



Make your professional corporation pay for your life insurance

BY MIKE SHEFFAR CFP, CLU, CH.F.C., TE

The tax advantage of owning life insurance inside a corporation

Most professionals understand the taxation aspects of their disability insurance coverage and know if they pay the premiums personally, the long-term disability benefits will be tax free. Similarly, if you pay for your life insurance policy personally, the death benefit goes to your beneficiary tax free. What happens when your professional corporation buys an insurance policy and pays the premiums?

You might think the death proceeds would be taxed if it they were received by the corporation and then paid out to your estate. This need not be the case. If properly structured, you can have your professional corporation pay the premiums and your family can still receive all or most of the death benefit tax free.

Using the right dollars

Most business people, incorporated professionals included, would rather use corporate dollars rather than personal dollars to pay expenses. This is particularly the case when the professional corporation pays a much lower rate than the business owner pays personally.

Take a look at this example to see the dramatic savings of paying for life insurance inside of your professional corporation. The amount of corporate income required to fund a \$1,000 life insurance premium is \$668 less if the policy is owned in and paid for by the professional corporation.



	Personally owned individual life insurance policy	Corporate-owned individual life insurance policy
Annual premium	\$1,000	\$1,000
Policy owner	You	Your corporation
Premium payer	You	Your corporation
Beneficiary	You	Your corporation
Corporate earnings required	\$ 1,866	\$ 1,198
Salary paid to fund the insurance premium	<u>(1,866)</u>	<u>(N/A)</u>
Remaining in the corporation	0	1,198
Corporate tax (small business rate of 16.5%, 2008)	<u>0</u>	<u>(198)</u>
After-tax remainder left in the corporation	\$ 0	\$1,000
Salary received by the professional	\$ 1,866	
Personal tax (rate of 46.4%)	<u>(866)</u>	
After-tax remainder used to pay insurance premium	\$ 1,000	\$1,000

Where the professional corporation is eligible for the small business deduction, there is a significant savings in the before-tax corporate earnings required to pay life insurance premiums. The cumulative effect of this annual saving can be substantial.

It is important to note that premiums paid by a corporation are not typically tax deductible except in very specific circumstances.

How your estate gets the death benefit out of the professional corporation

The professional corporation receives the life insurance proceeds entirely tax free. The Income Tax Act adds the difference between the insurance proceeds received and the adjusted cost basis of the life insurance policy to the corporation's "capital dividend account." To the extent of this capital dividend account, the insurance proceeds can be paid out to the shareholders as a tax-free capital dividend.

The capital dividend created by a term life insurance policy will equal all (or all but a tiny portion) of the proceeds paid to the professional corporation. In the case of life insurance with cash values, a portion of the proceeds will not be added to the capital dividend account (i.e., the adjusted cost basis). This portion will have to be paid as a taxable dividend to the estate. However, the taxable element is relatively insignificant in comparison with the total death benefit.

The capital dividend account can create other tax and financial planning opportunities, which are too complex to cover here. To understand them completely, you should consult a financial planning professional and a tax specialist.



Are there disadvantages to owning the policy in the professional corporation?

The principal disadvantage is the exposure of the life insurance cash values and the death benefit to corporate creditors. The magnitude of this risk is generally much less than the risk to a manufacturing company, for example, or similar enterprise that has a large line of credit or other significant debt.

Personally owned to corporately owned

If you decide you want your professional corporation to own a life insurance policy you currently own personally, you can transfer ownership of the policy to the professional corporation and at the same time make the corporation the beneficiary. This transfer of ownership can present other tax-planning opportunities.

If you are purchasing a new life insurance policy, you can have the corporation as owner and beneficiary right from the start.

Group insurance plans, including association plans and creditor insurance sold through banks, do not offer this flexibility and cannot be used to take advantage of this strategy

One part of the big picture

If you are incorporating your practice, it is an ideal opportunity to take a look at your total financial security planning picture; and ownership of life insurance policies is just one part of that picture.