Advantages of corporate-owned life insurance

There can be many reasons for a corporation to own a life insurance policy on a shareholder’s life. Some of those reasons include:

1. **Buy – sell agreements**

   Funding a buy-sell agreement with a life insurance death benefit often requires the corporation to own the policy.

2. **Key person needs**

   If there will be a need for money at a key person’s death to help the business hire and train a replacement, and replace lost profits, the corporation should own the life insurance policy and receive the death benefit.

3. **Potential tax savings**

   In general, life insurance premiums are paid for with after-tax dollars. A corporation that is a Canadian controlled private corporation (CCPC) is generally eligible for the small business tax deduction, and may pay tax at a lower rate than the insured shareholder. If so, the corporation will not need to earn as much money as the insured to pay the premiums.

   This is not a complete list. Depending on the corporation’s and shareholder’s circumstances, there may be many reasons for a corporation to own a life insurance policy on a shareholder’s life. However, circumstances may change, and clients need to think beyond the advantages noted above. Ownership planning is an exercise in balancing many factors, some of which may conflict. What is good planning for cost or tax reasons today may be bad planning for business continuity or other purposes tomorrow. This bulletin examines some of the drawbacks
to a corporation owning life insurance on a shareholder’s life. Part II will look at some personal ownership planning considerations.

**Drawbacks to corporate-owned life insurance**

1. **Owner and life insured part ways**

What happens if the shareholder/insured retires, leaves the company or sells his or her interest in the company? Every business owner needs to think about their exit strategy. Part of that thinking should include the corporate-owned life insurance policy.

When the shareholder/insured leaves the company, getting the policy out can create tax problems. The policy will need to be valued, requiring the services of a consulting actuary.

On the other hand, leaving the policy in the corporation would only benefit the remaining or new shareholders. The client may be uninsurable, or insurable only at a higher rate. Yet he or she may need the additional insurance for his or her own personal planning needs. Even if the client had no need for the insurance, he or she may feel uneasy about his or her death representing a windfall for others.

2. **Assumed tax advantages may not exist**

If one reason for having the corporation own the policy is the expected tax benefits, it’s important to examine the requirements for those benefits to make sure that they apply to your client. Here are some potential tax advantages that, depending on the corporation’s and shareholder’s circumstances, may not apply.

Generally, the life insurance policy death benefit minus the adjusted cost basis (ACB) may be credited to the corporation’s capital dividend account (CDA) and paid out tax-free to the shareholders. However, other amounts apart from the life insurance policy death benefit may be added to or subtracted from the CDA. If the CDA balance is negative when the insured dies, the amount of the death benefit that may flow out to the shareholders tax-free will be reduced (or eliminated if the negative balance exceeds the policy death benefit minus its ACB). It is possible to mitigate this risk with appropriate tax planning before or after the insured dies to make sure that as much of the death benefit as possible flows to the shareholders as a tax-free capital dividend.

If there are other shareholders in the corporation, they will be entitled to a capital dividend in proportion to their ownership interests in the corporation. If the company has grown, and new shareholders have been added, the original purpose of having almost all of the policy death benefit flow out as a capital dividend to the deceased shareholder’s family may be frustrated. One way to prevent this result, if the life insurance proceeds’ primary purpose is not to redeem the deceased shares, is to create a special class of shares for the family members. Assuming that appropriate tax planning has been done, a capital dividend may be declared only for the family members’ shares, thereby allowing the corporation to flow the proceeds of life insurance to them but not to the other shareholders.

If the insured shareholder was a controlling shareholder and becomes a non-resident of Canada (for example, by retiring to the United States) the corporation may no longer qualify as a CCPC. If that happens, the corporation will no longer qualify for the lower rate of tax that initially made it attractive to have it pay the insurance premiums, and will not be able to pay any part of the death benefit as a capital dividend.

3. **Creditors’ claims may threaten a corporate policy or proceeds from it**

One attraction to incorporating is that a shareholder’s personal assets are generally protected from the claims of the corporation’s creditors. The flip side of that benefit is that corporate assets are exposed to the claims of the corporation’s creditors. Under most provinces’ insurance laws, a corporate-owned life insurance policy only benefits from creditor protection when the corporation names an irrevocable beneficiary to receive the death benefit. However, naming an irrevocable beneficiary creates other complications. If the corporation wants to post the death benefit minus the policy’s ACB to its capital dividend account, it must name itself as the beneficiary. Further, if the shareholder dies, payment of the death benefit to a third party other than the corporation could create tax problems. For example, if a shareholder or close relative were named as a beneficiary, the CRA could deem the policy payments made by the corporation to be a taxable benefit to the shareholder.
4. Corporate ownership and control of the policy

Single shareholder companies have few issues about who controls the company. But if there are several shareholders with significant ownership rights, decisions about owning and maintaining corporate assets, including corporate-owned life insurance policies, are subject to the will of the shareholders controlling a majority of shares. That majority may or may not include the insured. The originally intended use for the proceeds, such as funding a buy-sell share redemption agreement, is not guaranteed unless a shareholders’ agreement is in place and kept up to date.

5. Saving personal dollars may cost unnecessary capital gains tax

Shareholders of qualifying small business corporations benefit from the lifetime $750,000 capital gains exemption – the first $750,000 in capital gains is exempt from tax. The exemption could save a shareholder over $170,000 in tax when they sell the shares in their business. However, qualifying the company for the exemption is very important. One of the requirements is that at the time the gain is realized, 90% of the fair market value of the corporation’s assets must be used in an active business carried out in Canada. Further, in the twenty-four months leading up to the realization of the gain, 50% of the fair market value of the corporation’s assets must have been so used.

Life insurance policy cash values are passive assets, and do not count towards the 90% or 50% requirements noted above. The CRA uses the policy’s cash surrender value to measure the value of a life insurance policy for capital gains exemption purposes. It could be useful to create a holding company that would own any life insurance policies, in order to keep the policies out of the operating company, and not jeopardize the operating company’s status as a qualifying small business corporation. However, there may be tax consequences associated with such transfers, so you should consult your tax advisors before pursuing this option.

Advising clients

Your advice is important in helping clients have the confidence to buy life insurance. This means making recommendations that meet current needs and wishes – but also keeping an eye on the future. As such, some recommendations are based on the facts of today, while others are based on the possibilities of tomorrow.

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1 Assumes that half the capital gain, $375,000, is brought into income and taxed at a combined federal provincial rate of 46%, for a tax bill of $172,500.