The Corporate Investment Shelter

Many successful business owners retire with more assets than they need to live well. With that realization, their focus can shift from providing retirement income for themselves to maximizing the value of their estate for their heirs. Corporate-owned life insurance can help them achieve that objective.

The corporate investment shelter (CIS) strategy uses an exempt life insurance policy to increase the after-tax value of the client’s estate. The impact of this strategy can be dramatic, but careful planning is needed to realize all its benefits.

Corporate investments

As companies prosper, they often accumulate more money than they can use in their business. When that happens their owners may create a holding company to own shares of the business (the operating company) and the surplus wealth that the operating company generates. Tax laws facilitate this strategy by allowing money to flow between such companies as tax free inter-corporate dividends. Among other benefits, this strategy moves corporate investments beyond the reach of the operating company’s creditors, and makes it easier to one day sell the business separate from the surplus wealth that it has generated.

The holding company can place this surplus wealth in a variety of investments, including stocks, bonds, mutual funds or guaranteed investment certificates (GICs). Later, when the operating company is sold, the holding company can invest the proceeds of sale in the same portfolio.

Because withdrawals from a corporation are treated as taxable dividends, shareholders in high tax brackets often prefer to leave their holding company’s investments where they are. If they don’t need the money, they’d only have to pay tax on the withdrawal (as a dividend), reinvest it, and deal with ongoing personal taxation on the investment returns. Absent any need for the money, a shareholder can leave their investments in a holding company indefinitely, even until death.
But there’s no special tax deferral for investments left in a corporation. While corporations enjoy the same tax benefits as individuals regarding capital gains and dividends, Canada’s tax laws discourage corporations from owning investments that aren’t used in the business by taxing the income those investments earn at the highest corporate rates. While some of that tax is refunded to the corporation when it pays out a taxable dividend, the shareholder still pays tax on the dividend.

The tax picture only gets worse. At death, a shareholder will be deemed to have disposed of all their assets, including the shares in their holding company, at fair market value (FMV). The value of the holding company will include the value of all the investments it owns. Any tax resulting from that disposition will have to be paid on the deceased’s terminal tax return. If the shareholder’s estate doesn’t have enough cash to pay the tax, it may need to withdraw money from the holding company. That withdrawal will be treated as a taxable dividend to the estate.

If the shareholder’s final tax liability can be paid without using corporate funds, the holding company’s shares can be passed to the estate’s beneficiaries without touching the corporate-owned investments. But if the estate beneficiaries need cash, they will have to take taxable dividends from the holding company once they own the shares. That could create more complications. If a minority shareholder needs cash, he or she may not be able to persuade the majority to declare a dividend. But if dividends are paid, they are paid in proportion to each shareholder’s ownership interest, and are taxable to each shareholder, even if only one shareholder needs the cash.

There is also a risk of double taxation. As noted above, when a shareholder dies, they are deemed to have disposed of their shares at FMV. Any investment the corporation owns contributes to the shares’ FMV. Because the deceased’s final return must include any taxable gains on shares resulting from this deemed disposition, the estate or beneficiaries will receive the shares with the shares’ adjusted cost base (ACB) set equal to their FMV. But the adjustment to the shares’ ACB does not apply to the investments the corporation owns. If the corporation sells those investments after the shareholder’s death, any investment gains resulting from the sale will also be taxed.

Because of the tax problems that arise with corporate-owned investments like securities or GICs, they may not be the best choice for maximizing the value of a shareholder’s estate.

The life insurance advantage

The CIS strategy offers a significant advantage over taxable investments. With this strategy, the corporation uses excess cash flow or redundant assets to pay premiums for a Sun Par Protector or Sun Par Accumulator life insurance policy. Either Sun Par Protector or Sun Par Accumulator is an ideal choice to use with this strategy because they both offer guaranteed premiums and death benefits. Further, as long as premiums are paid on time and in full, and no changes are made to the policy, the policy will remain in force for the life of the insured.

Both life insurance policies feature cash value accumulation, but there is no tax payable on the growth of the policy cash value as long as it remains in the policy. On death, the corporation receives the policy's death benefit tax free. Most or all of the death benefit can pass tax free to the shareholder's estate as a tax free capital dividend. As a result more money can pass to the estate compared with taxable investments. In this way, life insurance helps optimize the value of the deceased’s estate.

Planning considerations

There are two significant planning risks with the CIS strategy, though. First, accessing the cash value of a corporate-owned life insurance policy during the insured's lifetime can be costly. Second, while this strategy may dramatically increase the estate’s value, it can also increase the tax liability in the shareholder’s terminal return. We’ll discuss both issues in turn.

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1. In 2012 the rate varies from 44.67% in Alberta and New Brunswick to 50.67% in Nova Scotia. The rate is approximately 46.5% in Ontario.

2. The excess of the life insurance death benefit over the policy's adjusted cost basis may be posted to the corporation's capital dividend account. Capital dividends may be paid to shareholders tax free.
Accessing cash value

A shareholder who anticipates needing money from their holding company may want their company to own taxable investments instead of life insurance. Though the policy cash value grows tax deferred, the corporation will have to pay tax on any policy gains it realizes from taking a withdrawal or from surrendering the policy. The resulting tax burden may offset any advantage the corporation would have received from tax-deferred accumulation of the policy's cash value. Furthermore, proceeds from a life insurance policy withdrawal or surrender may not be posted to a corporation's capital dividend account (and in turn paid as a tax free capital dividend to the shareholder). Whatever part of the withdrawal or surrender was left after the corporation paid taxes would again be taxed as a dividend when paid to the shareholder. Another drawback to withdrawing money from a whole life insurance policy like Sun Par Protector or Sun Par Accumulator is that cash withdrawals reduce the policy's death benefit by a greater amount than the withdrawal.

Borrowing against the policy's cash value is an alternative to taking cash withdrawals. The corporation could take a policy loan or borrow money from a financial institution using the policy to secure the loan. Alternatively, the shareholder could borrow the money personally, and have the corporation pledge the policy as security for the loan.

But these alternatives all create tax issues. Some or all of a policy loan will be taxable if the loan amount exceeds the policy's adjusted cost basis, and the entire proceeds will be taxed as a dividend when paid to the shareholder. Third party loans are not treated as income to the borrower, but still raise tax issues. If the corporation borrows the money from a financial institution, the borrowed money will not be treated as income to the corporation or to the shareholder. But the corporation will only be able to pay the money to the shareholder as a taxable dividend.

A shareholder can avoid the dividend issue by borrowing directly from the financial institution, using the corporation's life insurance policy as collateral security for the loan. The borrowed money will not be treated as income for the shareholder. But unless the shareholder pays a reasonable guarantee fee to their corporation, the Canada Revenue Agency (CRA) will treat the corporation's willingness to let its policy secure the shareholder's loan as a taxable shareholder benefit. Shareholder benefits are taxed as income to the shareholder, with no deduction to the corporation.

Further drawbacks are that the right to borrow money may not be available until policy cash values have grown, interest will be payable on the borrowed money, and loan interest rates will usually exceed the policy cash value growth rate. Further, a loan from a third party financial institution will be a demand loan – repayment could be required at any time – and the interest rate may fluctuate. While policy loans are not subject to these drawbacks, over time, the tax cost of a policy loan could equal or outweigh the tax that would have been paid on a withdrawal.

All in all, a shareholder should consider the CIS strategy only when they are sure that they or the corporation won't need any money from the policy during the shareholder's lifetime.

Increased tax liability on terminal tax return

Even when the policy is held until the insured's death, and no withdrawals or loans are taken from the policy, the full advantage of the CIS strategy may be reduced without careful planning. While the death benefit from a

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3 A policy gain is the policy's cash surrender value minus its adjusted cost basis.
4 We discuss these tax issues in greater detail in our Financial Advisor bulletin, “Corporate Retirement Strategy: What is a guarantee fee and how do you value it?” available at https://www.sunlife.ca/advisor/v/index.jsp?vgnextoid=ad23575fb252f110VgnVCM1000009b80d9fRCRD&vgnextchannel=ad23575fb252f110VgnVCM1000009b80d9fRCRD&vgnextfmt=default&vgnLocale=en_CA&authgroup=SLFDEFPUB.
corporate-owned life insurance policy can increase the estate’s after-tax value, the policy’s cash values can increase the tax liability on the shareholder’s terminal tax return.\(^6\)

When someone dies, the Income Tax Act deems them to have disposed of all their assets immediately before death at FMV. For assets that have appreciated in value, this requirement forces the executor to report those assets’ taxable capital gains on the shareholder’s terminal tax return, even if no transaction actually took place.

Shares of closely held corporations are capital property, and are deemed to be disposed of at FMV immediately before death. The cash value (though not the death benefit value) of a corporate-owned life insurance policy will contribute to the FMV of those shares.

Tax-deferred growth of the policy's cash value may result in significant accumulations within the policy, possibly exceeding what would have accumulated from owning taxable investments. The CIS strategy could therefore result in an increased capital gains tax liability in the shareholder’s terminal tax return, and reduce the advantage of using corporate-owned life insurance to shelter investment income.

### Planning strategies

Fortunately, proper planning can prevent or reduce the increased tax liability in the terminal return and help the CIS strategy achieve its full potential. A few alternative strategies are available, including an estate freeze, the pipeline strategy, and share redemptions. We discuss each strategy below.

#### Estate Freeze

An estate freeze can halt the increase in value of the shareholder’s shares, and thereby limit the tax payable on his or her terminal return. To implement an estate freeze, the shareholder exchanges his or her common shares for fixed-value preferred shares of equal value. Since the shareholder’s ACB in the old shares carries over to the new shares, the shareholder’s capital gains tax liability is limited to the capital gains tax liability already in the old common shares at the time of the freeze. To complete the freeze, new common shares will be issued to those expected to succeed the shareholder in the business, typically adult children already working in the business, or key employees. The new common shares will initially have no value, but will grow in value as the company grows in value.

The technique transfers any future growth and future capital gains tax liability to the shareholder’s successors. To the extent that the company’s value increases because of increases in the insurance policy’s cash values, that gain accrues to the successors’ common shares, not to the shareholder’s preferred shares, whose value and ACB is already fixed.

At the shareholder’s death, the life insurance policy pays a tax free death benefit to the corporation. An amount equal to the death benefit, minus the policy’s adjusted cost basis at the time of the shareholder’s death, can be posted to the corporation’s capital dividend account. Capital dividends can be paid tax free. The shareholder’s personal representative could use a capital dividend to help pay the tax owing on the terminal return, and possibly on the estate’s tax return. For the common shareholders, any capital gain in their shares attributed to the increase in the life insurance policy’s cash value would disappear at the shareholder’s death because the policy would end at that time. Yet any unused portion of the capital dividend account could still be used for the common shareholders’ benefit after the estate had disposed of its preferred shares.

There are some caveats to using this structure. First, shareholders will not want to implement this strategy if they are not prepared to give up future growth in the company’s value to the common shareholders. Second, if a common shareholder predeceased the insured, his or her shares would have experienced an increase in value attributable to any increase in the life insurance policy’s cash value. That shareholder’s estate would

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\(^6\) The deceased’s executor files a terminal tax return to report and pay tax on all the deceased’s income from the beginning of the year until the date of death. The executor also files an estate tax return (or returns, if the estate is open over multiple tax years) to report and pay tax on the estate’s income from the date of death.

\(^7\) When dealing with capital gains, the Income Tax Act uses the term “adjusted cost base”. The difference between sale price and adjusted cost base is a capital gain or loss. When dealing with life insurance, the Act uses a term that sounds similar, “adjusted cost basis”. The difference between a life insurance policy’s cash surrender value and its adjusted cost basis is taxable gain. The two terms sound similar, and share the same acronym, but mean different things.
have to pay increased tax on the resulting capital gain, but a death benefit would not be paid at that time. Life insurance policies on the common shareholders could help protect their estates from that potential consequence. We discuss estate freezes more fully in our Financial Advisor bulletin, "Estate Freezes: recognizing the opportunity."

**Pipeline strategy**

The pipeline strategy is a method for turning the ACB that arises on the deemed disposition at death into a loan that can be repaid without incurring further tax.

The strategy works like this. When a shareholder dies, the holding company’s shares are subject to a deemed disposition, and capital gains tax on any resulting gains (the difference between the shares’ FMV and their ACB). The shareholder’s personal representative reports the gain and pays the tax on the shareholder’s terminal return. Paying the tax increases the shares’ ACB so that the shares’ ACB equals FMV. The beneficiaries receive those shares with no unrealized capital gains. They then sell the shares to a new company for FMV, taking back a promissory note from the new company for the value of the shares. The sale generates no tax consequences because there is no gain in the shares to tax.

Since the new company owns all the shares in the holding company, it owns the holding company. The new company then has the holding company pay a dividend equal to the value of its shares. Since the dividend is an intercorporate dividend, it can be paid tax free to the new company. Using the dividend proceeds, the new company repays the promissory note. Loan repayments are also tax free.

Life insurance can improve the outcome of the pipeline strategy by adding liquidity to the holding company. It should also be noted that the CRA has been cautious in its public commentary regarding pipeline planning. However, the agency has granted two favourable rulings involving post-mortem pipeline plans where the corporations had activity and were not merely corporations holding cash. For those planning for dividends using insurance on post-mortem redemptions, capital dividends can reduce tax.

There are a number of rules to consider when implementing the pipeline strategy that go beyond the scope of this article, so it is important to have tax advice before deciding to implement the strategy. We will discuss the pipeline strategy in more detail in a subsequent bulletin.

**50% solution**

Another strategy would be for the corporation to use the proceeds from the corporate-owned life insurance policy death benefit to redeem 50 per cent of the deceased’s shares from the estate using a tax free capital dividend, and to redeem the rest of the shares with a taxable dividend. The redemption of shares from the estate will result in a capital loss equal to the redemption amount. This capital loss can then be carried back to offset the capital gain in the terminal tax return.

This strategy may offer a better result than paying capital gains tax in the terminal tax return. Ideally, this insured redemption would be combined with an estate freeze, with the redemption applying to the freeze shares.

**Partial redemption**

It may also be possible to use a partial redemption for optimal results. An estate freeze would be implemented to limit the tax liability on the terminal return. The corporation would use tax free capital dividends to redeem the deceased’s shares to the extent of the allowable 50 per cent loss carry back. The balance of the deceased’s shares would be purchased outright by the heirs using a note, which they could repay using a capital dividend paid on their own common shares. In order to allow for this outcome, the shareholders’ agreement must provide the parties with sufficient flexibility.

We will discuss the 50% solution and partial redemption strategies more fully in a subsequent bulletin.

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8 Available at https://www.sunlife.ca/advisor/v/index.jsp?vgnextoid=21b5962b0540d210VgnVCM10000017d2d09fRCRD&vgnextfmt=default&vgnLocale=en_CA&authgroup=SLFDEFPUB.
Conclusion

Corporate-owned life insurance can be a very effective tax and estate planning tool. The rules surrounding corporate-owned life insurance and these strategies are very complex. It is important that financial advisors are aware of these rules and the impact they may have, and that they work with a team of competent professionals before recommending a strategy like the CIS.

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