrender value the policy. Each year, the difference between the premiums paid in the year and the increase in the cash value is recorded as income or expense for the year. When the death benefit is received, the asset (if one exists) is eliminated and the difference between the death benefit and the asset is recorded as accounting income.

If a policy is heavily funded in the early years, the increase in the cash surrender value will usually be less than the premiums paid; therefore, an expense will be recorded. This decreases the accounting value of the company's assets on the balance sheet. Consideration should be given to the impact this might have on any debt covenants or shareholder agreements that the corporation is subject to.

For more information on accounting for life insurance, refer to the Tax Topic, "Accounting for Corporate Owned Life Insurance and Critical Illness Insurance".

Life Insurance as a Corporate Asset – Valuation and Tax Considerations

A corporate owned life insurance policy affects the fair market value of the shares of the corporation. For example, if a corporation that owns a life insurance policy is sold, the value that a buyer is willing to pay will include the "value" of the policy owned by the corporation, as determined by the buyer.

Similarly, for many tax provisions it is necessary to take into account the value of a corporate owned life insurance policy. When a specific income tax provision applies, the tax treatment and valuation is determined under the specific provision. However, when a specific income tax provision does not apply, CRA uses general valuation principles, as set out in Information Circular IC 89-3 "Policy Statement on Business Equity Valuations" dated August 25, 1989, to determine the value of a corporate-owned life insurance policy. CRA considers such factors, among others, as the cash value and death benefit of the policy, the terms of the policy such as riders and conversion privileges and the health of the life insured.

One of the income tax provisions that specifically provides for the valuation of a corporate owned life insurance policy is subsection 70(5.3) of the Act. This provision deems the value of a corporate owned (or partnership owned) life insurance policy on the life of the taxpayer to equal the cash surrender value of the policy for purposes of the deemed disposition of the shares (or partnership interest) on the death of the taxpayer under subsections 70(5) and 104(4) of the Act, and for purposes of the deemed disposition upon becoming or ceasing to be a resident of Canada under section 128.1 of the Act. Note however, that if a value is determined under a shareholder's agreement in respect of shares belonging to a deceased taxpayer, that agreement will generally be determinative of value if the conditions outlined in Information Circular IC 89-3 are met. For more detail, refer to the Tax Topic, "Corporate-Owned Insurance — Valuation Issues Regarding the Deemed Disposition Rules at Death (Subsection 70(5))".

In addition, a life insurance policy is generally considered a "passive" asset. As such, the value of the policy can affect whether the shares of the company qualify for the lifetime capital gains exemption, whether the shares qualify for the rollover of family farm and fishing corporations or whether the corporate attribution rule in subsection 74.4(2) of the Act could apply to the shares. (For further details, refer to the Tax Topic entitled, "The Lifetime Capital Gains Exemption).

For the purposes of determining whether the corporation's shares, on a disposition, qualify for the lifetime capital gains exemption or whether the shares qualify for the rollover of family farm and fishing corporations, it is necessary to determine the proportion of the corporation's underlying assets used in an active business. Owning a passive asset, such as a life insurance policy, may affect whether or not the shares are considered qualified shares. For these purposes, the policy will generally be valued at its cash surrender value under subparagraph 110.6(15)(a)(i) or (ii) of the Act, provided the shareholder is the life insured.

The corporate attribution rule in subsection 74.4(2) of the Act will not apply if the corporation qualifies as a "small business corporation" as defined in subsection 248(1) of the Act. This definition requires (among other things) that "all or substantially all" of the assets of the corporation are used principally in an active business. Owning a passive asset like a life insurance policy may cause a corporation to fail this test. For this purpose, the life insurance policy is valued at fair market value using general valuation principles. (For more detail on the corporate attribution rules, refer to the "Corporate Owned Life Insurance – Tax Considerations" Tax Topic.)

Generally, the small business deduction entitles CCPCs to a tax reduction on the first $500,000 of active business income carried on in Canada (for details on these rules, refer to the "Corporate Taxation" Tax Topic). However, the deduction is phased out where the corporation's "taxable capital" for the immediately preceding year exceeds $10 million and is eliminated when the corporation's taxable capital exceeds $15 million. Taxable capital for this purpose is a complex calculation, but generally includes the capital, retained earnings and debt of the corporation less an investment allowance. Since a life insurance policy does not qualify as an eligible investment for purposes of the investment allowance (see CRA technical interpretation 2003-0049531I7), to the extent that a life insurance policy increases the capital of a corporation, it may affect whether the corporation is entitled to the small business deduction. For example, if the growth in the cash value is recognized as income and therefore increases retained earnings (refer to the Tax Topic, "Corporate Owned Life Insurance – Tax Considerations").

Future Changes in Share Ownership

If corporate ownership is contemplated, consideration should be given as to whether the shares of the corporation may be sold in the future. If selling the shares is a possibility and it is likely that the current shareholder will want to keep the policy, it may not be advisable to hold the policy in the corporation. The policy could be transferred to another company prior to a sale, but transfers trigger a disposition of the policy. Since there are no rollovers available for transferring policies between corporations or between corporations and individuals, any disposition to a related party will trigger a policy gain to the extent that the cash surrender value exceeds the ACB of the policy. In addition, consideration must be given as to how the recipient of the policy will be taxed on the transfer. If the consideration paid for the policy is less than the fair market value of the policy, the recipient of the policy may have a taxable benefit. Where the policy is transferred as a dividend in kind to a connected corporation, there may not be a taxable benefit (dividends paid to a connected corporation are generally not subject to income tax). However, if the policy is transferred as a non-taxable dividend in kind, in anticipation of a sale, subsection 55(2) of the Act may apply to deem the tax-free, inter-corporate dividend to be a taxable capital gain. Refer to the Tax Topic, "Transfer of an Insurance Policy Involving Corporations and a Shareholder or Employee" for a more complete discussion of transfers.

Corporate Groups

In some cases, there may be several corporations owned by the client/life insured, including operating companies, holding companies that own shares of operating companies, and investment companies that hold marketable securities or other investments. Since operating companies are often more likely to be sold and may have more exposure to creditors, it is often preferable to place insurance policies in holding companies or investment companies. However, if the death benefit is needed in the operating company, consideration should be given as to how the funds can be transferred or directed to the operating company at the time of death. One option would be to designate the operating company as beneficiary with the parent holding company as owner of the policy. In this case, the operating company will receive the full CDA credit equal to the full amount of the death benefit. This is because the CDA credit is reduced by the policy owner's ACB of the policy. Since the holding company (not the operating company) owns the policy, the ACB belongs to the holding company; the operating company has a nil ACB in the policy. However, CRA has provided commentary that taxable benefit issues may arise in such structures and that GAAR could apply when considering the CDA credit to Opco (for example, refer to CRA technical interpretation letters 9824645, 9908430, 2004-0065461C6, 2007-0127251E5, 2010-0359421C6 and Question 1 from the 2010 APFF CRA Roundtable).

As a result, it is often preferable to have the corporate owner paying the premiums and being the beneficiary of the policy. Most structures in which one corporation owns a life insurance policy and another corporation either pays the premiums or is designated as beneficiary give rise to potential tax issues. If it is desirable for one corporation to own the policy, but the death benefit proceeds are needed in another corporation within the corporate group, it should be possible to transfer the proceeds as a capital injection, an inter-corporate loan or a dividend in kind rather than using a beneficiary designation. (For a more extensive discussion of the tax issues related to ownership and beneficiary designations in the corporate context, refer to the Tax Topic, "Corporate Owned Life Insurance – Tax Considerations".)

Creditor Protection Issues

Personal ownership of a policy can provide greater opportunities to protect the life insurance policy from creditors, both during life and after death, through appropriate beneficiary designations. In contrast, corporately owned policies are generally exposed to the corporation's creditors.

For a personally owned policy, creditor protection during the life of the insured can be achieved in two ways: by making an irrevocable beneficiary designation in respect of a life insurance policy or by designating, as beneficiaries, certain family members specified in provincial insurance legislation. (This can protect the policy itself and any cash value of the policy from creditors of the owner, subject to certain limitations). Since a corporation does not have "family members", this method of creditor protection is not available to corporations. Using an irrevocable beneficiary designation for a corporate owned policy may not be practical due to the taxable benefit issues that arise when a corporation designates another person or corporation as beneficiary of a policy it owns. An irrevocable beneficiary designation made by a corporation should, at least in theory, provide the same type of creditor protection as it does for a personally owned policy.

Creditors of the policy owner cannot make a claim against the proceeds of a policy that are payable upon the death of the life insured if the policy owner designates a beneficiary. When a beneficiary designation is made to a third party, the insurance proceeds payable upon the death of the life insured belong to the beneficiary and do not belong to the policy owner or the estate of the owner (in the case of an individually owned policy). Insurance proceeds are not subject to the claims of the owner's creditors. Subject to certain limitations, the insurance death benefit would be protected if a corporate owner designates another person (including another corporation) as beneficiary, but again, this may not be practical due to the taxable benefit issues discussed earlier.

In most provinces, insurance proceeds are generally excluded from matrimonial property division if the proceeds are received personally. However, if a corporation receives the proceeds and then distributes them to the shareholder, the proceeds are not excluded. The treatment of insurance proceeds for the purposes of matrimonial property may be an important consideration especially where the beneficiary of a corporately owned policy may be the owner of the corporation (or a related company) and may influence whether the insurance is held personally or in the corporation. In addition, the policy is an asset to the owner (individual or corporate); this may affect valuations used for family law purposes in some provinces. For more information on creditor protection and life insurance, refer to the Tax Topics, "Creditor Protection and Life Insurance", "Limitations on Creditor Protection and Life Insurance" and "Life Insurance and Property Issues on Marriage Breakdown".

Accessing Policy Values

A common planning strategy is depositing funds into a life insurance policy in excess of what is needed to pay for the death benefit. This strategy accumulates cash value in the policy that may be accessed in the future. The owner can access the cash values by assigning the policy as collateral security for a loan, utilizing policy loans (if permitted under the policy terms) or making policy withdrawals. If accessing the policy value is contemplated, the owner should consider where these funds will be needed and how they will flow to the right person.

For example, if a policy is held in the corporation but there is a desire to access the policy values personally, then withdrawals would need to flow out to the shareholder as salary or dividends. Similarly, if the policy is assigned as a collateral loan, there may be tax implications where the individual or the corporation is the borrower. For example, if a corporately owned policy is assigned as collateral security for a personal loan, consideration must be given to the possibility that a shareholder benefit has been conferred under subsection 15(1) of the Act. Alternatively, if the corporation is the borrower, the loan proceeds must flow to the shareholder as salary or dividends. Caution must also be used in these situations to ensure that the policy is not deemed to be a Retirement Compensation Arrangement causing the premiums paid on the policy to become subject to a 50% refundable tax. For a discussion of the issues associated with leveraged life insurance, refer to the Tax Topics, "Leveraged Life Insurance (Corporate and Personal)".

Future Changes in Residency

Individuals leaving Canada are deemed to dispose of most assets that they hold, including shares in a private corporation. A personally owned life insurance policy is excluded from the deemed disposition rules. However, the fair market value of shares in a private corporation will include the cash surrender value of corporate owned insurance. Consequently, when the shareholder leaves Canada, the capital gains tax will be higher, reflecting the corporation's ownership of a cash value life insurance policy. Therefore, personal ownership on emigration from Canada, avoids triggering a gain equal to the cash value. (Note that a policy owned by a non-resident will be subject to withholding tax on any policy gains arising on disposition, such as policy loans and withdrawals. For more details, refer to the Tax Topic, "Emigration from Canada: Tax Implications").

The income tax treatment of the policy and the death benefit in the new country of residence should also be considered. Canada allows for a certain amount of value to accumulate in an exempt life insurance policy without being subject to Canadian income tax. When a person immigrates to a new country, they, and the life insurance policy they own, will be subject to the income tax rules in that country. For example, the accumulation of funds within the life insurance policy may be subject to tax, or at a minimum, the rules governing how much accumulation is allowed will be different from the rules in Canada. Similarly life insurance death benefits are received tax-free in Canada, but this may not be the case in all jurisdictions. If a departure is planned, these rules will be important if the policy is owned personally. However, if a corporation whose shareholder is leaving Canada owns the policy and the corporation remains resident in Canada, the policy will continue to be taxed under Canadian income tax rules, thus avoiding this issue.

If the policy is corporate owned, consideration must be given as to how the life insurance proceeds will flow out of the corporation. To receive a CDA credit, a corporation must be a Canadian resident corporation, but does not need to be Canadian controlled. Therefore, a Canadian resident corporation owned by a non-resident shareholder could receive a CDA credit on receipt of a life insurance death benefit. However, it is unlikely that a capital dividend paid to a non-resident will receive the same tax-free treatment in the shareholder's new country of residence as it would in Canada. Additionally, the capital dividend will be subject to Canadian withholding tax (refer to technical interpretation 2009-0327001C6). As a result, unless the corporation has other Canadian resident shareholders, there may be no tax efficient mechanism to extract life insurance proceeds from the corporation. This may suggest that it is preferable to own a policy personally if the shareholder is leaving Canada, unless the proceeds are intended to go to Canadian resident shareholders or remain inside the corporation.

US Estate Tax

If a person is a U.S. person (i.e., citizen, green card holder or resident of the United States), they are subject to US estate tax. Life insurance proceeds are included in the value of an individual's estate for U.S. estate tax purposes if the individual has any "incidence of ownership" in the policy. Therefore, the death benefit of a personally owned life insurance policy on the life of the owner will be included in their estate. Similarly, if the U.S. person owns all the shares of a corporation that owns a life insurance policy on their life, the death benefit of the policy will be included in the value of the shares for U.S. estate tax purposes. In these circumstances, it is common to hold the policy through a special trust called an Irrevocable Life Insurance Trust ("ILIT") that can be structured to avoid inclusion of the death benefit in the estate of the life insured. For more details, refer to the Tax Topic, "U.S. Estate Taxes".

Buy-Sell Funding

When insurance is used to fund the buy-out of a shareholder at death, there are several structures that can be used. Some involve personally held insurance (such as the criss-cross method) and some involve corporately owned insurance (such as the promissory note method or redemption method). The decision as to which buy-sell method should be used will include all the ownership considerations discussed above, as well as some additional considerations.

One consideration is the tax result where the insurance is owned by the shareholders versus the corporation. If personally owned insurance is used to fund a buy-sell agreement (using the criss-cross method), the surviving shareholders will have an increased adjusted cost base of their shares and the deceased will receive capital gains treatment. If corporate-owned insurance is used to fund the buy-sell agreement, the promissory note method, the redemption method or some combination of the two can be used to accomplish the buy-sell. The promissory note method has the same tax consequences as the criss-cross method. If the shares of the corporation are redeemed, the survivors have an increased ownership in the company but their adjusted cost base does not change. The deceased's estate will receive dividend treatment on the redemption proceeds and some or all of the dividend may be characterized as a tax-free capital dividend.

Personally-owned insurance to fund a buy-sell agreement can get complicated where there are more than two shareholders involved. Multiple policies on the same life insured will be necessary; it may be difficult to track and determine whether the premiums have been paid on all the policies to keep them in force. With corporate-owned insurance, only one policy is necessary for each shareholder; therefore, administration is easier.

Differences in age, sex or health of the shareholders can result in significant differences between the premiums on each insurance policy. If the policies are owned personally, this may result in a disproportionate cost allocation. If the policies are owned corporately, the premiums are effectively allocated based on percentage ownership of the company.

In the past, one of the most important reasons for using corporate ownership for buy-sell funding was the ability to defer capital gains tax by redeeming shares with life insurance during the first year of the estate. The stop-loss rules introduced in 1995 and contained in subsection 112(3) of the Act, reduce the benefits of this type of planning for shares that are not grandfathered. Planning around these rules has become quite complex and a complete analysis of the impact of the stop-loss rules is required to determine whether corporate or personal ownership is preferable.

For a complete discussion of utilizing insurance for shareholder buy-outs at death, refer to the Tax Topics, "Buy/Sell Agreements – An Overview of Funding with Life Insurance", "Buy/Sell Agreements – Corporate Redemption Method", "Buy/Sell Agreements – Criss-Cross Purchase Method", "Buy/Sell Agreements – Hybrid Method", and "Buy/Sell

Agreements – Promissory Note Method". For a discussion of the stop-loss rules, refer to the Tax Topic, "Stop-Loss Provisions and Grandfathering Rules".

Considerations for Transfers of Existing Policies
Most of the issues raised so far will be also applicable in considering whether a life insurance policy should be transferred into or out of a corporation. However, it will also be important to consider the potential tax implications of the transfer itself. A transfer will always trigger a disposition of the policy and therefore may give rise to a policy gain if the proceeds exceed the ACB of the policy. If it is a non-arm's length transfer, a transfer for no consideration or a distribution from a corporation, the proceeds will be deemed under subsection 148(7) of the Act to equal the CSV of the policy.

Another aspect of any transfer is to consider whether any taxable benefit has been conferred as a result of the transfer. For transfers out of a corporation to a shareholder, employee or other related party, if the transferee does not pay fair market value for the policy, often the transferee will be considered to receive a taxable benefit. When a policy is transferred into a corporation, the corporation would generally want to pay fair market value consideration for the policy. If it pays more than fair market value, a taxable benefit could arise in the hands of the transferor. Refer to the Tax Topic, "Transfer of an Insurance Policy Involving Corporations and a Shareholder or Employee" for a more complete discussion of transfers.

Trust Ownership
Sometimes the solution to an ownership problem is to have a trust own the life insurance policy. A trust allows control over the policy by the trustees, and when desirable, allows discretion over the distribution of the policy or insurance proceeds.

A trust can sometimes be used to simplify administration where multiple policies would otherwise be required. For example, as noted earlier, in a life insured criss-cross buy sell arrangement, every shareholder must acquire a policy on every other shareholder to provide each shareholder with the funds to buy the shares of the deceased shareholder. Alternatively, a trust can be used to hold just one policy on every shareholder and also provide a mechanism to ensure that all the policies are kept in force (for more details, refer to the Tax Topics, "Buy/Sell Agreements – Criss-Cross Purchase Method" (with trustee & without trustee)).

Another situation where trust ownership makes sense is when the policy will be owned by someone other than the life insured and the preferred successor owner of the policy is someone to whom a transfer would result in a policy gain or who is a minor. For example, consider the situation where Mom (a single parent) purchases a life insurance policy on the life of her minor child, with the intent of over-funding it and passing it on to the child when they reach age of majority. If Mom names her sister or brother to be successor owner of the policy (in case she passes away before the child reaches the age of majority), a transfer at the time of her death would create a policy gain to the extent the cash surrender value exceeds the ACB at the same time. It would also be undesirable to name the child as successor owner (even though there would be a tax-free rollover to the child under subsection 148(8)) because a minor child cannot legally deal with the policy and may not be old enough for the responsibility. A solution is to place the policy in a trust with the child as beneficiary of the trust. In this way, there is no disposition on the death of Mom; the policy, policy withdrawals or death benefit can be distributed to the child as seen fit by the trustee(s).

Trust ownership also makes sense when there is a life insurance need in the trust or by the beneficiaries. For example, subject to the tax measures concerning trusts, in effect since January 1, 2016, and the Finance Canada legislative proposals submitted for public consultation on January 15, 2016, a trust may hold life insurance to fund the capital gains tax arising on the deemed disposition of capital property held by a spousal trust on the death of the spouse. There has been much CRA commentary on the effectiveness of this type of structure. For a more detailed discussion of the commentary, please see the Tax Topics entitled, "Trusts – Just the Basics" and "Trusts as a Planning Tool". Another example may be to fund the tax liability arising to the beneficiaries on growth shares that the trust acquired as a result of an estate freeze. A trust may also hold a life insurance policy as an alternative to other investments or for U.S. estate tax planning reasons, as mentioned earlier.

Shared Ownership – Split Dollar Life Insurance
It is possible for two parties (corporate or personal) to agree to share the benefits associated with a life insurance policy and to split the premium costs. To avoid taxable benefit issues, each party should pay a reasonable amount for the benefit they receive. It is also generally advisable to have a written agreement detailing how the premiums and benefits will be allocated to each party. A policy can be split in virtually any way, as long as it is possible to determine a reasonable allocation of premiums and benefits. Commonly, a universal life policy with a face plus death benefit is used with one party funding and entitled to the cash value of the policy and another party funding and entitled to the death benefit of the policy. In the context of personal and corporate ownership, a common arrangement is having an operating company entitled to the death benefit portion of the policy and an individual or holding company entitled to the cash value.

This structure can be useful in solving many of the issues discussed earlier, including:

- creditor protection issues;
- issues with cash value life insurance as a corporate asset of an operating company;

and

- a potential sale of an operating company.
- For a complete discussion of split dollar arrangements and their application, refer to the Tax Topics, "Split Dollar Life Insurance" and "Split Dollar Life Insurance – Applications".

Conclusion

Life insurance policies can be held personally, in a corporation or in a trust, or in more than one of these entities jointly. There are many things to consider in determining what the best ownership structure is in any particular situation. Sometimes the answer will be obvious: in other cases, the pros and cons of all of the issues raised in this Tax Topic will need to be weighed. It is important to keep in mind the objectives the life insurance is intended to fulfill, who is supposed to benefit from the proceeds and where the funds are available to fund the policy.

Last Updated: January 2016