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Corporate-Owned Life Insurance & Estate Liabilities

Life insurance has long been used by business owners to cover a range of estate liabilities.

The use of life insurance provides flexibility and most importantly, stability in what otherwise is typically a difficult time.

It is commonplace for life insurance to be held personally but under certain circumstances, corporate-owned insurance can be used to solve the same concerns.

This post will look at a couple of strategies that can be implemented within your small business corporation to address capital gains tax, probate fees and other estate costs on the passing of a shareholder.

Post Highlights:

1. Capital dividend planning
2. Pipeline planning
3. Capital loss planning

<u>Capital Dividend Planning</u>

We will consider the example of a husband and wife owned business. Each individual owns 50% of the shares in the business and each has fully used their capital gains exemption.

The shares have a nominal ACB and currently have a fair market value of $3 million.

The shareholders each intend to leave their shares to the other upon passing, resulting in a deferral of tax until the 2nd individual passes away.

For simplicity sake, we will assume that the capital gains inclusion remains at 50% and that a personal tax rate of 50% will apply. This would result in a tax liability of $750,000.

In order to plan for future growth, the shareholders should inquire with an underwriter to take out a joint second-to-die policy with coverage in excess of the tax liability.

The corporation would be the owner and beneficiary of the policy.

On the second death, insurance proceeds would be received tax-free. The proceeds less the ACB of the policy would result in a credit to the corporation's CDA account.

The corporation would be able to pay a tax-free capital dividend to the estate. The funds could then be used to pay estate liabilities.

The shareholders need to identify the corporate-owned policy within their individual Wills and provide instructions for the use of the funds. This would be specifically important if the shares were gifted to the children.

Pipeline Planning

The use of pipeline planning is geared for high net worth individuals with holding companies that retain significant assets.

In this situation, tax will be realized upon the deemed disposition of Holdco shares on death.

What may not be clearly evident however is the potential for additional taxes in the future given this business structure.

Payment of dividends or redemption of shares could result in tax payable in the future. Additionally, the Holdco could be responsible for tax on the disposal of assets in order to fund the above payments.

Pipelines, thru post-mortem planning, aim to eliminate or minimize these additional layers of tax.

Case study info:

- Taxpayer owns shares in a Holdco with a FMV of $6 million and an ACB of $2 million.
- Assets within the Holdco have the same characteristics for tax purposes.
- The taxpayer is not married and would report a deemed share disposition on death.

Planning without Insurance

Using a 50% tax rate, similar to the capital dividend example, the terminal return tax liability on the deemed share disposition would be approximately $1 million.

The estate would acquire Holdco shares with an ACB of $6 million. In order to distribute Holdco assets, capital gains tax would be triggered in the Holdco and could result in additional tax within the estate as well.

Steps to avoid additional tax as noted above:

- Estate incorporates a new company "Newco".
- The estate transfers Holdco shares to Newco for their FMV of $6 million.
- Consideration would be a promissory note issued to the estate by Newco.
- This would be classified as a shareholder loan in Newco's books.
- No capital gain or loss would be realized on transfer.
- Newco owns 100% of Holdco and the companies could amalgamate as "Amalco".
- Amalco now owns all investments originally in Holdco.
- Amalco also assumes Newco's promissory note.
- The *Income Tax Act* allows for the ACB of the investments to be "bumped".
- The bump, if specific conditions are met, results in no tax consequences.
- Amalco can then distribute funds to the estate without additional tax.
- Distributions would be treated as payments against the note owed to the estate.

Planning with Insurance

The above steps outline the benefits of pipeline planning to avoid additional layers of tax within an estate.

If Holdco is the owner and beneficiary of a $1 million policy on the life of the sole shareholder, additional benefits can be realized.

Insurance proceeds would be received tax-free by Holdco and would result in a CDA balance equal to the proceeds less the ACB of the policy.

As noted above, when Holdco and Newco amalgamate, the insurance proceeds and CDA credit would transfer into Amalco.

Amalco could then use the insurance proceeds to reduce the amount owing to the estate. These funds would be used to pay the deceased's tax bill.

The major advantage of this strategy is that the assets within Amalco do not need to be liquidated in order to repay amounts due to the estate.

Additionally, the CDA credit can then be used in future to extract tax-free funds from Amalco to the new shareholders of Amalco.

Capital Loss Planning

Another post-mortem tax planning option available to reduce a deceased's tax liability is capital loss planning.

While pipeline planning aims to preserve capital gains rates, capital loss planning aims to eliminate capital gains for dividend rates.

This strategy has become less useful in recent years as the discrepancy between capital gains tax rates and dividend rates continues to increase.

Capital loss planning should however be considered when the corporation has substantial balances in its CDA or RDTOH (refundable tax) notional accounts.

Conclusion

Estate planning is complex. Without the proper planning in place, your estate may be subject to multiple layers of tax.

Everyone has their own unique circumstances that warrants the need for unique estate planning discussions.

Planning needs to address not only potential tax consequences but asset distribution, beneficiary concerns and overall administration.

The above strategies are not applicable for everyone. A cost benefit analysis needs to be conducted to ensure you are receive correct value for fees paid to implement the estate plan.

Regardless of the plan that you ultimately choose to implement, it may be beneficial to look into life insurance options to preserve cash flow and care for your beneficiaries.

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