

Estate Planning with Life Insurance

Previous articles dealing with planning for the tax implications of death and estate planning for private company shareholders discussed the importance of addressing the tax that will arise by virtue of an individual's death. While planning to defer, limit and even reduce the amount of tax ultimately payable upon death are key aspects of a sound financial plan, it is also critical that consideration be given to how that eventual tax liability will be funded. Life insurance can be an effective tool to deal with this issue.

Tax Consequences at Death

An individual's terminal tax return will include all income received or accrued prior to death. The value of a person's RRSP or RRIF will be included as income on the terminal tax return, subject to certain exceptions noted below. Further, the deceased person is deemed to have disposed of all capital property, including real estate, marketable securities and shares of private companies, for their fair market value immediately before death. The tax cost of the various properties owned will determine the aggregate capital gain or loss that arises at the time of death. For tax purposes, ½ of capital gains realized are included in income and subject to tax. The tax liability arising on one's terminal tax return can be significant.

An exception to these general rules is that capital property left to a surviving spouse or a qualifying spousal trust is generally deemed to have been disposed of at its cost, rather than its fair market value. Further, the value of a person's RRSP or RRIF left to a surviving spouse may also be transferred without incurring tax at the time of death. While this provides an opportunity to defer tax until the time of the surviving spouse's death, this is still only a deferral – tax will ultimately be paid upon the death of the second spouse.

Planning for Terminal Tax Liability

A previous article discussed the benefits of implementing an estate freeze during one's lifetime. By implementing



an estate freeze, individuals may limit the value of assets attributable to them during their lifetime, thereby limiting the amount of tax that will be payable upon their death. An estate freeze allows any future growth in value to pass to a future generation, hopefully providing a lengthy deferral of that extra tax.

A further benefit of an estate freeze is that it provides the ability to quantify the amount of tax that will ultimately be payable upon death. Once this amount can be estimated, the individual may focus on how this tax liability will be funded. Key to this process is considering whether the estate will have sufficient liquidity to fund the tax liability without causing undue hardship to the estate and its beneficiaries. For example, where an estate's main assets are marketable securities, an RRSP or a RRIF, even though the tax liability may be significant, funds can be generated by selling a portion of the investment portfolio. On the other hand, where an estate's main assets are real estate or shares of a private company, it may be much more difficult to raise the necessary funds, since there may not be a ready market for those assets. In these situations, life insurance may provide a practical financing solution.

Types of Life Insurance

There are generally two broad categories of life insurance coverage – term insurance and permanent insurance. Within each there are various offerings with distinct features to meet different needs.

As the name implies, term insurance is temporary in nature

and provides coverage for a specified period of time. It is generally appropriate where the insurance need is for a specific or limited period of time. Term insurance provides a fixed death benefit if the person dies within the specified period of coverage. Upon the expiry of the coverage term (say every 10 years), the policy may generally be renewed for an additional term, albeit at higher premiums. Term policies generally expire once the individual reaches a certain age (typically at age 75). Prior to that time, the insurance coverage may lapse and be terminated if premiums are not paid. Term insurance is typically the least expensive form of insurance coverage in early years. However, as you can imagine, it becomes increasingly expensive with each renewal term as the individual ages. Many term policies also include a feature allowing the individual to convert the policy into a permanent policy by a certain age.

Permanent insurance provides coverage for life and is often used to deal with indefinite insurance needs. In addition to a fixed death benefit, these policies also provide for the tax-free accumulation of earnings or excess premiums in an investment account. This investment account may be drawn on during one's lifetime, but doing so may trigger tax. However, amounts paid out of the investment account upon death are generally received tax-free, in addition to the fixed death benefit component. Permanent insurance is more expensive in the early years, but the premiums remain fixed for life. There is no need to renew these policies and coverage remains in place so long as premiums are paid. An alternative to paying the annual premiums may be to draw on the policy's investment account to cover premiums. There are generally two types of permanent insurance – universal life and participating whole life. The differences between these two are beyond the scope of this article.

A variation of the above is term-to-100 insurance – essentially a low-cost form of permanent insurance. These types of policies are similar to regular term insurance in that they provide fixed life insurance coverage without the cash value investment accounts available under permanent policies. Annual premiums are fixed and must be paid for life (or to the age of 100) in order to maintain coverage. Subsequent to age 100, the policy will remain in place, but in general premiums are no longer required.

Structuring Life Insurance Ownership

In the context of a business owner (or owner of a holding company), life insurance may be owned and paid for either personally or by the corporation. In either case, life insurance premiums are generally not deductible expenses for tax purposes. However, as we will show, it is generally more tax-efficient to have life insurance policies owned and paid for by a corporation.

For example, consider an individual who is resident in Ontario, subject to personal tax at the top marginal rate and considering a life insurance policy that will

require annual premiums of \$10,000. In order to fund this annual premium personally, this individual would require a pre-tax salary of \$18,660 in order to be left with \$10,000 of after-tax funds. A corporation that is eligible for the small business limit tax rate would only require \$11,905 of pre-tax income in order to fund the same policy (i.e., to be left with \$10,000 of after-tax funds). Notwithstanding that the premiums are not tax-deductible expenditures, the shareholder will not be considered to have received a taxable benefit, provided that the corporation is the beneficiary of the policy.

Life insurance proceeds can be withdrawn from a corporation by paying tax-free dividends out of a corporation's Capital Dividend Account ("CDA"). The CDA is a notional account that allows a corporation to pay a tax-free capital dividend to its shareholders, to the extent of the balance in the CDA at the time of the dividend. There are several components to the CDA, including life insurance proceeds received (less the adjusted cost basis ("ACB") of the policy to the corporation). The ACB of a life insurance policy is basically calculated as the amount of premiums paid, less the actual cost to insure the life. Term policies may have little or no ACB, while permanent policies may have a significant ACB in early years, which may decline over time. Therefore, there could be limitations on a corporation's ability to pay tax-free dividends; the ACB should be verified with the insurance company prior to paying a capital dividend. It should be noted that the CDA balance created as a result of life insurance proceeds will carry forward even if the life insurance death benefit is used for other purposes, such as business operations.

If there are concerns about the possibility of having a significant reduction of the CDA balance as a result of the policy's ACB, it may be possible to plan around this issue by structuring the ownership of the insurance policy. For example, a holding company could own the insurance policy on the life of a shareholder, but the operating company could be the beneficiary of the policy. The operating company would receive a credit to its CDA for the full amount of the life insurance proceeds, because the ACB of the policy belongs to the holding company (i.e., the owner of the policy). It is important that there be valid business reasons for such a structure, other than to obtain a tax benefit. These issues should be considered up front, as it can be difficult to transfer a policy after acquisition without triggering negative tax implications. For this reason, if there is a possibility that a business may be sold in the future, it may be wise to have a holding company own the policy.

Uses of Life Insurance

There can be many uses for life insurance, with each situation being different in some respect. The following discussion addresses some of the more common uses.

Funding terminal tax liability

Perhaps the most common use of life insurance in the context of estate planning is to provide funds to cover

the taxes that will be payable upon death. The liquidity of an estate is a key factor in determining whether life insurance is required.

Assume Mr. Smith, a widower, dies owning an investment portfolio worth \$5,000,000 and a nominal cost. Mr. Smith's estate would have a tax liability of approximately \$1,160,000. While this is certainly a significant liability, the estate can nevertheless liquidate a portion of the investment portfolio to cover this liability.

On the other hand, the following facts will be used to highlight the issues that may arise in a private company context:

- Mr. Jones, a widower, owns 100% of the common shares of a successful company called JonesCo. The shares have a nominal cost and a fair market value of \$5,000,000 at the time of his death.
- JonesCo does not have a significant cash balance, as profits over the years have been reinvested to expand the business.
- Mr. Jones has previously used all of his \$750,000 lifetime capital gains exemption.
- Mr. Jones' other assets do not have a significant value.
- The provisions of Mr. Jones' will provide that his property is to be distributed equally to his two adult sons.

In this case, Mr. Jones' estate would still face a tax liability of approximately \$1,160,000. The options for funding this liability, however, are limited and may themselves create additional issues:

- JonesCo could borrow and use the loan proceeds to pay a dividend to the estate. However, the estate would be subject to tax on the dividend from JonesCo. In order to provide the estate with \$1,160,000 of funds on an after-tax basis, JonesCo may need to borrow up to \$1,690,000 and pay that amount as a dividend. Further, there is no guarantee that JonesCo would be able to obtain such a loan. Lastly, consideration should be given to JonesCo's ability to service this loan, particularly in light of the fact that the company will no longer be managed by Mr. Jones.
- The estate could borrow and use the loan proceeds to pay the tax liability. However, since the estate does not have much by way of other assets, it may be difficult for it to obtain a loan. A lender may require a guarantee from JonesCo. Finally, any interest incurred by the estate would not be deductible in computing its taxable income, since it is not incurred for purposes of earning income – a rather costly method of financing.
- The estate could sell JonesCo to raise the necessary funds. While JonesCo may have a value of \$5,000,000, it is a private company and it may take time to sell, assuming that a purchaser can be found. Further, it may be necessary to sell the company at a discount to accelerate the receipt of funds.

It is clear that life insurance would have been extremely

beneficial in Mr. Jones' situation, while Mr. Smith may be able to do without.

Estate equalization

This concept can be illustrated using the same facts as outlined above for Mr. Jones. Further, we will assume that:

- In addition to the shares of JonesCo, Mr. Jones has cash of \$1,160,000 at the time of death.
- Mr. Jones' son John is involved in the business, his son Mike is a public servant and has no interest in working in the family business.

In this situation, the estate has sufficient funds to pay the tax that will arise upon Mr. Jones' death. However, once the tax is paid, the estate is left with \$5,000,000 worth of JonesCo shares, which must be divided equally between his two children, one of whom has no interest in the business. This situation creates a whole set of other issues. John may resent the fact that Mike is not active in the business but owns half of the shares. John may also feel that Mike is reaping half the benefits of his hard work as the value of JonesCo increases in the future. Mike may have had other plans for his inheritance – be it investment, starting his own business, or even retirement. Further, the value of Mike's inheritance will be linked to John's ability to manage JonesCo over time.

In order to buy out Mike, JonesCo or John may need to borrow in order to redeem or purchase Mike's ½ interest in the company. In addition to possible financing issues discussed earlier, the tax implications of such plans can be complex.

The simplest solution may have been to use life insurance to generate sufficient funds to allow for the equalization of the brothers' inheritances. In an ideal scenario, the value of life insurance would be equal to JonesCo. This value could flow to Mike, such that John could be left with full ownership of JonesCo. The exact amount of life insurance needed or desired would be based on many factors, including the value of JonesCo, the extent of other assets within the estate and the amount of tax payable upon death. Further, consideration should be given to whether inheritances of equal value are actually fair, given that the ultimate value of John's inheritance will depend to an extent on his ability to run the business, while Mike's inheritance would likely be subject to less risk.

Preservation or creation of wealth

In some circumstances, liquidity and estate equalization are not of great concern, but parents may wish to replace funds that will be used to pay tax upon death. The driving desire could be to leave a larger estate to their family, or to cover an expected reduction in family income as a result of a parent's death. Life insurance may be a useful tool in these situations as well.

Consider the earlier example of Mr. Smith, for whom liquidity does not appear to be an issue. After paying the

tax resulting from Mr. Smith's death, his estate will be left with \$3,840,000 to distribute to his children. If Mr. Smith wants to leave a greater amount to his children, a life insurance policy could be used to fund the tax. Mr. Smith's beneficiaries may have special needs for which he would like to assist, or he simply may wish to provide them with as much financial security as possible. However, it is important to plan ahead and consider the implications upon death and the impact of taxes on one's estate.

Buy-Sell arrangements

Where a corporation has more than one shareholder, it is usually recommended that they have a shareholders' agreement that addresses important ownership and management issues. A key element of most shareholders' agreements is how to deal with the death of one of the shareholders. This is typically dealt with by including buy-sell provisions within the agreement and normally provides that the surviving shareholder will purchase shares owned by a deceased's estate. An alternative may be for the corporation to redeem the shares held by the deceased's estate. Such agreements generally provide for a transition of the business ownership, with limited interference in the business by the estate. The agreement will normally provide for a mechanism which establishes the value of the corporation for buyout purposes.

While having a buy-sell agreement in place is an important step, its success hinges on there being sufficient funds available to fund the purchase of a deceased person's shares. While it may be possible for the surviving shareholder or the corporation to borrow funds for purposes of executing the agreement, this may be an expensive option and may involve a significant amount of financial risk to the borrower. If a buyout were to be carried out over a number of years using the corporation's after-tax profits instead, there is a risk that the deceased's estate may not ultimately realize the full value of the shares (although it may have paid tax at that full value). In most cases, life insurance provides the most cost-effective and least risky method of financing such a purchase.

One alternative is for each shareholder to personally take out life insurance on the lives of the other shareholders. This provides the surviving shareholders with tax-free life insurance proceeds that can be used to fund the buyout of the shares from the deceased's estate. This is a relatively simple structure and may provide a good tax result to the vendor. A drawback of this type of structure is that the life insurance premiums are being paid with personal after-tax dollars, making it a more expensive way of funding life insurance. As discussed earlier in this article, it is generally more tax-efficient to have life insurance premiums paid by corporations. Also, it may be difficult to ensure that all shareholders are keeping their policies current by paying premiums as required.

Another alternative may be to have the corporation take out life insurance on the lives of the shareholders. In this way, the life insurance premiums, although not

necessarily deductible for tax purposes, are nevertheless being paid using corporate dollars, which is more efficient from a tax perspective. Upon the death of a shareholder, the corporation would receive tax-free life insurance proceeds. At that point, the two key alternatives are as follows:

1. The surviving shareholders may purchase the shares from the deceased's estate in exchange for a promissory note. The corporation can then pay a tax-free capital dividend to the surviving shareholders using the life insurance proceeds and the promissory note can be repaid using those funds; or
2. The corporation may use the life insurance proceeds to redeem the shares owned by the deceased's estate. The share redemption would typically result in a deemed dividend, which could be designated as a tax-free capital dividend.

Corporate-owned life insurance also has the advantage of providing more control over ensuring that the policy remains in place, since the shareholders would be aware of whether the corporation has paid premiums as required. A drawback is that any life insurance proceeds received by the corporation could be subject to claims by the corporation's creditors.

The decision as to the most appropriate method of structuring a buy-sell agreement will depend on a number of factors, including the corporate structure, each shareholder's family situation and creditor protection.

Charitable giving

Life insurance can also be used for charitable giving purposes, either to establish a private foundation or to make a significant donation to a charity. Life insurance can provide tax advantages that may increase the amount of donations or decrease the effective cost of donating.

A common strategy is to acquire a life insurance policy and to immediately assign the policy to a charity. At that point, the charity would be the owner and beneficiary of the life insurance policy, although the donor continues making annual premium payments on the policy. The premium payments made by the donor of the policy will be considered charitable donations and will be eligible for tax credits. So while the charity will ultimately benefit in the future when it receives the life insurance death benefit, the donor receives an annual tax benefit during his lifetime.

It may also be possible to donate an existing life insurance policy to a charity. In such a case, the donor will be considered to have made a charitable donation for an amount equal to the cash surrender value of the policy at the time it is assigned to the charity. The donor will be deemed to have disposed of the policy and will also be deemed to have taxable income equal to the difference between the policy's cash surrender value and its ACB – the tax credit from the donation should exceed any tax resulting from the disposition.

Further, premiums paid by the donor in the future will be considered charitable donations and will be eligible for tax credits.

Lastly, it is also possible to own a life insurance policy during one's lifetime and simply have a charity named as the beneficiary. While the annual premiums paid would not be considered charitable donations, the death benefit received by the charity would. This provides a relatively large tax credit to the deceased's estate and can be used to offset a significant terminal tax liability at the time of death.

Factors to Consider

From the discussion above, it is clear that there are a number of factors that should be considered prior to acquiring a life insurance policy. The first question should be what will the life insurance be needed for? This will help determine what type of policy is best suited to one's needs. Next, consideration should be given to whether the estate will have a need for capital, by estimating the terminal tax liability and taking into account the liquidity of the assets. Lastly, one should consider the timing of when life insurance proceeds may be needed. For example, where the plan is to leave the estate to a surviving spouse, tax will generally only result when the second spouse passes away. It may therefore be more feasible to acquire a joint-last-to-die policy, whereby the death benefit is only paid once the second spouse passes away. Annual premiums may be significantly lower and the funds are generally received at the time when they are most needed.

This article has discussed the key features, benefits and uses of life insurance. Life insurance is a financial asset that has a myriad of uses in connection with tax and estate planning. The proceeds received from life insurance may fund a person's terminal tax liability and may be a key aspect of an estate's overall liquidity. Life insurance planning is particularly important in a private company context.

Our clients generally find life insurance to be a complex affair. It can be difficult for individuals to ensure that they have the proper type and level of insurance coverage. It can also be a challenge to ensure that a person's life insurance coverage is consistent with their overall tax and estate planning objectives. More options and complexity can exist in a private company context. Individuals should consider their need for life insurance proactively.

Welch LLP can provide the expertise required to make proper choices from a life insurance perspective. We can ensure that you are presented with proper options vis-à-vis life insurance planning. Further, we can help ensure that the cost of life insurance is minimized while at the same time the benefits are maximized.

For more information about Estate Planning with Life Insurance please contact a professional at Welch LLP or visit us at: www.welchllp.com

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