The corporate value maximizer concept

Insurance

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Introduction

Successful private corporations often earn profits that are not immediately required for business operations. The corporation may choose to distribute those profits to shareholders as bonus/dividends or retain the profits in the corporation for investment purposes. These corporate investments can subsequently be used to fund business growth in the future or as a source of retirement income for the owner/manager. Until recently, there were also tax advantages associated with retaining profits in the business rather than distributing them to shareholders.

However, recent tax changes can adversely impact the corporations that decide to retain and invest the profits, generating passive income such as interest, dividends, etc. As well, distributing the profits as dividends to certain non-arm's length shareholders (e.g. family members or family trusts) may trigger the Tax on Split Income rules.

Due to the unique tax treatment, exempt life insurance policies may prove to be a more tax-effective way to use the corporate surplus than traditional investment products (which would be subject to the recent tax changes). Further, the life insurance policy provides a cost-effective method of creating liquidity on the death of a shareholder, which can be used for corporate needs or personal estate planning purposes.

This guide will discuss the corporate value maximizer concept and illustrate the important benefits of corporate-owned life insurance over more traditional investment products.

How does it work?

The corporation acquires an exempt permanent life insurance policy on the life of the shareholder and designates the corporation as the beneficiary. The amount of insurance is based on the liquidity needs of the corporation and/or the shareholder that would arise on death. For example, the corporation may require the insurance to repay debt or fund the repurchase of shares that the deceased shareholder owned. Alternatively, the shareholder may require more liquidity in their estate to fund taxes arising on death[1] or equalize estate bequests between family members. Where the shareholder has a spouse, it may be more advantageous for the corporation to purchase a joint and last-to-die life insurance policy on their lives, unless the corporation needs liquidity on the death of the shareholder.

After purchasing a life insurance policy, subject to the limitation prescribed in the Income Tax Act, the corporation will make deposits in excess of what is required to pay the cost of insurance charges. This will result in a policy reserve (including a cash surrender value) that will grow over time. This policy reserve can be used to pay insurance charges in the future and/or enhance the death benefit payable under the policy. In addition, much like any other corporate asset, the cash surrender value of the policy can be used as security for a loan should the business need additional funds.

On the death of the life insured (or the surviving spouse under a joint life insurance policy), the insurance proceeds are received by the corporation. The receipt of a death benefit creates a credit to the corporation's capital dividend account, generally equal to the death benefit less the adjusted cost basis of the policy. The corporation can retain the funds for business purposes or distribute part or all of the insurance proceeds to the shareholders. To the extent there is a positive balance in the corporation's capital dividend account, it can distribute the insurance proceeds as a tax-free capital dividend to Canadian resident shareholders.

What are the benefits of this strategy?

The following outlines the key benefits of using corporate profits to purchase an exempt corporate-owned life insurance policy. Please note that RBC Insurance's *Life Insurance for Business Owners Advisor Guide* discusses these topics in additional detail.

(a) Tax deferred accumulation

Any accumulating income on the policy reserve of an exempt life insurance policy up to a prescribed limit is not subject to accrual taxation.[2] Thus, much like a registered retirement savings plan, the growth of the cash surrender value of an exempt life insurance policy is not subject to tax provided there are no policy transactions that result in a taxable disposition.[3]

(b) Tax-free death benefit

The payment of a benefit under an exempt life insurance policy as a result of the death of a life insured is not considered to be a disposition of the policy.[4] Thus, the full amount of the death benefit under an exempt life insurance policy can be paid to the corporate beneficiary on a tax-free basis. As well, any portion of the policy's cash reserve that is included in the death benefit will not be subject to taxation. Thus, the tax-deferred growth accumulated during the lifetime of the policy is converted to a tax-free death benefit.

(c) Credit to the capital dividend account

The capital dividend account is a notional tax account that tracks certain amounts received by a private corporation that would have been tax-free had the shareholders of the company received them directly.[5] Generally, the excess of a death benefit over the adjusted cost basis of the policy received by the corporate beneficiary is included in the calculation of the capital dividend account balance. A corporation can pay a tax-free capital dividend from its capital dividend account to its Canadian resident shareholders.[6]

The portion of the death benefit equal to the adjusted cost basis can be distributed to shareholders on a taxable basis. However, the adjusted cost basis of an insurance policy generally declines to nil near life expectancy. Consequently, the amount of death benefit that can be credited to the capital dividend account increases as the life insured grows older.

(d) Collateral borrowing

The collateral assignment of a policy as security for a loan is not treated as a disposition of the policy, and therefore, will not trigger immediate tax reporting to the policyholder.[7] Where the loan proceeds are used to earn taxable income from a business or property, the loan interest may also be deductible.[8] In addition, there is another deduction that may be available where the policy is used for income-generating purposes, referred to as the collateral insurance deduction.

In order to claim the collateral insurance deduction, the following conditions[9] must be satisfied:

- The policyholder must be the borrower;[10]
- The policy must be collaterally assigned for a loan from a restricted financial institution,[11] which includes a bank, an insurance company or a trust company;[12]
- The interest payable on the loan must be deductible for income tax purposes; and
- The assignment of the policy must be required by the lender as collateral for the loan.

If the above criteria are met, the deduction is equal to that portion of the lesser of the following two amounts that relates to the loan amount owing from time to time during the year:

- The premiums payable for the year; and
- The policy's net cost of pure insurance for the year.

(e) Continued access to the small business deduction

The small business deduction reduces the tax rate on the first $500,000 of active business income earned annually by a private corporation.[13] This results in significantly less taxes being paid on business income earned by a corporation in relation to earning that income through a sole proprietorship.[14] Before 2018, if the after-tax profits that have benefited from the small business deduction were not required for business purposes, there was a potential tax advantage to the corporation investing those funds rather than distributing those profits to the shareholders to invest. This is due to the fact that there was an additional tax levied on the dividends, which reduced the after-tax amount available to invest by the shareholder. It is important to note that investment income earned by a corporation is taxed at a rate similar to the top marginal tax rates applicable to personal investment income. Therefore, the main benefit would be having more capital available to invest in the corporation.

Example:

Opco has a taxable income of $400,000, which qualifies for the small business deduction. Assuming the combined federal/provincial small business tax rate on this income is 12%, this would result in taxes of $48,000, leaving $352,000 in the corporation, which could be used for investment purposes. However, if the after-tax profits are distributed to an individual shareholder as a taxable dividend, that shareholder would only have approximately $184,000 to invest after paying tax on the dividend income. Assuming an after-tax rate of return of 5% on these funds, in the first year, the corporation would earn $17,600 vs. $9,200 for the shareholder.[15]

Because of the potential tax benefits arising from the corporate investment of after-tax profits that benefit from the small business deduction, eligibility for the small business deduction is now reduced once a corporation (and associated corporations) earns more than $50,000 of "adjusted aggregate investment income" (AAII) in the immediately preceding taxation year. For every dollar of investment income earned by the corporation in excess of $50,000, the small business deduction limit is reduced by five dollars. Thus, the small business deduction will be fully eliminated once the corporation's AAII exceeds $150,000 in the preceding year.[16]

However, income accumulating within a corporate-owned exempt life insurance policy is not considered to be AAII and will therefore not impact access to the small business deduction.[17] Therefore, it is possible for a corporation to accumulate income within an exempt life insurance policy without affecting the access to the small business deduction. Any taxable policy gain arising from the disposition of a corporate-owned life insurance policy will be included in a corporation's AAII for the purposes of these rules.

(f) Avoiding the Tax on Split Income rules[18]

The Tax on Split Income (TOSI) rules, which became effective from 2018, limit the ability of business owners to split business income and related capital gains with family members. Where these rules apply, the recipient will be subject to tax at the top marginal personal tax rate (over 50% in most provinces) on split income[19] received in the year, unless such income qualifies for a specific exemption from these rules.

While there are a number of exemptions from the TOSI rules, such exemptions may apply to one family member but not another, to one type of business but not another, or in one year but not another. Business owners and their professional advisors must look at ways to avoid the application of these rules or minimize their impact on family members.

Corporate-owned exempt life insurance on the life of a key shareholder may provide a long-term strategy for this purpose. This is because all or a significant portion of the death benefit can ultimately be paid to the Canadian resident family members (through the estate or directly as shareholders) as a tax-free capital dividend.

(g) Life insurance valuation rules on death

A taxpayer is deemed to have disposed of all capital property that they owned at the time of death for proceeds of disposition equal to the fair market value of those properties immediately before death.[20] Thus, if a corporation uses the after-tax income to acquire investments, rather than distributing those earnings to the shareholders, this will potentially increase the fair market value of the shares, and in turn, the capital gain that will ultimately be realized on the disposition of those shares.

The question then becomes, will using after-tax corporate earnings to fund a corporate-owned life insurance policy have a similar impact on the value of those shares upon the death of the shareholder/life insured? The answer is yes, but only to the extent of the cash surrender value of the policy. There is a special rule that provides that where the deceased owns shares in a private corporation, and that corporation owns life insurance on the deceased shareholder's life (or any other person not dealing at arm's length with the deceased shareholder), the fair market value of any such insurance policy will be deemed to be its cash surrender value immediately before death.[21]

Other important considerations

The following should also be considered:

(a) Tax status of shareholders

The corporate estate maximizer concept assumes that an individual shareholder is already paying tax near or at the top personal marginal tax rates and otherwise maximizing contributions to the Canada Pension Plan, registered retirement saving plans and tax-free savings accounts. If this is not the case, it may make sense for the corporation to pay out part or all of the earnings to the business owners as a bonus or dividend income (however, see section (f) Avoiding the Tax on Split Income rules) rather than retain those funds in the corporation.

(b) Creditor protection

Provincial insurance legislation provides creditor protection for life insurance policies in certain circumstances. While it might be possible for a corporate-owned policy to qualify for creditor protection, the designation of a family member as a beneficiary of the policy will trigger a shareholder benefit,[22] typically equal to the insurance premium being paid by the corporation.[23] Thus, where creditor protection of the insurance policy is important, this may require ownership of the policy through a separate holding company. The operating company can pay tax-free dividends (subject to safe income rules) to the holding company from its after-tax profits to fund the insurance policy owned by the holding company.

(c) Impact on the lifetime capital gains exemption

Capital gains arising on the disposition of shares of a private corporation owned by an individual shareholder may qualify for the lifetime capital gains exemption.[24] The exemption is available with respect to capital gains arising on the disposition of shares in a qualified small business corporation (QSBC shares).[25] There are a number of requirements that must be satisfied for shares to qualify as QSBC shares including the fact that "all or substantially all"[26] of the assets owned by the corporation must be used in an active business carried on by the corporation in Canada immediately prior to the disposition of the shares.

The Canada Revenue Agency has indicated that a corporate-owned life insurance policy will be considered a "passive investment asset".[27] Thus, if the value of a corporate-owned insurance policy combined with other

passive investments becomes too great, the shares in the corporation may not qualify for the lifetime capital gains exemption.

This raises the question of what value should be given to a corporate-owned life insurance policy for purposes of the QSBC share definition. There is a specific rule that applies where a shareholder of the corporation (or a corporation connected with the corporation, such as a holding company) is the life insured under the corporate-owned life insurance policy.[28] This rule provides that the fair market value of the insurance policy at any time before the death of the life insured will be its cash surrender value.[29] The cash surrender value is to be determined without taking into account any policy loans against the policy.[30]

In situations where this rule does not apply (for example, the life insured is not a shareholder of the company in question), the Canada Revenue Agency has indicated that the policy will be valued based on the criteria set out in Information Circular IC 89-3. In this case, it is possible that the corporate-owned policy (including term insurance) could have a fair market value far in excess of its cash surrender value.[31] This could be the case, for example, if the life insured had a life-threatening illness such as cancer.

In circumstances where the shareholder has died, there is another rule[32] that will deem the value of the insurance proceeds to be the cash surrender value of the policy immediately before death, provided the insurance proceeds are used within 24 months from the date of death to redeem, acquire or cancel the shares owned by the life insured immediately before death.

(d) Future changes to tax laws

A client must understand that tax laws may change in the future, which could affect the tax treatment of life insurance policies held within a private corporation. The risk of future tax changes is perhaps greater with life insurance strategies. This is because, in many cases, they may be dependent on the death of the life insured, so they generally need to be in place over an extended period of time.

(e) Changes in credited insurance policy rates

As is the case with any investment strategy, changes in the underlying credited rates of return within the insurance policy can affect the cash value growth and death benefit payable under that life insurance policy. Alternative illustrations showing different credited policy rates will help educate the business owners on the sensitivity of the policy to various changes in credited rates.

(f) Avoiding a future transfer of the policy

Corporate ownership of a life insurance policy can be problematic where the shareholder is planning to sell their shares in the corporation and wishes to retain control of the insurance policy. The transfer of a life insurance policy from the corporation to a shareholder will be a disposition for tax purposes and may result in a taxable policy gain. As well, if the shareholder does not pay fair market value for the policy, this could result in a shareholder benefit equal to the amount by which the value of the policy exceeds the amount paid by the shareholder. Again, this situation can be avoided by having the life insurance policy owned by a holding company that will remain unsold rather than by the operating company.

(g) Probate planning

Several provinces impose probate fees based on the percentage value of the deceased's estate.[33] Typically, the value of shares held in a private corporation will increase the value of the estate, and therefore, result in higher probate fees.[34] Thus, to the extent that a corporation owns life insurance with a cash surrender value, this could result in higher probate fees.

However, where permissible (for example, in British Columbia and Ontario), it may be possible to use a secondary will that governs the distribution of shares in a private corporation on the death of a shareholder. A secondary will is not required to be probated. Therefore, the entire value of the shares held by the deceased (including the value arising from the cash surrender value of corporate-owned insurance policies) will not be subject to probate taxes.

Summary

This marketing guide has been designed to outline the benefits and other considerations in implementing a corporate value maximizer concept for shareholders of private corporations. However, the client should seek the assistance of legal and tax professionals before implementing any strategy.

[1] Subsection 70(5) of the Income Tax Act (the "Act") deems a deceased taxpayer to have disposed of all capital property immediately before death at its fair market value (FMV). As well, subsections 146(8.8) and 146.3(6) deem the annuitant under an RRSP or RRIF to have received the FMV of the property in those plans upon death. Note that there are exceptions to these deeming rules, in particular where the deceased's spouse is a beneficiary of the deceased's estate or is designated as beneficiary under the deceased's RRSP or RRIF.

[2] There is a specific exemption in paragraph 12.2(1)(a) of the Act.

[3] For example, a partial surrender of the policy or the taking of a policy loan could trigger tax reporting on gains in the policy.

[4] Paragraph (j) of the definition of "disposition" in subsection 148(9) of the Act.

[5] Defined in paragraph 89(1) of the Act.

[6] Subsection 83(2) of the Act.

[7] Paragraph (f) of the definition of disposition in subsection 148(9) of the Act.

[8] Paragraph 20(1)(c) of the Act.

[9] Paragraph 20(1)(e.2) of the Act.

[10] For example, if the borrower is the shareholder, and the loan is secured by a policy owned by the corporation, the collateral insurance deduction will not be available.

[11] The term "restricted financial institution" is defined in subsection 248(1) of the Act.

[12] The lender must require the insurance be assigned as collateral as a term of the borrowing. See Norton v. The Queen, 2010 TCC 62.

[13] Subsection 125 of the Income Tax Act. The federal tax rate is generally reduced 9% and the provinces also provide reduced tax rates on active business income up to provincial limits.

[14] For example, if a sole proprietor living in Ontario earned $200,000 of active business income, the average rate of tax on this income would be approximately 35% and the marginal tax rate on additional income would be over 50%. However, the same level of income earned within a corporation would be taxed at a rate of approximately 12%. But if the corporate income is distributed to a shareholder, the amount of taxes payable by the corporation and the shareholder would be approximately the same as what would be paid if the income was earned directly through a sole proprietorship.

[15] It is important to recognize that the corporate retained earnings plus the after-tax return on those earnings will be subject to another layer of personal tax when distributed to the shareholder, so the overall tax benefit would be much lower.

[16] Paragraph 125(5.1)(b) of the Act.

[17] See the definition of "adjusted aggregate investment income" in subsection 125(7) of the Act and the definition of "aggregate investment income" in subsection 129(4) of the Act.

[18] Section 120.4 of the Act.

[19] Split income can include taxable dividends received from private corporations, income arising from the shareholder benefit rules under subsection 15(1) of the Act and taxable capital gains arising from the disposition of shares in a private corporation.

[20] Subsection 70(5) of the Act.

[21] Subsection 70(5.3) of the Act. This rule can also apply where the policy is a multi-life policy and the other life insured does not deal at arm's length with the shareholder. See CRA technical interpretations 2005-0138111C6 and 2005-0138361C6.

[22] Subsection 15(1) of the Act.

[23] CRA Technical Interpretation 2004-008190 dated June 23, 2004.

[24] Section 110.6 of the Act. The lifetime exemption limit is indexed and for 2020 is equal to approximately $880,000. However, the limit is increased to $1 million where the disposition involves qualified farming and fishing property.

[25] Defined in subsection 110.6(1) of the Act. Also see the definition of "small business corporation" in subsection 248(1) of the Act.

[26] This is understood to mean 90% or more of the assets.

[27] Canadian Tax Foundation 1988 Roundtable, Q. 32.

[28] Paragraph 110.6(15)(a) of the Act.

[29] Subparagraph 110.6(15)(a)(ii) of the Act.

[30] Definition of "cash surrender value" in subsection 148(9) of the Act.

[31] CRA technical interpretations 930100 and 9310105 (CALU 1993 CRA Roundtable Q.12).

[32] Subparagraph 110.6(15)(a)(ii) of the Act.

[33] For example, BC, Ontario and Nova Scotia impose probate taxes in the range of 1.5% of an estate's value

[34] Referred to as the estate administration tax in Ontario.

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