A tax reduction strategy for business owners

Business owners often have a significant portion of their savings held within their corporations. Corporate-owned life insurance can help mitigate or eliminate three tax issues that may arise in this situation.

First, income from corporate investments is taxed at the highest corporate tax rate. Second, on the business owner's death, corporate investments transferred from the corporation are typically received on a taxable basis. Third, passive income earned in the corporation may increase the corporate tax rate on active business income. Corporate-owned life insurance can help mitigate or eliminate these three tax issues.

Planning for high corporate tax rates on investment income

Business owners often accumulate wealth within a holding company because they don't need all their business's profits to fund their lifestyle. This achieves a significant tax deferral since these funds are left at the corporate level and not paid out to the business owner as a taxable distribution (dividend or salary). These corporate funds are often used to purchase investments that generate income that's taxed at the highest corporate rate, which ranges between 50.2 and 54.7% depending on the province or territory.

In contrast, the growth in policy values within a life insurance policy is tax-advantaged, meaning it isn't typically subject to taxation.[i] As a result, the policy's growth isn't slowed down by taxes. Over time, the tax erosion on a corporation's passive investments can become a significant cost of earning investment income corporately.

For example, suppose Stephen is 50 years old, a non-smoker and a standard risk life insured. His corporation purchases a Canada Life participating whole life insurance policy on his life with a $25,000 annual premium paid over 20 years.[ii] The

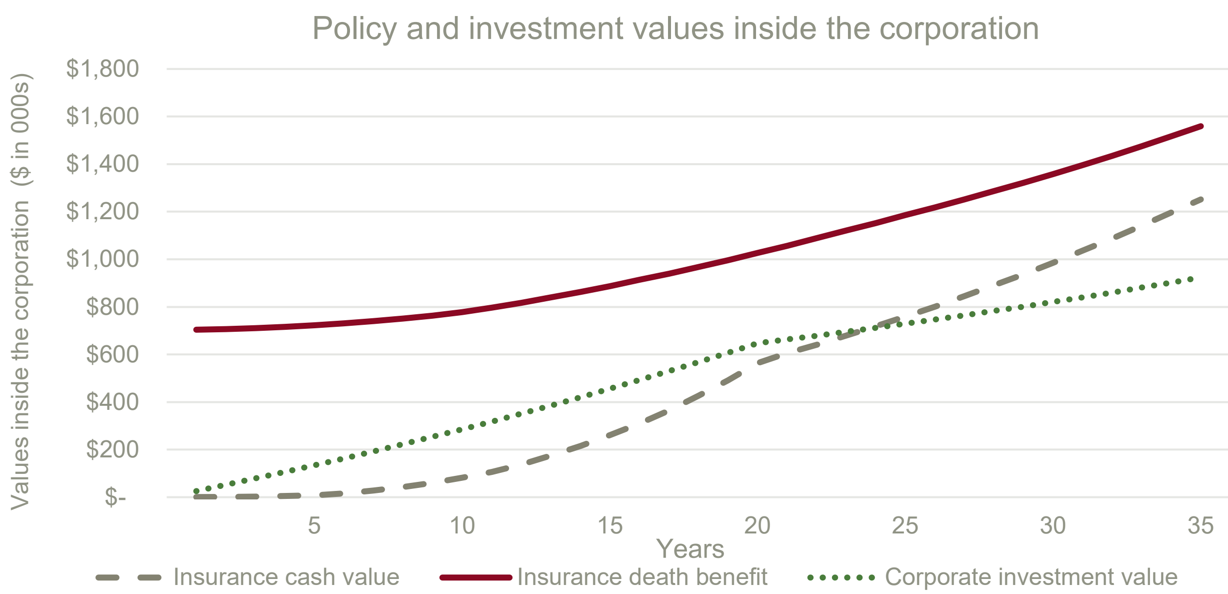


table below compares the year-over-year values from the insurance to those of a corporate investment where the same premium dollars are invested in a corporate-owned guaranteed investment certificate earning interest at 5%. The corporation's tax rate on passive income is 52% and Stephen's personal tax rate on non-eligible dividends is 45%. Over the long term, both the policy's cash value and death benefit may outpace the corporate investment, which is partly attributable to its tax-advantaged growth.

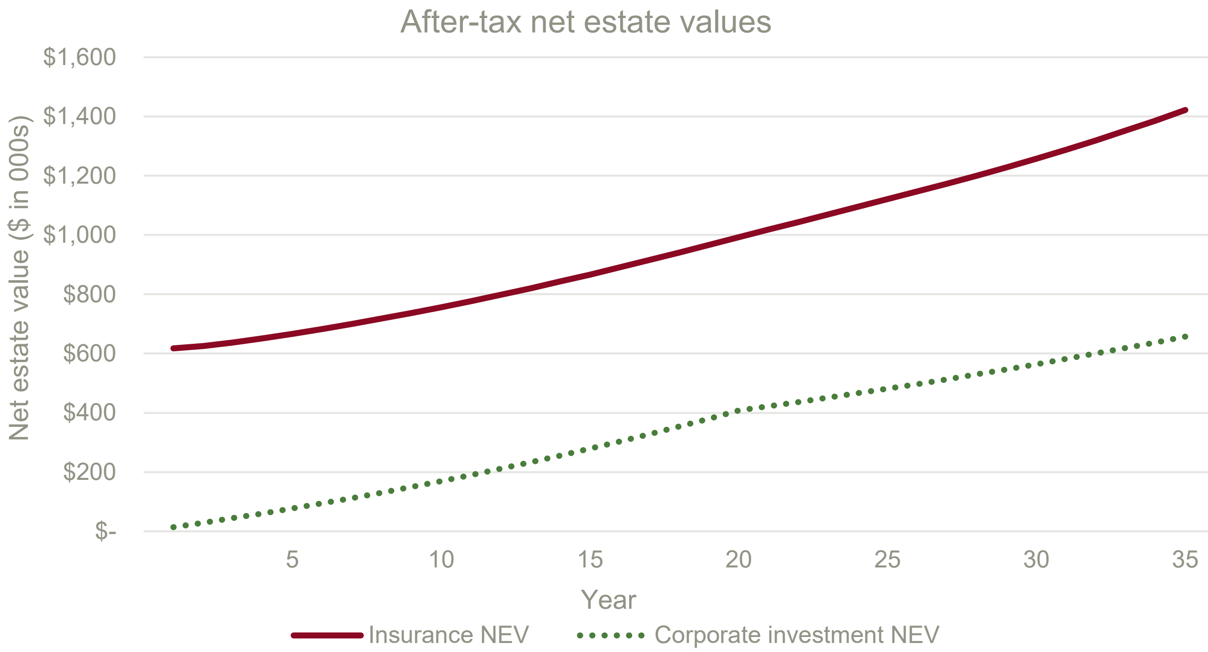
Planning for tax erosion on assets distributed to your estate or heirs

When you die you'll likely transfer the shares of your corporation to either your estate or a family member(s). If you plan to have your corporation distribute its assets to your estate or your heirs after you die, there will likely be a tax cost. This can significantly decrease your net estate value (the after-tax value of your estate). Corporate-owned life insurance is a planning solution for eliminating or significantly reducing this tax cost of transferring corporate wealth.

In many cases, the net estate value derived from a corporate-owned life insurance policy is much higher than that derived from lower risk corporate investments. This is the result of the tax-advantaged growth of policy values described above, but also from the corporation's capital dividend account (CDA) credit that's generated from receiving life insurance proceeds as beneficiary.

The CDA credit allows the life insurance proceeds to be paid as a tax-free capital dividend to Canadian resident shareholder(s). Generally, an amount equal to the life insurance proceeds received by a private corporation less the policy's adjusted cost basis (ACB) may be added to its CDA. The ACB of a life insurance policy is generally the sum of the cumulative premiums paid, less the net cost of pure insurance (NCPI). NCPI is an assumed mortality cost in the *Income Tax Act* (Canada) and, over time, it may reduce the ACB of the policy to nil. At that time, the CDA credit would equal the full amount of the life insurance proceeds.

If the corporation has a CDA balance, it can pay a tax-free capital dividend to its Canadian resident shareholder(s). Depending on the deceased owner's estate plan, the shareholder(s) could include the estate, spouse or heir(s). Using Stephen's policy information from above, the chart below compares the year-over-year net estate values from the insurance to the corporate investment. Corporate-owned life insurance often produces significantly higher net estate values compared to a lower risk corporate investment.



Planning for tax erosion on business income from excessive corporate passive income

The 2018 federal budget introduced a rule that reduces a corporation's access to the small business deduction (SBD) when it and associated corporations together earn more than $50,000 of passive income, which generally includes interest, dividends and taxable capital gains from the sale of investments. The SBD enables a Canadian-controlled private corporation to earn up to $500,000 of active business income (ABI) at tax rates as low as 12 per cent, depending on the province or territory. To date, Ontario and New Brunswick haven't followed this federal measure by changing their provincial corporate tax laws.

Policy value growth in a life insurance policy is tax-advantaged, meaning it doesn't produce income. As a result, a strategy for limiting the amount of passive income earned in a corporation, and therefore the grind on the SBD, is purchasing a permanent life insurance policy. This strategy involves repositioning corporate dollars that are otherwise intended for income earning investments, into a life insurance policy.

Continuing from the examples above, say Stephen's corporation earns $500,000 of ABI per year, saves $100,000 annually for investment and will continue to do so for 15 years. The corporation also has $2,000,000 of investment assets, half of which are fixed income with a 4% growth rate and the other half are equities with a 6% growth rate from realized capital gains. The corporation currently has more than $50,000 of passive income and, as a result, a portion of its ABI is taxed at the higher general rate of 26% instead of the small business rate of 12%.

Stephen has a life insurance need and his advisor shows him two scenarios using life insurance with different premium amounts to demonstrate how they may affect the taxation of his corporation's ABI. One scenario shows his corporation repositioning $150,000 of assets into a permanent life insurance policy for 15 years and the other scenario shows $100,000 of assets repositioned into a life insurance policy over the same period. The life insurance gives Stephen financial protection and shows him how repositioning investment assets into a policy also reduces the effect of the SBD grind that his corporation otherwise would have experienced. The chart below shows the added tax Stephen's corporation is paying on its ABI annually as a result of the SBD grind. The example shows how moving assets into a tax-advantaged life insurance policy can reduce the amount of a corporation's passive income to varying degrees and, therefore, mitigate the effect of the SBD grind.

The cumulative tax *cost* on the corporation's ABI of doing nothing is $602,204 and the cumulative tax *savings* on ABI of repositioning $2.25 million of assets into a life insurance policy is $479,897 and $319,831 when repositioning $1.5 million of assets.

Conclusion

Corporate-owned life insurance can help business owners reduce their tax costs on passive corporate income, the transfer of wealth after their death and, potentially, mitigate the increased tax costs passive income can create for the corporation's active business income.

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[i] Depending on the policy's ACB, a partial surrender/cash withdrawal or policy loan may result in a policy gain, which is treated as passive income of the corporation.

[ii] Canada Life's Estate Achiever Max 20, $702,053 basic coverage, paid-up additions, 2018 dividend scale.