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# Leveraged Life Insurance – Corporate Ownership

## Introduction
This Tax Topic will examine the issues and tax implications where a corporation acquires an exempt life insurance policy with the intent of accessing the policy's cash value by collaterally assigning the policy to a bank at a later date. It should be read along with the Tax Topic entitled "*Leveraged Life Insurance – Personal Ownership*".

## Exempt Life Insurance Policies
A corporation may purchase a permanent life insurance policy for a number of different reasons including: key-person protection; securing a debt obligation; funding buy-sell obligations; or funding a capital gains tax liability. 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 of the policy. Significant cash value can accumulate on a tax deferred basis if the maximum deposits permitted by the Income Tax Act (the "Act") 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. For detailed information on exempt policies refer to the Tax Topic "*The Exempt Test*".

## Accessing the Cash Value
There are several alternatives available to the policyholder in order to access a policy's cash value. The policyholder may surrender the policy (fully or partially). A partial surrender is commonly referred to as a withdrawal. A surrender is a disposition for tax purposes (subsection 148(9) definition of "disposition" at paragraph (a) of the Act), and therefore may give rise to a policy gain. The policy gain on a full or partial surrender is calculated as the excess of the proceeds received over the adjusted cost basis (ACB) of the policy. For a full surrender the entire ACB of the policy is used in this calculation. For a withdrawal, the ACB is prorated relative to the proportion of the policy's cash value that is withdrawn (for policies acquired after December 1, 1982). (Refer to the Tax Topic entitled "*Dispositions of Life Insurance Policies*" for further details). Upon a disposition of an exempt policy any policy gain realized must be included in the taxable income of the policyholder for the year (paragraph 56(1)(j) of the Act).

The policyholder may also request a "policy loan" from the insurer if the policy contract permits this. A policy loan is an advance payment of the policyholder's entitlement to benefits under the policy. The insurer obtains no legal right to sue for repayment, so it is not a true loan in the common commercial sense. A policy loan

made after March 31, 1978 is also a disposition of the policy for income tax purposes (subsection 148(9) definition of "disposition" at paragraph (b) of the Act).
The proceeds of from a post-March 1978 policy loan in excess of the ACB of the policy are included in the policyholder's income. Note that for a policy loan the ACB is not prorated – the loan proceeds are compared to the total ACB of the policy. For further details on policy loan taxation refer to the Tax Topic entitled "*Taxation of Life insurance Policy Loans and Dividends*".

Another method of accessing the accumulated cash value is for the policyholder to use the life insurance policy as collateral security for a bank loan. A collateral assignment of a policy is specifically excluded from the definition of "disposition" in subsection 148(9) paragraph (f) of the Act, and therefore will not give rise to a policy gain. The policy's cash value can continue to accumulate on a tax-deferred basis and may be used (within bank limits) as a continuing source of collateral loans to the policyholder. A collateral assignment will not change the policy's ability to produce tax-free proceeds on the death of the insured.

## Leveraged Life Insurance

A collateral assignment of a policy is often referred to as "Leveraged Life Insurance".

In general, the steps involved in leveraging a corporate-owned life insurance policy are as follows:

1. A corporation purchases an exempt life insurance policy and maximizes deposits to the extent permitted under the Act.
2. Over time, the cash value within the policy accumulates on a tax-deferred basis to create the asset that will later be leveraged.
3. When funds are required, a bank loan is secured with a collateral assignment of the policy. It may be structured with either the corporation borrowing or the shareholder borrowing using the corporate asset as collateral security. Where the corporation borrows, the funds are commonly used to invest or pay dividends or salary to a shareholder/employee.
4. The loan can be structured with interest payments only or interest and principal paid on a regular basis. Alternatively, the bank may agree to allow the policyholder to borrow the amount of the loan interest and add that amount to the outstanding loan amount (i.e. capitalize the interest). Most banks require that the loan balance not exceed a specified percentage of the policy's cash value (this percentage is often referred to as the "margin").
5. If the loan remains in good standing (i.e. the loan balance does not exceed the bank's stated margin to the policy's cash value), it may be structured so that repayment does not occur until death. Upon the death of the life insured the proceeds from the life insurance policy will repay (either directly or indirectly) the outstanding loan. Any remaining death benefit proceeds will be paid to or remain with the named beneficiary(ies) under the policy (normally, the corporation).

Leveraged life insurance presentations or "concepts" attempt to demonstrate the financial benefits of using a policy in this way at some point in the future. When presenting this analysis, disclosure of the financial and tax risks associated with this strategy should be made and sensitivities to these risks should also be demonstrated.

## Financial Risks

The financial risks that should be considered when assessing the viability of utilizing an exempt life insurance policy as collateral security for a loan in the future include:

- assumptions shown in leveraged life insurance presentations may differ from actual events
- performance of the life insurance product may differ from projections
- bank loan interest rates may differ from projections
- bank practices may change
- leveraging of equity-based accounts may be subject to reduced leveraging margins
- life expectancy may differ from projection assumptions

A detailed discussion of each of these risks is provided in the "*Leveraged Life Insurance - Personal Ownership*" Tax Topic.

## Tax Issues

In addition to financial risks, there are tax issues to consider in the context of leveraged life insurance where a corporation owns the policy. The main issues include:

- the bank loan as a policy loan
- changes to the Income Tax Act and possible grandfathering
- the General Anti-Avoidance Rule (GAAR)
- cash value life insurance as a corporate asset
- the deductibility of interest expense
- applicability of the retirement compensation arrangement (RCA) rules
- issues arising in shareholder borrowing structures

A detailed discussion of the risks associated with the bank loan as a policy loan, changes to the Income Tax Act and possible grandfathering and GAAR are provided in the "*Leveraged Life Insurance – Personal Ownership*" Tax Topic.

**Cash Value Life Insurance as a Corporate Asset**

The corporate leveraged life insurance concept involves a corporation owning a cash value life insurance policy. The life insurance policy is an asset of the corporation and therefore may affect the corporation's provincial capital tax liability and the corporation's small business deduction. An individual shareholder's ability to claim the capital gains exemption (section 110.6 of the Act) on a disposition of shares in the corporation may also be affected by a corporate-owned cash value life insurance policy. These issues are discussed in detail in the Tax Topic "*Corporate Owned Life Insurance – Tax Considerations*."

**The Deductibility of Interest Expense**

A deduction for interest expense (not exceeding a reasonable amount) is allowed pursuant to paragraph 20(1)(c) of the Act provided the following conditions are met:

i. the amount must be paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer), pursuant to a legal obligation to pay interest on borrowed money, and
ii. the borrowed money must be used for the purpose of earning income from a business or property or to acquire a property for the purpose of earning income from a business or property.

For interest to be deductible, subparagraph 20(1)(c) requires that the borrowed money is used for, or used to acquire property for "the purpose of earning income from a business or property". "Income" refers to things like interest, rents, royalties, business income, or trading gains. It does not include capital gains. For example, funds borrowed to invest in investments which only generate capital gains will not earn "income" and therefore, the interest on such borrowed funds will not be deductible. In the case of an investment such as mutual funds or securities where the primary objective in connection with the borrowings is capital growth, it would be possible to deduct the interest as long as there is also an expectation to earn income (i.e. interest or dividends).

If the corporation is borrowing and is using the funds to pay a bonus to the shareholder, the interest should be deductible. If the corporation is borrowing and using the funds to pay a dividend or to redeem shares, Canada Revenue Agency (CRA) currently accepts that the borrowed money is used to "fill the hole" created by removing the capital. As a result, CRA will accept that the purpose test is met provided the distribution does not exceed the capital of the corporation, and that the capital (before it was distributed) was being used for purposes that would have qualified for interest deductibility had the capital been borrowed money. Capital for this purpose generally includes contributed capital and accumulated profits. (Paragraphs 1.48-1.52 of Income Tax Folio S3-F6-C1:Interest deductibility, dated March 6, 2015).

If the shareholder is borrowing the funds, using the corporate owned life insurance policy as collateral security, and is using the funds to directly finance his/her lifestyle, the interest expense will not be deductible. If the shareholder uses the funds for investment purposes, the interest is paid in respect of funds used to gain or produce income and may be deductible.

It is important to note that the deduction for interest expense under paragraph 20(1)(c) of the Act is restricted to simple interest. The deduction of compound interest (interest on interest) is allowed under paragraph 20(1)(d) of the Act only to the extent that it is paid pursuant to a legal obligation to pay interest, and the simple interest on which it arises would be deductible under paragraph 20(1)(c) if it were paid in the year or payable in respect of the year. This means that if interest is allowed to compound, and consequently is not physically paid until the life insurance policy death benefit repays the loan, then the compound interest would only be deductible at the time of death.

Note that several technical interpretations from CRA create some uncertainty in this area (#2004-007034 and #2005-0116661C6.) These interpretations would appear to allow interest on money borrowed to pay simple interest to be deductible, but the implications for compound interest remain unclear.

A strategy to avoid compound interest arising, and thus ensure annual deductibility for all the interest, is to pay all of the loan interest out of pocket each year. If cash is not available, assets that generate income could be sold and the proceeds from the sale used to pay the loan interest. Then a new loan can be arranged (equal to the cash utilized to pay the interest), and the loan proceeds can be used to repurchase the assets. Since the new loan is used to purchase an income earning property, interest on the loan should be deductible annually. The same series of steps would need to occur each year to avoid compound interest.

For a detailed review of the interest deductibility rules refer to the Tax Topic entitled "*Interest Deductibility*."

**Applicability of the Retirement Compensation Arrangement (RCA) Rules**

In the case where the leveraged life insurance is owned by a corporation and is structured with the corporation borrowing from the bank to make a bonus payment to the shareholder, the provision of the Act that deals with the RCA rules may apply. Subsection 207.6(2) of the Act deems the RCA rules to apply to situations where:

1. the employer has an obligation to provide benefits that are to be received or enjoyed by any person, on, after, or in contemplation of any substantial change in services rendered by a taxpayer, the retirement of a taxpayer, or the loss of an office or employment of a taxpayer
2. the employer acquires an interest in a life insurance policy, and
3. it is reasonable to assume that the life insurance was purchased, in whole or in part, to fund the obligation.

If the RCA rules apply, the corporation owning the life insurance policy will be deemed to be the custodian of an RCA and the interest in the policy will be considered the subject property of an RCA. As a result, the corporation would not only have to pay the insurance deposit, but also a refundable tax to CRA equal to the amount of the deposit.

The following summarized rules with respect to an RCA investing in and owning a life insurance policy would also apply (for detailed information on RCA plans funded with life insurance refer to the Tax Topic "*Retirement Compensation Arrangements*"):

- Where the property of a RCA trust is an exempt life insurance policy, there is no refundable tax liability in respect of the cash value accumulation within the exempt policy.
- A policy gain arising from the disposition of an exempt policy is subject to the 50% refundable tax.
- The life insurance death benefit proceeds are received by the RCA trust tax-free.
- Any payment out of the RCA trust is taxable to the recipient. Accordingly, the death benefit proceeds under the insurance policy can only be flowed out of the RCA trust on a taxable basis.
- The refundable tax will be returned to the RCA trust as amounts are paid out of the plan, to the extent that there is a balance in the refundable tax account. $1 is refunded for every $2 in payments made.

The application of these rules would significantly impact the benefits and costs of the leveraged corporate life insurance structure.

The first test in the RCA deeming provision is that an obligation by the employer to provide benefits to an employee must exist. In shareholder owner/manager situations it can be argued that no obligation to provide the benefits would exist. That is, a private corporation would not likely have an obligation to provide any benefits, whether they be future bonuses or death benefits, to a controlling shareholder. The shareholder in his capacity to make decisions on behalf of the company could cause the company to pledge the life insurance policy as collateral security at any time. The shareholder acting in his or her capacity to direct the company could also cause the corporation to make a bonus payment. Accordingly, it is arguable that the first test of the RCA deeming rules would fail and the arrangement should not be deemed an RCA.

Particular consideration should be given to whether the RCA deeming provisions would apply to situations where the person receiving the bonus is a minority shareholder. It may be questionable in this case whether a minority shareholder has the power to direct the decisions of the company. The facts of each particular case would need to be reviewed to determine if an obligation by the company to provide post retirement benefits has been established.

Consideration should also be given to situations where the employee receiving the bonus is not a shareholder. It may be more difficult in this case to argue that there is no obligation to the employee, as the employee would not have the capacity to control the corporation to pay out a bonus or to borrow the funds. An employee is also more likely to want formal documentation of his/her entitlement under the arrangement. Again the facts and circumstances would determine if an obligation to provide post-retirement benefits has been established and if it is reasonable to consider that the life insurance was purchased to fund the obligation.

Another situation for consideration is where the employee may receive a bonus under the plan prior to termination of employment but there has been no substantial change in the services rendered by the employee. The plan may not qualify as an RCA and may fall into the Salary Deferral Arrangement (SDA) rules which require immediate income inclusion for the employee. Again it is a question of fact whether or not "a particular plan or arrangement was entered into with an intention of funding benefits that may be paid after retirement or the severing of or substantial change in employment services rendered." (#2002-013070iE5)

## Issues Arising in Shareholder Borrowing Structures

In the case where the leveraged life insurance is corporate owned and it is structured with the shareholder borrowing personally using the corporate owned life insurance policy as collateral security, consideration must be given to certain issues specific to this structure.

**Shareholder Benefit Issue**
The first issue is whether a taxable benefit is conferred on the shareholder.

Subsection 15(1) of the Act applies to require an amount or value of a benefit that has been conferred on a shareholder by a corporation to be included in the shareholder's income. The shareholder benefit issue must be considered while the loan is outstanding as well as at repayment on death.

A benefit may be assessed during the time the loan is outstanding and incrementally if that loan increases due to interest being added to the loan amount. A benefit may be received if a more favourable interest rate is obtained or if the terms of the loan are more favourable because of the corporate security supporting the loan. CRA has addressed the issue of whether a corporation's guarantee of a bank loan made to a shareholder gives rise to a taxable benefit. At the 1986 Canadian Tax Foundation Round Table, question 62, CRA addressed this issue as follows:

In theory, a benefit could very well arise as a result of a corporation guaranteeing a bank loan of a shareholder or an employee. For instance the benefit could be the difference in rates charged with and without the corporation's guarantee or what the borrower would have to pay to a third party to provide a similar guarantee. Unless there is some evidence, however, that the shareholder or employee is not, from the outset, able to repay the loan, it is unlikely that the Department would attempt to assess such a benefit. Should the corporation be called upon to honour the guarantee, this would of course, clearly be a taxable event.

Since that time, CRA has confirmed this position in subsequent round tables and technical interpretations (see technical interpretations #2000–0002575 dated March 29, 2000, #2001-0112885 dated January 10, 2002 and #2006-0174011C6 Question 14, 2006 CALU Roundtable dated May 9, 2006).

To summarize their comments, it appears that during the period when the loan is outstanding, CRA's general position is to assess a benefit where the shareholder does not deal at arm's length with the corporation. The taxable benefit may be measured as the difference in interest rates charged with and without the pledge of the corporate security or as the amount that the borrower would have to pay to a third party to provide similar security for the loan. If the shareholder can demonstrate that sufficient assets are available to repay the loan personally and borrowing could be obtained using personal assets as security at the same terms and interest rates received using the corporate security, it is unlikely that a shareholder benefit would be assessed. In the leveraged life insurance scenario, the shareholder would need to demonstrate that the same borrowing terms would be applied whether using shares of the corporation or other personal assets as collateral security or using the corporate owned life insurance policy.

Also a benefit may be assessed is at the time of repayment of the bank loan, usually at death. If the loan is repaid directly with the proceeds of the life insurance policy, there will be a taxable benefit assessed to the shareholder. This is because the corporation is entitled to the funds from the life insurance proceeds but instead the proceeds are used to repay a personal loan of the shareholder. Direct repayment of the outstanding loan could occur if the loan does not remain in good standing with the financial institution and the financial institution forces the withdrawal of the cash value from the life insurance policy to repay the loan. Direct repayment may also occur on death if the life insurance death benefit proceeds are paid directly to the bank pursuant to the collateral assignment of the policy. In both of these situations, if the insurance proceeds directly repay the loan, a taxable benefit equal to the loan balance would be assessed to the shareholder, which could cause severe hardship. In the event of a policy withdrawal there would also be a disposition for tax purposes which could result in a policy gain to the policyholder.

At the time repayment occurs, the transactions should be structured to ensure that a direct payment from the policy is not made. This would involve the release of the collateral security by the financial institution in order to allow the funds to be paid to the corporation. The bank may require the borrower or estate to provide temporary alternative security to replace the security provided by the life insurance policy. The funds would then be paid directly to the corporation. If the repayment is a result of a forced withdrawal of the cash value of the policy, the funds should be received by the corporation and then used to pay a taxable dividend to the shareholder so the shareholder can repay the outstanding bank loan. If the repayment is a result of death, the corporation would receive a capital dividend account credit equal to the proceeds of the policy less the adjusted cost basis of the policy. The corporation would use the capital dividend account credit to pay a tax free capital dividend to the estate. This would allow the estate to repay the shareholder's personal borrowing.

If for any reason the bank fails to release its security and requires repayment directly from the insurance proceeds, a taxable benefit will result at that time. The amount of the benefit will be equal to the amount of the proceeds used to repay the shareholder's personal borrowing and could result in a significant tax liability. It is therefore extremely important that all parties to the arrangement understand the intended structure.

**Use of the capital dividend account**
Where a shareholder leverages a corporate owned life insurance policy, the capital dividend account is used to facilitate the loan repayment at death. As noted above, in this situation the insurance proceeds will flow into the corporation, then the corporation will pay a dividend to the shareholder so that the shareholder has the funds to repay the loan. To avoid taxation of the dividend, it will likely be paid as a capital dividend to the extent of the available CDA. Consequently, the capital dividend account available to make subsequent distributions to the shareholder will be reduced. Compare this to the situation where the corporation leverages the policy (corporate borrowing) where the loan is repaid utilizing the insurance proceeds, and the balance in the capital dividend account remains fully available for future distributions to the shareholder.

**Impact on estate freezes**
Where an estate freeze is contemplated by a shareholder, care should be taken to ensure that the freeze is not done for a value that is below the expected future loan balance. As noted above, at death, the proceeds of the life insurance need to flow through the corporation to the shareholder – usually as a capital dividend to avoid taxation of the amount. If the shareholder has frozen preferred shares, the amount would most likely be flowed to the shareholder in the form of a redemption of those shares, which would trigger a deemed dividend. This dividend would most likely be elected as a capital dividend to the extent of the available CDA balance. However, if the loan is greater than the redemption value, it will be difficult to get any amount greater than the redemption value out to the shareholder in a tax effective manner in order to repay the loan.

**Valuation of shares**
The corporate owned policy and any related borrowing may impact the valuation of shares held by a deceased shareholder for capital gains purposes. In general the value of a life insurance policy for the purpose of valuing shares owned by an individual at death is deemed to be the cash surrender value of the policy. (For details refer to the Tax Topic "*Corporate-Owned Insurance — Valuation Issues Regarding The Deemed Disposition Rules At Death (Subsection 70(5))*.") When a corporation uses a life insurance policy as collateral security for a corporate loan, the cash value will increase the value of the shares for this purpose, while the loan amount will reduce the value of the shares. When an individual uses a corporate owned life insurance policy as collateral security for a loan, again the cash value of the policy will increase the value of the shares, but because the loan is to the individual rather than the corporation, the loan will not reduce the share value. This should be factored into the decision as to whether a particular leveraged arrangement should be structured with corporate borrowing or shareholder borrowing.

**Variations in structure of shareholder borrowing**
The above issues discussion assumes that the shareholder, when borrowing uses the corporate life insurance policy as collateral security for a personal loan and that the borrowed money is either used for personal expenses (and therefore would not give rise to interest deductibility) or for personal investing (and thereby may give rise to interest deductibility). In the latter case, what if the shareholder invests in, for example, debt or a separate class of redeemable preferred shares (with paid up capital (PUC) and ACB equal to the redemption amount and with a dividend entitlement) of the corporation?

On its face, this structure appears to mitigate the "Use of capital dividend account", "Impact of estate freezes" and "Valuation of shares" issues discussed above, as the debt (or redemption) to the shareholder could be repaid (or funded) with life insurance proceeds without the need to pay a capital dividend and the debt outstanding (or the redemption amount) to the shareholder could offset the portion of the cash value used to secure the personal borrowing to the shareholder. However, it is not clear that the potential shareholder benefit issues can be mitigated.

Would this structure give rise to a greater GAAR risk? In addition to mitigating some of the above issues, which the mitigation of which in themselves may be seen as giving rise to tax benefits, there would be an obvious immediate tax benefit. Interest deductions would offset income at high personal tax rates (assuming the individual pays tax at the high marginal rate which in many provinces is at or near 50%) as opposed to offsetting active business income at a lower corporate tax rate (which on average is near 27%). Given that the company ends up borrowing from or being obligated to redeem shares held by the shareholder that used the corporation's asset as security for a personal loan, the series of transactions could be viewed as lacking a business purpose other than obtaining the tax benefit. On the other hand, it is a well-established principle of tax law that a taxpayer is entitled to structure his or her affairs in a tax effective manner.

## Applications of the Corporate-Owned Leveraged Life Insurance Concept

Examples of where the concept is used include:

- bonus payments using corporate borrowing
- retirement redemption using corporate borrowing
- personal borrowing to supplement lifestyle
- living buyout using personal borrowing

### Bonus Payments Using Corporate Borrowing

A corporation has a sole shareholder who is also the key employee. The corporation needs key person protection on the life of the shareholder/employee to ensure that funds are available to continue the corporation in the event of death. The corporation acquires and is the beneficiary of an exempt life insurance policy insuring the shareholder/employee. Deposits are made to the policy and the cash value in the policy accumulates on a tax-deferred basis.

After significant cash value has accumulated in the policy, the corporation may wish to pay a bonus to the shareholder/employee without impacting the cash flow of the corporation. The corporation could borrow the funds required for the bonus using the life insurance policy as collateral security for the loan. The loan interest may be deductible to the corporation as the funds are being used to earn income from business. The applicability of the RCA deeming rules should not apply if an obligation to provide the shareholder/employee with benefits does not exist.

At the death of the shareholder/employee, the life insurance death benefit proceeds will be received by the company tax-free and will be used to repay the outstanding bank loan.

### Retirement Redemption Using Corporate Borrowing

A company is owned equally by two shareholders. Each of the shareholders has exchanged their participating common shares for fixed value preferred shares and other family members have subscribed for new participating common shares. One shareholder intends to retire at a certain point in the future and, pursuant to the terms of their shareholders' agreement, the company will redeem his preferred shares over several years. If the shareholder dies before all the shares are redeemed, the shareholders' agreement provides that the company will redeem the remaining outstanding shares from his estate.

The company acquires and is the beneficiary of an exempt life insurance policy insuring the shareholder's life with a face amount equal to the redemption value of the preferred shares. This amount of insurance ensures that the funding is available to purchase the remaining shares from the estate if the shareholder dies prematurely before the scheduled redemption is completed. The company makes deposits to the policy during the years prior to retirement. The cash value in the policy accumulates on a tax-deferred basis.

On retirement, the company borrows an annual series of bank loans to fund the scheduled redemption of the preferred shares. The life insurance policy is used as collateral security for the loan. The loan interest may be deductible to the company if the funds generated when the shares were originally issued were used to produce income from business or property (see the section above that discusses interest deductibility).

Upon death, the life insurance death benefit proceeds are received by the company tax-free and are used to repay the outstanding bank loan. If the shareholder dies prior to having all of the preferred shares redeemed, the company will use a portion of the death benefit to redeem the remaining shares from the estate.

**Personal Borrowing to Supplement Lifestyle**

A corporation has a sole shareholder. The corporation needs key person protection on the life of the shareholder to ensure that funds are available to continue the corporation in the event of death. Therefore the corporation acquires and is the beneficiary of an exempt life insurance policy insuring the shareholder. Deposits are made to the policy and the cash value in the policy accumulates on a tax-deferred basis.

The shareholder may need additional personal funds to supplement lifestyle. Therefore, after significant cash value has accumulated in the policy, the shareholder may wish to use the corporate life insurance policy as collateral security for a personal loan. The loan payments are received by the shareholder tax-free. The loan interest will not be deductible, as the funds are not being used to earn income from business or property. In order to avoid the inclusion of a taxable benefit in income, the shareholder would need to demonstrate that the same borrowing terms would apply whether using personal assets as collateral security or using the corporate owned life insurance policy.

At the death of the shareholder, the estate replaces the security provided by the life insurance policy with another asset allowing the financial institution to release the collateral assignment of the life insurance policy. The death benefit proceeds would then be received by the company tax-free. The company would receive a credit to its capital dividend account equal to the proceeds from the life insurance policy less the adjusted cost basis of the policy. The company would use the capital dividend account credit to pay a tax free capital dividend to the estate. The funds from the capital dividend would be used to repay the outstanding bank loan. Once the loan is repaid, any excess may remain in the estate.

**Living Buyout using Personal Borrowing**

Two shareholders own a company. One of the shareholders wishes to be bought out by the other on retirement. The buy-out would take place over a number of years. If the shareholder dies prior to retirement, the estate should receive full consideration for the shares. In order to take advantage of the capital gains exemption the shareholder wishes his shares to be purchased by the remaining shareholder. The remaining shareholder prefers to use corporate, rather than personal cash flow, to provide the funding for the buy-out.

The company acquires and is the beneficiary of an exempt life insurance policy. Deposits are made to the policy until the shareholder retires and the cash value in the policy accumulates on a tax-deferred basis.

When the shareholder retires, the remaining shareholder purchases the shares and gives consideration of a promissory note payable over a number of years. The retiring shareholder has a disposition and capital gain on the sale and uses the capital gains exemption to shelter a portion of the gain.

The remaining shareholder borrows the funds required to make the annual payments on the promissory note. These personal loans are secured by the pledge of the corporate owned life insurance policy as security. Since the funds are borrowed to purchase common shares, the loan interest should be deductible. In order to avoid the inclusion of a taxable benefit in income, the shareholder would need to demonstrate that the same borrowing terms would be available if the loan were secured with shares of the corporation or other personal assets of the shareholder rather than using the corporate owned life insurance policy as security.

When the retired shareholder dies, the remaining shareholder replaces the security provided by the life insurance policy with other assets allowing the financial institution to release the collateral assignment of the life insurance policy. The death benefit proceeds would then be received by the company tax-free. The company would receive a credit to its capital dividend account equal to the proceeds from the life insurance policy less the adjusted cost basis of the policy. The company would use the capital dividend account credit to pay a tax free capital dividend to the remaining shareholder. The funds from the capital dividend would be used to repay the outstanding bank loan and any balance outstanding on the promissory note.

## Conclusion

Significant financial benefits can be provided by leveraged life insurance strategies using corporate owned insurance. In assessing these benefits, one should also be aware of the financial and tax risks associated with this strategy and sensitivities to these risks should be illustrated.

Last updated: July 2015

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