Reasons Why You Should <u>Not</u> Buy 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 more that it is absolutely essential and a brilliant tax maneuver to hold life insurance inside a corporation they own.

Not so quick.

Advantages of Corporate Owned Life Insurance

No doubt this is what you have heard about why you should own your life insurance policies inside a corporation instead of holding the 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 is no preferential tax rates on revenue from rental properties or passive income (e.g. investment income). And if the Federal Liberals get their way there may not even be preferential tax rates on your active business income as an incorporated professional (did you see the tax changes proposed July 2017?). Lastly, this reason alone of hunting out tax breaks is not enough to get you to own life insurance inside a corporation. Read on.

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 a lot harder after death.

So, with two "vague" advantages to putting your life insurance inside a corporation you own now let's look at the reasons not to do it.

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Disadvantages of Corporate Owned Life Insurance

Where do we start – there are so many reasons owning life insurance inside a corporation is 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 corporation can screw up 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.

But I'm just warming up….let's keep going:

- 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. Why, oh why, would you put personal assets inside a high-risk business? Every lawyer under the sun teachers 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 – dumb.
- 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 get a share of all assets – including your insurance policy and the proceeds on death.

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

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- 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 personal hands. 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 in order for the premiums to start being paid by the policy (instead of 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 XX 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? It is downright dangerous to assume you will continue to get
    a juicy 6%/year and to bet a fortune in money on this - make sure you run the illustrations using a 1% rate of return to see your worst-case scenario.
  - I am awestruck when I see executives and business owners ploughing $30,000/year or more into product with so many moving parts:

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- Tax rules have been massively changing around these policies in general as well as corporate taxation rules – how can you commit mega 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. Yet you continue to buy such policies and fork over huge cash on a product that clearly may be legislated out of existence at this rate. How much money are you prepared to lose if you have to unwind your corporate owned life insurance in the future?
- 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 miles below past highs because of their struggles to make money in products. Knowing this do you really think you are getting a "deal" on buying new life insurance today?
- 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.

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 Cadillac 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

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further, we have seen people that do have issues even after the payment period is completed – they find themselves needing money 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 insurance 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 later in life.

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 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 or cancel/shrink the policy. Did they 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?

So, let's finish with some insurance agent transparency about life insurance sales:

- 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 or did you sign on the dotted life for whatever he put in front of you? Prices and characteristics of policies can vary widely between companies. Even agents have their "favourite" insurance companies and policy types. But they may not be right for you – if we comparison shop for a $2,500 vacation cost to Cuba surely you will comparison shop for an insurance policy that may cost you $100,000 or more?
- Know magnitude of a purchase that could cost you tens of thousands of dollars per year and affect one half of your lifetime it would always be wise to also get a second opinion from a <u>second agent</u> or better still from <u>someone not paid by the product sale</u>.
- Did he 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.

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- Did the 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 juicy 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 agent above are you confident you ended up with the right policy?
    - Did they explain all the compensation? If not, why not? And you bought anyway?
- Did the agent outline that you are paying this commission cost from inside the policy – a whopper of a hit to your investment returns inside the policy – and that even if you try to get out of the policy now the insurance company will charge back the commission to your anyway in many cases (called surrender fees)?
- And this last one is troubling: 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 they 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. This is a very bad sign if you had policies cancelled and new policies purchased as part of your move to corporate owned life insurance policies.

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.

Now an agent you barely know who is poised to earn hundreds of thousands of dollars in commission if they can just convince you to put tens of thousands of dollars a year into a product you don't need or understand, with no guarantees, with no easy way out later, with costs you can't see, for your goals and life that is ever changing in a constantly shifting tax regime.

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Think twice folks.

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