Business

solutions that meet your objectives

STANDARD LIFE

www.standardlife.ca

Cash Options:

Calculating the Most Cost-Effective Life Insurance and Critical Illness Insurance Option to Fund Corporate Business Continuity

Introduction

Universal life insurance can be an efficient method to finance a number of business continuity contingencies. At death it will provide tax-free cash to fund a major part of the rights and obligations of buy-sell agreements. Tax-exempt growth within the policy enhances the payout.

But who should own the insurance and who should pay the premiums? The corporation or the individual shareholder/employee?

If the least expensive after-tax cost is the only consideration, the answer to this question can easily be obtained by comparing the corporate-owned option with those of the six individual ownership options that cover three salary and three dividend options and are appropriate (from a tax perspective) in the circumstances. These calculations can easily be done with Standard Life's handy Cash Option Calculator spreadsheet.

The six options

1. **Corporate ownership vs. Individual ownership (Salary)**
   Corporation pays the shareholder/employee additional salary/bonus sufficient to cover the annual insurance premiums and pay the income tax on the monies received.

2. **Corporate ownership vs. Individual ownership (Employee taxable benefit)**
   Corporation pays the insurance premiums. The individual is charged an employee taxable benefit of which the tax payable on that benefit is funded by salary.

3. **Corporate ownership vs. Individual ownership (Employee taxable benefit)**
   This option is virtually the same as option 2 with the exception that the tax payable on that taxable benefit is funded by dividend rather than salary.

4. **Corporate ownership vs. Individual ownership (Dividend payment)**
   Corporation pays a dividend to the individual to fund the insurance premiums.

5. **Corporate ownership vs. Individual ownership (Shareholder taxable benefit)**
   Individual's tax on the shareholder taxable benefit is funded by salary.

6. **Corporate ownership vs. Individual ownership (Shareholder taxable benefit)**
   Individual's tax on the shareholder taxable benefit is funded by dividend.

Which option will be the most cost-effective?

There is no simple answer to this question. You have to run the numbers to find out. However, because of the favorable tax treatment for Canadian Controlled Private Corporations (CCPC) – in the case of income up to the "business limit" ($200,000 for 2002 and earlier years and increasing to $300,000 for 2006 and later years)[1] – it will generally be most cost-efficient for the corporation rather than the individual shareholder/employee to own and pay the premiums on a life insurance policy. This is certainly the case if the individual is in the top marginal tax bracket. As of January 1, 2003, the combined federal/provincial income tax rates for active business income up to $225,000 ($400,000 in Alberta) ranged from a low of 16.12% in New Brunswick to a high of 22.16% in Quebec.

Individuals receiving salary or dividends at the top marginal tax rates would be paying higher tax rates than those paid by small businesses on the general "up-to-$200,000" (subsequently increased) threshold. Top combined federal/provincial personal marginal tax rates for salary ranged from a low of 39% in Alberta to a high of 48.64% in Newfoundland at January 1, 2003.For individuals at the top marginal rates, combined federal/provincial tax rates on dividends ranged from 24.08% in Alberta to 35.08% in Manitoba.

Consider more than just after-tax cost

The decision on who should own the insurance policy and who should pay the premiums should cover more than merely the issue of the least expensive after-tax option.

There may be valid reasons why it would make more sense to have the shareholder/employee (or the corporation) own the policy and pay the premiums – even if that produces a higher after-tax cost.

For example, as a matter of corporate policy, the company may decide it is most appropriate for the shareholder/employees to own and pay the insurance premiums as individuals. Perhaps some of the shareholder/employees have joined the company recently and the thinking is that it would not be fair in that case for the corporation to take on the cost pr responsibility for paying for the newcomers.

On the other hand, there are at least two compelling arguments for the corporation owning the insurance and paying the premiums. One of these arguments is that the corporation as a whole benefits from business continuity planning and should therefore, as a matter of policy take on the responsibility for arranging and paying for the insurance. A second argument for corporate ownership of the insurance and payment of the premiums is that this reduces the likelihood that one or more of the shareholder/employees will neglect or forget to keep their individual policies paid up and in force. If this were to happen, of course, funding for a buy-sell arrangement could be jeopardized.

---

[1] The rates used were determined based on information available as at June 30, 2003. Updated information will be available mid-2004, once all the provinces have presented their budgets.

The 2003 federal budget increased the "business limit". The business limit that applies proportionately based on the calendar year is as follows:

Calendar 2002 – 2002:	$200,000
Calendar 2003:	$225,000
Calendar 2004:	$250,000
Calendar 2005:	$275,000
Calendar 2006+:	$300,000

Critical Illness coverage considerations

Under the Income Tax Act (ITA), mortality gains on Life Insurance policies owned by a private corporation, where the corporation is beneficiary, can be credited to the Capital Dividend Account (CDA).

These amounts (i.e., the death benefit in excess of the Adjusted Cost Basis (ACB) can be paid to surviving shareholders from the CDA tax-free. The calculator assumes that whether a LI policy is corporately or individually owned, the benefits will reach the hands of the appropriate party(ies) tax-free. We are assuming that the ACB of the life insurance policy is zero.

This is not true with Critical Illness (CI) benefits received by a corporation as an owner. The only way that CI benefits can be paid out is either as

1. Salary and wages. Generally the least tax effective way.
2. Taxable dividend. Generally the most tax effective way, but;
    - The individual(s) requiring the benefit must be a shareholder(s).
    - The shareholder(s) receiving the benefits must be the only ones requiring the benefits.

Because the corporation cannot pay CI benefits tax-free, the critical illness portion of the calculator uses the following assumptions:

- The insured is a shareholder of the corporation
- The benefits need to be in the hands of the shareholder employee
- A CI lump sum benefit will be received by the corporation on a tax-free basis
- The CI lump sum benefit will be distributed to the purchasing shareholder(s) as a taxable dividend.

Case study

John and his sister Samantha are each 50% owners of Johnsam Company, a Canadian-Controlled Private Corporation located in Ontario. It currently is a Qualified Small Business Corporation. The company's present value is $2,500,000. John, 43, and Samantha, 39, are both non-smokers. They want a buy-sell agreement that will fund 100% of the company's current value. After several meetings you have agreed on a Perspecta UL policy with proposed premiums as follows:

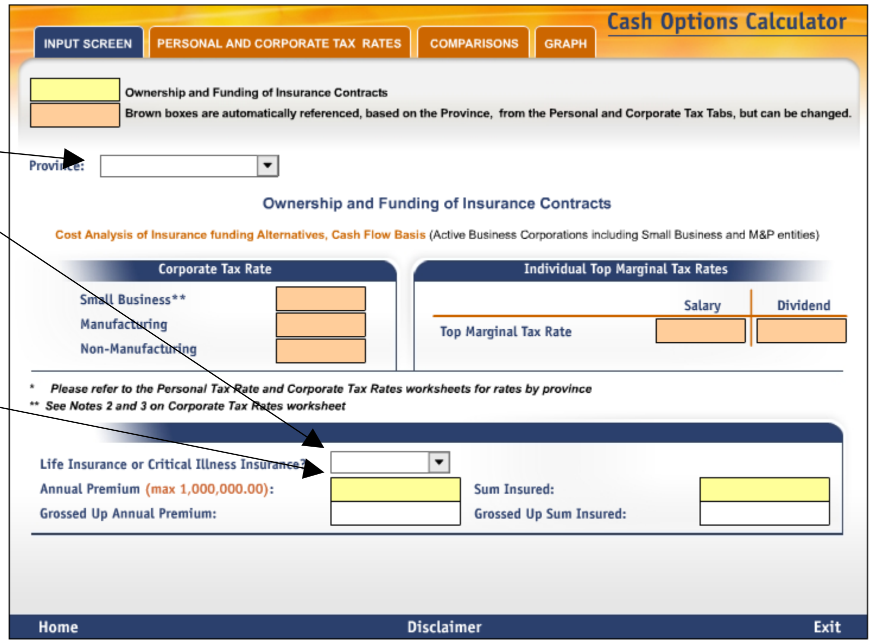
	Sum insured	**Annual deposit**
John	$1,250,000	$15,276.04
Samantha	$1,250,000	$ 9,052.08
	$2,500,000	$24,328.12

John and Samantha are residents of Ontario. They are both in the top income tax bracket and pay tax at a marginal rate of 46.41%. Their business, on the other hand, is in the lowest corporate tax bracket at 18.62%. Using the calculator, you determine that corporate payment of the premium when it is the owner of the policy is the best method, from a cost perspective. The corporate funding method will cost $29,894.47. This is much less than any of the individual ownership options. The least expensive of the individual ownership options – where the corporation pays a dividend to the individual to fund the insurance premium – is $43,533.52. This is a difference of $13,639.05.

How to use the Cash Options Calculator

Using the calculator is as easy as 1, 2, 3!
The numbers shown in these instructions are for illustrative purposes only and not those used above.
Prior to entering information in the **input screen** you must decide how the individual is to be treated. Select "Treat as employee" or "Treat as shareholder"

1. Select province
2. Specify "life insurance" or "critical illness insurance"
3. Enter premium amount and sum insured in yellow fields.



4. You're done!
A comparison of different funding options will automatically be illustrated when you click on the "Comparison" tab. Display the results graphically by clicking on the "Graph" tab. Print the entire calculation by clicking on the "print results" tab.