Business Needs

Introduction

There are many situations where life insurance can provide for the needs of a business following an individual's death. The funding needs covered include the following:

- Business Loan Protection
- Key Person Funding
- Buy-sell Funding
- Capital Gains Tax Planning
- Wealth Creation
  - Grouped Plans
  - Retirement Funding
  - Estate Wealth Transfer
- Executive Compensation
  - Split Dollar

Business Loan Protection

Business loan protection involves the use of life insurance to create immediate working capital for a business to repay business debts in the event of the death of a business owner or other key executives.

In many small business situations, adequate financing is difficult to obtain. Creditors will often require that business owner(s) personally guarantee a loan. The untimely death of a business owner or another key executive may cause creditors to demand immediate repayment of outstanding business debts. This may place an unbearable burden on the business and force the liquidation of key business assets at fire sale prices at a time when business results may already be severely impacted by the death. In addition, if the business owner has personally guaranteed the debts incurred by the business, the business owner or the owner's estate may be liable for any outstanding debts that the business cannot pay.

In the absence of proper planning, the survival of the business may thus be affected by the death of the business owner or another key executive.

A solution is to purchase an insurance policy on the life of the business owner(s) or other key executives. Proceeds from the life insurance policy received as a consequence of the death of the life insured are tax-free and may be used to pay down the outstanding business debts.

A creditor may require the purchase of collateral life insurance to protect the interests of the creditor, particularly in small business situations in which the death of a business owner may impair the value of business assets used to secure the debt. In other cases, the business owner(s) may simply have a desire to have business debts fully repaid in the event of death to minimize financial risks for the heirs and to permit the continuation of the business free of debt.

Generally, life insurance premiums paid for business loan protection are not deductible for tax purposes. However, in the case of a life insurance policy that has been collaterally assigned to a restricted financial institution, a portion of the premiums may be deductible. As noted earlier, in the case of a private corporation the receipt of a death benefit under a life insurance policy will result in a credit to the corporation's capital dividend account. The credit to the capital dividend account is not affected by the fact that the insurance policy may have been collaterally assigned to a creditor.

A life insurance policy purchased for business loan protection can improve the ability of a business to negotiate loans, and provide for the repayment of business debts in the event of the death of a business owner or another key executive using tax-free life insurance proceeds. It can also prevent the business owner(s) or their estate from becoming personally liable for the business debts in the event of a death.

Key Person Insurance

Key person insurance protection involves the use of life insurance to create immediate working capital for a business to meet immediate cash needs and to find a replacement in the event of the death of a business owner or a key executive.

The business owner(s) and/or other key executives spend considerable time and effort in acquiring the knowledge, experience, judgment, reputation, relationships and skills that make them valuable to the business. The death of such an individual results in the loss of a key member of the management team and can have a severe financial impact. During the resulting disruption, lenders may curtail credit, creditors may press for immediate payment, debtors may delay making payments, employees and customers may lose confidence, and competitors may take advantage of the situation.

Large corporations are often in a much better position to prepare for key executive turnover by sheer size and numbers. Unfortunately, finding an immediate replacement with the same qualifications as a deceased owner or executive is seldom possible in small business situations. It is often necessary to look outside of the business to find a replacement, causing delays, disruption and reduced efficiency. The resulting effect on business profits may further weaken the financial stability of the business. In the absence of proper planning, the very survival of the business may thus be affected by the death of a business owner or a key executive.

A solution is for the business to purchase an insurance policy on the life of the business owner(s) and/or key executives. In the event of death, the life insurance proceeds provide the business with needed working capital to meet immediate cash needs and to provide a source of funds for finding, attracting, hiring, and training a replacement for the deceased executive or, in the case of the death of a business owner, to hire interim management.

Life insurance premiums paid by the business for key person insurance protection are not deductible for tax purposes. However, life insurance proceeds received as a consequence of death are tax-free. In the case of a private corporation that receives life insurance proceeds as a consequence of death, the excess of the proceeds over the adjusted cost basis of the policy credits (increases) the capital dividend account of the corporation. Under subsection 83(2) of the Income Tax Act, R.S.C. 1985, c. I (5th Supp.) (ITA), the corporation can elect to pay tax-free capital dividends to the shareholders of the corporation to the extent of any balance in the capital dividend account.

Key person insurance protection provides many potential benefits to the business, the business owner and the owner's family. It helps to assure creditors and employees of the business that the business will continue notwithstanding the death of the key person. The life insurance proceeds provide immediate cash at the time of death to cover working capital needs of the business, and to find and train a suitable replacement for the deceased. The value of these benefits to the business in the event of the death of the owner-manager or other key executive will usually far exceed the cost of the life insurance.

Buy-Sell Funding

A key component of an integrated financial plan is planning for business succession. The business interest often accounts for a substantial portion of the wealth the business owner has accumulated. Ensuring a plan is in place for the eventual transfer of the business interest will help the business owner realize full value for the business interest and will also help the business, and the remaining owners, survive the transition. This is particularly true in the event of premature death.

Changes in ownership may create financial obligations on the part of the remaining owners, and may also have income tax implications for the withdrawing owner and the remaining owners.

An integral part of the succession plan is to ensure financing is in place in the event of death to fund the purchase and sale of the business interest. The succession plan should also provide the business owner with sufficient liquidity to fund the related income taxes and, where possible, take advantage of any tax deferral or tax minimization strategies that may be available.

In the case of closely held corporations or partnerships, one of the most important tools for implementing the business succession plan is the shareholders' agreement or partnership agreement. Once the business succession plan is developed, an agreement can be drafted to reflect the needs and wishes of the various parties.

Life insurance is generally an efficient means of funding the obligation under a buy/sell agreement in the event of the death of a shareholder or partner. There are numerous ways to structure a buyout on death and life insurance funding plays an important role in ensuring the buyout occurs. In considering the various methods for structuring a buy/sell agreement, it should be kept in mind that there is no "right way" to proceed. Each method has its own 'pros' and 'cons' and must be considered in light of the circumstances of a given situation.

In the corporate context an important threshold consideration is whether to fund the buy/sell arrangement with 'corporate owned' or 'personally owned' life insurance. The cross purchase method is generally funded using personally owned insurance. The promissory note method, the share redemption method and the hybrid method are funded with corporate owned insurance. Each structure has differing advantages from a tax perspective and depending upon the facts one structure may be more favourable over another.

Capital Gains Tax Planning

Life insurance can also be an effective way of funding the tax liability that arises as a result of a deemed disposition of capital property at death. Paragraph 70(5)(a) of the ITA provides that, unless a rollover is available, a deceased taxpayer is deemed to have disposed of each capital property owned by him or her immediately before death for proceeds equal to the fair market value at that time. To the extent that the fair market value exceeds the deceased's adjusted cost base (ACB) of the property, a capital gain will be realized for tax purposes. The deceased may utilize any remaining capital gains exemption if the property consists of "qualified small business corporation shares" or "qualified farm property" (both terms are defined in subsection 110.6(1) of the ITA). Any taxable capital gains that are not sheltered by the capital gains exemption or qualify for a rollover will be subject to tax in the deceased's terminal return.

An individual who owns shares in a corporation, a partnership interest, or business assets (as in the case of a sole proprietorship) will be deemed to have disposed of these properties at death. As a result, a tax liability may arise in the form of capital gains and recaptured capital cost allowance. If funds or other assets are not available to pay the tax liability, the shares or partnership interest may have to be sold, or business assets may have to be liquidated, possibly for a price below the fair market value.

Life insurance may be purchased to provide the necessary funds at the right time to pay the tax liability resulting from the capital gains and recaptured depreciation triggered upon the death of the individual. Life insurance is a particularly valuable funding vehicle if the beneficiaries wish to retain the property or if the market conditions will not provide the estate with an amount equal to the fair market value of the property. The individual could own the life insurance policy, or it may be owned by the corporation or partnership and flowed out to the individual's estate after death.

Wealth Creation

Often the retained profits or surplus cash of a business, whether an operating company or an investment holding company, are invested in GIC's, or taxable investments, and are not paid out to the shareholder. However, these taxable investments may not be the most advantageous way for the corporation to invest its' retained profits. Instead profits could be deposited into an exempt life insurance policy that is required to provide key-person insurance, business loan protection, or some other business insurance need.

Retirement Funding/ Estate Wealth Transfer

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 the maximum deposits permitted by the ITA are deposited into the exempt policy. The deposits can be designed so that they remain tax-sheltered within the contract and pay for the cost of insurance and expenses in future years.

This may be an attractive alternative to taxable investments for a corporation which has excess cash reserves not set aside for a specific purpose. It is ideal for a private corporation or its owner who:

- Desires a higher immediate estate value,
- Has annual income retained but not earmarked for any particular use,
- Desires a tax deferred investment, and
- Desires a tax-free death benefit.

If the corporation or shareholder desires access to the cash at some future date prior to death, the cash surrender value of the policy can be accessed through policy withdrawals or a collateral loan secured against the insurance policy. Policy withdrawals may trigger some income tax at the time of withdrawal (for details refer to the Tax Topic “Dispositions of Life Insurance Policies”.) Advances to the corporation received as a collateral loan will be tax free, and if the proceeds are used for the purpose of earning income from a business or property, and the other requirements of 20(1)(c) of the ITA are met, the interest expense may be deductible for tax purposes.

Executive Compensation

Another business use of life insurance is in situations where an employer is interested in providing an employee with a supplementary benefit package. Supplementary benefit packages are often used by employers as a means of attracting executives. These packages offer a wide assortment of benefits that may include life insurance protection. The life insurance protection ensures that upon death the dependants of the executive receive an inflow of capital that can be used to cover funeral expenses, education costs, reduce debt, and provide a future stream of income.

The policy may be purchased by the business/employer, or may be owned and funded jointly by the employer and the executive. The executive’s dependants would be named as the beneficiary of all or a portion of the policy. The portion of the life insurance premium paid by the employer related to the executive’s interest in the policy must be reported as a taxable benefit to the executive on the employee’s Statement of Remuneration Paid (T4 Supplementary Slip). It is important that the amount reported on the T4 slip represents a reasonable cost for the benefit received.

Split Dollar Life Insurance

There are many situations in which an insurance policy is needed by one party to provide protection in the event of death of an individual and another party has a need or desire for a tax-sheltered investment vehicle. In these cases one policy can provide for the needs of both parties by using an arrangement commonly referred to as “split dollar life insurance”. In these arrangements typically one party owns and pays for a level death benefit portion of the policy, and the other party owns and funds the remaining interests in the policy (generally the cash value).

In the business context a split dollar arrangement has numerous applications. For example, an employer may have a need for key person insurance on an executive and the executive might have a desire for tax-sheltered investment. The employer and the executive could enter into a split dollar arrangement where the employer pays for and owns a level death benefit on the life of the executive and the executive pays for and owns the cash surrender value component of the policy. The beneficiary of the level death benefit is the employer, and the beneficiary of the cash value is designated by the executive (his spouse for example).

The following table provides other examples of split dollar arrangements applicable to business situations:

Death Benefit Need	Tax-Sheltered Investment Need
Buy-Sell Funding (corporation/partnership)	Shareholder or Partner Investment Vehicle