

## A business owner's choice to insure, borrow, or save



Business owners generally have three options for funding an estate liability or other estate-planning objectives: purchase permanent life insurance, borrow, or save.

Funding an estate liability or other estate-planning objectives using life insurance is typically the most cost-effective option when considering whether to insure, borrow, or save, particularly when its corporate-owned and funded. This article summarizes the merits and considerations of each option.

### Liquidity at death

There may be a need for cash at death for various reasons, such as, a capital gains tax liability, estate equalization among heirs, financially dependent family members or charitable legacies.

For example, married couple Angela and Ryan are both 60 years old and own a successful family business. They have two adult daughters who are currently working full-time in the business and aren't shareholders of either corporation.<sup>i</sup> On the last death of Angela and Ryan, there is estimated tax liability at death of \$1.9 million arising through their equal ownership of the holding company ("Holdco") shares and a vacation property.<sup>ii</sup> Holdco owns all the shares of an operating company (Opco) which carries on the family business.

Angela and Ryan want the Holdco to pay for their chosen option since it's their main source of liquidity. They consider the following three options to fund their estate liability at death within Holdco:

1. Permanent life insurance
2. Self-insuring by investing in marketable investments
3. Obtaining a bank loan after death

Angela and Ryan's advisor uses Canada Life's *Corporate value of insurance* tool to help demonstrate the tax efficiency and cost advantages of corporate-owned life insurance in comparison to the other two options.

### Option 1: Life insurance

Corporate-owned life insurance has tax benefits not available to other financial products and loans. For example, a corporation's capital dividend account ("CDA") credit allows life insurance proceeds to be paid as a tax-free capital dividend to Canadian resident shareholder(s). 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. Without a CDA balance, corporations generally distribute assets as taxable distributions (i.e. bonus or dividend).

Angela and Ryan are interested in a low-risk, cost-effective, permanent life insurance solution. A Canada Life joint-last-to-die participating whole life insurance policy with the lifetime-guaranteed enhanced-coverage option meets these criteria.

Angela and Ryan's advisor recommends Holdco purchase a Canada Life participating whole life insurance policy with \$2 million of coverage using the lifetime-guaranteed enhanced-coverage option paid over 20 years. The policy's minimum annual premium is \$48,408 payable for 20 years.

The illustrated death benefit proceeds remain relatively flat at \$2 million and may begin to exceed that amount when Angela and Ryan are in their mid-80s<sup>iii</sup>. At their life expectancy of 90 years old, the death benefit proceeds may reach \$2,468,699.

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The receipt of death benefit proceeds by Holdco credits its CDA by \$1,909,763.<sup>iv</sup> Holdco could distribute a tax-free capital dividend to Angela's or Ryan's estate, as the case may be, to pay their final tax liability. The remaining balance, if any, of the death benefit proceeds could either be left in Holdco for investment purposes or paid out as a taxable distribution to Holdco's shareholders. Assuming a non-eligible dividend tax rate of 45%, the total net-estate value from the insurance payout would be \$2,217,178.<sup>v</sup>

Other areas where life insurance can generally do better than the other two options; include, having a conservative, lower-risk asset in their financial profile and providing an immediate estate enhancement with liquidity.

Let's examine the other two options available to Angela and Ryan for producing a liquid net-estate value of \$2,217,178.

### Option 2: Save (self-insure)

A second option for Angela and Ryan is to self-insure by investing in marketable securities within Holdco. Angela and Ryan are risk-adverse with their savings, consequently, Holdco will invest in a fixed-income security that produces interest income at a rate of 3%.

Interest income earned in a corporation is taxed at the highest rate, currently 51%. A portion of this tax is refundable to Holdco once it pays a taxable dividend to its shareholder(s). This refundable tax represents a significant limit to the growth potential of a corporate investment.

A second layer of tax on corporate investment arises when it's distributed from Holdco to its shareholder(s) as a taxable dividend. In this example, on the last death of Angela and Ryan, the savings are used to fund the personal tax liability. The refundable taxes previously mentioned will be paid out to the deceased shareholder's estate.

### Option 3: Bank loan

The third option for Angela and Ryan is to rely on the executor to arrange a bank loan through Holdco to fund the estate's tax liability arising on the last death of Angela and Ryan. Similar to the second option, since the loan proceeds are a corporate asset, they'll be distributed from Holdco as a taxable dividend. As established in the table below, Holdco needs a much larger loan to produce a net-estate value of \$2,217,178.

If the loan was obtained personally, the daughters would need to use costly, after-tax personal dollars to repay the loan rather than after-tax corporate dollars (or else a taxable benefit could arise). In addition, obtaining a bank loan isn't guaranteed. Financial underwriting is required by Holdco's bank on Opco, and potentially Angela and Ryan's heirs at the time of obtaining the loan.

## Summary of options

This table demonstrates several metrics illustrating how corporate-owned life insurance can be both a cost-effective and tax-efficient method of funding an estate liability or other estate planning objectives. This comparison can be shown with Canada Life's *Corporate value of insurance* tool.

**Generating the assumed life insurance net-estate benefit of \$2,217,178 at age 90 would require the following:**

	Premium/ investment (\$)	Total out of pocket (\$)	Present value <sup>vi</sup> total out of pocket (\$)	CDA credit (\$)	Internal rate of return (%)	Present value cost per \$1 of benefit* (\$)
Life insurance (annual)	48,408	968,164	741,797	1,909,763	4.51	0.33
Investment (annual)	82,397	1,647,934	1,262,630	0	1.96	0.57
Lump sum invested today	1,379,029	1,379,029	1,379,029	0	1.96	0.62
Bank loan held by corporation <sup>vii</sup>	N/A	3,147,591	1,116,730	N/A	N/A	0.50

To generate the same net-estate amount with investments using the same amount of premium would require an annual before-tax rate of return of 9.2%.

<sup>i</sup> The daughters' will inherit the Holdco shares in equal ownership on the last death of their parents, Angela and Ryan.

<sup>ii</sup> On the first death of Angela or Ryan, the spousal rollover under subsection 70(6) will apply so there is no tax liability on this death.

<sup>iii</sup> The illustrated death benefit proceeds are based on the current dividend scale (2020). The dividend scale represents the current dividends credited to policies based on the participating account's experience from the investment, mortality, expenses, and other components.

<sup>iv</sup> Insurance proceeds on death of \$2,468,699 less the adjusted cost basis of the policy of \$558,936.

<sup>v</sup> CDA balance \$1,909,763 plus after-tax dividend income \$307,415.

<sup>vi</sup> Present value discount rate of 3%.

<sup>vii</sup> Bank loan has a 10-year term at 5% interest rate. Interest deductibility is assumed based on the "filing the hole" concept described in paragraphs 1.48 to 1.52 of the Canada Revenue Agency's Income Tax Folio S3-F6-C1, Interest Deductibility.