



**COMBINED INSURANCE COMPANY OF AMERICA**

## **THE USE OF LIFE INSURANCE IN THE BUSINESS MARKET:**

- Using a Corporate Dollar to Pay Life Insurance Premiums
- Deductibility of Life Insurance Premiums
- Understanding the Capital Dividend Account of Private Corporations
- Funding a Buy-Sell Agreement
- Key Person Insurance

Continuing Education on the web

(Revised 08/2007)

## **USING A CORPORATE DOLLAR TO PAY INSURANCE PREMIUMS**

The use of the corporation to meet the insurance requirements of shareholder-owners of Canadian Controlled Private Corporations (CCPC) merits study as well as a few comments.

According to the Canadian Association of Family Enterprise (CAFÉ), family businesses in Canada generate 45% of the Gross Domestic Product (GDP) and provide a paycheque for about 50% of working Canadians.

Many of these corporations qualify for the low rate of tax on the first \$400,000 of active business income\* earned in a given fiscal period, provided at least 50% of the corporation is controlled by Canadian individuals, either directly or indirectly (by another private corporation). If the above conditions are met, the company qualifies for the “small business deduction” under Section 125 of the Income Tax Act.

The small business tax rate varies from province to province is substantially less than the general corporate rate.

To illustrate the potential savings that can result by the Corporation paying the premium, consider the following:

- Harold Gibbons, majority owner of a CCPC marginal rate of personal income tax is 45%.
- The corporate rate of tax on the first \$400,000 of active business income is 20%.
- Harold requires \$500,000 of Life Insurance with an Annual Premium of \$8,000.

An important point to remember is that in most situations premiums are paid with after-tax dollars, whether the policy is owned individually or owned by a corporation. \*\*

\* The exceptions to this rule is when a taxpayer borrows money to earn income and the lender requests that appropriate life insurance be maintained on the borrower. In addition, the purchase of life insurance for charitable purpose and registering a life insurance policy as a RRSP might result in a tax deduction.

## COMPARISON – OWNING AND PAYING THE \$8,000 PREMIUM INDIVIDUALLY OR HAVING THE CORPORATION PAY THE PREMIUM

### INDIVIDUALLY

Marginal Rate of Tax (MRT) is 45%

#### Formula

$$\frac{\text{Premium}}{1 - \text{MRT}} \\ \frac{\$8000}{1-.45} = \frac{\$8000}{.55} \\ = \$14,545.45$$

### CORPORATION

Taxed at 20%

#### Formula

$$\frac{\text{Premium}}{1 - \text{Corporate Tax Rate}} \\ \frac{8,000}{1-.20} = \frac{80,000}{.80} \\ = \$10,000$$

In order to pay an annual premium of \$8,000 an individual whose top dollars are taxed at 45% would have to earn \$14,545.45 to meet the premium payments whereas a corporation with a corporate tax rate of 20% would only have to earn \$10,000 to pay the same premium.

From a practical standpoint, which route do you think a business owner would prefer?

It should be noted however that if the corporation owns a policy on a shareholder, key employee, any individual, upon death the proceeds are paid to the corporation, not to the individual.

How to get the proceeds out of the corporation and in the possession of designated individuals on a tax efficient basis is a topic that we shall explore in this module.

## **DEDUCTIBILITY OF LIFE INSURANCE PREMIUMS**

### **BASIC RULE**

Generally, life insurance premiums are **not** deductible for income tax purposes whether the policy is owned individually, or by a corporation.

### **WHAT IS A COLLATERAL ASSIGNMENT?**

A collateral assignment is the temporary transfer of certain rights contained in a life insurance policy to third party. Mostly typically, a collateral assignment is used to transfer an interest in the death benefit and cash surrender value, if any, to a lender when the insured has secured a loan to generate income from a business.

It should be understood that the insured retains most of the rights found in the contract, however the insured cannot surrender the policy or withdraw funds from the policy.

As indicated, a collateral assignment is a temporary arrangement. The assignment is discharged when, and if the loan is paid off.

Generally, the assignment provides that any proceeds (death benefit or cash surrender value) are to be paid jointly to the assignor (the owner of the policy and borrower and the assignee (the lender).

The assignee, in the event of a claim will release any portion of the proceeds not required to discharge any balance remaining on the loan.

In order for the assignment to be effective in protecting the interest of the lender (the assignee), the collateral assignment must be registered with the insurer. Otherwise, the insurer would simply pay the proceeds to the beneficiary in the even of a death claim, by passing the lender.

### **AN EXCEPTION TO THE BASIC RULE**

Under specific circumstances however, a limited deduction is available when a taxpayer borrows money for the purpose of earning income and the lender as a condition of the loan requests in writing the collateral assignment of a life insurance policy.

In order to qualify for this limited deduction under Section 20(1) (e.2) of the Income Tax Act, all of the following conditions must be met.

1. An interest in the policy must be assigned to a Restricted Financial Institution (RFI) in the course of borrowing from the institution.

An RFI is defined in Subsection 248(1) of the Income Tax Act (ITA) and includes banks, trust companies, credit unions, as well as insurance companies.

2. The interest payable on the money borrowed is or would have been deductible in calculating the taxpayer's income for the year.
3. The assignment of the policy as collateral is a requirement of the "Restricted Financial Institution" as a condition of receiving the loan.

Provided these conditions are met, the taxpayer is permitted a deduction when calculating income for a given taxation year.

**AMOUNT DEDUCTIBLE**

The amount deductible is limited to the portion of the life insurance policy that has been assigned as collateral and is the LESSER of:

- The premiums payable by the taxpayer under the life insurance policy assigned as collateral; or
- The net cost of pure insurance (NCPI) under the policy for the year that can reasonably be considered to relate to the amount owing during the year under the loan.

**AN EXAMPLE**

If the amount owing under a loan taken by the taxpayer is \$750,000 and a life insurance policy with a Face Value of \$1,500,000 is assigned as collateral for the loan, the amount deductible would be limited to 50% of the premiums paid or the NCPI, whichever is less.

Amount of loan from an RFI	\$750,000
Face Amount of Policy Assigned as Collateral for the Loan	\$1,500,000
Annual Premium of Policy	\$4,500
Net Cost of Pure Insurance (NCPI) for the year	\$2,600

**PERMITTED DEDUCTION**

LESSER of PREMIUM or NCPI

\$4,500      or      \$2600

Loan = \$750,000

Face Amount = \$1,500,000

Therefore, 50% of the NCPI of \$2,600 or \$1,300 is the amount, which is deductible. The amount deducted is limited to the portion of the loan that "can reasonably be considered to relate to the amount owing from time to time during the year."

## **WHEN COLLATERAL IN EXCESS OF THE LOAN BALANCE IS REQUESTED BY THE LENDER (RFI)**

It is not unusual for the lender to request collateral in excess of the value of the loan.

A full deduction under Section 20(1) (e.2) might still be obtained provided the loan outstanding does not exceed the face amount of the policy, and provided the RFI has made the assignment of the life insurance policy as collateral as a bonafide condition of the loan and not as a formality to enable the taxpayer to tax deduct the full amount.

Expert guidance in this area is highly recommended however.

## **TYPES OF LIFE INSURANCE POLICIES, WHICH QUALIFIES FOR THE DEDUCTION**

Prior to 1990 only term insurance was permitted in order to obtain the deduction. Today, either term or permanent insurance may be used as collateral insurance.

### **NEW OR EXISTING POLICY**

It should be noted that the purchase of a new policy is not necessary for the purpose of securing a loan.

An existing policy can be used and assigned as a condition of the loan. However, it should be understood that the original purpose of purchasing the existing policy might be lost if assigned for collateral purposes.

Finally, while tax-deductible dollars are being used to pay part of the premiums, the death benefit of the life insurance is still paid tax-free to the beneficiary.

For greater clarity on the deductibility of premiums, Interpretation Bulletin IT 309R2, Premiums on Life Insurance Used as Collateral should be referred to. A copy of this Bulletin can be obtained by going to [www.cra-arc.gc.ca](http://www.cra-arc.gc.ca). - Hit **Forms and Publications**, and then hit **Document Type** go to **Income Tax Interpretation Bulletins (Its)**.

## UNDERSTANDING THE CAPITAL DIVIDEND ACCOUNT

### WHAT IS IT?

The Capital Dividend Account (CDA) is a notional tax account available to privately owned corporations only. Public corporations do not qualify for a CDA.

Basically, the purpose of the CDA is to record certain sources of income, which have been received by the corporation on a tax-free basis, and it provides a mechanism whereby these proceeds can be conveyed to shareholders on a tax-free basis.

It should be understood that this is an account that is not found on the actual financial statements of a private corporation, rather the amount credited to the CDA, and available to shareholders is usually reported in the notes of the financial statements.

### WHAT QUALIFIES AS A CAPITAL DIVIDEND?

To answer this question it is necessary to go to subsection 89(1) of the Income Tax Act, which contains those items classified as capital dividends.

The Capital Dividend Account consists of the aggregate of the following:

- The excess of a non-taxable portion of capital gains over the non-deductible portion of capital losses incurred by the corporation since 1971.
- Capital Dividends received by the corporation.
- The non-taxable portion of gains resulting from the disposition of eligible capital property.
- **The net proceeds of a life insurance policy received by the corporation as a designated beneficiary.**

### **MINUS**

**Any capital dividend distributed by the corporation.**

From the foregoing, you can understand why the use of the corporation might be considered attractive by shareholders of privately held corporations.

Previous reference was made to the tax benefits obtained when the corporation owns life insurance on shareholders/key employees.

Through the effective use of the CDA, most if not all of the proceeds can be liberated from the corporation on a tax-free basis.

## **WHAT ARE THE NET PROCEEDS OF A LIFE INSURANCE POLICY?**

The net proceeds essentially can be stated to be an amount equal to the amount paid out at the time of death minus the policy's adjusted cost basis (ACB).

## **A REVIEW OF THE ADJUSTED COST BASIS (ACB) OF A LIFE INSURANCE POLICY**

The calculation of the Adjusted Cost Basis (ACB) is determined by the date a life insurance policy was acquired. Grand-parented policies (policies acquired prior to December 2, 1982) are taxed much more beneficially than policies purchased after that date at the time of disposition.

For purposes of this module we will restrict our discussion of the ACB to policies acquired after December 1, 1982.

To calculate the ACB of a life insurance policy:

- Premium paid including premiums paid on any insurance term riders INCREASES the ACB.
- Riders added to a policy such as Disability Waiver of Premium, Guaranteed Insurability, and Accidental Death Benefit are ignored in the calculation.

However, riders attached to a grand-parented policy increase the ACB.

## **FACTORS REDUCING THE ACB – AFTER DECEMBER 1, 1982**

- Net cost of pure insurance (NCPI)
- Dividends paid on participating policies.
- Policy loans acquired.

If the dividends allocated to a policy are used to buy paid-up insurance or term enhancements, the ACB will be increased.

A clear understanding of the Net Cost of Pure Insurance (NCPI) is of prime importance to the life insurance professional, in particular the implications that could result if an exempt (protection oriented) policy is disposed of during lifetime.

## **NET COST OF PURE INSURANCE (NCPI)**

The NCPI in its simplest term is the pure mortality cost under the policy each year.

It is calculated using a formula contained in Regulation 308 of the Income Tax Act, and is based on factors obtained from the Canadian Institute of Actuaries.

The key to defining the NCPI is the term net amount of risk.

The net amount of risk is the difference between the total death benefit and the accumulating fund of the policy. As outlined in Regulation 307 of the ITA, the accumulating fund approximates the cash value of the policy.

## **BUSINESS CONTINUATION**

A major dilemma confronting shareholders, partnerships and sole proprietors is “What will happen to their equity in the event of their premature death?” To alleviate this concern, many shareholders and partners enter into a contractual buy-sell agreement, which clarifies how their interest will be distributed in the event of death, disability, or the sale of their business interest before or at retirement.

For purposes of this module, we shall restrict our comments to the challenges that can occur on the death of a shareholder/partner.

To arrange for an orderly transmission of business interests, it is important that business owners/partners have a buy-sell agreement.

### **WHAT IS A BUY-SELL AGREEMENT?**

- A legal written agreement between two or more parties providing for the disposition of a business interest at death, disability or at retirement.
- It provides for an orderly transfer of ownership.
- The agreement **MUST** contain an obligation by a shareholder/partner to sell and the other party (parties) to buy.
- An agreed price **MUST** be established or an agreed formula to determine the purchase price.

### **RATIONALE FOR THE BUY-SELL AGREEMENT**

- There is reluctance on the part of surviving shareholders/partners to share in the future growth of the company, in particular when a surviving spouse and/or children are not active in the business. As well, generally the surviving spouse and/or children do not have the necessary expertise.
- If proper steps are not taken regarding the disposition of shares at death, the very real possibility of a significant reduction in the value of the shares is ever present.
- Generally the requirements of the deceased’s estate are for income and liquidity whereas the surviving shareholder’s concerns centre around replacing the deceased shareholder so the business can continue to function as normally as possible.

A properly executed Buy-Sell Agreement funded with life insurance would achieve these objectives.

However, it should be noted that options are available, other than life insurance to fund a Buy-Sell Agreement.

1. Borrow money to finance the purchase of a deceased's shareholder's equity. The problem with this approach is that the money borrowed has to be repaid as well as the interest on the loan.
2. Financing the purchase of the deceased's shares with cash flow from the business is another option available. The problem with this approach is twofold; the future success of the business could be affected due to these payments from profits or retained earnings. As well, additional expenses will generally be incurred by the business due to the loss of the expertise of a major shareholder/partner.
3. The use of a Sinking Fund: The principals of the firm could set aside cash each year in a reserve fund to be used to buy out the deceased's equity, however the deficiency in this approach is as follows.

If a premature death results, the survivors are confronted with the burden of paying for the unfunded portion of the purchase price over time.

As a funding medium for a Buy-Sell Agreement, life insurance is unsurpassed. For a modest expenditure each year, life insurance is the only method that fully guarantees that the full amount of cash required is available exactly when needed.

Life insurance is generally found to be the simplest, most economical way to fund a Buy-Sell Agreement.

### **METHODS OF FUNDING A BUY-SELL AGREEMENT**

1. Individually held – Criss Cross Basis
2. Corporate owned – Promissory Note
3. Corporate owned – Split Dollar
4. Corporate Repurchase or Redemption of Shares

## **1. INDIVIDUALLY HELD – CRISS CROSS BASIS**

- Simplest and cleanest method of funding Buy-Sell Agreement either between shareholders or with key employee(s).
- Shareholders own the policies on the lives of other shareholders and they are the beneficiaries of the policies. (A trustee is normally appointed to administer policies when 3 or more shareholders.)
- At death, surviving shareholder(s) uses the life insurance proceeds to purchase shares as per the term of the Buy-Sell Agreement.
- The life insurance proceeds are paid to the owner tax-free.
- However, premiums paid for insurance are paid out of after-tax dollars.

## **2. CORPORATE OWNED – PROMISSORY NOTE TECHNIQUE**

- Corporation is owner and beneficiary.
- Face amount paid to corporation at death.
- Surviving shareholder(s) purchase the deceased shares from the deceased's estate, under the terms of the Buy-Sell Agreement, giving a promissory note to the estate.
- The corporation then declares and pays to the surviving shareholder(s), who are now the owner(s), a capital dividend.
- The surviving shareholder(s) use the tax-free dividend to retire the promissory note.

As previously indicated, the capital dividend account is a notional (collector) account available to **private corporations**, which can transmit the proceeds tax-free to shareholders. Face amount of life insurance minus adjusted cost basis (ACB) is directed to CDA. Usually credit ranges from 85% to 100% of proceeds.

Regardless of whether the life insurance to fund a Buy-Sell Agreement is owned personally or corporately using the promissory note technique, the tax considerations to the estate of the deceased are similar. That is, the shares owned by the deceased are deemed to have been disposed of for "fair market value", and if the fair market value of the shares exceeds the adjusted cost base of the shares, a disposition is deemed to have occurred and capital gain could be exigible. The taxable portion of the gain has to be included when completing the deceased's terminal return.

### **3. CORPORATE OWNED – SPLIT DOLLAR**

- In this situation, the employer and employee divide the life insurance premium cost and the life insurance proceeds, as per the terms of the Split Dollar Agreement, a legal agreement, prepared generally by the company's solicitor.
- Not generally recommended due to the complexity and cost of implementing. For example, as well as a Buy-Sell Agreement, a Split Dollar Agreement has to be executed outlining the rights of both the corporation and the shareholders.

### **4. CORPORATE REDEMPTION OF SHARES**

- (1) Upon death of shareholder, his or her shares are redeemed by corporation, rather than sold to surviving shareholders.
- (2) Surviving shareholder(s) therefore receive no additional shares, instead there are fewer shares outstanding, and the value of the shares are increased.

Changes to the Income Tax Act have made the Corporate Redemption method less favourable in recent years, and it is generally not recommended.

### **OVERVIEW – METHODS OF FUNDING BUY-SELL AGREEMENTS**

- (1) The advantage of corporation paying premiums applies only when its tax rate is lower than that of individual shareholders.
- (2) If there are no more than two shareholders, the administrative arrangements are much simpler with corporate life insurance.
- (3) Where there is a large age difference between shareholders, corporate owned insurance removes the burden for younger shareholder to pay higher premiums.
- (4) A general concern with corporate owned insurance arises when a company experiences financial difficulty. Creditors have first claim on cash value or on proceeds at death.

## **KEY-PERSON INSURANCE**

The importance of a key individual instrumental in the success of a business enterprise cannot be overlooked. Regardless of whether a corporation is a public corporation or a privately held company, opportunities abound for the perceptive life underwriter.

The consequence of losing a vital shareholder/employee can be devastating for the company. Some of the problems that can result are as follows:

- Replacing the vital employee and having the necessary capital to attract qualified talented individuals.
- Reassuring creditors that the company is stable and can meet any of its future commitments.
- Reassuring employees that the company is strong financially.
- The ability to seize additional business opportunities in the midst of the tragic loss.

Life insurance owned and payable to the company can be the difference between success and failure. The death of Walt Disney many years ago illustrates this point very clearly. At the time, the Disney corporation was confronted with significant financial challenges. When Walt Disney died prematurely, it was the one million-dollar key person policy that kept the company afloat.

## **HOW TO VALUE A KEY PERSON**

A number of approaches can be utilized to place a value on a key person that include the following:

- Contribution to the organization based on business earnings.
- Contribution based on the financial stability of the Corporation.
- Cost to replace the vital person by recruitment in the marketplace.
- Valuation based on Compensation.

The key point to understand is that there is no set formula to determine the specific value of a key person to an organization. Each situation is different. From a life insurance standpoint however, the basic rule of thumb appears to be in the range of anywhere from 3 to 5 times the annual compensation of the key person.

From an underwriting standpoint however, the purpose of the life insurance is to cover a specific risk and not to create wealth for the company.

Appropriate key person insurance can be the difference between the continued success and failure of a company upon the untimely death of a vital person.

## **CONCLUSION**

This concludes the Module on the use of Life Insurance in the Business Market.

As a professional and the holder of a life insurance license, you should have a general understanding of the use and application of life insurance for business purposes