New rules put the squeeze on the CDA

With upcoming 2017 legislative changes potentially increasing the tax burden of business owners, your window for taking action is closing.

For business owners, there are many reasons why the corporation might own life insurance, including:

- funding a buy-sell shareholders' agreement
- to help offset the economic loss the company may incur on the death of a key employee
- to provide funds for the owner's family to pay any estate debts or taxes owing
- to provide funds as a death benefit for the insured's widow(er)
- to help secure any loans or lines of credit with the bank

While some of these benefits are available through personally-owned life insurance, there can be significant savings when the premiums are paid by a corporation. This is because the corporation might be eligible for a tax rate that is dramatically lower than the corporation owner's personal marginal tax rate.

Let's take a look

A business owner in the highest marginal tax bracket in Ontario, 53.3% for 2016, would need to earn $2.14 for every $1.00 of insurance premium. His/her corporation, which is eligible for the small business tax rate (in Ontario) of 15%, would only need $1.18 for each $1.00 of premium. This additional $1.04 can be retained in the business as working capital or even invested wherever the business owner determines he/she can achieve the best return.

The Capital Dividend Account advantage

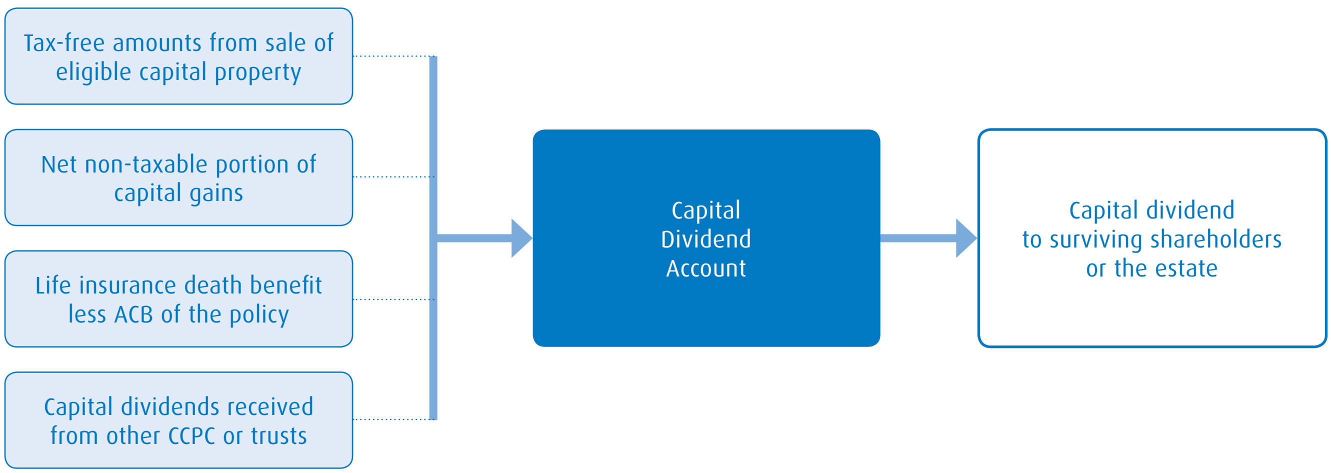
One significant benefit enjoyed by the owners of a Canadian-Controlled Private Corporation (CCPC) is the Capital Dividend Account (CDA), a notional account that appears on the company's financial statements. Any balance in the CDA can be paid out to shareholders as a capital dividend, and therefore be exempt from tax. Items that can be credited to the CDA include the tax-free amounts from the sale of eligible capital property, the non-taxable portion of capital gains, any capital dividends received from other CCPCs or trusts resident in Canada, and any life insurance death benefit, subject to a specific calculation.

Impact of upcoming legistative changes on the CDA

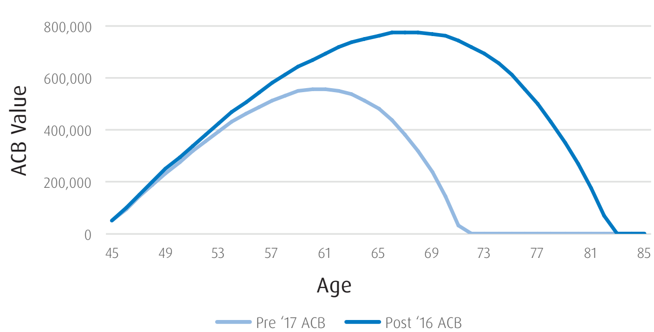
The upcoming legislative changes that come into effect on January 1, 2017 will impact that calculation. The amount that can be credited to the CDA is the death benefit received less the Adjusted Cost Basis (ACB) of the policy. Any remaining balance, if paid out, would be a taxable dividend. Currently, the formula for the calculation of the ACB is partially based on an older mortality table – the calculation results in a decrease in the ACB over time, thereby increasing the amount of the death benefit that can be credited to the CDA. With the new legislation, the insurance companies will be using a more recent mortality table, which results in the decrease in the ACB over a longer time period. This can mean that a smaller portion of the death benefit proceeds can be credited to the CDA and paid out as a tax-free dividend. A larger amount, if paid out, would be a taxable dividend, when compared to the same policy if issued prior to January 1, 2017.

Continued

How the Capital Dividend Account balance is calculated



Example of the impact of the changes on the Adjusted Cost Basis (ACB)



$1,000,000 Level COI UL policy, male age 45*.

The bottom line

Policies that are issued on or after January 1, 2017 will be subject to these new rules. Policies issued before then will be considered "grandfathered" and can still enjoy the maximum CDA benefit under the "old" rules. However, even policies that are issued prior to this date can lose their "grandfathered" status under certain conditions.

For more information on the Capital Dividend Account or on how the upcoming legislative changes may impact your exisiting insurance policies, please talk to your BMO Nesbitt Burns Investment Advisor, who will refer you to an Estate and Insurance Advisor (Financial Security Advisor in Quebec) from BMO Nesbitt Burns Financial Services Inc.

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*BMO Life, Life Dimensions LCOI, male 45, non-smoker

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