How Business Owners Can Continue To Shelter Income

In Face Of New Prohibitive Tax Law

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In the January 2016 *Canadian MoneySaver* edition I wrote an article called *An Easy Way to Save Money on a Prescribed Annuity.* I discussed the new tax legislation Bill C-43 and how it would increase the tax paid on non-registered prescribed annuities starting January 1, 2017. Bill C-43 is not limited to annuities. This new Bill will also reduce the amount of tax sheltering available to business owners who are looking to add a tax-exempt, corporate life insurance policy to their business assets.

The new tax legislation will update the old 1982 tax-exempt insurance laws for policies issued in 2017 or later. The updated rules reflect the fact that people are living longer. In insurance terms this will reduce the mortality rate which in turn will reduce the amount available for tax-sheltered growth and tax-free distributions on death.

Below are the main reasons owners of a Canadian-Controlled Private Corporation (CCPC) invest some of their profits into a tax-exempt permanent insurance policy (an exempt insurance policy is defined in regulations 306 and 307 of the Income Tax Act (ITA).

1. Tax-sheltered growth

Significant cash values can accumulate on a tax-deferred basis in the policy within the maximum deposits permitted by the Income Tax Act. The deposits can be designed so that they remain tax-sheltered within the contract. The key here is the tax-exempt limit. This is the maximum savings allowed inside a policy at a given point in time before it would lose its exempt status.

2. Tax-free distribution on death

There's a mechanism that allows the death benefit proceeds to go tax-free to shareholders through the corporation's Capital Dividend Account (CDA). The CDA credit is unique to corporate-owned life insurance. Upon death of the insured, a private corporation receives the death benefit tax-free. That amount less the adjusted cost basis (ACB) of the policy is added to the corporation's CDA. This is a notional account and appears on a company's financial statement which will have a significant benefit for owners of CCPC. The balance in the CDA can be paid out to shareholders as a capital dividend and thus be exempt from tax. The death benefit of a corporate-owned life insurance policy is one item that can be credited to the CDA tax-free.

Changes after December 31, 2016:

- The amount of tax-exempt growth allowed inside corporate-owned policies will be significantly reduced. Corporations will have less tax-sheltered accumulation room inside their policies reducing the amount of cash input available. This means more tax will be paid because your corporate savings are not being tax-sheltered.
- The amount of life insurance proceeds allowed to be distributed tax-free through the Capital Dividend Account (CDA) to shareholders of a private corporation will also be reduced.

  Because of the reduced mortality rate, the majority of insurance contracts will have a lower Net Cost of Pure Insurance (NCPI). This will cause the Adjusted Cost Base (ACB) to decrease more slowly and take longer to reach zero (the ACB is the amount used to calculate the taxable gain in a life insurance policy). To get the most tax-free money to your shareholders on death, you want a low ACB that reduces to zero quickly.

Specifically, for Universal Life products (a type of permanent insurance with a savings component) the level cost of insurance will increase. Depending on your age and other policy factors, a level cost Universal Life insurance policy could take anywhere from 8 to 18 years longer to reach an ACB of zero. This would result in a lower CDA credit which means your corporation will pay more tax on capital dividends paid to shareholders on death.

- It will take longer for a permanent insurance policy to be paid up. Depending on the product you choose and other variables, you may have to pay an extra 8 years in insurance premiums for your policy to be paid off.

The Cost of Waiting

The cost of waiting is well illustrated with the following example.

Harry is 50 years old, and a successful owner of a Canadian controlled private corporation. He is generating a significant amount of excess cash flow every year and retains a considerable portion of business profits within his corporation. Harry set up a holding company to house these profits and has been able to accumulate well over 5 million dollars of savings. Eventually he is looking to pass on a large portion of his surplus cash to his children in the most tax efficient manner.

If Harry did nothing, then on his death, Canada Revenue Agency could claim close to half of his company's assets in the form of estate taxes. The remainder would go to his children. Harry didn't like this arrangement and looked at other options.

How can Harry pass his corporate assets to his children in the most tax efficient manner?

Harry reviewed his corporate account to see how much money he was earning and how much he had saved. He would re-allocate those saved dollars he was never going to spend and move them slowly into a corporate-owned insurance policy. By setting up the insurance policy according to special provisions of the Income Tax Act, Harry could transfer his holding company's trapped surplus to his estate on a tax-preferred basis, and leave a greater legacy to his shareholders (his children).

Harry decided to apply for a 5 million minimum-funded, level cost- Universal Life policy. His holding company would be the owner and beneficiary of the tax-exempt plan. Each year Harry would re-allocate tax-free $64,438 from his corporate account to fund the plan.

Harry was specifically looking at when the policy's ACB would reduce to zero. At that point the entire 5 million insurance coverage could flow through the capital dividend account to his children tax-free. After 10 years the ACB would be $458,388. After 22 years it reduced to $111,953. On year 23 the ACB reached zero.

Under the current tax rules, if Harry died anytime after his 72nd birthday, the full death benefit of 5 million dollars would be distributed to his children tax-free through the company's CDA. At age 73, the ACB of the policy would reach zero and stay at zero for the rest of his life.

If Harry waited and bought the policy after December 31, 2016, at age 73 the amount that could be added to the corporations CDA would not be 5 million. It would be 5 million less $825,000. Instead, his children would receive $4,175,000 tax-free and the remaining $825,000 would have to be released as a non-eligible taxable dividend. In Ontario, the personal tax amount to distribute $825,000 to the shareholders' estate would be in excess of $373,000.

More importantly, under the new rules Harry would have to wait at least an additional 18 years before the ACB reaches zero. He would have to live to age 90 for that to happen.

(*Source:* BMO Life illustration Life Dimension minimum-funded Level COI male age 50 nonsmoker. NCPI vs. ACB July 2016: A New Era for Insurance Changes to the Adjusted Cost Base and Net Cost of Pure Insurance and the Capital Dividend Account).

In summary, buying the insurance before January 1, 2017, Harry can:

- Increase the potential amount of tax-free life insurance proceeds to shareholders (his children).
- Increase the amount of money that can be deposited into the policy and accumulated on a tax-exempt basis.
- Pay off the policy quicker by at least 8 years.
- Reduce his overall insurance cost.

(*Note:* Canadian insurers have not yet released new product and pricing information at this time. The exact numbers for the new change will be released sometime in early October of this year when new product software becomes available to their distributors).

Business owners should be aware of how the ACB on corporate-owned insurance policies will take longer to reduce to zero under the new tax rules. This will reduce the amount of tax-free death benefit a company can flow through their CDA balance. For maximum tax sheltering of business profits and tax-free distributions, a corporate-owned tax-exempt life policy should be purchased before December 31, 2016. All insurance policies purchased by that date will be grandfathered to the old more tax favourable rules.

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