

Savings Available Where Corporate Dollars Are Used to Acquire Life Insurance

In our Taxing Issues series, *The Tax Implications of Corporate-Owned Life Insurance*, we make the comment that corporate-owned insurance is advantageous from a cost perspective. This is a significant advantage that is available to the business owner who carries on an incorporated business. This will generally hold true where the corporation is also the beneficiary of the policy. Here, where the corporation is the beneficiary, the savings in each year can be significant and will be magnified where the insurance is in place for a number of years.

Where a business owner requires insurance, he or she will have to consider whether it should be owned by the corporation or should be owned personally. In this document we focus on the cost effectiveness of paying with corporate versus personal dollars. We will do so by looking at the annual pre-tax earnings that the corporation requires. Even though the corporation may own the contract, the employee or shareholder may still be the beneficiary. Our calculations therefore include the taxes relating to any shareholder (or employee) benefits. In these discussions we will assume that the corporation cannot deduct the premiums, as the policy is not being used as collateral.¹

The pre-tax corporate earnings are calculated for the following scenarios:

- The corporation owns the contract and is the beneficiary under the contract;
- The shareholder or employee owns the contract and is the beneficiary under the contract (a salary is drawn to pay the premiums);
- The shareholder owns the contract and is the beneficiary under the contract (a dividend is received to pay the premiums);
- The corporation owns the contract and the employee is the beneficiary under the contract (an employee benefit is reported and employee draws salary to pay tax);
- The corporation owns the contract and the shareholder is the beneficiary under the contract (a shareholder benefit is reported and the shareholder draws a salary to pay the tax);
- The corporation owns the contract and the shareholder is the beneficiary under the contract (a shareholder benefit is reported and the shareholder receives a dividend to pay the tax);
- The corporation owns the contract but the shareholder pays the premiums and is the beneficiary under the contract (a salary is drawn to pay the premiums and dividends are received to pay the tax on the salary).

In the calculations we have assumed that there are three possible corporate tax rates:

- a) Small business – 18%
- b) Manufacturing business – 34%
- c) Non-manufacturing business – 38%

The above rates have been determined as a simple average of the rates applying in the various provinces and territories. Care should be taken in applying the small business rate, as the taxable income threshold for this rate may vary for federal and provincial purposes.

The personal tax rates used in the calculations are also a simple average of the rates applying in the various provinces and territories:

¹ Paragraph 20(1)(e.2) of the Income Tax Act (Canada) (ITA) should be referred to for the conditions that must be met for the premiums to be deductible.

- a) Salary – 45%
- b) Dividends – 30%

The end of this document should be referred to for some general conclusions.

I. Corporation Owns the Policy and is the Beneficiary

Where the corporation owns the policy and is also the beneficiary under the policy, the annual pre-tax earnings that will be required for the payment of the premiums may be calculated by taking the premiums and dividing this amount by (1 – tax rate). As may be seen in Attachment 1, the lower the tax rate, the lower the pre-tax earnings required.

The Canada Revenue Agency (CRA) has confirmed that where the corporation owns the policy and is also the beneficiary, premiums will ordinarily not be a taxable benefit to a shareholder.² (The tax implications should be similar for an employee.) Thus, we do not have to consider the additional pre-tax earnings that would be required where the shareholder (or employee) is required to include a taxable benefit in income.

As a general rule, this is the most cost-effective approach, as shareholder (or employee) benefit implications do not arise. The pre-tax earnings will be less than those required where the shareholder or employee pays the premiums personally for a similar amount of insurance coverage. Only where the personal tax rate is less than the corporate tax rate would it make sense to have the policy be personally owned.

The taxpayer would want to meet with their tax advisor in order to establish what - personal and corporate tax rates will apply over the period of ownership of the policy. This determination should not be done by looking at only a few taxation years.

II. Pre-Tax Earnings Where the Shareholder or Employee Owns the Policy

(i) Shareholder or Employee Draws a Salary

Where the shareholder or employee is to own the policy they will require sufficient after-tax funds for the payment of the annual premiums. The corporation can pay them a salary and the after-tax amount can be used to pay the annual premiums.

As may be seen from Attachment 2, the required salary may be calculated by taking the annual premiums and dividing this amount by (1 – personal tax rate). The required salary is identical, irrespective of the corporate tax rate. Where the corporate tax rate is less than the personal tax rate, having the corporation pay the annual premiums is the preferred option.

In our calculations we have not considered the payroll (CPP/QPP and EI) and other taxes (e.g., Ontario's Employers' Health Tax) that would apply to salary and/or employee benefits. If these were to be folded into the calculations, they would increase the cost savings that arise by having the corporation pay the premiums.

(ii) Shareholder Receives a Dividend

If the shareholder is to own the policy, the shareholder could fund the annual premiums with the after-tax amount of the dividend. The pre-tax earnings that would be required are calculated in Attachment 3. This is generally a more expensive option than having the shareholder receive a salary, except where the corporation pays tax at the small business rates.

² See Technical Interpretation # 9813525 dated July 6, 1998.

III. Corporation Owns the Policy and Pays the Premiums but the Shareholder or Employee is the Beneficiary

A taxable benefit will have to be calculated where the corporation owns the policy but is not the beneficiary under the policy. 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).”³

As discussed below, the required pre-tax earnings will vary, depending upon the capacity in which the benefit was enjoyed.

(i) The Benefit was Received by Virtue of Employment

Under this scenario, the corporation pays the annual premium but the employee will include in employment income a taxable benefit equal to the amount of the corporate-paid premium. Where the benefit is by virtue of employment, the corporation will have a tax deduction for the amount of the benefit (i.e., the premium paid). However, the employee still owes tax on the benefit. Thus, the employee will need to draw a salary from the corporation, so this amount net of tax will be sufficient for the payment of the taxes on the amount included in employment income (i.e., the non-cash taxable benefit plus the actual salary).

As may be seen from Attachment 4, the pre-tax income that is required does not vary depending upon corporate tax rates. Instead, the personal tax rate drives the amount. Also, the pre-tax earnings are identical to those calculated where the employee (or shareholder) owns the policy and draws a salary from the corporation that is used to pay for the premiums (see Attachment 2).

(ii) The Benefit was received by Virtue of the Shareholding

Where a benefit is received by virtue of the shareholding, the corporation will not have a deduction for the shareholder benefit, *even though the shareholder has an income inclusion!* Since the shareholder has an income inclusion, additional amounts (salary or dividends) will have to be received from the corporation so taxes can be paid on the benefit.

“Double tax” situations are uncommon – and costly – but this is one! CRA’s position is clear. The corporation does not receive a deduction for the premiums even though the shareholder has an income inclusion! (Where salary is paid to enable the shareholder to pay the tax on the benefit, this salary is deductible.) As may be expected, this results in the highest required pre-tax earnings for the corporation.

(a) Shareholder Draws Salary to Pay Tax on Shareholder Benefit

As stated above, the shareholder has a tax liability for the shareholder benefit. As calculated in Attachment 5, the shareholder can receive a salary from the corporation so the after-tax amount is sufficient to pay the tax on the shareholder benefit. The higher the corporate tax rate, the higher the pre-tax earnings required.

(b) Shareholder Receives Dividend to Pay Tax on Shareholder Benefit

³ See paragraph 1 of Interpretation Bulletin IT-432R2 – Benefits Conferred on Shareholders.

As stated above, the shareholder has a tax liability for the shareholder benefit. As calculated in Attachment 6, the shareholder can receive a dividend from the corporation so the after-tax amount is sufficient to pay the tax on the shareholder benefit. Since the dividend is paid out of after-tax income, this results in higher required pre-tax earnings for the corporation than would be the result if a salary were paid to the shareholder so he or she could pay the tax on the shareholder benefit. Again, as the corporate tax rate increases, the required pre-tax earnings increase.

IV. Corporation Owns the Policy, but the Shareholder or Employee is the Beneficiary and also pays the Premiums

If the shareholder has to include a shareholder benefit in their income and the corporation does not have a deduction for the payment of the premiums, this “double tax” scenario makes this an expensive alternative. The appropriateness of paying the shareholder a salary so they could pay the premiums warrants investigation, as this will result in the corporation’s having a deduction for the salary.

As may be seen from Attachment 7, this scenario is preferred to the “double tax” scenario – even taking into account the dividend that the corporation must pay so the shareholder use the after-tax amount of the dividend to pay the tax on the salary.

V. Appropriate Tax Reporting

Where a shareholder or employee benefit arises, it is important that the corporation have systems in place that will result in the appropriate benefits being reported. CRA may assess penalties and interest where the appropriate benefits are not reported. Moreover, a taxpayer’s credibility is at stake with CRA where the appropriate benefits are not reported, especially in a shareholder context.

VI. Summary

In the attachments we have compared and contrasted a number of alternatives. Advisors in the insurance area generally counsel their clients who carry on an incorporated business to consider having **the corporation own** the insurance policy, as this is more cost-effective. This is appropriate where the corporation is also the beneficiary under the policy.

However, where the corporation is not the beneficiary, and employee or shareholder benefit implications need to be considered, the taxes on the benefit may make corporate premium payments considerably more costly. This is especially the case where “double taxes” result (i.e., a shareholder is assessed a benefit where the corporation does not have a corresponding deduction). In this situation, the appropriateness of having the corporation as the beneficiary should be reviewed (e.g., structuring a buy-sell agreement providing for share redemptions as opposed to having a buy-sell agreement to allow the shareholder to purchase the shares held by the other shareholders). If having the corporation as the beneficiary is not appropriate, the “double tax” should be avoided by paying an amount to the shareholder so he or she can pay the premiums. Paying a salary or dividend should be considered here.

It should be clear that care needs to be taken when insurance is put into place, especially as it relates to establishing who should own the policy and who should be the beneficiary under the policy. While it is possible to change the ownership of the policy, perhaps because insurance needs have changed, the tax consequences to both the corporation and the shareholder (or employee) will have to be considered.

This document is intended for general information only. It should not be construed as legal, accounting, tax or specific investment advice. Clients should consult a professional advisor concerning their situations and any specific investment matters. While reasonable steps have been taken to ensure that this information was accurate as of the date hereof, The Standard Life Assurance Company of Canada and its affiliates make no representation or warranty as to the accuracy of this information and assume no responsibility for reliance upon it.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE

Summary:

Assumptions:

Insurance premiums \$ 10,000

Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2) 18.00%

Manufacturing business 34.00%

Non-manufacturing active business 38.00%

Individual tax rates:

Salary 45.00%

Dividends 30.00%

Pre-Tax Earnings Required for Corporation

	<i>SBD Rates</i>	<i>Mfg Rates</i>	<i>Non-Mfg Rates</i>	
Corporation Owns the Contract and is the Beneficiary under the Contract	\$ 12,195	\$ 15,152	\$ 16,129	Attachment 1
Shareholder/Employee Owns the Contract and is the Beneficiary under the Contract (A Salary is Drawn to Pay the Premiums)	\$ 18,182	\$ 18,182	\$ 18,182	Attachment 2
Shareholder Owns the Contract and is the Beneficiary under the Contract (A Dividend is Received to Pay the Premiums)	\$ 17,422	\$ 21,645	\$ 23,041	Attachment 3
Corporation Owns the Contract & Employee is the Beneficiary under the Contract (An Employee Benefit is Reported and Employee Draws Salary to Pay Tax)	\$ 18,182	\$ 18,182	\$ 18,182	Attachment 4
Corporation Owns the Contract & Shareholder is the Beneficiary under the Contract (A Shareholder Benefit is Reported and Shareholder Draws Salary to Pay Tax)	\$ 20,377	\$ 23,334	\$ 24,311	Attachment 5
Corporation Owns the Contract & Shareholder is the Beneficiary under the Contract (A Shareholder Benefit is Reported and Shareholder Receives a Dividend to Pay Tax)	\$ 20,035	\$ 24,892	\$ 26,498	Attachment 6
Corporation Owns the Contract & Shareholder is the Beneficiary under the Contract (A Salary is to Pay the Premiums and the Shareholder Receives a Dividend to Pay Tax on Salary)	\$ 17,840	\$ 19,740	\$ 20,369	Attachment 7

Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE**Corporation Owns the Contract and is the Beneficiary under the Contract****Assumptions:**

Insurance premiums \$ 10,000

Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2) 18.00%

Manufacturing business 34.00%

Non-manufacturing active business 38.00%

Individual tax rates:

Salary 45.00%

Dividends 30.00%

1.1 Corporation Qualifying for Small Business Rates

Pre-tax earnings required by Corporation

Earnings required \$ **12,195** [Calculated as \$10,000/(1 - corp.tax rate)] or [10,000/(1-0.18)]

Proof:

Pre-tax earnings	\$	12,195	
Less: Corporate taxes		<u>(2,195)</u>	[Calculated as \$12,195 x .18]
After-tax earnings	\$	<u>10,000</u>	

1.2 Corporation Qualifying for Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required \$ **15,152** [Calculated as \$10,000/(1 - corp.tax rate)] or [10,000/(1-0.34)]

1.3 Corporation Qualifying for Non-Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required \$ **16,129** [Calculated as \$10,000/(1 - corp.tax rate)] or [10,000/(1-0.38)]

Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE**Shareholder/Employee Owns the Contract and is the Beneficiary under the Contract
(A Salary is Drawn to Pay the Premiums)****Assumptions:**

Insurance premiums \$ 10,000

Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2) 18.00%

Manufacturing business 34.00%

Non-manufacturing active business 38.00%

Individual tax rates:

Salary 45.00%

Dividends 30.00%

2.1 Corporation Qualifying for Small Business Rates

Pre-tax earnings required by Corporation

Earnings required \$ 18,182 [Calculated as \$10,000/(1 - personal tax rate applying to salary)]
or [10,000/(1-0.45)]

Proof:

Corporate earnings \$ 18,182

Less: Salary paid (18,182)

Corporate after-tax earnings \$ -

Gross salary received \$ 18,182

Less: Personal taxes (8,182) [Calculated as \$18,182 x .45]

Personal after-tax earnings \$ 10,000

2.2 Corporation Qualifying for Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required \$ 18,182 See 2.1 above.

2.3 Corporation Qualifying for Non-Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required \$ 18,182 See 2.1 above.

Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE**Corporation Owns the Contract and the Employee is the Beneficiary under the Contract
(An Employee Benefit is Reported and Employee Draws Salary to Pay Tax)****Assumptions:**

Insurance premiums	\$	10,000
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Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2)	18.00%
Manufacturing business	34.00%
Non-manufacturing active business	38.00%

Individual tax rates:

Salary	45.00%
Dividends	30.00%

4.1 Corporation Qualifying for Small Business Rates

Pre-tax earnings required by Corporation

Earnings required	\$	18,182	[Calculated as: \$10,000/(1 - tax rate applying to salary)] or [10,000/(1-0.45)]
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Proof:

Corporate earnings	\$	18,182	
Less: Deduction for taxable benefit		(10,000)	[Represents amount of corporate-paid premium]
Less: Salary paid		(8,182)	See below
Corporate after-tax earnings	\$	<u>0</u>	

Gross earnings	\$	18,182	[Represents amount of corporate-paid premium + salary required to pay tax thereon]
Less: Personal taxes		(8,182)	[Calculated as \$18,182 x .45]
Personal after-tax earnings	\$	<u>10,000</u>	

Personal tax on taxable benefit			
Taxable benefit	\$	10,000	
Personal tax thereon	\$	4,500	
Gross salary required	\$	8,182	[Calculated as \$4,500/(1 - .45)]

4.2 Corporation Qualifying for Manufacturing Rates

Earnings required	\$	18,182	See 4.1 above.
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4.2 Corporation Qualifying for Non-Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required	\$	18,182	See 4.1 above.
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Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE

Corporation Owns the Contract and the Shareholder is the Beneficiary under the Contract (A Shareholder Benefit is Reported and Shareholder Receives a Dividend to Pay Tax)

Assumptions:

Insurance premiums \$ 10,000

Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2) 18.00%

Manufacturing business 34.00%

Non-manufacturing active business 38.00%

Individual tax rates:

Salary 45.00%

Dividends 30.00%

6.1 Corporation Qualifying for Small Business Rates

Earnings required \$ 20,035

Calculated as:

[Original pre-tax earnings from Attachment 1 +
((shareholder benefit x personal dividend tax rate) /
(1 - personal tax rate) / (1 - personal dividend tax rate))]
or [\$12,195 + (\$10,000 x .45)/(1 - .30)/(1 - .18)]

Proof:

Corporate earnings \$ 20,035

Less: Corporate taxes (3,606)

\$ 16,429

[Calculated as \$20,035 x .18]

Less: Amount used for premium (10,000)

Amount available for dividend \$ 6,429

Dividend (Actual) \$ 6,429

Shareholder benefit 10,000

Earnings of shareholder \$ 16,429

Less: Personal tax on dividends (1,929)

[Calculated as \$6,429 x .30]

Less: Personal tax on shareholder benefit (4,500)

[Calculated as \$10,000 x .45]

Personal after-tax earnings \$ 10,000

6.2 Corporation Qualifying for Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required \$ 24,892

Calculated as:

[Original pre-tax earnings from Attachment 1 +
((shareholder benefit x personal dividend tax rate) /
(1 - personal tax rate) / (1 - personal dividend tax rate))]
or [\$15,152 + (\$10,000 x .45)/(1 - .30)/(1 - .18)]

6.3 Corporation Qualifying for Non-Manufacturing Rates

Earnings required \$ 26,498

Calculated as:

[Original pre-tax earnings from Attachment 1 +
((shareholder benefit x personal dividend tax rate) /
(1 - personal tax rate) / (1 - personal dividend tax rate))]

Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.

SAVINGS AVAILABLE WHERE CORPORATE DOLLARS ARE USED TO ACQUIRE LIFE INSURANCE**Corporation Owns the Contract and the Shareholder is the Beneficiary under the Contract
(A Salary is to Pay the Premiums and the Shareholder Receives a Dividend to Pay Tax on Salary)****Assumptions:**

Insurance premiums	\$	10,000
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Combined federal & provincial corporate tax rates (Note 1):

Small business (Note 2)	18.00%
Manufacturing business	34.00%
Non-manufacturing active business	38.00%

Individual tax rates:

Salary	45.00%
Dividends	30.00%

7.1 Corporation Qualifying for Small Business Rates

Pre-tax earnings required by Corporation

Earnings required	\$	17,840
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Calculated as:

$$\begin{aligned} & \$10,000 + (\$10,000 \times \text{pers. tax rate}) / (1 - \text{corp. tax rate}) / \\ & (1 - \text{personal tax rate on dividends}) \\ & \text{or } [\$10,000 + (\$10,000 \times .45) / (1 - .18) / (1 - .30)] \end{aligned}$$

Proof:

Corporate earnings	\$	17,840
Less: Deduction for taxable benefit		(10,000)
	\$	7,840
Less: Corporate taxes		(1,411)
Available for dividend	\$	<u>6,429</u>

[Calculated as \$7,840 x .18]

Dividend (Actual)	\$	6,429
Taxable benefit		10,000
	\$	16,429
Less: Personal tax on dividends		(1,929)
Less: Personal tax on deemed benefit		(4,500)
Personal after-tax earnings	\$	<u>10,000</u>

[Calculated as \$6,429 x .30]

7.2 Corporation Qualifying for Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required	\$	19,740
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Calculated as:

$$\begin{aligned} & \$10,000 + (\$10,000 \times \text{pers. tax rate}) / (1 - \text{corp. tax rate}) / \\ & (1 - \text{personal tax rate on dividends}) \end{aligned}$$
7.3 Corporation Qualifying for Non-Manufacturing Rates

Pre-tax earnings required by Corporation

Earnings required	\$	20,369
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Calculated as:

$$\begin{aligned} & \$10,000 + (\$10,000 \times \text{pers. tax rate}) / (1 - \text{corp. tax rate}) / \\ & (1 - \text{personal tax rate on dividends}) \end{aligned}$$

Note 1: The corporate tax rates used are an average of the various provincial/territorial rates.

Note 2: The threshold amounts for the Small Business Deduction and not the same for federal and provincial tax purposes are not identical and vary by jurisdiction.