Important Considerations for Life Insurance Policy Ownership

The ownership of a life insurance policy is an important consideration. The choice of owner has both short-term and long-term tax, legal, and estate implications. Too often, a single factor like after-tax cost of premiums drives the decision without investigating all the other issues that may have far greater impact on the ultimate outcome of the insurance purchase and its intended purpose. This article will explore the many issues you may want to consider before making this important decision.

Purpose of the insurance

The purpose for the insurance is the first consideration in the ownership discussion. Is the insurance required for a short-term protection need, either personal or corporate? With short-term needs there is often less risk associated with the ownership decision as unanticipated changes shortly after issue may be less likely and values may be less significant, yet it is still important to review all potential considerations. Often, the cheapest premium cost is the factor that drives the ownership decision. As the purpose for the insurance becomes more long-term in nature, such as providing a sources of future tax effective liquidity or estate succession, the ownership decision becomes more important.

Potential ownership options

Ownership options typically include an individual or their corporation. Trusts and partnerships may also be viable options in certain situations, but they are less frequently encountered. If the ultimate need for the death benefit is personal, using someone other than an individual to own the policy requires you to take into consideration how those funds will ultimately get to the right person. The potential impacts, both tax and future actions related to another owner, need to be considered.

Tax residence or citizenship

You always need to know the tax status of the potential owners before making the ownership decision. Foreign income, sales, or estate taxes may require special designs with respect to ownership to avoid adverse foreign tax implications. Whenever dealing with someone that has foreign citizenship or is a resident of a foreign country, a cross border tax specialist should be engaged to help work through the many complications that could arise.

Rights of other individuals in non-personal ownership structures

When dealing with corporations, trusts, or partnerships, there are often others who have rights associated with that entity's assets. Those other interests may control the entity and thereby control all the entity's assets, including entity-owned life insurance policies. If the death benefit is earmarked for a specific individual, the rights of those other parties need to be considered in the ownership decision. For example, if a corporation has multiple shareholders and the death benefit is to be earmarked for one shareholder, how do you avoid sharing the benefit with the other shareholders? Similar considerations need to be addressed in partnership situations or trusts with multiple beneficiaries. There are potential solutions for streaming benefits to a specific party, but they require additional planning and may entail additional tax risks.

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Corporate versus personal ownership considerations

Let us now look at some specific issues that should be considered when the choice is between personal and corporate policy ownership.

1. Premium funding

Life insurance premiums are generally not tax deductible, so they are paid with after tax dollars. Corporations may be subject to lower tax rates than individuals or trusts, so when a corporation is available, there is the temptation to use them as owners. Corporations are taxed at various tax rates depending on their tax status and the type of income they generate. Corporations taxed at the small business rate enjoy the greatest tax advantage whereas corporations that generate only passive type income would not see much tax advantage over personal ownership and premium funding. A corporation currently eligible for the small business tax rate may lose that status if the shareholder becomes non-resident in the future (consider those planning to retire abroad). Make sure you know the likely tax rate the corporation is subject to throughout the premium funding period to understand the magnitude of any benefit arising from funding the premium through the corporation.

2. Creditor protection

Creditor protection varies between common law and civil law jurisdictions (Quebec). The beneficiary is a key factor in determining creditor protection. An irrevocable beneficiary designation provides creditor protection regardless of who that beneficiary is. The other way to obtain creditor protection is based on the relationship of the beneficiary to either the life insured or policyowner, depending on which law governs. In common law jurisdictions, the relation between the life insured and the beneficiary is key. If that relationship falls within a prescribed class, the policy will be creditor protected. The prescribed class includes one's spouse, a child or grandchild, and one's parents. The prescribed class in Quebec is broader and is based on the relationship between the policyowner and the beneficiary. The Quebec prescribed class includes beneficiaries that are either spouse, ascendants, or descendants of the policyowner.

For corporate owned policies, naming someone other than the corporation as beneficiary has adverse tax consequences. Taxable benefits will likely arise for any premiums paid on such policies. Given the corporation does not fall into the prescribed class and designations outside of the corporation have adverse tax consequences, creditor protection is not likely available for a corporate owned policy. This may be an important consideration depending on the type of corporation and its potential exposure to creditors.

3. Future ownership transfers

There are certain tax-free rollovers available for policies owned by individuals pursuant to subsection 148(8) to 148(8.2) of the Income Tax Act. These include transfers to children or a spouse or common law partner. Specific conditions need to be satisfied for these rollovers to apply.[1] For corporate owned policies, no rollovers are available as insurance is not considered to be a capital property for tax purposes.[2] The transfer of corporate ownership will be treated as a disposition and taxes may arise.

If the client envisions a possible sale of the corporation in the future while the policy is an asset of the corporation, or if they believe they may wind-up the corporation and distribute assets personally some day, the tax costs associated with such a transfer should be considered. We have seen corporate owned structures involving professionals who want to wind-up their business after retirement, but the tax costs associated with the insurance policy have made that impractical. Personal ownership may have been a better option in those cases.

4. Tax free death benefits

Life insurance death benefits are generally received tax free by the beneficiary regardless of ownership structure.[3] Often in corporate owned scenarios, the death benefit is intended to be streamed to a shareholder. This secondary transaction may involve taxation for corporate owned policies that typically have the corporation as beneficiary to avoid other adverse tax consequences. For Canadian Controlled Private Corporations (CCPCs), the death benefit received less the policy ACB is credited to the Capital Dividend Account (CDA) and is potentially available for distribution to Canadian shareholders as a tax-free dividend (other transactions may create negative balances in the CDA before the death occurs limiting the amount of the death benefit that can be distributed tax-free). That means that if the full death benefit is to be distributed to a Canadian shareholder, an amount equal to the policy ACB may be taxable lowering the ultimate net death benefit received by the shareholder or their estate. In a worst case scenario where the insured passes shortly after issue, the ACB would be close to the premiums paid resulting in a tax cost upon distribution that may outweighs the tax saving from using cheaper after-tax corporate dollars to fund the policy (the ACB of a policy is often greatest during the premium funding period). No such reduction to the tax-free nature of the death benefit occurs for personally owned policies.

5. Valuation issues at death

Life insurance may impact the valuation of corporate shares upon the death of a shareholder for both income[4] and estate tax purposes. The Cash Surrender Value (CSV) immediately before death is included in the valuation of shares for income tax purposes while fair market value impacts valuation for estate tax purposes, where applicable.[5] Owning a high CSV type contract in a corporation could result in higher capital gain exposure for the deceased shareholder and potential higher estate taxes. Valuation is not an issue for personally owned insurance. The type of life insurance acquired may be a consideration in whether corporate or personal ownership is best.

6. Impact on Capital Gain Exemption

Holding permanent life insurance within a corporation may affect the shareholders ability to claim the Lifetime Capital Gains Exemption (LCGE). Qualification is conditional on several factors including that 90% or more of the assets at time of disposition are active business assets and that 50% or more were active business assets in the two prior years. The CSV of a life insurance policy is treated the same as marketable securities and other passive investments and as such, is not considered an active business asset. Where the shareholder is the life insured, the life insurance policy will generally be valued at its CSV for purposes of determining qualification for the LCGE. Since the LCGE applicable on the disposition of qualifying shares is $971,190 in 2023, the tax impact of whether shares qualify may have a material impact on taxes in the future. This could be a significant consideration in the ownership structure selected.

7. Beneficiary Designation

While personal ownership has no real limitations on beneficiary selection, corporate ownership dictates that the beneficiary of the policy should be the same corporation, or another downstream corporation, to avoid adverse tax impications.[6] If corporate funds are used to benefit anyone other than the corporation, shareholder benefit issue pursuant to subsection 15(1), or possibly the conferral of benefit rules in subsection 246(1), may come into play. On the other hand, designating the corporation as beneficiary eliminates any access to creditor protection. If someone other than the corporation, or a downstream subsidiary, is the target for the insurance death benefits, personal ownership should be considered or other planning such as life insurance shares may be appropriate.

8. Small Business Tax Rate (SBTR) Eligibility

Tax rules in effect for taxation years beginning after 2018 include an additional limitation on the ability to use the SBTR.[7] The small business limit will be reduced by $5 for every $1 of investment income above a $50,000 threshold. Under this formula, the SBTR will not be available when investment income reaches $150,000 in a given taxation year. Corporate owned insurance may help avoid some of the impact of these new rules as exempt life insurance held until death does not create passive income captured by these rules.

Conclusion

Determining the proper ownership structure for a life insurance policy is important to ensure the policy achieves its stated goal in the most effective manner. Taxation is an important factor, but not the only consideration. When reviewing the pros and cons of various ownership alternatives, be sure to consider both the immediate impacts as well as the longer-term impacts if the client's situation changes. Getting the ownership structure set up correctly at issue is important and less costly than having to change it in the future. It's time well worth investing!

[1] Contact your Business Development Manager for further guidance on this matter.

[2] Exceptions may exist for the wind-up of a wholly owned subsidiary and amalgamations.

[3] Exceptions to this general rule include certain multi-life policies or foreign beneficiary situations where estate, non-resident withholding, or other forms of tax may apply depending on the foreign jurisdiction.

[4] Subsection 70(5.3) of the Income Tax Act (ITA) provides that in the event of the death of a shareholder of a corporation, only the CSV of any insurance policy on the shareholder's life needs to be considered for purposes of determining the fair market value of the deceased's shares.

[5] Quebec has no probate (or estate administration tax) and the use of secondary Wills could keep share valuations out of the probate equation.

[6] Similar beneficiary designations implications apply to trusts. The trust should be the beneficiary of any life insurance policy owned by the trust to avoid conflicts with the trust terms and possible fudicary exposure for the trustee.

[7] Taxable capital between $10,000,000 and $50,000,000 will result in a proportional reduction to the SBTR eligibility. The greater of the taxable capital limitation and the passive investment income reduction will be applied to determine ultimate eligibility for the SBTR.

Continued

Life Insurance Policy Ownership Considerations

Appendix 1

The following table summarizes several issues you should consider before deciding on the ownership structure for a life insurance policy.

	Individual	Corporate	Trust
Premium funding	After personal tax dollars	After corporate tax dollars	After personal/trust tax dollars
Creditor protection	Possible	No	Possible, through trust
Future ownership transfer	Disposition	Disposition, S/H benefit	Rollout tax free
Tax free death benefit	Yes	Yes, CDA for distributions	Yes
Valuation tax impact at death	N/A	Yes, CSV for deceased	No, 21 year rule n/a
Impact CGE	N/A	Yes	N/A
Restriction on beneficiaries	No	Should be corporation	Limited by trust document
Passive investment income impact on taxes	N/A	Yes, if in excess of $50,000	N/A

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