Cash withdrawals from corporate-owned life insurance

There are three ways your corporation can access the cash value from its life insurance policy:

1. **Cash withdrawal or partial surrender** – withdraw cash directly from the policy

2. **Policy Loan**[i] – take a loan from the insurance company based on the policy's contractual terms

3. **Collateral loan** – assign the policy to a bank as collateral for a loan[ii]

This article looks at the tax implications, benefits, and considerations of using cash withdrawals and partial surrenders as a method of accessing the cash value of a corporate-owned life insurance policy. It includes an example showing how partial surrenders may supplement retirement income and enhance estate value.

"Cash withdrawal" and "partial surrender"

A "partial surrender" is where the policyowner either surrenders paid-up additions (PUAs) for their cash value, in the case of a participating whole life policy, or reduces the policy's basic coverage to access its guaranteed cash value, in the case of both participating whole life and universal life insurance (UL) policies.[iii]

A "cash withdrawal" is where the policyowner withdraws cash from a UL policy's account value.

Cash withdrawals and partial surrenders are treated the same way for tax purposes.

Benefits and considerations

Partial surrenders and cash withdrawals may appeal to you if you're not comfortable with taking on debt. By choosing partial surrenders or cash withdrawals you avoid dealing with a bank's financial underwriting to qualify for a loan and you don't face ongoing interest costs.

A consideration with both partial surrenders and cash withdrawals is that they remove assets from the policy which affects its future growth. They also decrease the policy's total death benefit with each withdrawal or partial surrender. In the case of:

- a cash withdrawal from a UL policy's account value, the death benefit reduction is on a direct dollar-per-dollar basis, and

- participating whole life, surrendering a PUA for $1 of cash, for example, would likely result in a greater reduction of the policy's total death benefit.

Another drawback is that potentially some, or even all, of the partial surrender or cash withdrawal could be taxable depending on the policy's adjusted cost basis (ACB) at that time. We'll discuss this in more detail below.

Taxation of cash withdrawals and partial surrenders

Partial surrenders and cash withdrawals are taxable dispositions of an interest in the policy. The tax consequences to the corporate policyowner primarily depends on the amount of cash taken from the policy (the proceeds) and the policy's ACB.

A policy's ACB

Like many other types of property, a life insurance policy has a cost base, referred to as its ACB. The policy's ACB increases as premiums are paid and at the end of each calendar year, the net cost of pure insurance (NCPI) is deducted from ACB.

NCPI is a government-prescribed estimate of the cost of insurance protection. NCPI increases as the life insured ages. Over time, NCPI generally grinds down the ACB. In some cases, the ACB reduces to zero by the time the insured person reaches life expectancy.

Calculating a policy gain

A life insurance policy's ACB is used in determining the tax consequences resulting from partial surrenders and cash withdrawals. A taxable policy gain generally arises if the cash withdrawn (or partial surrender) from a policy exceeds the prorated ACB attributed to the withdrawal. Generally, the calculation of the prorated ACB is based on the policy's total cash value in relation to the amount of cash withdrawn from the policy (i.e., policy ACB x [cash withdrawal / total cash value]).[iv] As a result, the after-tax portion of a cash withdrawal or partial surrender will often vary as both the cash value and ACB of the policy changes. The policy's ACB is affected by several factors, including premium payments, the eroding effect of the NCPI (discussed above), and prior cash withdrawals, if any. [v]

A policy gain realized by a corporation is treated as passive income. As a result, initially it's subject to high tax rates, but more than half of this tax can be recovered as it credits the corporation's refundable dividend tax on hand (RDTOH) account.[vi]

Let's look at an example in the table below where a corporation that owns a level cost UL policy makes two cash withdrawals of equal amounts from the policy's account value. One withdrawal occurs on day one and the other occurs 60 days later. Lets assume the cash value increases by $5,000 between the first and second withdrawal. At the time of the first withdrawal the policy has a cash value of $100,000 and an ACB of $60,000. Assume the corporate policyowner has a 51 per cent tax rate on its passive income:

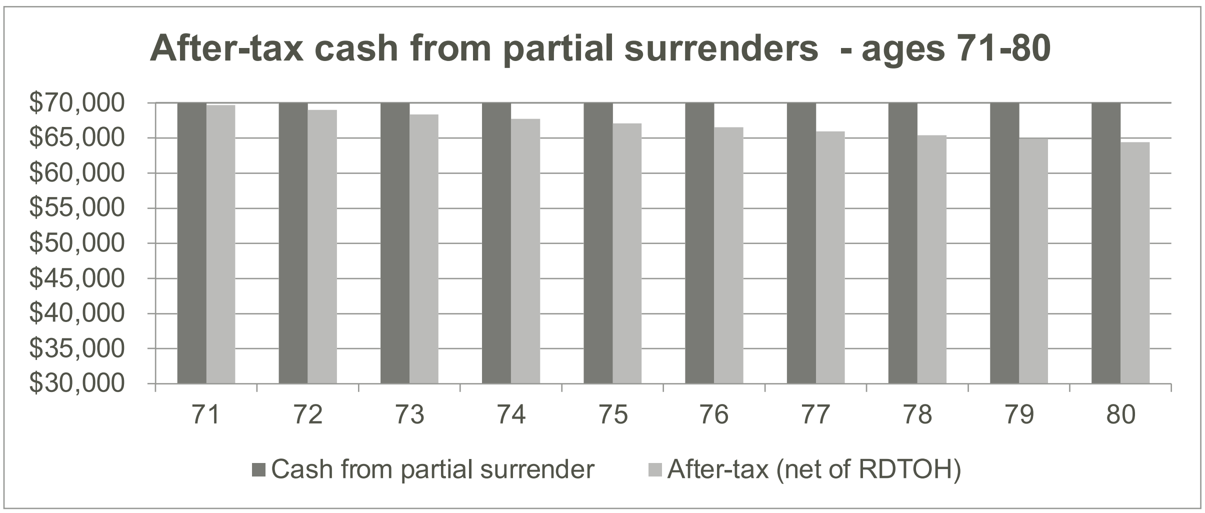
	Day 1	Day 60
Total cash value	**$100,000**	**$95,000**
Total cash withdrawal	**$10,000**	**$10,000**
Prorated ACB	$6,000	$5,684
Taxable portion	$4,000	$4,316
Corporate tax	$2,040	$2,201
Net to corporation	**$7,960**	**$7,799**
New policy ACB	$54,000	$48,316

Example – Michelle and her holding company

Let's look at another example using a corporate-owned participating whole life insurance policy.

Suppose the life insured is Michelle, age 50, a non-smoker and standard risk. Michelle has an insurance need based on her capital gains tax liability at death. She owns a holding company (Holdco) that purchases a Canada Life participating life insurance policy on her life[vii]. Holdco pays an annual premium of $50,000 for 20 years and is also the policy beneficiary.

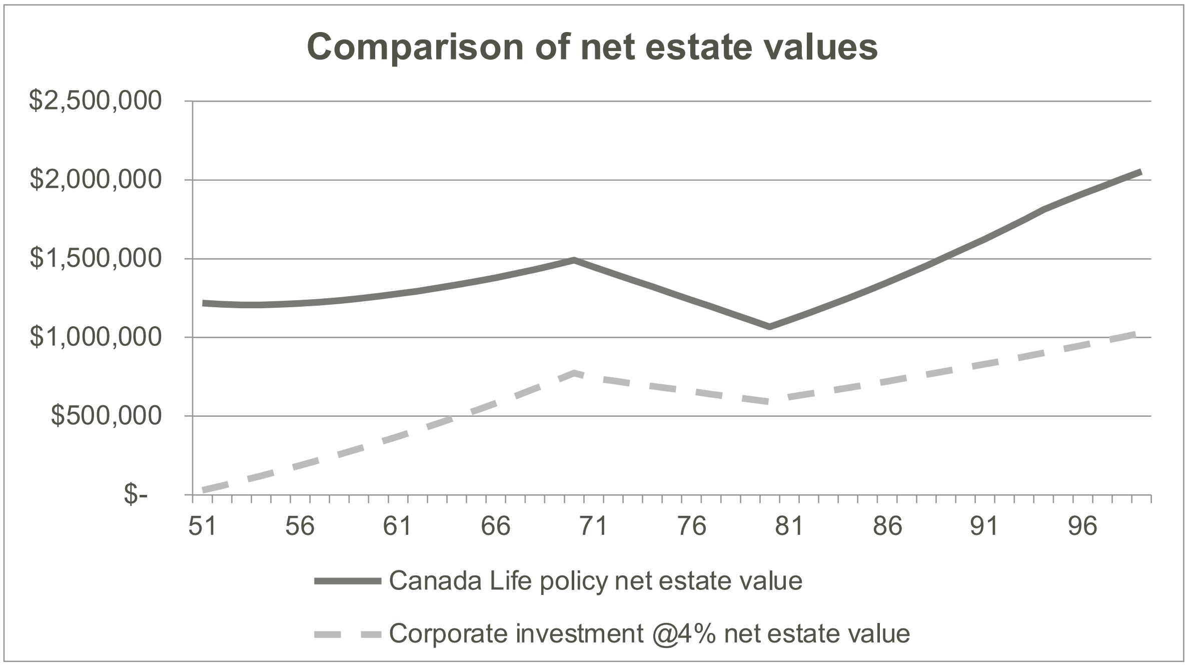
Holdco takes partial surrenders from its policy each year from Michelle's ages 71-80. Assuming the policy maintains a 5.10 per cent dividend scale interest rate, Holdco can obtain $73,361 of cash from the policy annually over this ten year period by surrendering PUAs. See the graph below to compare the annual after-tax amounts from the partial surrenders. Holdco's tax rate on its passive income is 51 per cent.



Comparison of net estate values from corporate partial surrenders

Assume Holdco purchased a guaranteed investment certificate (GIC) having a 4 per cent interest rate with the same premium dollars and also took the same after-tax withdrawal amounts to provide Michelle with income. Compare the net estate values from the GIC and the Canada Life participating life insurance policy. Michelle's estate's dividend tax rate is 44 per cent.

The net estate value from life insurance at age 90 is $1,567,377 compared to the GIC at $807,253. The main reasons why the net estate value from corporate-owned life insurance is attractive compared to corporate investments is because of the tax-advantaged growth of policy values and all, or significant portion, of the insurance payout credits Holdco's capital dividend account (CDA). The CDA credit is generally equal to the insurance payout less the policy's ACB. To the extent Holdco has a CDA balance, it can pay out tax-free capital dividends to its shareholder(s) who are residents of Canada. In contrast, the interest income from the GIC is taxed a high corporate rate and, generally, it's received as a taxable distribution when paid out to its shareholder(s).



Summary

Cash withdrawals and partial surrenders are appealing to corporate policyowners because they offer easy access to a policy's cash value, require no financial underwriting and result in no ongoing interest costs. From a tax perspective, they're dispositions of the policy and therefore may result in a policy gain. Overall, however, as the example with Michelle's Holdco illustrates, using cash withdrawals or partial surrenders as an income strategy is competitive with other corporate investments while potentially generating greater net estate values.

---

[i] All reference to policy loan in this article refer to a cash policy loan, not an automatic premium loan.

[ii] Collateral loans involve risk. They should only be considered by sophisticated investors with high risk tolerance and access to professional advice from a lawyer and accountant. The terms of future availability of collateral loans cannot be guaranteed. The loan or line of credit must be negotiated between the policyowner and the lender. It's subject to the lender's financial underwriting and other requirements. The policyowner should have enough income and capital to cover the interest and loan repayment, as well as the insurance premium.

[iii] Our level cost and annually increasing to 85 cost of insurance UL policies don't have guaranteed cash value.

[iv] Subsections 148(1) and (4) of the *Income Tax Act*.

[v] The policy ACB is reduced by the withdrawal amount, less any policy gain realized on the transaction.

[vi] A corporation's refundable taxes on aggregate investment income (AII) are tracked by its RDTOH account. AII generally includes net taxable capital gains and income from property like interest, rents and policy gains. A corporation adds 30.67% of its AII and 38.33% of dividend income to RDTOH. These taxes are refunded to the corporation when it pays a taxable dividend. The refund rate is 38.33% (i.e. $1 for every $2.61) of taxable dividends paid.

[vii] Canada Life Wealth max 20 of $1,230,315 with paid-up additions dividend option.