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Tax Topics

from Manulife's Tax & Estate Planning Group

Business Insurance Needs

Introduction
There are many situations where life insurance can provide for the needs of a business following an individual's death. This Tax Topic provides an overview of life insurance applications in the business context. Many of these applications are discussed in detail in other Tax Topics. When applicable, references to these more detailed discussions have been referenced in the text. The funding needs covered in this Tax Topic include the following:

- Key Person Insurance
- Business Loan Protection
- Buy-sell Funding
- Funding Capital Gains Tax on a Business at Death
- Executive Compensation
- Retirement Funding
- Wealth Creation

Key Person Insurance
Key person insurance protection involves the use of life insurance to create immediate working capital for a business to meet immediate cash needs and to find a replacement in the event of the death of a business owner or a key executive.

The business owner(s) and/or other key executives spend considerable time and effort in acquiring the knowledge, experience, judgment, reputation, relationships and skills that make them valuable to the business. The death of such an individual results in the loss of a key member of the management team and can have a severe financial impact. During the resulting disruption, lenders may curtail credit, creditors may press for immediate payment, debtors may delay making payments, employees and customers may lose confidence, and competitors may take advantage of the situation.

Large corporations are often in a much better position to prepare for key executive turnover by sheer size and numbers. Unfortunately, finding an immediate replacement with the same qualifications as a deceased owner or executive is seldom possible in small business situations. It is often necessary to look outside of the business to find a replacement, causing delays, disruption and reduced efficiency. The resulting effect on business profits may further weaken the financial stability of the business. In the absence of proper planning, the very survival of the business may thus be affected by the death of a business owner or a key executive.

A solution is for the business to purchase an insurance policy on the life of the business owner(s) and/or key executives. In the event of death, the life insurance proceeds provide the business with needed working capital to meet immediate cash needs and to provide a source of funds for finding, attracting, hiring, and training a replacement for the deceased executive or, in the case of the death of a business owner, to hire interim management.

Life insurance premiums paid by the business for key person insurance protection are not deductible for tax purposes. However, life insurance proceeds received as a consequence of death are tax-free. In the case of a private corporation that receives life insurance proceeds as a consequence of death, the excess of the proceeds over the adjusted cost basis of the policy credits (increases) the capital dividend account of the corporation. Under subsection 83(2) of the Income Tax Act, R.S.C. 1985, c. I (5th Supp.) (ITA), the corporation can elect to pay tax-free capital dividends to the shareholders of the corporation to the extent of any balance in the capital dividend account. (For a detailed discussion of these rules refer to the Tax Topic titled "Capital Dividend Account".)

Key person insurance protection provides many potential benefits to the business, the business owner and the owner's family. It helps to assure creditors and employees of the business that the business will continue notwithstanding the death of the key person. The life insurance proceeds provide immediate cash at the time of death to cover working capital needs of the business, and to find and train a suitable replacement for the deceased. The value of these benefits to the business in the event of the death of the owner-manager or other key executive will usually far exceed the cost of the life insurance.

Business Loan Protection

Business loan protection involves the use of life insurance to create immediate working capital for a business to repay business debts in the event of the death of a business owner or other key executives.

In many small business situations, adequate financing is difficult to obtain. Creditors will often require that business owner(s) personally guarantee a loan. The untimely death of a business owner or another key executive may cause creditors to demand immediate repayment of outstanding business debts. This may place an unbearable burden on the business and force the liquidation of key business assets at fire sale prices at a time when business results may already be severely impacted by the death. In addition, if the business owner has personally guaranteed the debts incurred by the business, the business owner or the owner's estate may be liable for any outstanding debts that the business cannot pay.

In the absence of proper planning, the survival of the business may thus be affected by the death of the business owner or another key executive.

A solution is to purchase an insurance policy on the life of the business owner(s) or other key executives. Proceeds from the life insurance policy received as a consequence of the death of the life insured are tax-free and may be used to pay down the outstanding business debts.

A creditor may require the purchase of collateral life insurance to protect the interests of the creditor, particularly in small business situations in which the death of a business owner may impair the value of business assets used to secure the debt. In other cases, the business owner(s) may simply have a desire to have business debts fully repaid in the event of death to minimize financial risks for the heirs and to permit the continuation of the business free of debt.

Generally, life insurance premiums paid for business loan protection are not deductible for tax purposes. However, in the case of a life insurance policy that has been collaterally assigned to a restricted financial institution, a portion of the premiums may be deductible. (For a full discussion of collateral life insurance and the requirements for deducting the life insurance premiums refer to the Tax Topic titled "Collateral Life Insurance").

As noted earlier, in the case of a private corporation the receipt of a death benefit under a life insurance policy will result in a credit to the corporation's capital dividend account. The credit to the capital dividend account is not affected by the fact that the insurance policy may have been collaterally assigned to a creditor. This is discussed further in the Tax Topic "Capital Dividend Account".

A life insurance policy purchased for business loan protection can improve the ability of a business to negotiate loans, and provide for the repayment of business debts in the event of the death of a business owner or another key executive using tax-free life insurance proceeds. It can also prevent the business owner(s) or their estate from becoming personally liable for the business debts in the event of a death.

Buy-sell Funding

A key component of an integrated financial plan is planning for business succession. The business interest often accounts for a substantial portion of the wealth the business owner has accumulated. Ensuring a plan is in place for the eventual transfer of the business interest will help the business owner realize full value for the business interest and will also help the business, and the remaining owners, survive the transition. This is particularly true in the event of premature death.

Changes in ownership may create financial obligations on the part of the remaining owners, and may also have income tax implications for the withdrawing owner and the remaining owners.

An integral part of the succession plan is to ensure financing is in place in the event of death to fund the purchase and sale of the business interest. The succession plan should also provide the business owner with sufficient liquidity to fund the related income taxes and, where possible, take advantage of any tax deferral or tax minimization strategies that may be available.

In the case of closely held corporations or partnerships, one of the most important tools for implementing the business succession plan is the shareholders' agreement or partnership agreement. Once the business succession plan is developed, an agreement can be drafted to reflect the needs and wishes of the various parties.

Life insurance is generally an efficient means of funding the obligation under a buy/sell agreement in the event of the death of a shareholder or partner. There are numerous ways to structure a buyout on death and life insurance funding plays an important role in ensuring the buyout occurs. In considering the various methods for structuring a buy/sell agreement, it should be kept in mind that there is no "right way" to proceed. Each method has its own 'pros' and 'cons' and must be considered in light of the circumstances of a given situation.

In the corporate context an important threshold consideration is whether to fund the buy/sell arrangement with 'corporate owned' or 'personally owned' life insurance. The cross purchase method is generally funded using personally owned insurance. The promissory note method, the share redemption method and the hybrid method are funded with corporate owned insurance. Each structure has differing advantages from a tax perspective and depending upon the facts one structure may be more favourable over another. A full discussion of buy/sell agreements and funding can be found in the Tax Topic "Buy/sell Agreements – An Overview of Funding with Life Insurance".

Funding Capital Gains Tax on a Business at Death

Life insurance can also be an effective way of funding the tax liability that arises as a result of a deemed disposition of capital property at death. Paragraph 70(5)(a) of the ITA provides that, unless a rollover is available, a deceased taxpayer is deemed to have disposed of each capital property owned by him or her immediately before death for proceeds equal to the fair market value at that time. To the extent that the fair market value exceeds the deceased's adjusted cost base (ACB) of the property, a capital gain will be realized for tax purposes. The deceased may utilize any remaining

capital gains exemption if the property consists of "qualified small business corporation shares" or "qualified farm property" (both terms are defined in subsection 110.6(1) of the ITA). Any taxable capital gains that are not sheltered by the capital gains exemption or qualify for a rollover will be subject to tax in the deceased's terminal return. (For a detailed discussion of these provisions refer to the Tax Topic "Taxation of Capital Property Held at Death").

An individual who owns shares in a corporation, a partnership interest, or business assets (as in the case of a sole proprietorship) will be deemed to have disposed of these properties at death. As a result, a tax liability may arise in the form of capital gains and recaptured capital cost allowance. If funds or other assets are not available to pay the tax liability, the shares or partnership interest may have to be sold, or business assets may have to be liquidated, possibly for a price below the fair market value.

Life insurance may be purchased to provide the necessary funds at the right time to pay the tax liability resulting from the capital gains and recaptured depreciation triggered upon the death of the individual. Life insurance is a particularly valuable funding vehicle if the beneficiaries wish to retain the property or if the market conditions will not provide the estate with an amount equal to the fair market value of the property. The individual could own the life insurance policy, or it may be owned by the corporation or partnership and flowed out to the individual's estate after death.

Executive Compensation

Another business use of life insurance is in situations where an employer is interested in providing an employee with a supplementary benefit package. Supplementary benefit packages are often used by employers as a means of attracting executives. These packages offer a wide assortment of benefits that may include life insurance protection. The life insurance protection ensures that upon death the dependants of the executive receive an inflow of capital that can be used to cover funeral expenses, education costs, reduce debt, and provide a future stream of income.

The policy may be purchased by the business/employer, or may be owned and funded jointly by the employer and the executive. The executive's dependants would be named as the beneficiary of all or a portion of the policy. The portion of the life insurance premium paid by the employer related to the executive's interest in the policy must be reported as a taxable benefit to the executive on the employee's Statement of Remuneration Paid (T4 Supplementary Slip). It is important that the amount reported on the T4 slip represents a reasonable cost for the benefit received.

Retirement Funding

It is common practice for public corporations and large private corporations to provide retirement benefits to their employees through some form of pension arrangement. However, an executive's pension may be limited under statutory plans such as registered pension plans. In these circumstances, it is common for the employer to provide executives with some form of "supplementary executive retirement plan" (SERP) to provide executives with the pension income they would receive if there were no statutory limits.

A SERP is essentially a promise by the employer to provide supplementary retirement benefits designed to bridge the gap between the retirement benefits provided under statutory plans and the desired retirement benefit based on the executive's final average earnings.

A SERP may be funded or un-funded. An un-funded SERP is essentially an unsecured promise of future benefits and has no immediate tax consequences. A funded SERP is one where the employer formally sets aside assets (typically in a trust) which will be used to fund the promise to the employee. One option is to use life insurance to fund the SERP. A funded SERP (whether or not funded with life insurance) will generally be taxed as a "retirement compensation arrangement" (RCA).

There are complex rules relating to the taxation of RCA's. The following is a very brief overview. In general, contributions made by the employer to an RCA are deductible by the employer in the year the contributions are made and no taxable benefit accrues to the employee. An RCA is subject to a 50% refundable tax on all contributions received by the RCA and on all income earned by the RCA. The refundable tax accumulates (without interest) until distributions are made from the RCA. Tax is refunded to the RCA on the basis of $1 for every $2 of benefits paid to a plan beneficiary. Payments out of an RCA are fully taxable to the employee at the time they are received. (For a more detailed discussion of RCA's refer to the Tax Topic "Retirement Compensation Arrangements".)

When an RCA is funded with a life insurance policy, the policy is subject to the same taxation rules as if the policy was outside of an RCA. The funds accumulating in an exempt life insurance policy are not subject to the refundable tax. Therefore, the funds are allowed to grow tax-sheltered. Any policy gain on a full or partial disposition of the life insurance policy will be subject to the 50% refundable tax. Death benefits are received tax-free by the RCA, but subsequent distributions to the plan beneficiary would be taxable in their hands. The employer may be a plan beneficiary, often for any residual amounts remaining after plan obligations to employees are fully satisfied. Where death benefits received by the RCA are paid to the employer corporation, it would not be entitled to an increase in its capital dividend account.

At retirement a number of choices are available to the RCA trust to fund the executive's supplemental pension. Provided the RCA trust document provides the trustee with the power to do so, the trustee may (1) withdraw funds from the policy, (2) collaterally assign the cash value to the bank and borrow against the cash value of the policy, or (3) pledge the cash value as security for loans taken by the corporation which in turn makes the pension payments to the executive. The choice of alternative will depend on the facts of the particular situation.

In summary, an over-funded life insurance policy can be an attractive method of funding a SERP (in the form of an RCA) due to the ability to shelter the growth in the policy from refundable tax.

Wealth Creation

Often the retained profits or surplus cash of a business, whether an operating company or an investment holding company, are invested in GIC's, or taxable investments, and are not paid out to the shareholder. However, these taxable investments may not be the most advantageous way for the corporation to invest its' retained profits. Instead profits could be deposited into an exempt life insurance policy that is required to provide key-person insurance, business loan protection, or some other business insurance need.

A permanent life insurance policy that qualifies as an "exempt policy", allows for tax-deferred growth of the cash value of the policy and tax-free receipt of the proceeds at death. The cash value growth within an exempt policy is not subject to annual accrual taxation and is only subject to tax if there is a disposition (deemed or otherwise) of the policy. Significant cash value can accumulate on a tax-deferred basis if the maximum deposits permitted by the ITA are deposited into the exempt policy. The deposits can be designed so that they remain tax-sheltered within the contract and pay for the cost of insurance and expenses in future years.

This may be an attractive alternative to taxable investments for a corporation which has excess cash reserves not set aside for a specific purpose. It is ideal for a private corporation or its owner who:

- Desires a higher immediate estate value,
- Has annual income retained but not earmarked for any particular use,
- Desires a tax deferred investment, and
- Desires a tax-free death benefit.

For a detailed discussion of this planning opportunity refer to the Tax Topic "Accumulating and Transferring Wealth Through the Use of Life Insurance - Corporate Ownership".

If the corporation or shareholder desires access to the cash at some future date prior to death, the cash surrender value of the policy can be accessed through policy withdrawals or a collateral loan secured against the insurance policy. Policy withdrawals may trigger some income tax at the time of withdrawal (for details refer to the Tax Topic "Dispositions of Life Insurance Policies".) Advances to the corporation received as a collateral loan will be tax free, and if the proceeds are used for the purpose of earning income from a business or property, and the other requirements of 20(1)(c) of the ITA are met, the interest expense may be deductible for tax purposes. (A further discussion of leveraged life insurance in the corporate context can be found in the Tax Topic "Leveraged Life Insurance – Corporate Ownership").

Split Dollar Life Insurance

There are many situations in which an insurance policy is needed by one party to provide protection in the event of death of an individual and another party has a need or desire for a tax-sheltered investment vehicle. In these cases one policy can provide for the needs of both parties by using an arrangement commonly referred to as "split dollar life insurance". In these arrangements typically one party owns and pays for a level death benefit portion of the policy, and the other party owns and funds the remaining interests in the policy (generally the cash value).

In the business context a split dollar arrangement has numerous applications. For example, an employer may have a need for key person insurance on an executive and the executive might have a desire for tax-sheltered investment. The employer and the executive could enter into a split dollar arrangement where the employer pays for and owns a level death benefit on the life of the executive and the executive pays for and owns the cash surrender value component of the policy. The beneficiary of the level death benefit is the employer, and the beneficiary of the cash value is designated by the executive (his spouse for example).

The following table provides other examples of split dollar arrangements applicable to business situations:

Death benefit need	Tax-sheltered investment need
Buy-sell funding (corporation/partnership)	Shareholder or partner investment vehicle
Business loan protection (corporation/partnership)	Shareholder or partner investment vehicle
Business loan protection (operating company)	Wealth creation (holding company)
Employee life insurance protection (employee)	Wealth creation (corporation)
Key person protection (employer)	RCA funding (RCA trust)

Split dollar life insurance is discussed in detail in the Tax Topics "Split Dollar Life Insurance" which analyzes the mechanics and technical details, and "Split Dollar Life Insurance – Applications" which explores in more detail situations where split dollar life insurance can be used as a creative alternative to solve complex problems.

Conclusion

There are many instances where insurance meets a need in the business context. Life insurance can play a vital role in the planning process to ensure funds reach the hands of intended parties to complete a business transaction, provide risk protection, or to fulfill another funding need.

Last updated: October 2013

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