# Paying taxes with corporate-owned life insurance

## Many business owners buy life insurance to give their estate the liquidity needed to pay taxes at death.

For many business owners, the corporate tax rate is lower than their personal marginal tax rate. This makes corporate ownership of life insurance policies attractive, even if the insurance is intended to fund personal estate objectives or liabilities, like capital gains taxes. However, this ownership structure results in a mismatch of where the death benefit is paid (to the corporation) and where it needs to be (in the estate). In other words, the corporation receives the death benefit when the deceased's estate trustee needs the money to pay the shareholder's final taxes.

So, how does a death benefit paid to a corporation get to the Canada Revenue Agency (CRA) as payment of a deceased's tax liability? This article discusses how a death benefit from a corporate-owned life insurance policy gets from the corporate policy beneficiary out to a shareholder's estate, and then paid to the CRA on account of the deceased's tax liability.

### Scenario: Paul and Holdco

Paul owns all the common shares of Holdco, a private corporation. Holdco owns all the shares of Opco (a successful family business). Holdco also owns and is the beneficiary of a level-cost universal life insurance policy on Paul's life with $1.5 million of coverage. The Income Tax Act (Canada) (the "Act") deems a person to dispose their capital property for tax purposes immediately before death for consideration equal to fair market value (FMV). The shares of Holdco are capital property. The current estimated FMV of these shares is $5 million and their adjusted cost base is nominal.

The insurance policy owned by Holdco was bought to pay for the capital gains taxes arising at Paul's death. The bulk of these taxes come from his ownership of shares in Holdco. The death benefit gets paid by capital and taxable dividends paid from Holdco to his estate. Paul's Will names his eldest daughter Jeanne as the estate trustee. The Will contains broad powers for the estate trustee to gather funds to pay taxes arising in his terminal tax return. Jeanne and her two other siblings inherit the shares of Holdco equally. There's no spousal rollover available to defer the capital gains tax liability.

### Paul dies

After Paul's death, Jeanne controls Holdco as the estate trustee. She elects herself as sole director so she has power to pay dividends. After submitting required documentation to our claims department, Holdco receives a cheque for the $1.5 million death benefit, as the named beneficiary under the policy.

### Calculating the capital dividend account

At this stage of the process, Holdco's capital dividend account (CDA) gets credited with an amount equal to the insurance death benefit less the adjusted cost basis (ACB) of the policy. To the extent Holdco has a CDA balance, it can pay out tax-free capital dividends to its shareholders (who are residents of Canada). Jeanne shouldn't pay out a capital dividend without knowing Holdco's exact CDA balance. Her knowing only the insurance death benefit and policy ACB isn't enough information to pay out a capital dividend to Paul's estate.

Holdco's tax accountant must determine its CDA balance according to the rules set out in the definition of "capital dividend account" in subsection 89(1) of the Act. It's a complex task because it involves a cumulative calculation starting from the beginning of Holdco's first taxation year that ended after 1971 and ending immediately before the CDA balance gets calculated.

There are some fine details in the calculation to be aware of and a tax professional needs to be involved in that determination. For example, in some situations where a corporate policy beneficiary has historically realized more capital losses than capital gains, its CDA may not be as high as expected resulting in an otherwise lower amount of the death benefit that may be distributed as a capital dividend.

Canada Life and design are trademarks of The Canada Life Assurance Company.

If Holdco paid a capital dividend of an amount greater than its CDA balance, it would still be tax-free to the shareholder[i], but Holdco would be subject to Part III tax equal to 60% of the excess. This tax can be avoided if Holdco files an election pursuant to subsection 184(3) of the Act, which results in the portion of the dividend in excess of the CDA balance being deemed to be a separate taxable dividend[ii].

Holdco has no obligation to immediately use its CDA balance (unless there's an agreement or direction in the Will). It could leave the insurance death benefit in its bank account and not pay out any capital dividends for years. However, Holdco purchased the insurance policy on Paul's life to fund his tax liability at death, so Jeanne will want the insurance funds in her hands as estate trustee sooner rather than later.

The tax accountant tells Jeanne that he/she performed a CDA calculation for Holdco last year. Since that time there haven't been other events that affected its CDA (other than receiving life insurance proceeds). Canada Life™ provides details of the policy's ACB to Jeanne so Holdco's tax accountant can calculate the corporation's CDA. The death benefit is $1.5 million and the policy's ACB is $100,000 immediately before death. Based on that, Jeanne now knows that Holdco's CDA balance is $1.4 million. This means that the death benefit is more than the CDA balance available. The section in the Act that governs the payment of capital dividends states that the election must be made for the full amount of the dividend. As a result, Holdco must pay out two separate dividends:

1. Tax-free capital dividend in the amount of $1.4 million
2. Regular non-eligible taxable dividend in the amount of $100,000

| CDA calculation | |
|---|---|
| Opening balance CDA | $0 |
| Death benefit from life insurance | $1,500,000 |
| Policy ACB | ($100,000) |
| Credit to the CDA | $1,400,000 |
| Capital dividend balance paid out tax-free | $1,400,000 |

## Paying a capital dividend

To pay the capital dividend, Jeanne – in her capacity as estate trustee and director of Holdco – declares a dividend in the amount of $1.4 million, which is recorded as a formal director's resolution in the corporate minute book. Also, she arranges to file an election with the CRA so the dividend gets deemed to be a capital dividend. The election procedure is simple but time sensitive. Holdco's tax accountant prepares the election in a prescribed tax form (T2054) and files it with the CRA along with a certified copy of the director's resolution declaring the dividend and (this is optional) documentation showing the calculation of the CDA balance.

The election must be filed by the earliest of either the day the dividend becomes payable and the first day any part of the dividend gets paid. A penalty is payable if the election is filed after its due date.

## Paying a taxable dividend

To pay the taxable dividend, Jeanne declares a dividend in the amount of $100,000 also by formal director's resolution.

## Paying Paul's taxes

The tax accountant calculated the tax liability owing in Paul's terminal return to be $1.3 million. As estate trustee, Jeanne has liquidity for paying this tax liability as a result of receiving both the capital and taxable dividends from Holdco. Let's figure out exactly how many after-tax dollars are left over in Jeanne's hands for paying taxes and how much of that amount forms part of the residue of Paul's estate.

Canada Life and design are trademarks of The Canada Life Assurance Company.

Assuming Paul's estate qualifies as a graduated rate estate, it has access to graduated tax rates. We'll assume in this example that the estate's marginal tax rate on non-eligible dividend income is 45%. As a result, the net estate value generated from the insurance is calculated as follows:

| **Holdco's death benefit paid to Paul's estate** | |
|---|---|
| Capital dividend received | $1,400,000 |
| Taxable non-eligible dividend received | $100,000 |
| Estate's tax liability as shareholder | ($45,000) |
| Net estate value from life insurance | $1,455,000 |
| Terminal tax liability | ($1,300,000) |
| Insurance proceeds included in residue of Paul's estate | $155,000 |

The taxes owing from the terminal return ($1.3 million) must get paid by the filing due date for Paul's T1 final return, which varies depending on the date of his death. Also, to pay Paul's estate tax liability ($45,000), Jeanne also needs to file a T3 Trust Income Tax and Information Return no later than 90 days after its tax year-end.

Paying life insurance out of a corporation is a process that an estate trustee should carry out with the assistance of a tax professional. Paying a capital dividend involves a complex calculation and potentially costly penalties if it's more than the corporation's CDA balance.

This material is for information purposes only and should not be construed as providing legal or tax advice. Reasonable efforts have been made to ensure its accuracy, but errors and omissions are possible. All comments related to taxation are general in nature and are based on current Canadian tax legislation and interpretations for Canadian residents, which is subject to change. For individual circumstances, consult with your legal or tax professional. This information is provided by The Canada Life Assurance Company and is current as of October 2021.

---

[i] That said, under subsection 185(4), a person who has received a dividend in respect of which an excessive election has been made is jointly and severally liable with the corporation for that person's proportionate share of the Part III tax that becomes payable by the corporation.

[ii] The subsection 184(3) election also requires concurrence of all shareholders who received or were entitled to receive any portion of dividend.