INSURANCE PLANNING: SPLIT BENEFICIARY AGREEMENTS

QUBE WHITEPAPER

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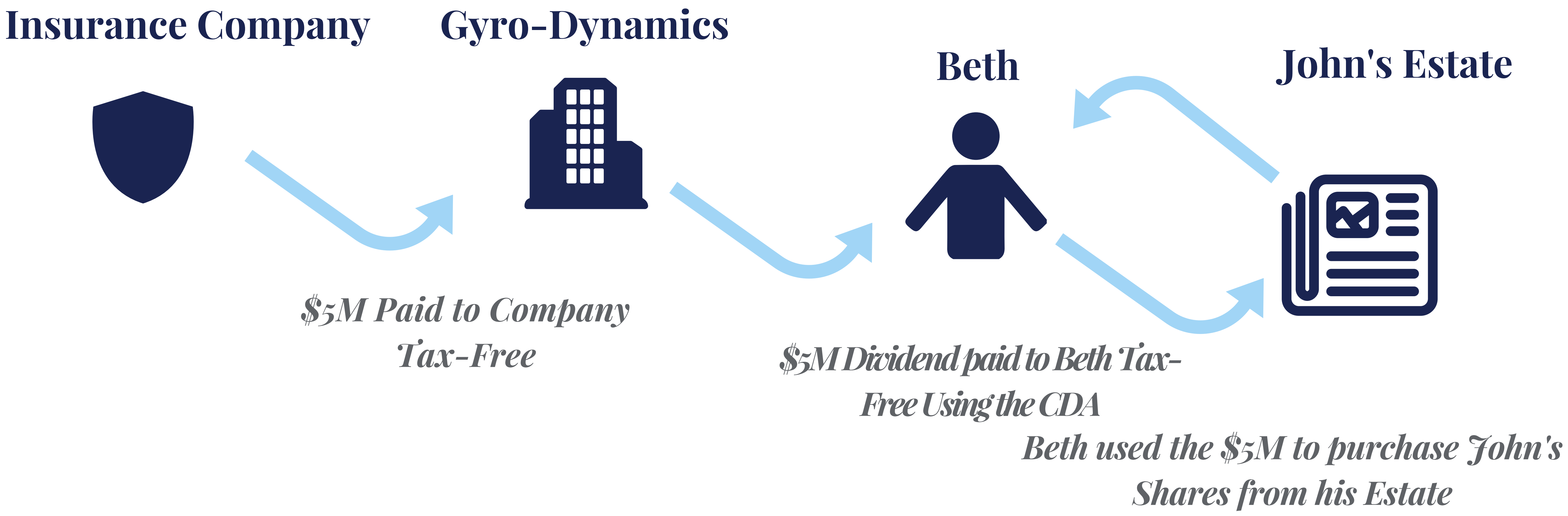
Life insurance can be a cost-efficient tool to fund various needs upon the death of a shareholder or key employee. For example, it can provide the necessary cash to surviving shareholder(s) to purchase the shares of their deceased partner. Or, it can provide funding to assist the corporation in the transition when a key employee has been lost. Life insurance can be cost effective, in part, because policies are offered preferential tax treatment under the Canadian tax code. In addition to most death benefits being tax-free, proceeds received by a corporate beneficiary can, depending on tax planning used, flow through a notional tax account called the Capital Dividend Account "CDA". Dividends received by a taxpayer from a corporate CDA (called capital dividends) are free of tax. The ability to generate tax-free dividends on a tax-free insurance payout makes insurance desirable in the corporate context.

Example: John and Gyro-Dynamics

John is the owner-manager of Gyro-Dynamics, a ventilation company that he started over 20 years ago. John's daughter Beth is hoping to buy the corporation from her father but will require several years to pay it off. As John has other children who are not involved in the business, he worries that if something were to happen to him, Beth could struggle to complete her payments.

The corporation is valued at $5M and John is in reasonable health for his age (56). Gyro-Dynamics places an insurance policy on John's life for $5M (term 10) at a cost of $13,000 per annum. This is a non-deductible corporate expense.

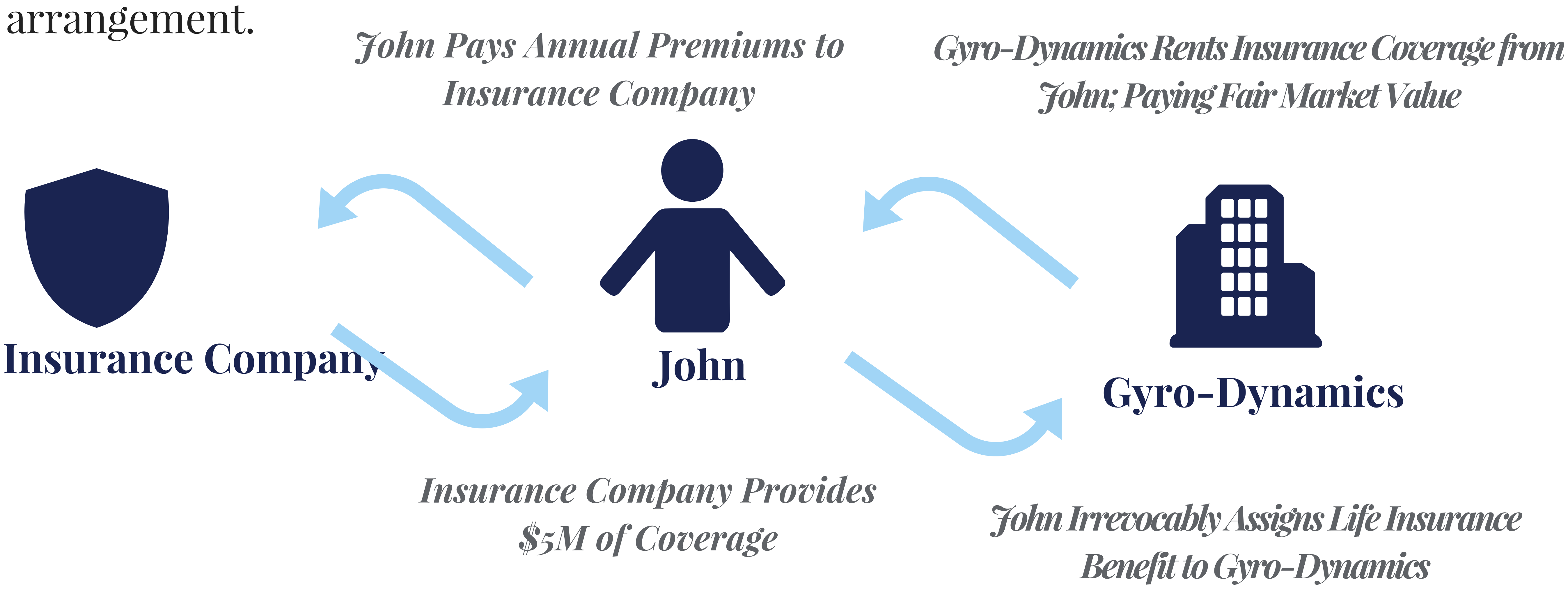
John then has a terrible accident and dies. The insurance company pays Gyro-Dynamics $5M tax-free. Beth, with the help of a well-crafted shareholder's agreement, can pull this cash from the company tax-free using the CDA and purchase John's shares from his estate.



The Split Beneficiary Arrangement

These types of arrangements are not new and a tax dialogue with CRA goes back to the late 1980's on various versions over the years. In the "split beneficiary arrangement", the death benefit on a personally owned life insurance policy is irrevocably assigned to a related company for a specific period. It is a second contract to the insurance policy which separates the death benefit from the policy (or a portion thereof) and asks for payment for that benefit based on its fair market value.

In our above example, instead of Gyro-Dynamics purchasing the life policy on John, John could purchase the policy and then write a contract (split beneficiary arrangement) offering the death benefit to the corporation until his retirement and/or purchase of his shares by Beth. This would be a classic split beneficiary arrangement.



Why Split Beneficiary?

John may have insurance needs that will transcend the situation with Beth (selling her his shares). For example, he may have charitable giving interest or US Estate Tax risk that he contemplates insuring. Once he retires from Gyro-Dynamics and the split beneficiary arrangement has been satisfied, he may wish to use the insurance for these other purposes.

It is also possible that John purchased insurance years ago, in an amount other than that needed by the corporation and wishes to use that insurance for the arrangement with Beth. Without changing the policy ownership, a split beneficiary arrangement will allow him to offer the required death benefit to the corporation for the required period for a fair and reasonable reimbursement.

Split beneficiary contracts are simple and flexible, allowing part, or all, of the death benefits of a policy to be offered to related parties for agreed periods of time.

The Corporate Commitment (Policy Premium Reimbursements)

Determining how much the corporation should pay for the assigned death benefit is a critical step in split beneficiary planning. The fair amount of premium charged will be a question of fact and determined using several possible proxies including annual renewable term costs, 5, 10 or 20-year term, term-65 or 100 rates, or even rates charged within Universal Life Policies. These all can represent "fair market value". One could also use NCPI (Net Cost of Pure Insurance) as it does represent the pure cost of insurance used as a measure of value under the ITA.

While the Income Tax Act (ITA) does not have specific rules regarding the tax treatment of a split beneficiary arrangement, nor how to proceed with the determination of "fair market value", it does discuss the existence of multiple owners of insurance policies and the ability to divide policy interests between them. Also, CRA has developed an administrative position regarding these arrangements which has evolved over the years.

For example, the CRA has held a longstanding position that the amount paid by one party to another should reflect what a person would pay for comparable rights in an open market. In 1987, CRA communicated that the benchmark it was considering for quantifying the value of a death benefit would be the NCPI (Net Cost of Pure Insurance). That same year, CALU (Canadian Life Underwriters Association) submitted a policy proposal to CRA agreeing that NCPI would be a reasonable proxy for value determination. While conclusions were not made, dialogue has continued over the years with each case open for interpretation by CRA on whether the pricing model used is appropriate. The issue at hand is if the amount the corporation paid to the shareholder for access to the death benefit was excessive, or not, and if a resulting taxable benefit would be conferred to the shareholder.

The taxation of corporate payments could be viewed from several perspectives. For example, one could make the argument that the life insurance is "property" and by "selling or renting" a portion of this property (the death benefit), the owner is deriving income from that property. On the other hand, and according to several tax planners, the counterargument is that the owner is merely defraying or being reimbursed for the costs of owning the policy. Corporate reimbursements are common and this would simply be another one.

Comments from CRA on shared premium arrangements came in 2010 and 2012 at what are called CALU Roundtable sessions with CRA. In both sessions, CRA maintained its position that if the corporation pays an amount that "should" be paid for maintenance of the insurance and ultimately receipt of the death benefit proceeds there is no taxable benefit to the shareholder. Concluding, each party is expected by CRA to pay the correct amount for what they get. Since there is an incentive to have the corporation reimburse as much as possible, tax risk does exist should CRA challenge the arrangement and its pricing model.

Our Pricing Model

In split beneficiary arrangements, the corporation reimburses the shareholder for access to the death benefits up until that shareholder's retirement age.

The Fair Market Price for coverage is based on the Net Cost of Pure Insurance (NCPI). The NCPI provides a measure of the annual cost associated with the mortality risk for a life insured in a particular year for tax purposes. It is determined by multiplying the net amount at risk (NAAR) each year by a prescribed mortality factor. In accordance with legislated changes for post-2016 policies, we apply legislated mortality rates as specified in the Canadian Institute of Actuaries 1986-1992 mortality table (see ITA RSC 1985, c.1 (5th Supplement), regulations 1401(1) and 1401(4)). Further to this, for the purposes of calculating the NCPI, the net amount at risk is determined as the difference between the death benefit for this policy and an actuarial calculation referred to as the Net Premium Reserve (see Regulation 308(1)(b)(C)).

In order to determine the working horizon for each shareholder, and their subsequent insurance needs, we define an expected retirement date in our model. Our applied assumption that each shareholder is expected to retire at age 70 is based on published Statistics Canada research.[2]

Quick Pay Option

The corporation has the option to pay for its coverage annually, or in accelerated installments. If prepayments are made, one needs to track a notional prepaid account and future payments discounted using the CRA prescribed rate.

Considerations

Should the shareholder terminate the employment relationship, or insurance coverage before the specified contract period, a taxable benefit would be incurred to the shareholder based on the position of the notional prepaid amounts. If circumstances change and the company determines that there is no ongoing need for insurance on key persons, the arrangement can be modified simply by changing the beneficiary designation. Again, tax implications on prepaid amounts might apply.

1 Reference papers are 2010-0359421C6 and 2012094356661C6

2 Table 282-0051 from the 2016 Labour Force Survey estimates (LFS), suggests that the average age of retirement for incorporated and unincorporated working owners is approximately 69.4.

Back to our Case Example: Gyro-Dynamics

Gyro-Dynamics Inc. has need for $5M of insurance on John, until his age 70. John happens to own such a policy (held in his personal name) and while it is costing John $13,000/annum, a pricing model is required to ensure that a fair and reasonable reimbursement is provided to John by the company for use of the death benefit until his retirement. John then assigns Gryo-Dynamics as the beneficiary on his policy using a split beneficiary agreement.

Using the pricing model, Gyro-Dynamics should reimburse John for its use of the insurance annually, or in various pre-payments. The annual amount ranges between $25,751 at age 56 and $120,396 at age 70. These amounts represent the minimum annual reimbursements that John should receive. If the company decides to do so, it can reimburse the full $833,120 to fulfill its funding commitment in a one-time payment, or alternatively it could spread these payments out over a longer period such as 5-years (see table). Prepaid amounts are tracked in a notional account in the event that the split beneficiary contract is terminated prematurely (prior to retirement). Each year, the pricing model determines the applicable minimum and maximum amounts based on prior funding made and time to retirement.

Should Term Insurance be used is likely that the funding model would permit reimbursements to John beyond his actual cost. For example, John negotiated his term policy at $13,000/annum. Corporate reimbursements are intended as tax-free amounts to John.

Age	NCPI	(Prepaid in 1 Year)	(Prepaid in 5 Years)	(Prepaid in 10 Years)	Notional Account (1 Year Prepay)
56	25,751.94	833,120.26	171,655.93	87,962.57	833,120.26
57	28,494.47		171,655.93	87,962.57	807,368.32
58	31,585.65		171,655.93	87,962.57	778,873.85
59	35,075.20		171,655.93	87,962.57	747,288.20
60	39,012.81		171,655.93	87,962.57	712,213.00
61	43,448.13			87,962.57	673,200.19
62	48,480.62			87,962.57	629,752.06
63	54,159.79			87,962.57	581,271.44
64	60,634.79			87,962.57	527,111.65
65	67,905.08			87,962.57	466,476.86
66	76,069.78				398,571.78
67	85,327.53				322,501.99
68	95,727.26				237,174.47
69	107,367.65				141,447.21
70	120,396.99				34,079.56
Net Present Value		833,120.26	833,120.26	833,120.26	

Qube Investment Management Inc.

Qube offers implementation support and maintenance of Split Beneficiary Arrangements for our clients. It is possible that insurance is already in place to support such an arrangement. Should insurance be required, Qube believes low-cost term insurance provides the optimal tradeoff in most circumstances. Term insurance is often a fraction of the cost when compared to Universal Life or Whole Life policies.

We offer more than just insurance planning:

Program Implementation.
We will assist the client in establishing the Split Beneficiary Policy Agreement, Corporate Contribution funding schedule (pricing model) and underwriting the required amount of insurance, if applicable;

On-going Maintenance.
We will provide an updated Annual Statement summarizing to the client the balance of equity in the Notional Prepaid Premium Account and advice on the eligible Corporate Contribution room.

Plan Termination.
We will advise on the approximate taxable benefit upon premature termination of the Split Beneficiary arrangement if and when applicable.

If you would like more information on the Split Beneficiary Arrangement and what it would look like for you, please contact Noah Clarke, MA

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