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Re-thinking Owning Life Insurance Inside a Corporation

By Kurt Rosentreter, CPA, CA, CFP, CLU, CIMA, TEP, FCSI

All the rage in Canada right now is insurance agents convincing dentists, doctors, lawyers, business owners and other self-employed professionals that it is a brilliant tax maneuver to hold life insurance inside their corporation(s).

Not so quick doc.

Advantages of Corporate Owned Life Insurance - Maybe

This may be possibly what you have heard about why you should own your life insurance policies inside a corporation instead of holding the insurance policies personally:

- Premiums will cost you less since they are paid with lower taxed dollars inside a corporation.
- On death, the proceeds of the policy will pay tax free into the corporation and then you can remove the money tax free from the corporation ala the capital dividend account.

While aspects of these characteristics are true, all is not as it appears. For the premiums to cost you less, the revenue inside the corporation needs to be taxed at a preferential tax rate. There has not been preferential tax rates on revenue from rental properties or some passive income historically (e.g. investment income). And the new corporate tax rules that the Federal Liberals proposed for 2018 (introduced in July 2017) will raise taxes on more passive income in the future.

The tax-free payout on death used to be – read used to be – a decent reason to consider owning life insurance policies inside a corporation if the situation warranted it. But changes to the tax rules by the Minister of Finance in recent years has made getting the life insurance proceeds out of the corporation tax free a lot harder after death now.

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Disadvantages of Corporate Owned Life Insurance

There are several reasons owning life insurance inside a corporation can be a bad idea:

- If you ever sell your business, you will likely want to sell the shares (vs. assets) in order to access the \$800,000+ capital gains tax exemption on private company shares. Holding a life insurance policy inside your operating corporation for sale can limit or deny access to this exemption – for this reason alone you likely should never, ever buy a life insurance policy inside a corporation holding a business that may be sold someday.
- If you ever want to sell the shares of a business held inside a corporation and the same corporation owns a life insurance policy, the buyer does not want to buy your life insurance policy that the company owns. In some cases, you are in trouble – there may be no way to move the insurance policy out of the corporation without incurring a monstrous taxable benefit costing you hundreds of thousands in taxes at the time of sale. The insurance policy never should have been purchased inside a corporation that could be sold, closed down or restructured.
- Let's say someone sues your business. You lose the court case. You declare bankruptcy of the business. All of the assets of the corporation get caught up in the bankruptcy – including your big, fat money-filled life insurance policy. Every lawyer under the sun teaches that business owners and self-employed professionals need to “creditor proof” their net worth. This means you structure your assets to be protected from lawsuits. By purchasing a life insurance policy inside your business corporation, you are doing the exact opposite – not too smart.
- Any chance you may bring a partner into your business? Any chance you may want to give them part ownership in your business to keep them around or as a succession plan? If so, they are not going to want to own your life insurance policy which is exactly what happens if you make the corporation the owner of your life insurance policies. When they buy in, they can get a share of all assets – including your insurance policy and the proceeds on death.

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Let's now move on to more of the practical, common sense reasons not to hold your life insurance inside a corporation:

- For life insurance policies owned inside a corporation the only choice as a beneficiary of the policy is the corporation itself. You are the life insured. The corporation is the policy owner. And the beneficiary is the corporation as well – not your spouse, not your kids. So this means if you die, the money goes to the corporation right away – not your family. And because the corporation is a legal structure, even if is merely your family corporation, it may take weeks or months to eventually get the corporate cash into your family's hands to pay bills. Who are the officers and directors of your corporation? What will the tax impact be? Do the corporate shares need to go through probate? Are there other owners of the corporation that will have a say on what gets paid out and when? Complexity, complexity, complexity, is what you sign up for when you put your life insurance inside a corporation. And all of this takes time – time when your spouse and heirs will not have the money in their hands. Not even to pay the funeral costs. If this was money the family was counting on to pay the bills after your sudden death, know that you made the money a lot harder to get at compared to when the life insurance was held personally, and your family was the direct beneficiary. You cannot just write a cheque for money coming out of a corporation.
- Often, I am seeing professionals and business owners being convinced by insurance agents to “dump” huge cash amounts into these life insurance policies as part of the strategy of tax sheltering money inside the policy during the premium payment period. I have seen executives putting \$20,000, \$50,000 even \$100,000/year for fifteen or twenty years to balloon up the policy savings so that investment returns will become high enough to pay the premium from within the policy (instead of by you) after a set period of payments. The term is called reaching “paid up” status. People making these payments are being told they will not have to make any more premium payments after a set date. So, let's look at all of these facts and why you need to be careful:
 - As part of the process of selling you the policy the agent shows you illustrations of how the money will grow as invested inside the policy – eventually reaching a point where the policy pays for itself. Agents regularly claim that the policy will earn 6%/year inside the policy and show how this has been the case for years in the past. But did they show you how the rate of return you can expect has been coming down over the years since interest rates in the marketplace have fallen so much?

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- It is not recommended you “buy the sales pitch thinking you too will get 6%/year for 30 years without doing some “what if” scenario analysis - make sure you run the illustrations using a 1% rate of return to see your worst-case scenario. Consider basing your premiums on a much lower expected return. You cannot afford to be wrong when you are poised to sink tens of thousands of dollars into a product that cannot easily be changed once it is purchased.
- I am awestruck when I see executives and business owners ploughing \$30,000/year or more into a universal life or whole life insurance product with so many moving parts:
 - Canadian tax rules have been changing around these life insurance policies in general in recent years. So have rules for Canadian corporation tax – how can you commit significant money to a product that may be irrelevant in 1,5,10 years because the tax rules change? Fall 2016 saw new limitations to how much money can be tax sheltered inside insurance policies. Summer of 2017 saw the Liberal Federal government all but make corporations for professionals irrelevant. Before that they tinkered with the stop loss rules affecting life insurance payouts on death. Think twice about making huge investments in life insurance products at a time when the governments clearly have sent signals they don’t like the tax rules around life insurance – and whether it is tax changes in 2018 or 2038 it could affect you give the long term nature of owning life insurance.
 - We have seen the costs of insurance policies rising significantly in recent years. Insurance companies are getting out of products they cannot make money in. Insurance company stock prices are below past highs because of their struggles to make money in various products. If you don’t have a sense of how costs affects policy coverage or your rate of return earned inside the policy then think twice about buying in the dark.
 - The embedded rate of return in the policy is not guaranteed as discussed above. If the rate of return is 1%/year instead of 6%/year would you still buy the insurance policy? Do you even understand how this works? Doctors and dentists sold into these policies with the promise of massive death benefits someday and no taxation – dreams that may be far from reality by the time end of life comes.

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Now let's even get more practical – let's talk about your retirement.

If you can afford to put \$15,000 to \$50,000/yr or more into these fancy insurance policies inside a corporation during your working years I assume you are making at least a few hundred thousand a year for an income.

If this is the case, let's look at your retirement plan – you are going to need \$3,000,000 to \$5,000,000 in savings at retirement to replicate the income and lifestyle you have today.

So long before you plough big cash into a life insurance policy that you likely don't need and that may never use in retirement, let's make sure you are saving for your own retirement first, are debt free, are kid financially free – because if you are not on the road to \$5 million in savings don't buy this policy.

Also, on retirement, when you buy these policies you enter into a commitment to make hefty deposits for ten to twenty years. So, make sure during that period that you don't get divorced, don't get fired, don't get sick and unable to work because anything that may disrupt your financial wellbeing over that twenty-year period could be a disastrous for an insurance policy that requires these deposits.

To go even further, we have seen people that do have personal issues even after the premium payment period is completed – they find themselves needing money to live and bingo they are forced to withdraw the capital from within the policy to pay bills or to pay out the divorce. These insurance policies are not designed to be used as a piggy bank when a crisis hits and would prove to be a very expensive form of financing in these cases. Basically, unless you can guarantee me absolutely nothing will change in your life for half a century then we can consider buying life insurance after age 50.

And what if your payments into the policy end up going longer than the ten or fifteen years they promised? We have seen a few instances now where the dentist planned to retire the year after the big premium payments are scheduled to stop only to hear that he needs to continue to make the big premiums several more years as investment results inside the policy were not quite as the illustration showed eight years ago at the point of purchase. The dentist now looks on in horror as he cannot afford the mega insurance premium on the retirement income he was planning – and is now forced to work longer just to have money to fund the insurance policy. Did the agent warn you this could happen when you bought the policy? Are you prepared to carry the cost of these policies after you retire and your salary is gone if you have to?



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Finally let's finish with some talk about insurance commissions and product shopping and what information the insurance agent shared with you.

- When you bought the insurance policy for your corporation did the insurance agent shop around different insurance companies and explain the differences in pricing and policy characteristics between policy types and insurance companies? Prices and characteristics of policies can vary widely between companies. Even agents have their "favourite" insurance companies and policy types.
- The purchase of a life insurance policy could cost you tens of thousands of dollars per year and affect one half of your lifetime. It is always wise to also get a second opinion from a second agent or better still from someone not paid by the product sale.
- Did the insurance agent explain the different types of insurance policies that you could buy for the corporation (term to 100, whole life, universal life) and what is best and why? Did she show you differences between different company products? These three types of life insurance policies are all very different and all are possible solutions for your needs and wants.
- Did the insurance agent outline his or her compensation from selling you the policy? Let's look at this closer:
 - Insurance agents get paid differently according to the type of policy they sell you. For example, selling a 50-year-old male a \$1,000,000 Term to 100 death benefit policy for your corporation could have a premium of \$14,115 per year and an upfront commission to the agent of \$17,645. But selling you a whole life policy instead with a premium of \$16,232 per year, has an upfront commission of \$27,054.
 - With such a staggering difference in compensation paid to the selling insurance agent above are you confident you ended up with the right policy?
 - Did they explain all the compensation? If not, why not?
- Did the agent outline that the commission they earn are paid from within the insurance policy and this cost is netted against your investment returns inside the policy. Also, that if you try to cancel the policy now the insurance company may charge back the commission paid to the agent to your policy and you pay for it all at once (called surrender fees)?

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- And this last one is concerning: If you already had existing life insurance coverage those policies could have been moved into your corporation instead of selling you a new policy. Did the insurance agent offer to do this or was the agent adamant you needed to buy a fresh policy? Old policies were purchased when you were younger making them cheaper than buying new today. In Canada, agents are not allowed to “replace” good old policies with newer coverage that could pay new commissions to them.

In Conclusion

Few of us need life insurance after age 60. Our kids are grown up. Our mortgages are gone. And our retirement savings or pensions are likely almost in place. The period of your life where you needed life insurance as a safety net is usually done by this point.

Life insurance in the second half of your life can serve as a tax shelter or help preserve an estate on death. Permanent life insurance can play a role in your finances later in life. But what my article shows you is that buying life insurance as part of your estate plan takes careful planning by qualified professionals that evaluate all the pros and cons of different product types, know income tax rules well, take time to look at your entire picture and offer transparent value-priced advice and products.

If you have purchased corporate owned life insurance and you don't feel you have had proper advice from a trained insurance expert, contact our office for an insurance review. Leaving poor policies in place hoping they will get better later in life may in fact make matters worse with time. Act now.

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