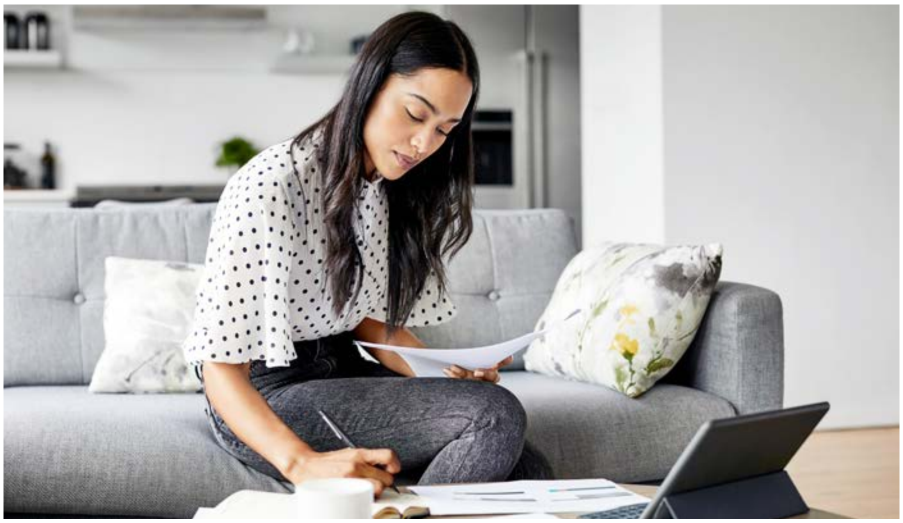
CASE IN POINT

Sales Tax Estate Planning Underwriting & Product Newsletter

Young professionnals and positioning a life insurance policy



Some clients who are professionals (e.g. medical doctors, dentists, lawyers or accountants) choose to exercise their profession through a corporation (hereinafter "ProfessionalCo"). Younger professionals may not have a ProfessionalCo yet but may be interested to include one as part of their tax planning in the coming years. However, those same young professionals may want to acquire a life insurance policy early in their professional lives.

This situation leaves them with the following questions: should I wait until I've created my ProfessionalCo to buy a life insurance policy? Should I create my ProfessionalCo now in order to acquire a life insurance policy? Could I acquire a life insurance policy now and transfer it in a few years to my ProfessionalCo once it is created?

Let's look at certain elements on which advisors can provide guidance to these young professionals.

Our case study

Let's look at the situation of Jessica who is a 30-year-old non-smoking software engineer with a good salary. She does not have a corporation as part of her tax planning yet, but her accountant has suggested that she include one at some point in the next few years. Jessica would like to buy a life insurance policy now. However, she wants to know if she could transfer the policy to her corporation in the future and what would be the tax consequences of doing so.

Alex Papale,
Tax Retirement & Estate Planning Services

Alex is a well-regarded Tax and Estate Planning specialist with a sought-after ability to analyze and articulate complex matters. He completed graduate studies in tax law which allows him to provide suggestions for comprehensive solutions to problems faced by Canadian residents and business owners. Before joining Empire Life, Alex worked for renowned accounting and legal firms, where he regularly advised clients on various tax and estate planning matters.

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Empire Life

Case in Point

Tax considerations

When the ownership of a life insurance policy changes, it is considered a “disposition” as per the rules of the Income Tax Act. A policy gain, which would be fully taxable for the original owner of the policy, would result if the proceeds of the disposition are greater than the adjusted cost basis (ACB) of the policy at time of transfer.

When a shareholder transfers a life insurance policy to a corporation she controls, some special rules will apply. These rules will establish deemed proceeds of disposition for purposes of determining whether a policy gain is realized or not. The deemed proceeds of disposition will correspond to the greatest of :

1. the value of the interest in the life insurance policy (generally equal to the CSV of the policy);
2. the fair market value of the consideration given for the interest in the life insurance policy; and
3. the ACB of the policy at time of transfer.

Generally, since a corporation wholly owned by one shareholder would not pay that shareholder to obtain the life insurance policy, the element 2) above would be equal to zero. This means that, in such a case, the deemed proceeds of disposition for Jessica would depend on what the CSV and the ACB at time of transfer are. If the ACB is greater than the CSV of the policy at time of transfer, the deemed proceeds of disposition would be equal to the ACB to the policyholder at time of transfer. Therefore, the transfer should not result in a policy gain for the transferor (for the original policyholder). However, if the CSV of the policy is greater the ACB at time of transfer, the deemed proceeds of disposition would be equal to the CSV of the policy at time of transfer. Therefore, the transfer should result in a policy gain equal to the difference between the CSV and the ACB at time of transfer.

When these special rules apply, the deemed proceeds of disposition previously established become the ACB of the new policyholder.

Back to our case

With the help of her financial advisor, Jessica has decided to go forward with an Optimax 8-Pay with paid-up additions from Empire Life. She needs coverage of $500,000 which she will get with 8 equal annual premium payments of $16,570. The projected ACB to the policyholder and the total CSV of the life insurance policy are the following:

Year of policy	ACB to the policyholder	Total CSV of policy
1	$16,363	$7,005
5	$81,489	$58,855
10	$129,539	$123,401
11	$129,151	$130,538
15	$127,050	$163,121
20	$122,809	$214,467
25	$116,047	$280,527
35	$87,275	$470,747
45	$10,018	$760,552
55	$0	$1,168,168

Here are a few comments that Jessica’s advisor could make regarding the consequences of transferring this life insurance policy to a ProfesionnalCo to be created if the corporation does not give anything to Jessica to acquire the life insurance policy:

- For years 1 to 10 of the policy,
  - the ACB is greater than the projected CSV of the policy;
  - therefore, transferring the life insurance policy during those years from Jessica to her ProfessionalCo should not result in a policy gain for Jessica;
  - there should not be any adjustment of the ACB as a result of the transfer.
- At year 11 of the policy and for following years,
  - at year 11 of the policy and for the following years, the projected CSV of the policy is greater than the ACB;
  - therefore, transferring the life insurance policy during those years from Jessica to her ProfessionalCo would likely result in a policy gain for Jessica;
  - the ACB of the life insurance policy will increase as a result of the transfer. This could have a negative impact on the credit to the ProfessionalCo’s capital dividend account (CDA) that would result when the death benefits are paid at Jessica’s death.

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Since Jessica's advisor understands the special tax rules that would apply to the transfer of the life insurance policy considered by Jessica, she understands that the ProfessionalCo could pay Jessica a certain amount without triggering (or increasing) a policy gain. Therefore, the advisor could make the following additional recommendations:

- If the life insurance policy is transferred in years 1 to 10 of the policy, Jessica's ProfessionalCo could pay Jessica any amount equal to or lower than the ACB of the policy without triggering a policy gain;
- If the life insurance policy is transferred in any year after year 10 of the policy, Jessica's ProfessionalCo could pay Jessica any amount equal to or lower than the CSV of the policy without increasing the policy gain realized.

If the ProfessionalCo does not have cash available to pay Jessica at time of transfer, the ProfessionalCo could issue a promissory note in the desired amount in favour of Jessica. This way the corporation could pay Jessica the desired amount over time as liquidity becomes available.

How we can help

Our tax and estate planning team can assist you and your clients in matters of tax and estate planning involving incorporated professional and small business owners. Contact your account manager to see how the team can help you and your clients.

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