Tax-free dividend with life insurance

Imagine this scenario. You are the primary shareholder of a Canadian controlled private corporation. Locked inside your company is $500,000 surplus capital for which you have no immediate personal need, but to which you will eventually want your heirs to have access.

Convert a taxable dividend into a tax-free dividend

If you receive the surplus capital in the form of a dividend, the entire amount will be subject to tax.

If you leave it in the corporation, the investment income will be taxed at the highest corporate tax rate, which, in some cases, can be higher than your personal income tax rate (only active business income is eligible for tax breaks). The strategic use of life insurance could significantly reduce the tax cost of passing on your private company shares.

This product is permanent life insurance. By transferring the $500,000 into a life insurance policy, the funds may grow tax-free. Upon the death of the insured, the corporation receives a tax-free death benefit. The benefit, less the adjusted cost basis, is credited to the corporation's Capital Dividend Account.

The Capital Dividend Account can be paid out to shareholders (your heirs) tax-free. The result: you've increased the ultimate after-tax value of your corporation to your estate. In effect, you, as the business owner, may avoid being taxed twice – on the company's profits and on the increase in the value of the estate by the life insurance.

How does it work?

John, 72, and his wife, Susan, 71, both non-smokers, own a business that has a cash surplus of $500,000. This surplus could be invested inside the company at 6% or transferred into a permanent life insurance product such as a Universal Life or Whole Life policy.

An example follows, of how Universal Life insurance may work. The $500,000 could be used to buy a Universal Life policy with a face value of $1,150,000 and a projected rate of return of 5% (the more conservative rate for the life insurance policy reflects its long-term nature).

The following table illustrates the difference in projected estate values between using Universal Life insurance and leaving the surplus in the company.

Who can benefit from this solution?

Life Insurance may be useful for those who:

- Own an incorporated business that has surplus capital (retained earnings) and
- Have no personal need for the surplus capital, i.e., it is likely to form part of his or her estate.

If you own a company that has sold assets for cash, or have sold a business that had been owned through a holding company, life insurance may be the protection you need.

Continued

Life insurance may provide financial security for your business.

You've worked hard to build your business. A product of sacrifice and dedication, your success deserves to be protected from events beyond your control.

Permanent life insurance may offer that protection. It may help your business continue to operate and retain its value in the event of your death, or the loss of a partner or key employee. If you would like to learn more about converting a taxable dividend into a tax-free dividend through life insurance, contact your BMO Nesbitt Burns Investment Advisor who will refer you to an Estate & Insurance Advisor (Financial Security Advisor in Quebec) from BMO Nesbitt Burns Financial Services Inc.

Net Estate Value After Tax

Year	Ages	After tax value of the life insurance strategy	After tax value of Funds* left in the company invested at 6%**	Potential Life Insurance Advantage
1	73/72	$1,176,370	$320,780	$855,591
5	77/76	$1,300,069	$384,452	$915,617
10	82/81	$1,477,763	$475,354	$1,002,409
20	92/91	$1,426,280	$702,727	$723,553
25	97/96	$1,149,416	$844,140	$305,276

* The amount is paid as a taxable dividend.

**The dividend amount includes any RDTOH. (Refundable Dividend Tax on Hand)

Values are at January 3, 2017 and are not a guarantee of future earnings, rates of returns or premiums. Policy is BMO Life Dimensions (Low Fees). Ontario tax rates used for personal dividend tax rate and corporate investment income tax rate. Based on the assumption that the insured are healthy.

BMO® | BMO Estate Insurance Advisory Services