

Life Insurance: Corporate versus Personal Ownership

When business owners (of an incorporated business) buy insurance, they have to decide whether the corporation should own the insurance, or whether to own it personally. This document highlights the various issues business owners should consider.

The *Taxing Issues* series offers two related additional documents: *The Tax Implications of Corporate-Owned Life Insurance (PC 5675-07-2005)* and *Savings Available Where Corporate Dollars are used to Acquire Life Insurance (PC 5676-08-2005)*. Those documents focus on the tax and cost implications of corporate-owned life insurance. This document focuses primarily on the various qualitative considerations.

I. The Starting Point

The business owner and his or her advisor should start by asking three key questions:

- What is the insurance needed for (i.e. the purpose the life insurance)?
- Who should receive the proceeds of the life insurance?
- When will the insurance proceeds be required?

A business owner could encounter a number of situations in which acquiring insurance is appropriate. The insurance need could relate to the business or it could be personal. It could include:

- Estate and/or succession planning (including buy-sell agreement funding)
- Key person
- Paying taxes at death
- Liquidating debts at death
- Charitable bequests.

More often than not, the purpose of the insurance will determine who should receive the proceeds (i.e. be the beneficiary under the policy) and when the proceeds will be needed. It is essential to complete appropriate tax planning. This will ensure that premiums are paid on a tax-effective basis and insurance proceeds are received on a tax-effective basis.

There are advantages and disadvantages to corporate and personal ownership. The business owner and advisor should consider a number of factors when determining the appropriate structure. These are discussed on the following pages.

Note that in addition to situations in which insurance is needed, there are also situations in which the ownership of insurance is appropriate (and very desirable) from an investment perspective. Paramount among these is the ability to build up a significant investment component within certain insurance policies on a tax-deferred basis.

There are a number of financial strategies an individual or corporation might use to enhance income, or individuals might use to enhance their estate. However, these are beyond the scope of this document and warrant a separate discussion.

II. Factors Influencing Corporate Ownership

Tax Considerations

(a) Tax Deductibility of Insurance Premiums

Corporations cannot generally deduct premium costs. However, specific provisions in the Income Tax Act (ITA) may permit a deduction where the premiums are paid for a policy that has been used as collateral. Even then, the corporation must meet a number of conditions laid out in the ITA to have a deduction. The deduction may be for less than the amount of the premium that was actually paid, as it will be limited to the Net Cost of Pure Insurance.¹

For more detail, please refer to *Savings Available Where Corporate Dollars are used to Acquire Life Insurance*. This document looks at how much pre-tax earnings a corporation would require in order to pay the premiums, or have the shareholder (or employee) pay the premiums.

As a general rule, where premiums are not deductible, and the owner of the policy is the beneficiary of the policy, the party with the lower tax rate should pay the premiums. The calculations become more complex where the corporation owns the policy but the shareholder (or employee) is the beneficiary, as taxable benefit considerations must be factored in. Having a shareholder benefit arise adds to the costs considerably, as a “double tax” situation occurs. That is, premium costs are not deductible to the corporation, yet the shareholder has a benefit on which taxes are payable.

(b) Taxable Benefit Implications

Even though a corporation may own the insurance policy, a shareholder or employee may be the beneficiary under the policy. If this is the case, the corporation should be reporting a taxable benefit (generally for the full amount of the insurance premium). The shareholder or employee must pay the appropriate personal taxes on the amount.

It will be necessary to determine whether a shareholder who is the beneficiary had the coverage by virtue of his or her shareholdings or by virtue of his or her employment. This is important since the corporation will only have a deduction for the benefit when it is received by virtue of employment. “Employee benefits” are tax deductible to the corporation. This should be contrasted with the situation where the benefit was received by virtue of the shareholding. Where this is the case, the corporation does not have a deduction, even though the shareholder has an income inclusion.

(c) Access to Capital Dividend Account

Private corporations can take advantage of the Capital Dividend Account (CDA) mechanism, whereby life insurance death proceeds in excess of the adjusted cost basis (ACB) of the policy are credited to the CDA account.² The balance in the CDA may then be declared a capital dividend, which is not taxable to shareholders resident in Canada.

The amount credited to the CDA account depends on a number of factors, including the ACB of the interest in the policy at the time of the death. Practically speaking, many corporations will be able to credit all or substantially all of the death proceeds to the CDA account, especially where the insured is older. Thus, death proceeds flowed through a private corporation’s CDA will be tax-free to a shareholder, as they would have been on a personally owned policy.

¹ See paragraph 20(1)(e.2) of the Income Tax Act (Canada) (ITA), as well as Regulation 308.

² See subsection 89(1) of the ITA.

Please refer to *The Capital Dividend Account*, which is part of the *Taxing Issues* series, for more information.

If a corporation were to receive a disability payout under a life insurance contract, this amount would be tax-free to the corporation. The amount could not, however, be credited to the CDA account. The corporation would generally distribute these proceeds as either salary or wages or as a taxable dividend.

(d) Availability of the \$500,000 Capital Gains Exemption

The enhanced \$500,000 capital gains exemption is still available in respect of dispositions of shares of Qualifying Small Business Corporations (QSBCs). The Department of Finance's goal when drafting the legislation was to ensure that the \$500,000 exemption only be available in respect of shares of certain corporations carrying on Canadian active businesses. The ITA contains complex rules about which corporations qualify as QSBCs. There are numerous requirements, including those related to what percentage of assets (as measured on a Fair Market Value (FMV) basis) has to relate to a Canadian active business. A 90% test applies at the time of disposition, and a 50% test applies in up to a 24-month period leading up to the disposition.

Shareholders who have not already taken advantage of this tax incentive should make sure that corporations that own life insurance policies do not go "off side," that is, loses access to the exemption. Where a corporation has an interest in an insurance policy, the first step is to determine whether the policy can be considered to be used in an active business. The next step is to determine the FMV of the interest in the policy, so that there may be a determination of whether the 50% and 90% tests are met. (See below discussion on Valuation of Shares.)

This is a complicated area, and we refer you to *The Tax Implications of Corporate-Owned Insurance* for a detailed discussion. Given the significant tax savings associated with this \$500,000 exemption (which should be multiplied where there is more than one shareholder), we strongly recommend contacting a professional advisor.

Business owners may choose to establish a separate corporation that will own the insurance, rather than have the operating company own the insurance. They should take care to establish an appropriate shareholding structure. Having a separate corporation may be advantageous, as it may provide an additional measure of creditor protection because the insurance should not be available to creditors who may have claims against an operating company. Also, since the insurance is not in the operating company, the QSBC status of the operating company will not be impacted (presuming that the operating company does not have an interest in the corporation holding the insurance. If it does, the FMV of the operating company would be determined by taking into account the downstream shareholdings).

(e) Valuation of Shares

As discussed above, where a corporation has an interest in an insurance policy, it's important to consider the policy's FMV. From a tax perspective, the valuation of the insurance is important for at least two reasons:

- I. Determining any capital gains that will arise upon a deemed disposition at death, and
- II. Determining whether the \$500,000 capital gains exemption will be available.

The ITA contains specific provisions relating to determining a policy's FMV. Specific ITA provisions come into play when determining the FMV at the time of death.³ It may be possible to use the Cash Surrender Value (CSV) as a proxy for FMV if certain conditions are met. If the tax rules do not permit the use of CSV, use the CRA's general valuation principles.⁴

³ Subsection 70(5.3) of the ITA should be referred to.

⁴ See paragraphs 40 and 41 of *Information Circular IC-89-3 – Policy Statement on Valuations ("IC-89-3")*.

Different provisions in the ITA come into play when we are looking at whether shares are shares of a QSBC for purposes of determining whether the \$500,000 capital gains exemption will be available.⁵ Here, where the insurance is used to redeem, acquire or cancel the shareholder's shares, generally within 24 months of death, it may be possible to use the CSV as a proxy for FMV.

Again, we refer you to a detailed discussion in *The Tax Implications of Corporate-Owned Insurance*.

(f) Other Tax Considerations

While we have noted the major tax concerns, there are also other tax implications to consider. These include such items as the impact on:

- Capital tax (and large corporations capital tax) calculations,
- The small business deduction,
- The deemed Retirement Compensation Arrangement (RCA) rules, etc.

Financial & Other Considerations

(a) Accounting Treatment

Where a corporation has an interest in an insurance policy, it's essential to consider the impact on the financial statements. For example, where there is an interest in any policy having a CSV, this CSV should be recorded on the Balance Sheet, with changes in this value flowing through the Income Statement each year.

(b) Creditor Protection

Where the corporation owns the insurance contract, it is an asset that will be available to creditors of the corporation. It may be appropriate to have the contract owned by a holding company as opposed to an operating company, especially in situations where the operating company is engaged in a business with above normal risk exposures (e.g., construction, etc.).

(c) Liquidity Considerations

A Universal Life contract may have a significant CSV. Thus, it is a corporate asset that may be pledged to a financial institution and used for leveraging purposes. Therefore, the corporation may have access to a significant source of funds. The loan proceeds will be received on a tax-free basis. (Alternatively, consider a policy loan. Here, a policy gain would be reported to the extent that the policy loan exceeds the ACB of the policy. In essence, the policyholder will be able to obtain a loan up to the amount of the ACB of the policy on a tax-free basis. Further advances would, however, be taxable.)

Take care when structuring such arrangements, and make sure there is an appropriate review of tax and other implications (including a review of the risks associated with leveraging). In certain situations (e.g., triple back-to-back arrangements), it may be possible to arrange for the deductibility of loan interest.

Where the borrowed funds are to be flowed out to a shareholder (or employee), take care to avoid the deemed RCA rules.

Where funds are required, the policyholder might consider either taking a policy loan or a partial cash surrender rather than collateralizing the contract.

⁵ Subsection 110.6(15) of the ITA should be referred to.

(d) Funding of Buy-Sell Agreements

Insurance is often acquired to fund a buy-sell agreement. Corporate-owned insurance is often used in this context, especially where there are multiple shareholders. This may be appropriate where the shareholders are of varying ages and/or there are health issues involved. The result is that the shareholders do not pay varying amounts of insurance premiums because of the differences in ages or health of the insureds. Furthermore, where the corporation owns the insurance policy, the corporation is likely to have better administrative processes (including the appropriate personnel) in place. This will ensure that premiums are paid on a timely basis, and that the policy does not lapse. In a multiple shareholder situation, this is considerably easier than having multiple policies on the same insured (i.e., shareholder).

Structuring buy-sell agreements is a complicated process. Always obtain appropriate professional advice. There are multiple structures to choose from (for example, a corporation may employ either the promissory note method or the redemption method).

(e) The Stop-Loss Rules & Grandfathered Shares

Under a typical share redemption strategy where the shares are to be redeemed upon the death of the shareholder, the share redemption will often be funded by corporate-owned life insurance. Here, the life insurance death proceeds would be credited to the CDA, with the corporation then paying a capital dividend.⁶ Prior to the introduction of the “stop-loss” rules (see next paragraph), the share redemption would have given rise to a capital loss to the estate, which would then have been carried back and applied against any capital gains on the deceased shareholder’s final tax return. Thus, a significant tax deferral would have been available to shareholders of a private corporation.

Legislation (referred to as the “stop loss” rules) was introduced in 1995. This resulted in significant changes to share redemptions occurring after April 26, 1995.⁷ While these rules did not change the way in which the amount credited to the CDA was determined, they limited the ability of individuals to claim a capital loss on the disposition of the shares where a capital dividend had previously been received on these shares. While new strategies such as the “50% Solution” are now being employed, these are not as tax-advantageous as the pre-April 26, 1995 rules.

It is important to understand the “grandfathering” rules introduced at the time the same time as the “stop loss” rules. Under these rules, acquiring new or additional life insurance (or the replacement or conversion of an existing policy) is permitted, with the old rules applying to “grandfathered shares.”

Shares are grandfathered in two situations. The first occurs when there is an existing agreement. That is, if the disposition is pursuant to an agreement in writing that was made before April 27, 1995.

The second occurs when insurance was in place at that time. Here, the shares need to be held by the individual (other than a trust) or by a trust under which the individual (other than a trust) was a beneficiary on April 26, 1995. The corporation must have been a beneficiary under a life insurance contract that insured the individual or their spouse at that time. Furthermore, it must be reasonable to conclude that a main purpose of the insurance was to fund the redemption, acquisition or cancellation of the shares.

Taxpayers seeking to avoid the application of the “stop loss” rules should read the grandfathering rules carefully to assure that they escape their application, where possible.

⁶ Subsection 84(3) of the ITA should be referred to.

⁷ Subsection 112(3) should be referred to.

(f) Future Insurance Needs

As indicated above, from a creditor protection concern, it may be appropriate to have a holding company hold the interest in the insurance contract. Using a holding company is also preferred in situations in which the operating company may be sold, yet the insurance is to be retained. Where the insurance is in the holding company from the outset, any tax implications associated with transferring the interest in the policy are avoided.

Transferring the insurance contract between corporations will likely be a taxable transaction, whether the transfer is as a “gift” or whether some amount of consideration is paid. The transfer will be a disposition, and a policy gain may arise.⁸ Furthermore, since the holding company is a shareholder of the operating company, it will be necessary to consider “shareholder benefit” implications.⁹

The shareholder benefit rules apply to corporate shareholders as well as individual shareholders. A corporate shareholder would report the amount as income from property. However, it does not appear that the operating company is viewed as having paid a dividend for dividend refund purposes.¹⁰ It is simply a one-sided inclusion, without the operating company being considered to have paid a dividend.

While the “shareholder benefit” implications could be avoided by having the contract “dividend” to the holding company, a policy gain could still arise.¹¹ (Here, the holding company would receive a tax-free inter-corporate dividend from the subsidiary corporation, with the insurance contract being a “dividend in kind.” Part IV tax implications would still have to be considered here.) The dividend would have to be for the FMV of the contract.¹²

The appropriateness of the dividend in kind strategy may be reduced where the FMV of the contract is significantly in excess of its CSV, as the ACB is capped at the CSV. To determine the FMV, refer to CRA’s general valuation principles. They dictate consideration of factors such as age and health of insured, special rights contained in policy, paid-up options, etc.¹³

III. Factors Influencing Personal Ownership

Tax Considerations

(a) Tax Deductibility of Insurance Premiums

As with corporate-owned insurance, premium costs are generally not deductible. An exception to the rules is where the premiums are for a policy that has been used as collateral. The insurance will, of course, have to have been acquired in order to earn income from a business or property. A deduction will not be available in respect of insurance, which has been acquired for other than income producing purposes.

A number of additional conditions laid out in the ITA also must be met, including that interest on the related borrowings be deductible.¹⁴ This is an interesting condition, given the uncertainty surrounding the interest deductibility rules. On October 31, 2003, the Department of Finance introduced draft legislation relating to interest deductibility, which would have significantly tightened the rules, especially for individuals. However, this legislation has not been tabled. In fact, in the February 2005 Federal Budget the government announced that it would be modifying these rules. It is not possible at this point to know what the outcome will be.

⁸ Subsections 148(1) and (7) of the ITA should be referred to.

⁹ Subsection 15(1) of the ITA should be referred to.

¹⁰ See paragraph 23 of *IT-432R2 – Benefits Conferred on Shareholders*.

¹¹ Dividends in kind are discussed in *Interpretation Bulletin IT-67R3 – Taxable Dividends from Corporations Resident in Canada*.

¹² Subsection 148(7) of the ITA should be referred to. The valuation principles discussed in IC-89-3 should be referred to.

¹³ Paragraphs 40 and 41 of IC-89-3 should be referred to. Also, see Technical Interpretation # 2000-0056205, dated April 10, 2001.

¹⁴ See paragraph 20(1)(e.2) of the Income Tax Act (Canada) (“ITA”), as well as Regulation 308.

(b) Taxable Benefit Implications

Where the policy is owned personally, “employee benefit” and “shareholder benefit” concerns are avoided. The employee or shareholder will typically draw a salary or receive dividends from the corporation and will use the after-tax amount to pay the premiums. (The corporation will have a deduction for the salary paid.)

Again, we refer you to *Savings Available Where Corporate Dollars are used to Acquire Life Insurance* for a cost comparison of personal versus corporate ownership.

(c) Tax-Free Receipt of Proceeds at Death for Individual Beneficiary

Where the beneficiary is an individual, the full amount of the life insurance proceeds payable at death is non-taxable. (The ACB of the interest in the policy is not relevant for this purpose.)

Where there is a corporate policy with a corporate beneficiary, the amount of the life insurance death proceeds received by the corporation is also non-taxable. However, personal ownership overcomes the problem associated with corporate ownership – getting the proceeds into the hands of the shareholder on a tax-free basis.

A corporation will only be able to credit the CDA with the life insurance death proceeds that are in excess of the ACB. The amount of the death benefits up to the ACB will in all likelihood be distributed as a taxable dividend, with taxes being paid on the amount at the appropriate personal dividend tax rate.

(d) Tax-Free Receipt of Certain Disability Benefits

Some insurance policies contain “disability benefit payout” provisions. For example, a Universal Life policy may permit a payout in the event of a severe physical or mental impairment of the insured, with a payout of up to CSV of the policy (as adjusted for the next 12 months’ premiums and any outstanding loan balance). These payouts are not taxable, as they do not constitute a “disposition” of the contract.¹⁵ If a corporation were to receive such a disability benefit, while the amount would not be taxable to the corporation, the amount could not be flowed out to a shareholder via the CDA. Thus, a corporation would likely be in the situation of distributing what was tax-free to it to its shareholders (or employee) on a taxable basis.

(e) Departure from Canada and the “Departure Tax”

The ITA contains rules under which individuals are deemed to dispose of certain assets at the time they leave Canada.¹⁶ The disposition is at FMV, with the result that significant income taxes (i.e., a “departure tax”) could arise at that time. The “departure tax” rules have seen significant changes in recent years. These changes are effective for departures after October 1, 1996.¹⁷

Under the revised rules, there is a deemed disposition of all property, with certain exceptions.¹⁸ There is an exception for items meeting the “excluded right or interest” definition.¹⁹ An excluded right or interest has a lengthy definition, but includes “an interest ... in a life insurance policy in Canada, except for that part of the policy in respect of which the individual is deemed ... to have an interest in a related segregated fund trust”.²⁰ Since most personally held policies would be “an excluded right or interest,” there would not be a related

¹⁵ See part (h) of the definition of “disposition” contained in subsection 148(9) of the ITA.

¹⁶ Paragraph 128.1(4)(b) should be referred to.

¹⁷ Significant changes were made in 1996 (see Department of Finance News Release #99-066). Draft legislation was released December 23, 1998, and then amended December 17, 1999. The legislation finally received Royal Assent on June 14, 2001.

¹⁸ See paragraph 128.1(4)(b) of the ITA.

¹⁹ See subparagraph 128.1(4)(b)(iii) of the ITA.

²⁰ See part (l) of the definition of “excluded right or interest” contained in subsection 128.1(10) of the ITA.

departure tax liability for post-October 1, 1996 departures from Canada. Note that interests in segregated fund trusts are not considered to be “an excluded right or interest.”

Different rules apply where a private corporation holds the interest in the life insurance policy. When we look at the deemed departure rules, there is no exclusion for shares of private corporations.²¹ Thus, holdings in shares of private corporations are subject to the deemed departure tax rules. Furthermore, when we look to see how an interest in a life insurance policy might be valued, we find specific tax rules.²² These rules require using the CSV.

It should be noted that while the CSV is the appropriate measure where the corporate-owned insurance is for a single life, interests in joint-life contracts and multi-life contracts are problematic. In a recent Technical Interpretation, CRA confirmed, “Finance stated that at the time subsections 70(5.3) and 148(8)... were enacted there was no policy intention to have the provisions apply to life insurance policies under which more than one life is insured.”²³ Thus, for such contracts, it would appear that CRA’s general valuation principles would apply.²⁴

Financial and Other Considerations

(a) Creditor Protection Concerns

Life insurance contracts enjoy considerable creditor protection. Refer to the *Insurance Act* of a province to ascertain the specific circumstances in which creditor protection is available. For example, creditor protection may vary during the period the insured is alive from what is available at the time of the death of the insured.

The common law provinces have virtually identical legislation. Generally, protection will be available where there is a given family relationship between the life insured and the designated beneficiary (i.e., the beneficiary is the spouse, child, grandchild or parent of the person whose life is insured). It is important to realize that creditor protection is lost where an estate is the beneficiary under a contract.

Quebec has a broader class, which includes all ascendants and descendants as well as their married or civil union spouse. Furthermore, in Quebec, the relationship must be between the owner and the beneficiary.

(b) Family Law Considerations

Seek legal advice to determine if insurance proceeds form part of matrimonial property that will be subject to division. Many provinces have a specific exclusion for proceeds (or a right to proceeds) of a life insurance policy that are payable at death. Thus, this may create a bias for having a personally owned policy as opposed to a corporate-owned policy.

(c) US Estate Taxes

Where an individual is subject to foreign as well as Canadian taxes, always seek professional advice with respect to taxes (including estate taxes) in the foreign jurisdiction. For example, in certain situations life insurance proceeds may be subject to US estate taxes.

²¹ See 128.1(4)(b).

²² See subsection 70(5.3).

²³ See Technical Interpretation # 2004-0065441C6, dated May 4, 2004.

²⁴ See paragraphs 40 and 41 of IC-89-3.

(d) Administrative Ease

An individual may be one of several who own shares in a corporation. Thus, he or she will likely not be able to deal at will with any corporate assets (including corporate-owned insurance). He or she may require the consent of other shareholders. The insurance (especially where it is acquired in a buy-sell context) will in all likelihood be subject to a shareholders' agreement.

Furthermore, with corporate-owned insurance, the shareholder will have to satisfy the insurer (and any other interested parties) that he or she has the authority to deal with the asset. Thus, additional documentation will have to be undertaken.

Finally, where the insurance is a corporate asset and has a significant investment component, it is also possible that the shareholders' investment philosophies may differ. This may make it difficult for shareholders to make investment decisions.

It can be seen that in certain circumstances, personal ownership may be appropriate. (Alternatively, in some situations a holding company might hold the insurance, so the shareholder of the holding company and not the shareholders of the operating company control this asset.)

IV. Summary

Structuring the ownership of insurance is complex. Certain factors suggest that the insurance should be corporate-owned whereas other factors may indicate that personal ownership is more appropriate. We recommend a thorough analysis before making a decision. Given that business and other circumstances may require the acquisition of insurance contracts with significant face value, it is essential to assess all tax and other considerations.

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.