Bolstering the balance sheet

CPA WHITEPAPER

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Why business owners are investing millions in a strategy that CPAs often miss

As Canadian Controlled Private Corporations (CCPCs) grow, they employ a comprehensive team of professionals to manage their complex and expanding interests. Increasingly, affluent business owners will rely on Chartered Professional Accountants (CPAs) to partner with other professionals to offer multi-dimensional strategies aimed at ensuring business sustainability. Without professional collaboration, there's a missed opportunity to deliver value-added service to key clients.

It might surprise you that today, more and more of Canada's wealthiest business owners are turning to **permanent life insurance** to help protect their estates and address tax issues. It might also be surprising that hundreds of millions of dollars are being used to purchase corporate-owned policies each year. CPAs can deliver significant value to their clients by seeing the opportunity that insurance offers as a tax-efficient asset, and not just an expense.

Ironically, many CPAs who specialize in creating tax efficiencies don't expand their team to include life insurance professionals. Used well, life insurance provides an opportunity to help solve three significant problems for their business owner clients:

- Minimizing corporate tax during lifetime asset accumulation
- Minimizing personal tax at death
- Preserving and improving liquidity for the business

This article examines how permanent life insurance helps enhance a corporate balance sheet by minimizing tax burdens and enhancing liquidity. We'll also look at how CPAs are uniquely positioned to bring this solution to the table, and why introducing this wealth preservation strategy will help solidify your role as a vital member of a client's advisory team.

Protecting human capital vs. retaining financial capital: two sides of the same coin

Traditionally, CPAs have viewed insurance as a necessary expense that addresses a specific need. For example, a business owner client takes out a 10-year loan to expand the business. Insurance is a useful tool to help safeguard the assets of the company against an unexpected death. Because insurance may be seen as a cost, and not an investment, an inexpensive 10-year term insurance policy to cover the liability is recommended.

In this scenario, the need to protect human capital — such as key person protection to help insure against the loss of an important shareholder, or managing the risk of early death when holding a large loan — is met. But protecting human capital is a minimum requirement. Is wealth preservation being maximized as well? Insurance can go beyond helping to satisfy protection needs. A CPA well versed in wealth preservation will know that permanent life insurance can enhance the value of the business through tax-efficient cash value growth during the life of the policy, and a tax-free payout to beneficiaries at death. Permanent life insurance may also improve the corporation's liquidity position as certain insurance products offer significant early cash value that is easily accessible for growth opportunities. Permanent insurance can outperform many other investment options for business owner clients who want to balance tax-adjusted returns, maintain access to liquidity, and satisfy a protection need.

While permanent insurance can be a robust tool, it isn't always an option. Business owner clients must have a justifiable death-benefit need, such as funding a terminal tax liability. They must also meet certain qualification criteria, including the ability to afford the coverage, and relatively good health for life insurance company underwriting requirements. Some clients are excluded from coverage even if it's required as an important part of their financial plan.

If a business owner client meets the insurance eligibility requirements, working with an insurance professional can help them understand options that go beyond simple term insurance. In fact, wealthier business owners often have larger and more diverse advisory teams that can include insurance professionals. By coordinating the delivery of advice, advisors take a leadership role on the team and expand their influence.

Rethink the expense label: it's a balance sheet discussion

When a client has a liability they need to cover in the event of death, the immediate reaction tends to focus on finding the cheapest way of securing that protection. Helping to cover the liability with insurance is often seen as another expense that reduces cash flow or retained earnings, which could have been used to support business growth. If the only goal is minimizing expenses to cover the need, then term insurance can be the obvious choice, especially when the liability is short term in nature.

Let's flip the discussion and consider the scenario where the liability is permanent, and therefore requiring a permanent insurance solution. Rather than trying to minimize the insurance premium expense, let's try to help cover the liability by optimizing the solution like an investment. One option could be investing money with hopes of maximizing the return. That comes with the risk of tax-erosion on investment income and capital gains. Some types of permanent life insurance offer an investment component, which makes for an interesting comparison. The higher premiums associated with permanent insurance might cause a negative reaction when compared to term, but consider the balance sheet and see what happens when insurance is viewed as an asset.

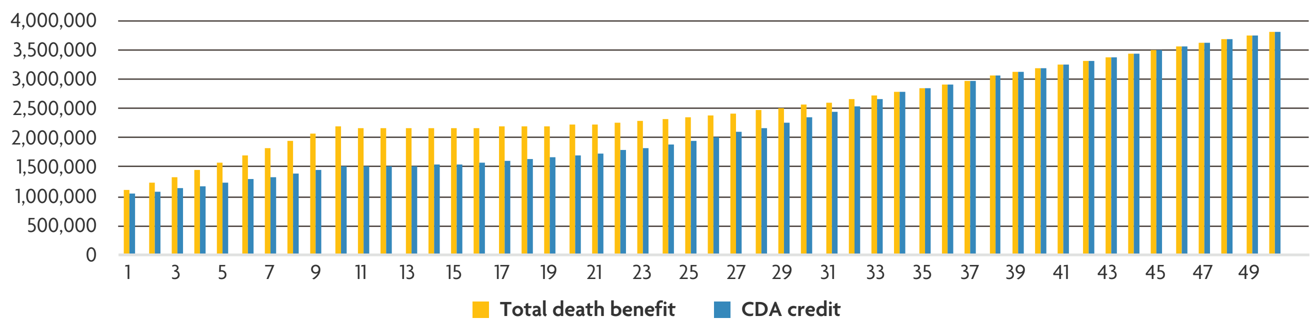
Permanent insurance, unlike term insurance, includes the potential for a cash accumulation fund. The investments in the fund are tax sheltered, including at death when the insurance benefit is paid out. Certain insurance products provide a high degree of stability and include a variety of investment options. They even offer options to grow the business by using the policy's value as collateral for a loan, helping to provide the liquidity that many business owners seek.

On the other hand, traditional investment portfolios are subject to annual taxation of earned interest, dividends received and realized capital gains. When these assets are liquidated, it also triggers taxation of deferred capital gains. For corporations, money is typically moved to the estate or new shareholders by payment of a taxable dividend.

Transferring funds in a corporation from taxable investments to a permanent life insurance policy can help reduce overall annual taxable investment income. At the death of the insured person, the tax-free death benefit is paid to the designated corporate beneficiary, and this amount, less the policy's adjusted cost basis, can be credited to the corporation's capital dividend account (CDA). For corporate beneficiaries, the CDA helps provide a tax-efficient method of moving money out of the corporation to the estate or new shareholders. Any portion of the death benefit that exceeds the CDA credit can be paid out of the corporation as a taxable dividend.

The following graph shows how long it takes for the full death benefit of a 50-year-old male to be credited to the corporation's CDA using a permanent life insurance policy.[1] The full death benefit can pass through the CDA in 34 years. Before the 34th year, no less than 70% of the death benefit will be available to the CDA with the excess treated as other assets.

Death benefit vs CDA



1 The example is of a 50-year-old male non-smoker. The insurance policy is a Sun Par Accumulator policy life pay for $1 million of death benefit. The max plus premium option is used and the policy is illustrated using 10 premiums with offset in year 11. The dividend scale interest rate is 6.25%.

The cash surrender value (CSV) of a corporate-owned life insurance policy is a corporate asset and should be included in the company's balance sheet. The significance of the CSV and the client's objectives will help you determine where the amount should be included. If the client has no intention to dispose of the policy, the CSV should be classified in the **non-current asset** section under **other assets**, or as **life insurance CSV** on the balance sheet. Disclosure is optional depending on the materiality of the amount. If the client's intention is to do a full or partial disposition of the policy in the near future, the CSV should generally be classified as **cash and cash equivalents** in the **current assets** section of the balance sheet.

Let's look at an example of the balance sheet impact of a hypothetical lower premium term policy vs. a hypothetical higher premium participating whole life insurance product with early CSV (Quick Pay Permanent) over the first 20 years. The term policy has annual premiums of $50,000 each year. The participating whole life policy is being quick paid over 10 years with annual premiums of $200,000.

TERM TO 100					QUICK PAY PERMANENT				
Year	Annual premium	Total CSV	Impact on balance sheet	Impact on income statement	Year	Annual premium	Total CSV	Impact on balance sheet	Impact on income statement
1	50,000	0	-50,000	-50,000	1	200,000	150,000	-50,000	-50,000
2	50,000	0	-100,000	-50,000	2	200,000	320,000	-80,000	-30,000
3	50,000	0	-150,000	-50,000	3	200,000	510,000	-90,000	-10,000
4	50,000	0	-200,000	-50,000	4	200,000	720,000	-80,000	10,000
5	50,000	0	-250,000	-50,000	5	200,000	950,000	-50,000	30,000
6	50,000	0	-300,000	-50,000	6	200,000	1,200,000	0	50,000
7	50,000	0	-350,000	-50,000	7	200,000	1,500,000	100,000	100,000
8	50,000	0	-400,000	-50,000	8	200,000	1,800,000	200,000	100,000
9	50,000	0	-450,000	-50,000	9	200,000	2,200,000	400,000	200,000
10	50,000	0	-500,000	-50,000	10	200,000	2,700,000	700,000	300,000
11	50,000	0	-550,000	-50,000	11	0	2,900,000	900,000	200,000
12	50,000	0	-600,000	-50,000	12	0	3,100,000	1,100,000	200,000
13	50,000	0	-650,000	-50,000	13	0	3,300,000	1,300,000	200,000
14	50,000	0	-700,000	-50,000	14	0	3,500,000	1,500,000	200,000
15	50,000	0	-750,000	-50,000	15	0	3,700,000	1,700,000	200,000
16	50,000	0	-800,000	-50,000	16	0	3,900,000	1,900,000	200,000
17	50,000	0	-850,000	-50,000	17	0	4,100,000	2,100,000	200,000
18	50,000	0	-900,000	-50,000	18	0	4,300,000	2,300,000	200,000
19	50,000	0	-950,000	-50,000	19	0	4,500,000	2,500,000	200,000
20	50,000	0	-1,000,000	-50,000	20	0	4,700,000	2,700,000	200,000

With the low cost Term to 100 policy, there is a premium paid each year that affects the income statement but there is never any CSV build up. This depletes the balance sheet value each year. In the early years of the Quick Pay Permanent policy, the premium paid, less the growth in the CSV, will show as an expense on the corporation's income statement. But over time (and in some cases, as early as 10 years), the growth in the cash value can begin to exceed the premium paid. Rather than an expense, the policy is now adding to the corporation's income and bolstering the balance sheet.[2]

Clients will often approach a trusted CPA advisor for their opinion on an insurance proposal. CPA advisors can help ensure clients are truly informed about their options by working with an insurance professional. If insurance is viewed as just an expense, then term insurance is almost always the first recommendation. But if CPA advisors can help clients move beyond the expense label and think about insurance as an asset, they can enhance the value of their service — particularly for high net worth business owners.

2 This income also needs to be considered against the corporation's ability to claim the small business deduction. As a passive asset of the corporation, the CSV of the policy should be taken into account when determining eligibility for the lifetime capital gains exemption. In most cases, the premium expense is not tax-deductible by the corporation. Where the policy has been pledged as collateral for a loan or line of credit, appropriate disclosures should be made.

A high net worth case study

To see the benefits of life insurance in a corporate scenario, consider the more descriptive and typical case of Charles. Charles is a 50-year-old entrepreneur who has built a successful architectural firm. In 1998, he incorporated. Charles' daughter plays an active role in the business, and she would like to take over the company one day. Charles discussed estate planning with his tax advisors and decided to implement an estate freeze. As part of his estate planning, Charles exchanged his common shares in the operating company for fixed value preferred shares with a redemption value of $5,000,000 and an adjusted cost base and paid up capital of $0. His daughter subscribed for new common shares in the operating company for $100.

Given his profession, Charles saw the value of real estate and invested most of his company assets into various properties. He also holds an investment portfolio of primarily fixed income investments. This structure provides Charles the necessary liquidity to take advantage of new business opportunities whenever they come along.

Charles' financial advisor recently reviewed his financial plan. The booming growth of his company and his keen eye for real estate opportunities have led to incredible success. But they've also left Charles with a major tax liability that's continuing to grow, and will need to be considered as part of his estate planning process.

When Charles dies there will be a deemed disposition of his shares at fair market value resulting in a capital gain of $5,000,000, half of which will be included as income on his terminal tax return. Assuming a 54% personal income tax rate, he'll owe approximately $1,350,000 in income taxes attributable to this deemed disposition in the year of death.[3] After death, his estate will own the preferred shares with an adjusted cost basis of $5,000,000, however the paid up capital of the shares is not increased and remains at $0. If the estate redeems the preferred shares there will be a deemed dividend of $5,000,000 resulting in additional taxes to be paid by the estate of $2,000,000 (assuming a 40% tax rate). The redemption will also cause a disposition of the shares owned by the estate and a capital loss of $5,000,000. If loss carry-back post mortem planning is undertaken within the first year of death, this capital loss may be eligible to be carried back to his terminal return. The executors of his estate and his tax advisor will implement this type of planning and redeem the shares within the first taxation year so the overall taxes on Charles' death will be $2,000,000.

Charles discussed his goals with his financial advisor. One of his main priorities is to ensure his estate is in the best possible position. Many of the early years that could have been spent with his growing family were instead spent growing his business, and it's clear he feels an obligation to leave his spouse and children with the largest legacy he possibly can. He recognizes that he will have a large amount of tax to pay at death and, as a result, he is concerned his estate may not be left with as much as he wants it to have.

Charles' financial advisor first suggests setting aside enough money to self-fund the tax liability. This strategy seems reasonable to Charles given his company's growth and his level of liquidity. Charles' CPA thinks there is a better way to handle this situation. In consultation with the CPA, an insurance advisor shows Charles how a $5,000,000 life insurance policy on his life as a potential solution. The insurance advisor presents both permanent and term life insurance options. The policy premiums can be paid by the operating company using after-tax corporate dollars. (Because Charles' corporation qualifies for the low small business tax rate, paying with corporate dollars may cost less than if Charles paid the premiums with his personal after-tax dollars). When he dies, the death benefit would be paid to the corporate beneficiary and an amount equal to the proceeds less the adjusted cost basis of the policy immediately before death will be included in the corporation's CDA (which can be paid to a shareholder tax-free, subject to stop loss rules as discussed later in this article).

3 Charles has previously utilized his lifetime capital gains exemption on a disposition of a company.

What type of life insurance policy should he choose? Charles isn't ready to let go of opportunities to continue to grow his business and assets. Initially, Charles was interested only in the cheapest possible option to make sure his family's needs are fully covered, at least until his children are well into their own careers. After talking it over with his CPA, he's inclined to go with a 20-year term life insurance policy with the lowest annual premiums. This would leave higher cash flow for his business endeavours, and provide at least a degree of protection for his family.

Charles and his CPA are now facing a misconception common among successful business owners and their accountants. His initial reaction was to take the cheaper $5 million term 20 policy[4]. But the term 20 option doesn't build any cash value, and unless he renews the policy at the end of the term, his coverage is likely to expire before his death. This option is really just an expense for his business and certainly doesn't seem appropriate for helping to cover a need that is permanent in nature.

Charles' insurance advisor also presents illustrations for two permanent life insurance policies:

- A Term to 100 for $5 million, paying the minimum annual premium each year
- A participating whole life policy for $5 million, quick paid over 10 years[5]

The annual premium for the permanent insurance options are much higher when compared to the original 20-year term option. Charles is struggling with whether he should sacrifice business growth in exchange for leaving a larger and more meaningful legacy to his family. Here is the balance sheet and income statement impact to Charles for the three options over the first 20 years:

	TERM 20				TERM TO 100				PARTICIPATING WHOLE LIFE			
Year	Annual premium	Total CSV	Impact on balance sheet	Impact on income statement	Annual premium	Total CSV	Impact on balance sheet	Impact on income statement	Annual premium	Total CSV	Impact on balance sheet	Impact on income statement
1	15,525	-	-15,525	-15,525	67,578	-	-67,578	-67,578	351,225	256,338	-94,887	-94,887
2	15,525	-	-31,050	-15,525	67,578	-	-135,156	-67,578	351,225	568,847	-133,603	-38,716
3	15,525	-	-46,575	-15,525	67,578	-	-202,734	-67,578	351,225	949,699	-103,976	29,627
4	15,525	-	-62.100	-15,525	67,578	-	-270,312	-67,578	351,225	1,301,557	-103,343	633
5	15,525	-	-77,625	-15,525	67,578	-	-337,890	-67,578	351,225	1,670,002	-86,123	17,220
6	15,525	-	-93,150	-15,525	67,578	-	-405,468	-67,578	351,225	2,053,021	-54,329	31,794
7	15,525	-	-108,675	-15,525	67,578	-	-473,046	-67,578	351,225	2,452,328	-6,247	48,082
8	15,525	-	-124,200	-15,525	67,578	-	-540,624	-67,578	351,225	2,867,382	57,582	63,829
9	15,525	-	-139,725	-15,525	67,578	-	-608,202	-67,578	351,225	3,299,076	138,051	80,469
10	**15,525**	**-**	**-155,250**	**-15,525**	**67,578**	**-**	**-675,780**	**-67,578**	**351,225**	**3,746,843**	**234,593**	**96,542**
11	15,525	-	-170,775	-15,525	67,578	-	-743,358	-67,578	-	3,997,866	485,616	251,023
12	15,525	-	-186,300	-15,525	67,578	-	-810,936	-67,578	-	4,131,153	618,903	133,287
13	15,525	-	-201,825	-15,525	67,578	-	-878,514	-67,578	-	4,268,794	756,544	137,641
14	15,525	-	-217,350	-15,525	67,578	-	-946,092	-67,578	-	4,410,834	898,584	142,040
15	**15,525**	**-**	**-232,875**	**-15,525**	**67,578**	**-**	**-1,013,670**	**-67,578**	**-**	**4,554,942**	**1,042,692**	**144,108**
16	15,525	-	-248,400	-15,525	67,578	-	-1,081,248	-67,578	-	4,702,353	1,190,103	147,411
17	15,525	-	-263,925	-15,525	67,578	-	-1,148,826	-67,578	-	4,853,832	1,341,582	151,479
18	15,525	-	-279,450	-15,525	67,578	-	-1,216,404	-67,578	-	5,009,040	1,496,790	155,208
19	15,525	-	-294,975	-15,525	67,578	-	-1,283,982	-67,578	-	5,167,988	1,655,738	158,948
20	**15,525**	**-**	**-310,500**	**-15,525**	**67,578**	**-**	**-1,351,560**	**-67,578**	**-**	**5,329,769**	**1,817,519**	**161,781**

4 Based on SunTerm 20 policy, $5 million coverage, 50-year-old male non-smoker, illustrated October 2017.

5 The Term to 100 is based on a min funded Sun UL T100 for $5 million. The participating whole life is based on a Sun Par Accumulator II policy, $5 million base coverage, 50-year-old male non-smoker, life pay with premium offset beginning at year 11, paid-up additional insurance dividend option at current minus 1%, illustrated October 2017. Premium offset is a non-contractual feature that is sensitive to changes in the dividend scale, and is not guaranteed.

After 20 years, the 20-year term insurance option would have resulted in a total expense of $310,500. If Charles doesn't convert or renew the policy (at a renewal premium of $206,000 annually), the protection would end and the corporation would receive nothing in return. This term policy also provides no cash value. For the Term to 100, the total expense after 20 years is higher at $1,351,560. For this type of protection, if Charles continues paying until death his corporation will receive the death benefit but the negative effect on his balance sheet will continue to grow. This Term to 100 policy also provides no cash value.

The participating whole life policy would require $3,512,250 in premiums over the same period. At first glance, this seems excessive in comparison to the term and Term to 100, until you consider the cash value. By year eight, the cash value in the policy is greater than the premiums paid and continues to grow by more than the amount of annual premium. The policy quickly becomes a value-generating asset on the corporation's balance sheet.

While the premiums may be significantly higher, a participating insurance policy isn't just an expense for Charles' business. It's a permanent protection solution that will help to grow the legacy he leaves for his family. At the same time, it's an investment for the future of his company that can help to reinforce the corporate balance sheet and provide access to cash for new opportunities.

What if Charles had decided that he would rather invest the money (self-insure) instead of paying the premiums for the participating policy?

Here's a look at how his net estate values would compare at a few select ages.[6] As this table shows, it's clear that as an estate-planning tool, the participating insurance policy provides more value than self-insuring. What's also surprising is that for the self -insurance option, it takes approximately 25 years to break even. Taxation on these investments ends up eroding significant value.

NET ESTATE BENEFIT ON DEATH

AGE	INVESTMENT (SELF-INSURANCE)	PARTICIPATING POLICY	INSURANCE ADVANTAGE
70	$3,161,875	$8,566,946	$5,405,071
80	$4,005,760	$9,425,981	$5,420,221
90	$5,009,514	$11,073,771	$6,064,257

When Charles dies, the death benefit will be paid to his company, and an amount equal to the proceeds (less the adjusted cost basis) will be included in the company's CDA (which can be paid to a shareholder tax-free). The company can use the proceeds received from the death benefit to redeem the preferred shares held by the estate. On the redemption, the company's tax advisors will choose to treat the portion of the dividend as a capital dividend equal to 50% of the capital gain[7] and the balance will be a taxable dividend. As a result, the total taxes to be paid on the terminal return and redemption of the shares will be reduced to $1,000,000 (assuming a 40% tax rate). The company will also have the remainder of the death benefit and a substantial capital dividend account credit, which can be used to pay a tax-free capital dividend to the new shareholder at any point in the future.

6 Based on Sun Life Corporate Investment Strategy illustration, October 2017. Investment option assumes annual contributions of $351,225 for 10 years (matching premium payment cash flows for participating policy), with a 3.5% rate of return on a 100% fixed income investment. Corporate investment tax rate is assumed at 50%, and shareholder dividend tax rate at 40%.

7 Assuming the shares are not considered to be grandfathered and the provisions in subsection 112(3.2) of the *Income Tax Act* (Canada) will apply to deny a portion of the capital loss if an amount greater than 50% of the capital gain is designated as a capital dividend. Note that since there are no provisions to split a dividend into a capital portion and taxable portion, additional planning will need to be implemented to help ensure the appropriate capital dividend election.

Clients need protection to manage risk

Clients want protection that satisfies two simultaneous goals: optimizing the value of their business for future shareholders, and taking advantage of opportunities to grow.

CPAs — like other financial professionals — are under increased pressure to provide multi-dimensional solutions. Viewing insurance as an asset that can potentially enhance the balance sheet opens up another opportunity to deliver value-added service. As demonstrated in the case study with Charles, creating strong links with insurance professionals who deliver this advanced level of insurance consultation can help satisfy client needs in an innovative way.

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