A discussion of corporate-owned life insurance

Persons who seek their livelihood in business are often motivated by a need to place their fate in their own hands. Of course, the desire to make money for themselves and their families is not the least of their drives. As such, our life insurance products must be adapted to meet the needs and desires of this special class of person – the Canadian businessperson.

As you are aware, in the course of running a business, many owners choose to incorporate their business. Corporations issue shares and the shareholders own the business. The shareholders may be hired by the corporation and, as employees; they are paid salaries in addition to all other benefits the corporation can provide to its employees.

Most of these shareholders would prefer to see, in the event of death, his/her shares pass on either to family members or fellow shareholders. The major concern is that the family will have sufficient money to maintain the kind of lifestyle that it has become accustomed to. If family members are not able to assume control of the business, a practical solution to this problem is to enter into a buy-sell agreement amongst the other shareholders. As a funding means, corporate-owned insurance is an attractive option. However, it should be recognized that buy-sell funding is not the only reason why business people should consider having their corporation purchase life insurance.

Why buy corporate-owned life insurance?

Life insurance provides for the payment of cash at death, a financial benefit that is unique and incomparable. Business people need life insurance for these key reasons:

1. To provide funds for the family to pay estate debts and taxes on capital gains and to give the family a sum of money independent of the risks and hazards of private business.

2. As noted above, to provide funds to fulfill the terms of a buy-sell agreement amongst shareholders.

3. To pay the debts of the corporation so that creditors' claims are satisfied and the business can either continue on a profitable basis or can be sold at a maximum price. Preferred shares can be redeemed and/or common shares repurchased where permitted by company articles.

4. To provide funds to help offset the economic loss of the death of the key employee. Life insurance funds will allow time to hire, promote and train new key people.

5. To provide funds for a death benefit to the insured's widow(er). The amount paid out is deductible to the corporation. The amount received by the surviving spouse is tax-free to the extent of the lesser of $10,000 and the employee's annual salary.

6. Where the policy has cash values, these appear as an asset on the corporate balance sheet. The cash values can be utilized as additional collateral or emergency funds during the insured's lifetime. During their accumulation period, the increases in cash values are tax sheltered.

Advantages of corporate-owned life insurance

Where the corporation is eligible for the small business deduction and other corporate tax credits, there is a significant savings in the before-tax earnings required to pay premiums.

These savings can become quite substantial as premiums are paid year after year.

1. Corporate-owned life insurance can use the capital dividend as a route to pay the proceeds without tax at the death of an insured shareholder; whether the corporation or the surviving shareholders purchases the shares from the deceased shareholder's estate. A further advantage of capital dividends is they do not reduce the adjusted cost basis of the shares.

2. In a situation where the insurance is required to fund a buy-sell agreement, there will be more than one insured shareholder. There will probably be different ages and unequal premium rates. There may also be cost differences among shareholders due to underwriting premium ratings. Corporate-owned policies help to equalize the resulting premium differences.

3. Again, where insurance is being used to fund a buy-sell agreement, the surviving insured shareholders do not have to purchase the policies owned by the deceased shareholder on their lives as would be the case if they owned the insurance individually. The corporate-owned policies simply remain in force on the surviving shareholders.

4. Where the corporate-owned policies have cash surrender values, such values are an asset of the corporation, and would show as an asset on the balance sheet. Any investment gain during the accumulation period is tax sheltered and is not exposed to corporate investment tax rates. A disposition, such as cashing in the policy or taking a policy loan where the proceeds exceed the cost base, would result in a taxable gain.

5. From a psychological standpoint, there is a preference among shareholders to spend corporate dollars rather than personal dollars. An expenditure on life insurance premiums is more favourably regarded when the disbursement is made from the corporation's surplus rather than the shareholder's personal wallet.

Disadvantages of corporate-owned life insurance

1. As the corporation is the beneficiary of the insurance policy, the proceeds may be subject to the claims of any corporate creditors. Creditor protection under the various insurance acts does not extend to corporations.

2. If creditor claims are seen as a problem, then business loan insurance should be purchased on key executives. The premiums for corporate-owned insurance are non-deductible except for premiums on collateral term insurance.

3. For purposes of the deceased shareholder's tax return and the capital gains calculation, the deemed disposition at death must take into account the cash surrender value of life insurance policies owned by the corporation. In a non-arm's length sale, the receipt of life insurance proceeds by a corporation potentially can increase the value of the shares for purposes of a sale of the shares by the estate after death.

4. Under the new Family Law Act in Ontario, shares purchased by the surviving shareholder from the deceased's estate using life insurance proceeds would not fall into the "net family property" of the surviving shareholder. Where the shareholder purchases the shares using a tax-free capital dividend from the

corporation, it is not clear whether this would be considered using life insurance proceeds to avoid the net family property calculation.

5. Corporate-owned insurance can potentially affect the status of shares for purposes of qualifying as small business shares under the $500,000 capital gains exception. The definition requires that substantially all (90 per cent or more, Canada Revenue Agency (CRA) view) of the assets be used in an active business. CRA takes the position that normally an insurance policy is not considered to be used in an active business nor do life insurance proceeds qualify as active assets.

In the case of a deemed disposition at death, in determining whether a corporation qualifies as a small business corporation at the time of death, the value of the policy is determined immediately before death and is not limited to cash surrender value. Rather consideration could also be given to the life expectancy of the insured according to mortality tables and the state of health of the insured as it is known to others. It is further arguable by CRA that the holdings of insurance policies on shareholders who have not died may also have an impact on the share valuations at death and, presumably, to the status of the company as a small business corporation.

Conclusion

Despite some of the concerns raised above, the many significant advantages of corporate-owned insurance means that this type of ownership should be considered by all business people and their financial advisors.