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ESTATEPLANNING

Corporate - Owned Life Insurance

Liberate your Profits Tax-Free

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The 2018 Federal Budget was reassuring news for business owners and affluent families who have been sitting on the sidelines, waiting to make planning decisions. The good news is that life insurance solutions will continue to enjoy unique, tax-free treatment under Canada's Income Tax Act.

Corporate-owned insurance policies - whole life, universal life, term to 100 - can be relied upon to help accumulate and preserve wealth tax efficiently inside a private corporation. If structured properly, they can extract capital tax-effectively for your family and favourite charities.

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This article explains why successful business owners acquire permanent life Insurance, and how they do it using leverage and immediate financing, thus keeping their own money working in their business or investment portfolio.

Life Insurance: Why would a business owner want it?

The traditional perception of life insurance is that it is a financial product providing income replacement at death, funds tax liabilities and partnership buyout agreements, covers key people in an organization or is used to equalize an estate.

Most wealthy Canadians are sufficiently self-insured by virtue of their assets. They feel, and rightly so, that they don't need insurance for traditional risk mitigation purposes.

That said, corporate-owned life insurance is used by wealthy individuals as a tax-effective way to accumulate passive wealth inside a company, enjoy access to that wealth, and transfer it tax-free to surviving beneficiaries.

The Problem

In many businesses, the retained profits or surplus cash are invested in taxable investments. This is often the case when the business owner doesn't need the extra income and has a higher marginal tax rate than their business. Consequently, they take advantage of the low corporate tax rates on active business income by saving money in their corporations, if they don't require it for personal purposes. This results in a tax deferral, but eventually these assets will come out of the corporation and get taxed at high dividend tax rates, depending on the taxpayer's post mortem planning. My previous TaxLetter® article "The Tax Grind" articulates this problem.

The Solution

A solution to this problem is to invest some of the retained profits in tax-exempt, permanent life insurance. There are two main benefits to making such an investment, namely:

i) The savings component of the life insurance policy can grow on a tax-free basis; and

ii) A significant portion, if not all, of the policy proceeds payable at death can be paid to the shareholder's estate as a tax-free, capital dividend.

Other Income Tax Advantages of Corporate-Owned Life Insurance

One big advantage is that the premiums are paid with corporate after-tax dollars, which are taxed at a much lower tax rate than the individual shareholder's personal tax rate. The corporate tax rate applicable to active business income (in Ontario) is approximately 13.5 per cent, and 50 per cent on investment income. The top individual marginal tax rate in Ontario is approximately 53.5 per cent.

A further advantage is that upon death, an individual is deemed to have disposed of his/her property at its fair market value. As it pertains to shares of a corporation which owns a life insurance policy, the Income Tax Act dictates the value of the life insurance policy at its cash surrender value immediately before death. This value is typically much less than the policy's payout following death, and significantly less than the value of the property that would have otherwise been accumulated by the corporation, had it not purchased the life insurance policy. As a result, purchasing life insurance can help reduce the tax payable at death in respect of shares of a private corporation, since it usually leads to a lower valuation for the corporate shares than if life insurance had not been purchased.

Acquiring a policy without using your cash

Most people would prefer to tie up as little of their cash as possible on life insurance premiums. They prefer to use it in other places, like their business or investment portfolio that will reap profits for them.

Most buyers of life insurance are unaware of tax-effective leveraging strategies that can allow them to protect and grow their wealth cost-efficiently, while enjoying tax deductions.

Many of our clients use a leveraging strategy to acquire their life insurance. Simply put, they pay the premiums and immediately borrow back those funds. This allows them to get life insurance at just a fraction of the true premium cost, without reducing cash available for their use. As a result, they enjoy tax benefits and increase their estate values.

The cash surrender value (CSV) that builds in an exempt whole life or universal life insurance policy can be used to reduce your net, out-of-pocket costs to buy the policy. This allows your money to keep working for you in whatever qualified investment(s) you choose. The insurance is totally free, but this is a smart way to keep your own money working for you in the investments of your choice.

It all happens through a premium financing strategy called an Immediate Financing Arrangement (IFA), the subject of my March 2016 TaxLetter® article. The IFA uses your insurance policy as collateral for a line of credit with a Canadian bank. The money from the loan can go into your business or property to produce income.

A corporate IFA can also increase the size of your company's Capital Dividend Account. This account tracks certain tax-free surpluses that are accrued by a private corporation, and may be distributed in the form of tax-free capital dividends to the shareholders of the corporation.

A recent case

A 50-something couple owned a company for many years and sold it a few years ago. They now own a holding company containing the proceeds of the business sale.

The husband continued working as an executive and was about to retire. His current portfolio of non-registered assets and real estate is worth about $14 million. With other personal assets added in his net worth is about $17 million.

When we first met, he was aware of the $5 million potential tax liability at his death, and had no formal plan to prepare for it.

We started with an insurance death benefit of $5 million to cover that tax liability. If he deposited the maximum amount into this policy, just a little more than $250,000, he would have a cash value of more than $177,000 in the first year. By providing a little more collateral in the form of other investible assets, we structured a bank loan that allowed him to borrow the entire $250,000 that he just put into the policy.

By borrowing the money, he could invest it and end up neutral from a cash-flow perspective. He would deposit $250,000, but leverage back $250,000 to invest. He would also have a $5 million insurance policy that would pay out after both he and his wife pass away.

We showed him how the policy would grow if he continued this process for a period of about 10 years. The death benefit of the policy grew to about $14 million at his life expectancy.

Because there's an outstanding loan, an interest expense must be paid. With the loan proceeds being reinvested to produce income, he can deduct the interest expense from other income. By using the life insurance policy as collateral, he can deduct the Net Cost of Pure Insurance (NCPI) of the policy as well. After factoring in the tax savings from these deductions, the client's first year out-of-pocket expenses total $6,400. He received a $5 million life insurance policy for $6,400 in the first year.

Every year, the outstanding loan balance and his out-of-pocket expense would grow. At age 90, his out-of-pocket will only be $54,000, which is much less expensive than the regular required premium to fund the initial $5 million death benefit.

How it ended

His estate could net out more than $11 million. That's equivalent to an after-tax rate of return of 7.88 per cent (or a before tax rate of return of 15.9 per cent, assuming a corporate tax rate of 50.17%). These rates of returns don't include any potential returns generated by the portfolio that might grow using the borrowed proceeds, though returns cannot be guaranteed. There is always a risk that the investment portfolio will decline in value and be worth substantially less than the borrowed proceeds.

The other interesting opportunity created for the client and his corporation is the additional capital dividend account (CDA) credit. His corporation receives a credit to the CDA for the death benefit less the adjusted cost basis of the policy. In this case, the CDA credit is $14,200,000. The insurance death benefit will be used to first pay back the loan and the remaining amount can be paid out of the corporation tax-free using part of the CDA balance. When the loan is paid off, the CDA credit won't be used up, and his corporation will still have a credit of $2,593,000. Thus, we created a mechanism to get another $2,593,000 paid out of his corporation tax-free, and save an additional $1,100,000 in tax.

Total death benefit (age 90)
$14,263,103
Outstanding loan balance
$2,593,850
Net death benefit
$11,669,253
Total CDA credit
$14,263,103
CDA used to pay net insurance proceeds
$11,669,253
Remaining CDA still available
$2,593,850
Additional tax savings (43% tax)
$1,153,555

In summary, we helped the client:

☛ substantially increase his estate,

☛ get money out of his corporation tax-free,

☛ establish liquidity to fund taxes after both he and his wife have passed,

☛ achieve all of this without redirecting more cash flow away than he was comfortable with.

Don't do it yourself. Seek professional help. The best way to get financial peace of mind starts with advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner. ❏

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He guides successful business owners, who are already challenged for time, through the complex process of ensuring the people and organizations they care about are taken care of.
If you are like his other successful business owner clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Incompletions rob us of energy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His approach is simple. He makes sure what is important to you gets done. He gets you organized, provides a big picture view of your financial affairs, determines your strategy and helps you take action. He will simplify the complicated, so you and your family can rest easy. He can be reached at 416-364-2929, toll-free at 1-800-566-2001 or Mark@WEALTHinsurance.com.
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