Corporate-owned life insurance

Business owners have two options when choosing how to own a life insurance policy: corporate[i] or personal. Why choose corporate ownership? Using low-tax corporate dollars to pay the insurance costs is a significant incentive for corporate ownership, but there are other considerations with corporate-owned life insurance.

Why opt for corporate-owned life insurance?

A big advantage of a corporate-owned life insurance policy is the annual savings from the corporation paying insurance costs with dollars that were taxed at a lower active business rate. Life insurance costs are generally not tax-deductible. That means fewer pre-tax dollars are needed when the policy is owned by a corporation instead of an individual, since personal tax rates are usually higher than corporate tax rates on active business income.

Let’s look at an example. Tracy owns a Canadian corporation and considers buying a life insurance policy with an annual premium of $10,000. Tracy’s personal marginal tax rate on regular income is 50% and her corporation’s small business tax rate is 15%. If Tracy purchases the policy personally, her corporation will have to earn and then pay $20,000 to her to have $10,000 after-tax to pay the annual premium. In contrast, if Tracy’s corporation owns and funds the life insurance policy, it would only have to earn $11,765 before taxes to fund the $10,000 annual premium. This results in savings of $8,235 per year.

Apart from tax savings, there are other reasons why a corporation would own a life insurance policy. For example, it may need insurance for key person coverage (key employees/owners), funding for a shareholder buyout, or insuring a bank loan.

Structuring a corporate-owned life insurance policy

In most cases, the corporate policyowner should also be the beneficiary of the policy. If a shareholder is the beneficiary of the policy, the amount of annual premium paid by the corporation would likely be considered a taxable shareholder benefit[ii]. Taxable shareholder benefits are taxed as ordinary income of the shareholder and are not deductible by the corporation.

How life insurance proceeds are distributed tax-free from the corporate owner

In many cases, the net estate value from a corporate-owned life insurance policy is the same compared to a personally owned policy. This is the result of the corporation’s capital dividend account (CDA). The CDA credit allows the life insurance proceeds to be paid as a tax-free capital dividend to Canadian resident shareholders.

Generally, an amount equal to the life insurance proceeds received by a private corporation, less the policy’s adjusted cost basis (ACB) may be added to its CDA.

The ACB of a life insurance policy is usually the sum of the collected premiums paid minus the net cost of pure insurance (NCPI). NCPI is defined as an assumed mortality cost in the Income Tax Act (Canada) (ITA) and over time, it may reduce the ACB of the policy to zero. At that time, the CDA credit would equal the full amount of the life insurance proceeds. As long as the corporation has a CDA balance, it's able to pay a tax-free capital dividend to its Canadian resident shareholders. Depending on the deceased shareholder's estate plan, the shareholders could include the estate, spouse, or heirs.

A corporation can pay a capital dividend as a cash dividend or as payment upon a redemption of shares. Canada Life™ can provide details of the policy's ACB to help a tax professional calculate the corporation's CDA balance. Before the capital dividend is paid, an election[iii] needs to be filed with the Canada Revenue Agency (and Revenue Quebec, if applicable). Any part of the insurance proceeds not covered by the CDA balance would generally be paid from the corporation as a taxable dividend[iv].

Corporate-owned life insurance can maximize estate values in comparison to corporate investments

Business owners often collect wealth in a holding company because they don't need all their business' profits to fund their lifestyle. This leads to a significant tax deferral since this money is left at the corporate level and not paid out to the business owner as a taxable distribution (dividend or salary). These corporate assets are often used to purchase investments that generate income taxed at the highest corporate rate, which ranges between 48.7% and 54.7% depending on the province or territory and may also reduce the operating company's small business limit[v]. In contrast, the cash value growth in a tax-exempt life insurance policy is tax-advantaged, meaning it isn't subject to taxation. As a result, the policy's growth isn't slowed by tax and it doesn't reduce the corporation's small business limit like other forms of passive corporate income[vi]. The tax-advantaged growth in a policy and the CDA are two unique advantages that life insurance has over corporate investments – making it a tax-efficient tool for transferring corporate wealth to a surviving spouse or the next generation.

For example, suppose Tracy is age 50, a non-smoker and a standard risk life insured. Tracy's corporation purchases a Canada Life participating life insurance policy with a $10,000 annual premium that's paid over 20 years[vii]. Compare the estate values from this arrangement to the estate values if the same premium dollars are invested in a corporate-owned guaranteed income certificate (GIC), earning interest at 4%. The corporate tax rate on passive income is 51%, and Tracy's personal tax rate on non-eligible dividends is 45%.

Estate values

Age	GIC at 4%	Estate Values
75	$174,297	$391,693
85	$226,384	$578,719
95	$289,631	$816,810

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

This comparison shows an enhancement to Tracy's estate for her heirs compared to a GIC. With a GIC, the interest income is subject to tax at a high rate and after Tracy's death, the proceeds are distributed to her estate as a taxable dividend. With life insurance, the growth in policy values is tax-advantaged and all or a significant portion of the insurance proceeds are paid to her estate as a tax-free capital dividend.

Other considerations

There are tax and non-tax considerations when deciding to own a life insurance policy corporately:

- A corporate-owned life insurance policy doesn't provide overall creditor protection to the policy's cash value. Ideally, a life insurance policy with cash value should be held in a holding company to protect it from potential creditors of the operating company.

- Corporate ownership adds complexity to estate plans where the intended end recipient of the insurance proceeds won't be a shareholder of the corporate policyowner.

- There may be significant tax consequences if the policy is transferred, which, for example, may occur where the corporate owner is to be sold or purified before a sale. As a result, serious thought should be given to the ownership of a life insurance policy and whether a minor corporate restructuring is needed.

- The cash value of the policy is reflected in the value of the shareholder's shares at death for tax purposes[viii]. This is generally not an issue where there's a spousal rollover or an estate freeze is implemented.

- The cash value of the policy may disqualify the shareholder from using their lifetime capital gains exemption (LCGE) in respect of a disposition of the corporation's shares. For a shareholder to use the LCGE, one of the tests requires that at the time of the disposition of the shares, all or substantially all (generally understood to mean 90%) of the fair market value of the corporation's assets need to be used principally (generally understood to mean 50%) in an active business[ix]. A policy's cash value is a passive asset for the purposes of this test. This is also the case with marketable securities like stocks and bonds.

Summary

There are many advantages to corporate-owned life insurance, including tax savings from the use of corporate dollars to pay insurance costs and the maximized estate values from both the tax-advantaged growth in policy values and CDA. The determination of whether a life insurance policy is owned corporately or personally needs to be fully analyzed for both tax and non-tax implications.

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[i] Where the corporation owns, pays the insurance costs, and is the beneficiary of the policy on the life of the shareholder.

[ii] Subsection 15(1) of the Income Tax Act (ITA).

[iii] Canada Revenue Agency (CRA) form T2054.

[iv] Subsection 184(3) of the ITA.

[v] Included in this tax is a refundable tax called refundable dividend tax on hand (RDTOH). Generally, 30.67% of corporate passive income credits the RDTOH account and is refunded to the corporation at a rate of $1 for every $2.61 of ineligible dividends paid.

[vi] Depending on the policy's ACB, a partial surrender/cash withdrawal or policy loan may result in a policy gain which is treated as passive income of the corporation.

[vii] Canada Life Estate Achiever Plus Max 20, paid-up addition dividend option.

[viii] Pursuant to subsection 70(5.3) of the ITA, where a life insurance policy on the life of the deceased shareholder or a person who is not dealing at arm's length with the deceased shareholder is corporate-owned, its cash surrender is included in the value of the shares at death for tax purposes.

[ix] Subsections 248(1) and 110.6(2.1) of the ITA.