2018 Issue No. 4
July 2018

EY Wealth Insights — Canada

Corporate-owned life insurance: an overview

Corporate-owned life insurance (COLI) is generally used by a corporation to provide protection in the event of the death of key shareholders or employees. There are many reasons why a corporation may consider the purchase of COLI. Among the more common motivations are:

- To provide key-person protection in the event of the death of a shareholder or key employee — proceeds from the policy provide funding to avoid business disruption
- To provide liquidity for the buyout of a shareholder's interest in the corporation in the event of his or her death
- To provide collateral or guarantee repayment of corporate borrowing

Regardless of the business reason for acquiring COLI, there are significant tax issues to consider. This article explores some key questions to keep in mind when acquiring COLI.

How is the death benefit treated for tax purposes?

Life insurance proceeds received by a corporation from a COLI policy on the death of an insured person are generally not subject to tax. Although the corporation may have to include in income amounts in respect of the disposition of an insurance policy, death benefit payments under an exempt life insurance policy are not subject to this requirement. An exempt policy is one in which the savings component is not in excess of limits imposed under tax law. Most life insurance policies sold in Canada are exempt policies and so death benefits received under a COLI are usually tax-free.

What is the capital dividend account and how does it affect the payout of life insurance proceeds received on the death of the life insured?

The capital dividend account (CDA) is a notional tracking account for non-taxable amounts that can be paid or distributed from the corporation as tax-free capital dividends. Death benefit proceeds in excess of the policy's adjusted cost basis (ACB) increase the CDA.

In addition, any death benefit proceeds that are assigned to secure a collateral loan are constructively received by the corporation when the lender applies the death benefit proceeds to reduce the corporation's indebtedness.

EY Wealth Insights is a newsletter that covers tax strategies and related topics for preserving wealth. For more information, please contact your EY advisor or EY Law advisor.

A capital dividend must be declared by way of a shareholders' resolution. Care should be taken to ensure that the CDA account balance is sufficient to allow for the dividend.

Generally, amounts that would be received tax-free if received directly by an individual may be included in the CDA of a corporation in order to preserve the tax-free nature of these amounts on distribution to shareholders. If the CDA has a positive balance, a capital dividend may be paid.

The most common amounts to be included in a corporation's CDA are:

- The tax-free portion of capital gains realized by the corporation to the extent they exceed the non-deductible portion of the corporation's capital losses
- Capital dividends from another corporation
- Death benefit proceeds from the life insurance policy

In addition, retroactive changes will affect the CDA benefit on death for non-arm's-length transactions after 1999 and before 21 March 2016.

Tax tip

Maintain an up-to-date calculation of the corporation's CDA balance in order to determine whether tax-free distributions from the corporation may be made. The CDA is a notional account that tracks certain amounts that would otherwise be received tax-free (less certain amounts that would not be deductible) if received personally, and allows them to retain their tax-free nature on distribution.

Will the premiums paid be deductible?

Generally, premiums paid under a life insurance policy will be considered to be on account of capital and so will not be deductible. However, a corporation may be able to claim a limited deduction for life insurance premiums in circumstances where an interest in a policy has been assigned as collateral for a loan. For the premiums to be deductible, the following conditions must be satisfied:

- The policy must be assigned to a "restricted financial institution," which includes banks, trust companies, insurance companies and non-corporate lenders such as credit unions.
- The policy assignment must be required by the lending institution as collateral for the borrowing.
- The interest in respect of the borrowing must be otherwise deductible.

It is important to note that the policy assignment must be required by the lending institution and not simply accepted as a source of collateral. Care should be taken in drafting the loan agreements and related documents to ensure this condition is satisfied. If the above criteria are met, a deduction will be available in respect of the life insurance policy equal to the least of:

- The premiums payable under the policy for the year
- The net cost of pure insurance (NCPI) in respect of the year as determined in accordance with the prescribed rules
- The lesser of the above amounts that can reasonably be considered to relate to the amount owing from time to time during the year

With respect to the above, the NCPI represents a notional cost of insurance based on prescribed assumptions and mortality rates as provided in Canadian income tax regulations. This amount may be substantially different from the actual premiums payable under the policy.

In determining the amount that can reasonably relate to the amount owing, consideration should be given to the actual amount of the indebtedness and any changes to that amount during the year. If the life insurance coverage under the assigned policy is $500,000, and the average balance owing under the loan during the taxation year is $200,000, the amount deductible would likely be limited to 40% of the lesser of the premiums payable and the NCPI for the policy in respect of the year.

Does the type of life insurance policy affect premium deductibility?

There are two basic types of life insurance policies: term policies and whole life policies. A term policy provides insurance protection for a specified period and typically has no investment component. Whole life (also known as "permanent") policies may take several forms and usually have an investment component in addition to the life insurance component. Whole life policies include:

- Participating life insurance policies where the policyholder may receive a share of the profits in the form of policy dividends
- Universal life (or UL) where the policyholder selects the investments underlying the savings component of the policy
- Other whole life policies with or without guaranteed cash values

In theory, whether the corporation purchases term insurance or whole life insurance (including participating insurance and universal life insurance), the rules regarding deductibility of the premiums remain the same. However, there may be advantages to using participating life insurance policies rather than universal life policies where a corporation wishes to deduct the premiums. Since one of the limitations on deducting premiums is the amount of premiums "payable" under the policy for the year, there may be situations where there is no premium payable under a universal life policy. In particular, the Canada Revenue Agency (CRA) has indicated that the cost of insurance charges funded by way of monthly deductions from the account value of a universal life policy would not be deductible.[1] This could result in no deduction being available in a given year in respect of a universal life insurance policy assigned as collateral to secure a loan.

Tax tip

Speak with your tax or insurance advisor to determine whether all or a portion of the premiums paid for your COLI policy can be deducted, or whether it is possible to structure future borrowings to make the premiums deductible.

Who should be the beneficiary of COLI?

Many business owners have both an operating company and a holding company. While there may be a desire to hold COLI in the operating company, consideration should be given to owning the insurance in the holding company if possible. This allows the holding company to retain the policy in the event of the future sale of the operating company and may protect the policy from creditors in the event of the company's bankruptcy.

Further, where an operating company holds a COLI (and pays the premiums) and a holding company is the beneficiary of the policy, the holding company may be treated as having received a shareholder benefit for tax purposes. This means that the holding company would have to include the amount of the benefit in computing its taxable income for the year.[2]

The CRA is generally not concerned about situations where the money flows downward from parent to subsidiary unless there is an attempt to confer a benefit in order to reduce taxable income.

Can a policy previously acquired be transferred to a corporation by a shareholder?

An individual shareholder may already hold a life insurance policy that he or she wants to transfer to the corporation to use, for example, as key-person insurance. It is possible for the shareholder to make such a transfer, and until relatively recently, there could be certain benefits in doing this.

Prior to 22 March 2016, the tax rules permitted transactions where a non-arm's-length shareholder sold a policy to a corporation for fair market value (FMV). This non-arm's-length transaction was deemed to occur at the policy's cash surrender value (CSV),[3] with no other tax consequences to the shareholder. The CSV is the amount of cash the insurer would pay if the policyholder were to surrender or cash in the policy at a point in time. If the FMV significantly exceeded the CSV, the shareholder received a

[1] CRA document 9901875.
[2] CRA document 2009-0347291C6.
[3] Subsections 148(7) and (9) of the *Income Tax Act*.

tax-free payment from the corporation. The corporation's ACB after a purchase of a policy from a non-arm's-length shareholder was deemed to be the amount of the CSV, not the FMV. This also meant that when the insured individual died, a higher amount could be credited to the CDA (and hence distributed as a tax-free capital dividend) than if the ACB was set at the FMV.

This planning opportunity was eliminated for transactions occurring after 21 March 2016. Under the current rules, when a shareholder of a corporation sells a life insurance policy to the corporation for FMV, the deemed proceeds of disposition are the greatest of the CSV, the policy ACB, and the actual FMV of the consideration paid by the corporation to the shareholder. The corporation is deemed to acquire the policy at that same amount. This means that it is no longer possible to remove excess value from the corporation through the sale of a life insurance policy by a shareholder.

Learn more

To learn more on this topic, refer to the March 2017 issue of *Wealth Insights*. For more information on this and any other topics that may be of concern, please contact your EY or EY Law advisor or one of the following professionals:

Russ Lavoie
+1 416 943 2295
russ.lavoie@ca.ey.com

Reya Ali-Dabydeen
+1 416 943 2220
reya.ali-dabydeen@ca.ey.com

Nancy Avoine
+1 418 640 5129
nancy.avoine@ca.ey.com

Doris Foo
+1 416 943 2232
doris.foo@ca.ey.com

Mal Leighl
+1 416 943 3986
malkit.leighl@ca.ey.com

Matt MacInnis
+1 416 943 3991
matthew.macinnis@ca.ey.com

Benoît Millette
+1 514 879 3562
benoit.millette@ca.ey.com

Jillian Nicolson
+1 416 943 4474
jillian.nicolson@ca.ey.com

Mike Vantil
+1 604 891 8315
michael.p.vantil@ca.ey.com

Martin Wickins
+1 416 943 2598
martin.wickins@ca.ey.com

2573233