Life insurance wasting freezes

canada life

Wasting freezes make sense for business owners who need income from their corporation to fund their lifestyle. If a business owner doesn't need all of the income generated from the waste, then a full wasting freeze doesn't make sense. In these situations, business owners are prepaying tax at a high dividend tax rate rather than at a lower capital gains tax rate at death.

To eliminate a tax liability at death, business owners should consider redeeming only enough shares to fund their lifestyle and purchase permanent corporate-owned life insurance with its excess cash. This article outlines this strategy and describes how it can significantly enhance a business owner's after-tax estate value (referred to as the "net estate value").

Wasting freezes

Many business owners will have a significant tax liability on their death due to the taxable capital gain from the deemed disposition of their shares, unless they have a spouse or common-law partner to leave their shares to on a tax-deferred rollover basis.

An estate freeze is a common estate planning transaction for business owners to reduce or eliminate their tax liability at death. The business owner exchanges their growth common shares for fixed-value preferred shares, or "freeze shares," and typically a family trust acquires new growth common shares from the corporation. All the growth in the corporation is reflected in the shares owned by the trust.

Some clients "waste" the freeze shares by having the corporation redeem (i.e., purchase) a set amount of these shares over time, in conjunction with an estate freeze so that they don't own any shares at death. This is called a wasting freeze. For tax purposes, the redemption of the freeze shares gives rise to a deemed dividend to the business owner.

Don't waste freeze shares where income isn't needed

Usually the deemed dividend on a wasting freeze equals the value of the redeemed shares. Dividend tax rates are high, especially on non-eligible dividends, and have been getting closer to tax rates applied to regular income. Capital gains tax rates are still the lowest among the different sources of income.

It makes sense to do a wasting freeze when the business owner needs the income from the corporation. When the business owner doesn't need all of the income generated from the planned share redemptions, it doesn't make sense to do a wasting freeze because the business owner prepays tax at higher, dividend tax rates instead of lower capital gains tax rates at death.

When a tax professional recommends a staged wasting freeze to eliminate the tax liability at death, the business owner may consider the following strategy, using a wasting freeze and corporate-owned life insurance. As an alternative to prepaying tax at higher rates, business owners can waste only enough freeze shares to fund their lifestyle and have their corporation purchase a permanent life insurance policy with funds that otherwise would've been used in the waste. This strategy may provide the business owner with both financial protection and the liquidity needed to pay their tax liability at death, if any.

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The corporate-owned life insurance advantage

In many cases, the net estate value derived from a corporate-owned life insurance policy is much higher than what may have been derived from lower risk investments. From a tax perspective, this is the result of two factors.

1. The growth in policy cash value within an exempt life insurance policy is tax-advantaged, meaning it isn't subject to taxation while inside the policy. As a result, the policy's growth isn't limited by tax at the policyholder level.
2. The corporate beneficiary of the life insurance policy gets a credit to its capital dividend account (CDA) generated by receiving a life insurance death benefit as beneficiary. To the extent the corporation has a CDA balance, it's able to pay a tax-free capital dividend to its Canadian resident shareholder(s).

More specifically, 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 life insurance policy's ACB is generally the sum of the cumulative premiums paid, less the net cost of pure insurance (NCPI). NCPI is defined as an assumed mortality cost in the *Income Tax Act* (Canada) and, over time, it may reduce the policy's ACB to nil. At that time, the CDA credit would equal the full amount of the life insurance proceeds.

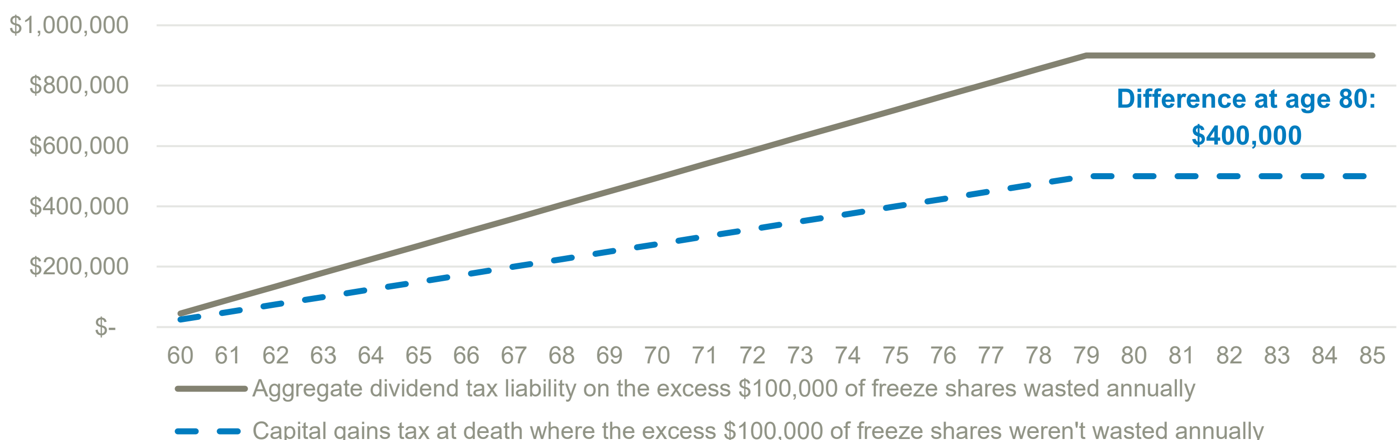
Next, we'll look at this strategy by comparing the net estate value derived from the corporate-owned life insurance to that derived from doing a full wasting freeze and investing the personal after-tax funds not needed to fund the business owner's lifestyle.

Example using life insurance in a wasting freeze

We'll look at Michael's situation to show how this strategy can significantly enhance a business owner's net estate value.

Over wasting results in excessive taxation

Michael is 60 years old and a shareholder in a family business. He recently did an estate freeze and, as a result, owns fixed-value preferred shares (i.e., freeze shares) with an aggregate redemption value of $5,000,000 and a nominal adjusted cost base. Michael's accountant recommends that he redeem $250,000 worth of shares annually over 20 years, as part of a wasting freeze transaction, to eliminate his tax liability at death. Michael also has a separate class of discretionary dividend shares, class B shares, to receive dividends from the corporation in case he needs more income when the freeze shares are fully redeemed. **Michael only needs income from redeeming $150,000 worth of freeze shares so he's prepaying higher rate dividend taxes on $100,000 of freeze shares annually.** The chart below shows the aggregate dividend taxes Michael pays on the $100,000 of shares redeemed annually, compared to the capital gains tax liability he would otherwise pay on death if these shares weren't wasted. Life insurance isn't yet part of this discussion. The difference between the lines in the chart represents the extra taxes paid for wasting the freeze shares when the income isn't needed.



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The hybrid wasting freeze is an alternative that uses life insurance

As an alternative to wasting the $100,000 of freeze shares not needed to supplement the individual's lifestyle, let's instead have the corporation purchase a participating whole life insurance policy on Michael's life with a $100,000 annual premium paid for 20 years.[i]

Compare the net estate value at age 85 of the hybrid wasting freeze plan (corporate-owned life insurance policy with the wasting freeze) and the original wasting freeze plan scenario. In the original plan scenario, the after-tax portion of the $100,000 of annual redemption proceeds ($55,000) is invested in a conservative portfolio consisting of 75% fixed income assets having a 4% growth rate and 25% in equities having a 6% growth rate from realized capital gains. Michael's marginal tax rate is 50% on regular income and 45% on non-eligible dividends.

Wasting freeze with life insurance	Original wasting freeze plan
• Don't waste the excess $100,000 of freeze shares, only waste the $150,000 needed for income	• Waste the full $250,000 of freeze shares
• Purchase life insurance corporately with an annual premium of $100,000 paid for 20 years	• Invest after-tax portion of wasting freeze not needed for income in a conservative portfolio ($55,000 annually for 20 years)

In the life insurance scenario, the post-mortem plan is for the corporation to redeem the remaining freeze shares from Michael's estate. Assuming death at age 85, there would be $1,100,000 worth of freeze shares remaining. The tax treatment of this redemption is a deemed dividend. Generally, the corporation will elect half of the deemed dividend as a capital dividend so that the full capital loss that arose on the redemption can offset the capital gain in the terminal return arising from the freeze shares (this is the so-called "50% solution").

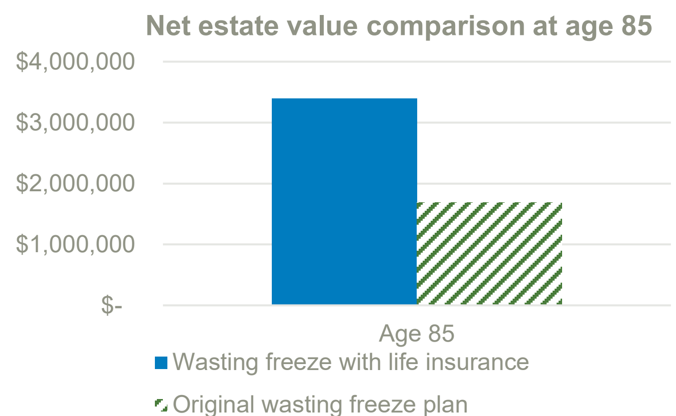
As a result, from the approximate $3,770,000 death benefit at age 85, $1,100,000 is used to redeem shares and $550,000 of CDA is used as well. The approximately $2,670,000 of death benefit proceeds and approximately $2,395,000 of the CDA balance remaining can be used and paid out to Michael's estate as a dividend on the Class B shares.

In the original wasting freeze plan scenario, the estate value is based on the value of the portfolio in the year of death, based on the parameters stated above. This value was eroded by the $900,000 of dividend taxes that Michael paid on the $100,000 of freeze shares that he had redeemed each year and the personal income taxes he paid on the portfolio's investment income.

Comparing the net estate values

The chart on the right compares the net estate values from each scenario. At age 85, the net estate value from the life insurance scenario is approximately $3,400,000. The net estate value from the original wasting freeze plan scenario is $1,690,453. The life insurance scenario advantage is approximately $1,700,000 or 101%.

The chart shows how retaining funds corporately and purchasing corporate-owned life insurance can result in significantly greater net estate values compared to situations where the corporation pays funds out to the shareholder and invests personally, which occurs when business owners redeem shares for income they don't need.



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[i] Canada Life's *Estate Achiever pay to age 100*, $2,188,375 basic coverage, paid-up additions, 2018 dividend scale.

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