

## The Tax Implications of Corporate-Owned Life Insurance

When insurance is being acquired, a key consideration is whether it should be owned personally or through a corporation. Tax and other implications should always be reviewed as part of the decision making process. There are advantages and disadvantages to both forms of ownership.

### I. Uses of Corporate-Owned Insurance

There are multiple situations in which a corporation may acquire an interest in a life insurance policy. While the corporation may “own” the policy, a separate decision still needs to be made with respect to the beneficiary designation. It is not uncommon to have a party other than the corporation (e.g., shareholder or employee) be the beneficiary under the policy.

Common applications for corporate-owned insurance include the funding for buy-sell agreements, paying taxes at death, funding of post-employment benefits and for the provision of key-person protection. Needless to say, corporate ownership is considerably more complex than personal ownership.

### II. Advantages of Corporate-Owned Life Insurance

The commonly cited advantages of corporate ownership include the following:

- Lower after-tax cost of premiums,
- Increased flexibility in buy/sell situations,
- Possible collateralization and thus a source of cash for the corporation,
- Less cumbersome in multiple shareholder situation,
- Shareholder preference for spending corporate rather than personal dollars, and
- Increased assurance that funds are available to pay required premiums and that these premiums are paid on a regular basis.

Given the advantages of corporate ownership, the associated tax implications need to be understood. In the discussion that follows, we will consider the tax implications to both the corporation and the shareholder (or employee).

### III. Tax Consequences for the Corporation

The two primary concerns for the corporation, as owner of the policy, will be the deductibility of the annual premiums and the treatment of the life insurance proceeds at death. Additional tax consequences that warrant review include the impact on the enhanced \$750,000 capital gains exemption and the deemed Retirement Compensation Arrangement (RCA) rules. (While the 2007 Federal Budget contained a proposal to increase the capital gains exemption to \$750,000, this measure was not included in Bill C-52, which received Royal Assent on June 22, 2007. Readers are urged to monitor the progress of this measure.)

## **(A) Deductibility of Annual Premiums**

A corporation may be able to deduct all or a portion of the life insurance premiums in two situations. The first instance will be where the policy is used as collateral. The second will be where the premium is considered to be a taxable benefit received in an employment context.

The Income Tax Act (Canada) (ITA) contains specific provisions relating to the deductibility of insurance premiums.<sup>1</sup> The corporation, as policyholder, will be able to deduct premiums paid for a life insurance policy where all of the following conditions are met:

- a) The policy is assigned to a restricted financial institution (bank, trust company, credit union or insurance company)<sup>2</sup>,
- b) The interest payable would otherwise (except in certain circumstances) be deductible in computing the taxpayer's income for the year, and
- c) The restricted financial institution requires the policy as collateral.

When the conditions for deductibility are met, the taxpayer will have to then determine the portion of the premium that is actually deductible. The deduction is capped at the lesser of:

- a) Premiums payable in respect of the year, and
- b) The net cost of pure insurance (NCPI) in respect of the interest in the life insurance policy.<sup>3</sup>

Both of the above will need to "reasonably be considered to relate to the amount owing from time to time during the year under the loan for which the insurance policy has been assigned as collateral".<sup>4</sup> If, for example, the life insurance coverage under the assigned policy were \$500,000, yet the loan outstanding throughout the taxation year was only \$250,000, the deduction would be capped at the lesser of one-half of the premiums or one-half of the NCPI.

It should be noted that "premiums" are not defined in the ITA. They are generally interpreted by the industry to mean all amounts paid into the policy up to the yearly maximum annual premium.

As stated above, the second situation in which the corporation will have a tax deduction is where a taxable benefit has been reported for an employee. However, where a person is shareholder as well as an employee, a determination has to be made of the capacity in which the individual received the benefit. If the benefit is received in an employment context, Canada Revenue Agency's (CRA) view is as follows:

"... The value of the benefit derived from life insurance coverage under a policy which is not a group term life insurance policy would ordinarily be the amount of the premium paid by the employer in respect of such coverage".<sup>5</sup>

Where the benefit was received by virtue of employment, the employer will have to report the appropriate taxable benefit and will be allowed a deduction in computing taxable income.<sup>6</sup> On this topic CRA has stated the following:

"... this result, however, is based on the presumption that the benefit is an employment benefit. Where benefits are provided to an employee who is also a shareholder, the income tax results

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<sup>1</sup> Paragraph 20(1)(e.2) of the Income Tax Act (Canada) (ITA) should be referred to here.

<sup>2</sup> The definition of "restricted financial institution" is defined in subsection 248(1) of the ITA and should be referred to here.

<sup>3</sup> Income Tax Regulation 308 should be referred to for a determination of the Net Cost of Pure Insurance.

<sup>4</sup> See paragraph 2 of *Interpretation Bulletin IT-309R – Premiums on Life Insurance Used as Collateral* (IT-309R2).

<sup>5</sup> See paragraph 20 of *Interpretation Bulletin IT-529 – Flexible Employee Benefit Programs*.

<sup>6</sup> See Technical Interpretation # 9924375 dated December 15, 1999.

will differ from that described above if the benefits are received or enjoyed by the particular individual in his or her capacity as shareholder. If only a shareholder receives the additional life insurance coverage, and other employees who are not shareholders are not provided with such coverage, it will normally be reasonable to conclude that the employee-shareholder has obtained the benefit by reason of his or her shareholdings and not by reason of his or her employment. If a benefit is a shareholder benefit, the amount is included in the individual's income by virtue of subsection 15(1) of the Act, and also there is no business deduction to the corporation for the payment of the premium.”<sup>7</sup>

It is therefore necessary to examine why the insurance coverage was put into place. In some situations it will be self-evident that the insurance was acquired by virtue of a person's shareholdings, for example, to fund a buy-sell agreement. In such a situation no deduction will be available at the corporate level. However, in other situations the shareholder will be considered to have received a benefit in an employee context. As stated above, this would happen where the shareholders and executives who are not shareholders are provided with similar corporate-funded life insurance coverage. Here, it could be argued that the coverage was provided to the executive group and was received by virtue of employment.

Where the corporation is the policyholder *and* the beneficiary of a life insurance policy on the life of a shareholder and pays the annual premiums, CRA has confirmed that “the premiums on such a policy would not ordinarily constitute a taxable benefit to the shareholder under subsection 15(1) of the Act”.<sup>8</sup>

We have prepared a document entitled *Savings Available Where Corporate Dollars are Used to Acquire Life Insurance* [PC 5676], which looks at whether it is cheaper to acquire life insurance with corporate or personal dollars. In many situations using corporate dollars is the preferred approach from a cost perspective. You may wish to refer to this document.

## **(B) Receipt of Life Insurance Proceeds at Death**

Life insurance proceeds received at death constitute a non-taxable receipt. Private corporations may make use of the Capital Dividend Account (CDA) mechanism.<sup>9</sup> The death proceeds in excess of the adjusted cost basis of the policy will be credited to the CDA. The corporation will be able to declare a capital dividend, which will be received tax-free by shareholders resident in Canada. The amount equal to the adjusted cost basis may be paid out as a taxable dividend. As discussed in (C) below, corporations will have to make the correct designation as to whether this gives rise to an eligible or ineligible dividend.

Please refer to our document entitled *The Capital Dividend Account* [PC 5674] for more detailed information on the CDA.

## **(C) New Eligible Dividend Rules**

With the introduction of the “eligible dividend” rules that are effective for the 2006 and later calendar years, corporations will have to determine whether taxable dividends paid are “eligible” or “non-eligible” dividends. A Canadian resident shareholder will generally prefer to receive eligible dividends, as these are subject to a lower effective tax rate than are non-eligible dividends. When we look at the top marginal tax rate applying to dividends, the advantage eligible dividends enjoy varies by jurisdiction. For 2007, the advantage could be as high as 12%-13% (in British Columbia, Manitoba, New Brunswick and Yukon) to as low as 5% (in Newfoundland).

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<sup>7</sup> See Technical Interpretation # 9924375 dated December 15, 1999.

<sup>8</sup> See Technical Interpretation # 9813525 dated July 6, 1998.

<sup>9</sup> See subsection 89(1) of the ITA.

The new rules for taxable dividends are important, because taxes payable are factored into many estate planning arrangements. Taxes are also factored into investment decisions (e.g., having a corporation acquire a Universal Life (UL) contract with a significant investment component or various- portfolio investments.) An incorrect determination of the type of dividend payable under these various scenarios, and hence using an appropriate applicable tax rate, could skew investment decisions or could result in less-than-optimal tax planning.

Corporations paying taxable dividends have a designation (and election process) that they must abide by. The rules vary (including the sequence in which eligible and ineligible dividends must be paid), depending upon whether the corporation is: (1) A Canadian-controlled private corporation (CCPC), or (2) A private corporation that is not a CCPC or a public corporation.

(i) CCPCs

CCPCs must calculate a General Rate Income Pool (GRIP).<sup>10</sup> While there are detailed rules for calculating the components of the GRIP, the intention of this account is to capture the (after-tax) post-2000 full-rate taxable income. Thus components of the account include taxable income for which the small business deduction has not been claimed, as well as eligible dividends received in the 2006 and later calendar years. (Dividends received by a corporation retain their character.)

A CCPC may only pay an eligible dividend to the extent of the balance of its GRIP at the end of the taxation year in which the dividend is paid. Thus, a corporation can pay an eligible dividend in anticipation of there being a positive GRIP balance at the end of the taxation year. Of course, care needs to be taken where this is done, since a penalty tax (generally equal to 20% of the excess) applies.<sup>11</sup>

There are special rules that allow CCPCs to elect to be treated as non-CCPCs.<sup>12</sup> Where this election is made the corporation may no longer claim the small business deduction. Also, the corporation would have to calculate its LRIP, as outlined in (ii) below.

(ii) Private Corporations that are not CCPCs

Private corporations that are not CCPCs (as well as public corporations) must calculate a Low Rate Income Pool (LRIP).<sup>13</sup> Again, there are detailed rules for calculating this balance. The purpose of the account is to capture the amount of income that has been subject to low tax rates (i.e., taxable income for which the small business deduction has been claimed). Hence, the LRIP also includes non-eligible dividends that have been received. Also, if the corporation was previously a CCPC, there may have been an amount that benefited from the small business deduction.

Private corporations that are not CCPCs (and public corporations) must first exhaust the LRIP balance by the payment of ineligible dividends before eligible dividends can be paid. Again, penalties apply to excess dividends.

(iii) Impact of New Rules

These new rules are relatively complex. Shareholders will want to contact their professional advisors in order to gain a complete understanding of the rules.

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<sup>10</sup> See definition of "general rate income pool" in subsection 89(1) of the ITA.

<sup>11</sup> See subsections 185.1 and 185.2 of the ITA.

<sup>12</sup> See subsection 89(11) of the ITA.

<sup>13</sup> See definition of "low rate income pool" in subsection 89(1) of the ITA.

Estate plans should be revisited, since many estate plans were designed using the assumption that capital gains were more tax effective than (non-eligible) dividends. Shareholder agreements and buy-sell agreements should also be revisited. Now that corporations could potentially declare three types of dividends (capital, eligible and ineligible dividends), shareholders will want to optimize planning that can be done here.

Let's look amounts that a corporation may receive that may ultimately give rise to ineligible dividends. Here we would want to consider partial or full surrenders of life insurance policies. Also, where life insurance death proceeds are received, it may not be possible to credit the full amount to the Capital Dividend Account, since the amount that may be credited is limited to amount that is in excess of the adjusted cost basis of the policy. Similarly, a corporation may hold portfolio investments. While eligible dividends retain their character, other investment income would generally give rise to ineligible dividends.

Corporations described in (i) above have greater flexibility in choosing what type of taxable dividends they pay, including when they pay them. As described above, eligible dividends could be paid at any time in the taxation year so long as the corporation has a balance in its GRIP at the end of its taxation year.

Payment of both eligible and ineligible dividends gives rise to a recovery of Refundable Dividend Tax on Hand (RDTOH) balances.

Corporations described in (ii) above must first exhaust LRIP balances by paying ineligible dividends.

Care should be taken in that appropriate decisions are made as to which corporation should hold a life insurance policy and portfolio investments, as this will have a bearing on dividend designations. (Of course, non-tax considerations will also have to be determined.)

#### **(D) Qualified Small Business Corporation Status & the Proposed \$750,000 Capital Gains Exemption**

While the general \$100,000 capital gains exemption was eliminated in 1994, the \$500,000 exemption for shares of small businesses was left intact.<sup>14</sup> The 2007 Federal Budget contained a proposal to increase the capital gains exemption to \$750,000, for dispositions on or after March 19, 2007. (A similar exemption remains for Qualified Farm Property and Qualified Fishing Property.<sup>15</sup>) The rules surrounding the use of this enhanced exemption are complex and taxpayers seeking to take advantage of this exemption are urged to seek professional advice. A full discussion of these rules is beyond the scope of this document. However, it is important to understand how corporate-owned insurance impacts the ability to claim this exemption.

The ITA provides that the exemption can only be claimed in respect of shares of a Qualified Small Business Corporation (QSBC).<sup>16</sup> The Department of Finance's intention in drafting the legislation was to ensure that only shares of certain companies that are engaged in Canadian active businesses qualify for the exemption. It is not intended that shares of corporations holding passive investments qualify for the exemption. Tax legislation contains a number of requirements, including specific requirements as to what percentage of the assets are used in a Canadian active business.<sup>17</sup> Here, a 90% test and a 50% test will be discussed, with the former applying at the time of disposition and the latter for the period (generally two years) prior to the disposition.

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<sup>14</sup> Section 110.6 of the ITA should be referred to here.

<sup>15</sup> Definition of "qualified farm property" and "qualified fishing property" contained in subsection 110.6(1) of the ITA should be referred to.

<sup>16</sup> Definition of "qualified small business corporation share" contained in subsection 110.6(1) of the ITA should be referred to.

<sup>17</sup> Paragraph (c) of the definition of "qualified small business corporation share" contained in subsection 110.6(1) as well as paragraph (a) of the definition of "small business corporation" contained in subsection 248(1) of the ITA should be referred to here.

(i) 90% Test

A 90% test applies at the time of the disposition of the shares (including any deemed disposition at death). At that time, the corporation must be a Small Business Corporation (SBC). A number of criteria have to be met for a corporation to be a SBC, including that it be a Canadian-controlled private corporation and that "substantially all" (interpreted to generally mean 90%) of its assets (on a Fair Market Value (FMV) basis) be used in a Canadian active business.<sup>18</sup> Even unrecorded assets such as goodwill enter into these calculations. The 90% can be met by including shares or indebtedness of connected SBCs.

Where corporate-owned insurance policies are held, a determination will have to be made as to whether the insurance policy can be considered to be used in an active business. Secondly, the FMV of it will have to be determined for purpose of applying the 90% test.

Where the purpose of the policy is to fund a share redemption, the policy will generally not be considered to be used in an active business. However, there are instances where the insurance will be considered to be used in an active business, for example, in the case of key person coverage. CRA has held that where on the death of a key employee the insurance proceeds are used to recruit, hire and train management personnel or used to overcome short-term financial difficulties occasioned by the death of the insured, the insurance proceeds could constitute active business assets.<sup>19</sup> Whether or not an insurance policy can be considered to be used in an active business is a question of fact and will be determined on a case-by-case basis.

(ii) Valuation of Life Insurance for Purposes of the 90% Test

As stated above, after the nature of the asset has been determined it will be necessary to determine the FMV for purposes of the 90% test. It is important to realize that the FMV of life insurance on the life of a shareholder is dealt with in two separate provisions of the ITA.

Subsection 70(5.3) is probably the better-known provision. This is the section of the ITA that comes into play when we are looking at capital gains arising at the death of the shareholder under the deemed disposition rules, and corporate-owned life insurance needs to be valued in order to determine a value for the shares. This provision provides that the CSV of life insurance becomes the appropriate measure when valuing the corporate-owned life insurance (except as discussed below for joint-life and other multi-life situations).<sup>20</sup>

The second provision comes into play *only* for purposes of the 90% test (and as discussed below the 50% test) that must be met in order to gain access to the \$750,000 capital gains exemption. Subsection 110.6(15) allows insurance on the life of a shareholder to be valued at CSV, but only where the insurance was acquired to redeem, acquire or cancel the shareholder's shares, generally within 24 months of death. The definition of "small business corporation" was amended in 1991, retroactive to 1988, to allow the CSV to be the proxy for the FMV.

There are two separate two-year periods. The first is the "look back" period that is discussed below under the "50% test" heading. This is separate from the two-year period discussed under the subsection 110.6(15) requirements, which commences at the time of death.

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<sup>18</sup> The definition of "small business corporation" contained in subsection 248(1) of the ITA should be referred to here.

<sup>19</sup> See CRA document # 9310100, dated May 17, 1993.

<sup>20</sup> See subsection 70(5.3) of the ITA.

(iii) *Multi-Life & Joint Coverages*

It is, however, problematic that the two provisions do not use identical language when referring to life insurance. When we look at subsection 110.6(15), the language provides that the shareholder wishing to make use of this relieving provision must be "... a person ... whose life was insured under an insurance policy owned by a particular corporation ...". This may be compared with the language used in subsection 70(5.3). Here, CSV may be used as a proxy for FMV only where "... the particular individual (or any other individual not dealing at arm's length with the particular individual at that time or at the time the policy was issued) was a person whose life was insured ...".

The lack of common language is significant when we are looking at other than single-life policies. In 2000 CRA responded to a taxpayer who queried whether subsection 110.6(15) would apply where the coverage was via a joint (last to die) or multi-life policy. CRA's view was that "... the fact that more than one person's life is insured under a life insurance policy owned by a corporation would not, by itself, mean that the requirements of paragraph 110.6(15)(a) of the Act would not be met".<sup>21</sup>

The above should be contrasted with the position that CRA has taken with respect to the application of subsection 70(5.3) in multi-life (including joint-life) situations. In 2000 CRA expressed the view that where there is a multiple-life policy, subsection 70(5.3) could not be relied on to provide that the CSV was the appropriate measure, as the legislation made specific reference to "the person whose life was insured", that is, it contemplated only one life insured.<sup>22</sup> The insurance industry had hoped that the March, 2001 amendments to subsection 70(5.3), where the reference to "the person whose life was insured" was changed to "a person whose life was insured", would have allowed the CSV to be used as the measure of FMV where there was a policy on more than one life.

In a Technical Interpretation issued in May, 2004, CRA stated that in fact "Finance confirmed that at the time subsections 70(5.3) and 148(8) were enacted there was no tax policy intention to have the provisions apply to life insurance policies under which more than one life is insured".<sup>23</sup> CRA then went on to state that it was CRA's view that an amendment would be required to subsection 148(8) of the Act so that it would contemplate multiple-life policies.<sup>24</sup>

It is fortunate that in a capital gains exemption context the legislation contains more permissive language. The life insurance provisions in the ITA were introduced before the insurance industry offered multi-life coverages. Hence, taxpayers contemplating acquiring a multi-life contract should have their professional advisors review any available material as to how CRA might interpret the ITA

(iv) *Valuing Insurance Where CSV cannot be used as a Proxy for FMV*

If we are in a situation where we do not meet the legislative requirements for using the CSV as a proxy for FMV, the general principles that CRA has published will apply. Here, the value will be derived by looking at factors such as: the policy's CSV, loan value and face value; the state of health of the insured and his/her life expectancy; conversion privileges; other policy terms, and; replacement value.<sup>25</sup> However, if the death of one of the shareholders is considered "imminent", additional factors might need to be considered. These factors would include: the possibility that insured will recover; effect on the business of the loss of a key

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<sup>21</sup> See CRA document # 1999-0006485, dated January 25, 2000.

<sup>22</sup> See CRA's Technical Interpretation # 2000-0014245 dated March 28, 2000.

<sup>23</sup> See CRA's Technical Interpretation # 2004-0065441C6 dated May 4, 2004.

<sup>24</sup> See above.

<sup>25</sup> See paragraph 40 of *Information Circular IC-89-3 – Policy Statement on Business Valuations*.

person; whether shares being valued represent a minority or majority interest, and; certain other factors (e.g., future earnings prospects and prospect for dividends).<sup>26</sup>

It is important to understand that while subsection 110.6(15) is a relieving provision, it does have limited application. Where the insurance is for other than buy-sell purposes, and the purchase / redemption / cancellation of shares does not take place in the required time-frame (generally 24-months), the relief will not be available. Shareholders entering into buy-sell arrangements may want to ensure that their buy-sell agreements are structured accordingly (e.g. requiring that share transactions occur within 24 months of death), so that they do not need to rely on ministerial discretion.<sup>27</sup> Where, as noted above, a portion of the coverage is for key person coverage, with the life insurance being in place so that it may actually be used to recruit, hire or train management personnel, this portion will be considered to be used for active business purposes.) Of course, where the life insured is not the shareholder, the provision will not apply.

(v) *50% Test*

While a 90% test applies at the time of disposition, a further 50% test applies during a “look back” period. A share will not be a share of a QSBC if during the 24 months preceding the disposition it was owned by anyone other than the individual or a person or partnership related to that person.<sup>28</sup> Furthermore, during this period, the corporation must be a CCPC and more than 50% of the FMV of the assets have to be attributable to a Canadian business.<sup>29</sup>

The issues that were discussed under the 90% test (using CSV as a proxy for FMV, etc.) are equally applicable for purposes of the 50% test.

(vi) *Additional Comments with Respect to the Proposed \$750,000 Capital Gains Exemption*

The \$750,000 capital gains exemption represents a significant tax savings opportunity to owners of incorporated businesses. Life insurance products are a cost-effective way to fund buy-sell arrangements. It is incumbent that these business owners obtain the appropriate professional advice so as to ensure life insurance is structured in a manner that will not eliminate access to approximately \$375,000 of tax savings. This amount will be multiplied where there are multiple owners, each seeking access to the \$750,000 capital gains exemption!

CRA has issued at least one technical interpretation in which it has accepted that an operating company might acquire an interest in a policy that would be used to acquire, redeem or cancel shares in a holding company that are held by the insured. Here, it did permit CSV to be the proxy for FMV.<sup>30</sup> Taxpayers contemplating implementing complex structures and insurance arrangements are well advised to seek an Advanced Tax Ruling so as to avoid uncertainty.

## **(E) The Funding of Post-Employment Benefits, Including Supplemental Pensions**

RCAs have gained considerable acceptance, especially given the desire for many employers to fund pensions that are in excess of the ITA-imposed limits. Many employers make a conscious decision to set up a trust that will receive funds (or will hold an interest in an insurance policy) that will be used to provide for these pensions, and possibly other post-employment benefits.

Other employers may, however, unwittingly cause the RCA rules to be applied. This is because the ITA contains deeming rules. An RCA will be deemed to exist where:

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<sup>26</sup> See paragraph 41 of *Information Circular IC-89-3 – Policy Statement on Business Valuations*.

<sup>27</sup> See clause 110.6(15)(a)(ii)(B) of the ITA.

<sup>28</sup> See paragraph (b) of the definition of “qualified small business corporation share” contained in subsection 110.6(1) of the ITA.

<sup>29</sup> See paragraph (c) of the definition of “qualified small business corporation share” contained in subsection 110.6(1) of the ITA.

<sup>30</sup> See Technical Interpretation # 9730575, dated January 20, 1998.

“... an employer is obliged to provide benefits that are to be received on, after, or in contemplation of any substantial change in the services rendered by a taxpayer, the retirement ... or the loss of an office or employment, and where the employer ... acquires an interest in a life-insurance policy that may reasonably be considered to be acquired to fund, in whole or in part, those benefits ...”<sup>31</sup>

Where it can be established that the life insurance was acquired to fund the pensions (or other post-employment benefits), an RCA is deemed to exist. Thus, the RCA rules, including the requirement to pay the 50% refundable tax come into play. In order to avoid the application of these deeming rules it is important that the purpose of the insurance coverage be well documented.

#### **(F) Other**

While this document discusses most of the major concerns, there are other tax implications that may need to be reviewed. The taxpayer may want to review capital tax and large capital tax concerns, any minimum tax concerns, access to the Small Business Deduction, and so forth.

### **IV. Tax Consequences for the Shareholder or Employee**

#### **(A) Taxable Benefit Implications**

Where the beneficiary under the life insurance policy is either a shareholder or an employee, a taxable benefit will need to be computed. As stated in an interpretation bulletin issued by CRA:

“If the person on whom the benefit has been conferred is both a shareholder and an employee, a determination will have to be made, taking into consideration all the relevant facts and circumstances of the particular case, as to whether the benefit was conferred by the corporation on the person as a shareholder or as an employee. In the latter case, paragraph 6(1)(a) of the Act applies, rather than subsection 15(1).”<sup>32</sup>

While a corporation will be concerned as to the capacity of the person receiving the benefit (shareholder benefits are not deductible to the corporation, whereas employment benefits are), this is less of an issue to the individual, as he or she will include the amount of the benefit in taxable income and will pay taxes thereon at the appropriate marginal tax rate.

There are, however, other tax implications that are subtler. For example, paragraph 6(1)(a) benefits enter into the computation of “earned income” for the purpose of calculating Registered Retirement Savings Plan contributions, whereas it is not clear that subsection 15(1) benefits would enter into “earned income”. (It would if it were considered business income, but would not if it were income from property.) CRA’s position here is not clear.

Also, if a company were providing coverage under a registered pension plan, it is clear that only T4 income could be covered, since contributions/benefit accruals are based on “compensation”, which is defined to include income from an office or employment.<sup>33</sup>

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<sup>31</sup> See subsection 207.6(2) of the ITA.

<sup>32</sup> See paragraph 1 of Interpretation Bulletin IT-432R2 – Benefits Conferred on Shareholders.

<sup>33</sup> See definition of “compensation” contained in subsection 147.1(1) of the ITA.

## **(B) Use by Shareholder of Corporate-Owned Insurance Policy as Collateral for Personal Loan**

The situation may arise where a shareholder wishes to use a corporate-owned policy as collateral for a personal loan. Here, CRA has held that a shareholder benefit arises with the benefit being equal to the fair market value of the right to use the corporation's property as security. The value of the benefit will be a question of fact, with the value being determined on a case-by-case basis. CRA put forth a couple of methods that might be considered. The first method calculated the benefit by comparing the interest rate that would be charged on an unsecured loan with the interest rate that would be charged where the corporate-owned insurance was used as security. The second method involved looking at what the shareholder would have to pay to a third party who provided similar security.<sup>34</sup>

Where a decision has been made to have the corporation hold the life insurance policy, as opposed to having the individual own the policy, the impact on creditor protection and probate will have to be considered.

Creditor protection is available where there is a preferred beneficiary. The various provincial insurance acts in the common law provinces provide that where a preferred beneficiary such as a spouse, child or parent of the life insured is selected, the life insurance policy will fall under the creditor protection provisions. (In Quebec, similar protection is offered where the spouse (married or civil union), ascendants or descendants of the policyholder are the beneficiaries).

Where, however, a corporation is a beneficiary, the life insurance proceeds will be available to the creditors of the corporation.

## **VI. Summary**

Business owners have multiple uses for life insurance. With incorporated businesses, the funding of buy-sell agreements and post-employment benefits, the provision of key-man insurance are major concerns. Corporate-owned insurance is commonplace, especially given its cost effectiveness and significant tax advantages (for example, access to the CDA mechanism). Where corporate-owned insurance is to be put into place, the business owner is urged to review the tax and other implications with their professional advisors to ensure that these implications are understood.

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<sup>34</sup> See Technical Interpretation # 2000-0002575, dated March 29, 2000.