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Professional Corporations and Life Insurance

Many professionals have the opportunity to run their business as a professional corporation [1]. The ability to incorporate raises a number of planning issues and opportunities. This includes using life insurance for tax and estate planning purposes. This Tax Topic will focus on how life insurance has a role to play for the incorporated professional.

Understanding who can incorporate
Traditionally, professionals have carried out their practices as either sole proprietors or in partnerships. While there are many positive tax and non-tax reasons for carrying on a business in one of these business structures, tax planning may be more limited under the current tax regime. As a result, professionals have lobbied provincial governments across the country for the ability to incorporate their practices. The provinces and territories have enacted legislation to permit certain professions to carry on their business activities through a professional corporation. Professionals can incorporate in all provinces and territories but in some jurisdictions, this right is limited to only a few professionals. For a list of professionals that can incorporate in the various provinces see Appendix “A”.

Insurance planning opportunities
Life insurance owned by a professional corporation allows cheaper after-tax dollars to be used to purchase the policy as compared to a sole proprietorship or partnership. This provides an opportunity to professionals that has not previously existed and therefore may entice professionals to consider life insurance in the planning process.

In order to retain the benefit of the small business deduction, it is common practice to retain corporate income up to the small business limit inside the corporation. This income gives rise to several planning options using life insurance.

a) Personal and corporate insurance planning
Salary, bonuses, or dividends paid to a shareholder/employee can be used for personal financial planning including the purchase of personal life insurance. Exempt insurance allows for a significant amount of tax-sheltered savings. One of the options available with the funds retained in the corporation may be to invest the funds in taxable investments. However, corporate owned investments are subject to a relatively high rate of corporate tax. An alternative to investing in taxable investments would be to put the excess profits into an exempt life insurance policy. The funds in the policy in excess of the amount needed to fund policy charges can grow on a tax-exempt basis during life. When the professional shareholder dies, a dividend may be paid out to the deceased shareholder’s estate or holding company tax-free by way of the corporation’s capital dividend account. (For more details refer to the tax topics entitled, “Accumulating and Transferring Wealth Through the Use of Life Insurance”)

[1] In Quebec, subject to the specific regulations governing professional orders, the *Professional Code*, CQLR, chapter C-26, authorizes members of professional orders to carry on their professional activities within a “limited liability partnership” (LLP) or a “business corporation.”

A corporation may also use life insurance for various other business needs including:

- Key Person Insurance;
- Business Loan Protection;
- Buy-sell Funding;
- Funding Capital Gains Tax on a Business at Death; and
- Executive Compensation.

A Split Dollar arrangement may also be considered in the professional corporation context. A split dollar arrangement recognizes that separate interests can be identified within a single life insurance policy. The particular interests in the policy can be matched to the parties that most require the benefits provided by the interest.

A Split Dollar arrangement can be used as a cost-effective means to provide buy-sell or key person funding while also providing a tax-deferred investment vehicle. The corporation and the professional shareholder, with the shareholder as the life insured, jointly purchase a life insurance policy. The corporation pays for and owns a level death benefit sufficient to fund the corporate insurance need. The shareholder pays for and owns the remaining interest in the policy (generally the cash surrender value).

It is important that the portion of the premium paid by the shareholder is a reasonable amount for the benefit received. If a reasonable amount is not paid, the Canada Revenue Agency ("CRA") could assess a shareholder benefit under subsection 15(1) of the Act. (See the Tax Topic entitled, "Split Dollar Life Insurance" for a further discussion of split dollar).

By using the Split Dollar arrangement, the professional corporation is provided with the insurance funding that it needs and the shareholder is provided with access to a tax-deferred investment vehicle that can ultimately be received tax-free if held until death.

b) Retirement and pension planning

Traditionally, professionals have been confined to pension planning utilizing RRSPs. As a result, professionals have only been able to contribute to their own pension planning by making contributions up to the maximum permissible for RRSPs thus limiting potential sources of income for professionals at retirement. The ability to incorporate now provides other options to better plan for their retirement.

Professional corporations may now consider purchasing an exempt life insurance policy with the intent of accessing the policy's cash value by collaterally assigning the policy to a bank at a later date. Accessing the cash value allows for a number of options, including using the funds to make bonus payments, to redeem shares thereby providing funds at retirement to the shareholder, personal borrowing for the shareholder or providing for a living buyout using personal borrowing. See the Tax Topic entitled, "Leveraged Life Insurance – Corporate Ownership" for a further discussion of these options.

As discussed previously, a split dollar arrangement may be used to enable the corporation to cover buy-sell funding needs and the shareholder to invest in the policy's cash value for this type of planning. Where the shareholder owns the cash value and wishes to use it to secure the loan the proceeds from the loan can then be used to provide additional cash flow in retirement.

A professional corporation may make tax-deductible contribution to an individual pension plan (IPP) or it may set up a retirement compensation arrangement ("RCA") to increase a professional's retirement savings. However, the decrease in corporate tax rates for active business income in recent years has significantly changed the landscape. RCAs for owner-managers compared to paying tax and retaining funds at the corporate level have become tax-disadvantaged. For a more detailed discussion on RCAs and the current tax treatment, please see the Tax Topic entitled, "Retirement Compensation Arrangements". Contributions to an RCA are subject to a 50% tax, which is refundable to the RCA when it distributes funds to the beneficiary. Note should be taken of technical interpretation (#2005-011993 dated April 25, 2005) regarding whether it would be acceptable to include the period of time during which an individual operated his or her practice as a sole proprietor before incorporation when determining the amount of benefits which could be provided to the individual from a RCA to be funded by the corporation. CRA's technical interpretation indicated that a partner or sole proprietor does not provide employment services to the partnership or sole proprietorship and therefore such periods would not be employment services for the purpose of determining the benefits that may be provided to the individual from an RCA.

When an RCA is funded with a life insurance policy, the policy is subject to the same taxation rules as if the policy was outside of an RCA. The funds accumulating in an exempt life insurance policy are not subject to the refundable tax. Therefore, the funds are allowed to grow tax-sheltered. Any policy gains on a full or partial disposition of the life insurance policy will be subject to the 50% refundable tax. Death benefits are received tax-free by the RCA trust, but subsequent distributions to either the employer or the beneficiary would be taxable in their hands. The employer corporation, if a residual beneficiary under the trust, would not be entitled to an increase in its capital dividend account (CDA) on distribution of the death benefit from the RCA trust to the corporation.

In order to pay the retirement benefits, the trustee of the RCA trust can use policy withdrawals or use the policy as collateral for a bank loan. As noted previously, policy withdrawals may cause a tax liability for the trust, but a subsequent distribution out of the RCA trust will generate a refund of the tax.

c) Buy-sell considerations

The same tax planning on buy-out can occur with a professional corporation as with any type of corporation. The outcome from a tax perspective for the individual shareholder and the surviving shareholders will be the same but for the consideration of the loss of status should a non-professional own the shares at death. This consideration may limit the structure options available to the professional and therefore limit their tax planning options. For a further discussion on buy-sell structures using life insurance see the Tax Topic entitled, "Buy-sell Agreements – An Overview of Funding with Life Insurance".

Conclusion

Life insurance has a role to play when a professional incorporates. It presents various options that should be considered in the professional's overall financial and estate plan.

Tax, Retirement & Estate Planning Services at Manulife writes various publications on an ongoing basis. This team of accountants, lawyers and insurance professionals provides specialized information about legal issues, accounting and life insurance and their link to complex tax and estate planning solutions.

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Appendix "A" – Who and Where Can Professionals Incorporate

Province	Professionals that can incorporate
Alberta	◊ Lawyers ◊ Medical Professionals ◊ Accountants ◊ Engineers ◊ Architects ◊ Chiropractors ◊ Dentists ◊ Physical therapists ◊ Optometrists ◊ Veterinarians
British Columbia	◊ Lawyers ◊ Engineers ◊ Architects ◊ Chiropractors ◊ Optometrists ◊ Pharmacists ◊ Veterinarians Note: The Health Care Professions Act permits professional corporations for the professions where regulations have been established – none exist
Manitoba	◊ Lawyers ◊ Medical professionals ◊ Accountants ◊ Engineers ◊ Architects ◊ Dentists ◊ Pharmacists
New Brunswick	◊ Lawyers ◊ Medical professionals ◊ Accountants ◊ Engineers ◊ Architects
Newfoundland	◊ Lawyers ◊ Medical professionals ◊ Engineers ◊ Dentists
Northwest Territories	◊ Engineers ◊ Dentists

Nova Scotia	◊ Lawyers ◊ Medical Professionals ◊ Accountants ◊ Chiropractors ◊ Dentists ◊ Veterinarians
Nunavut	◊ Engineering ◊ Dentists
Ontario	◊ Lawyers ◊ Medical professionals ◊ Accountants ◊ Engineers ◊ Architects ◊ Social workers ◊ Veterinarians ◊ Regulated Health Professionals (audiologists, dentists, chiropractors, massage therapists, midwives, nurses, pharmacist, physiotherapist, psychologists etc.)
Prince Edward Island	◊ Lawyers ◊ Medical professionals ◊ Engineers ◊ Architects ◊ Physiotherapists ◊ Psychologists ◊ Veterinarians
Quebec	◊ Lawyers ◊ Notaries ◊ Accountants ◊ Doctors ◊ Land surveyors ◊ Pharmacists ◊ Occupational therapists ◊ Architects ◊ Dentists ◊ Denturologists ◊ Optometrists ◊ Psychologists
Saskatchewan	◊ Medical Professionals ◊ Engineers ◊ Dental Technicians ◊ Pharmacists ◊ Lawyers
Yukon	◊ Medical professionals ◊ Engineers ◊ Dentists