TAX

BY JAMIE GOLOMBEK

Key person life insurance

Dealing with a third-party beneficiary.


GOLOMBEK

Life insurance is often an important tool for funding a liquidity event, such as the death of a business owner, as the proceeds can be used to immediately pay off creditors and provide often much-needed cash flow in a time of business uncertainty.

Business owners who operate their business through a corporation often choose to hold such life insurance inside the corporation for a variety of reasons, one of which is that from a tax point of view, an absolute savings can be realized if life-insurance premiums are paid for by the corporation. That's because, generally speaking, life-insurance premiums are not tax-deductible and thus it becomes cheaper to pay these non-deductible premiums with cheaper, after-tax corporate dollars.

In such cases, the corporation typically owns the policy and the death benefit can generally be paid out of the corporation to its shareholders, either mostly, or in many cases, entirely tax-free, as a special dividend, known as a capital dividend.

Most advisors emphasize to the business owner that the corporation should be the beneficiary of the life insurance policy so that the death benefit flows directly from the life insurance company into the corporation's capital dividend account (CDA).

But what happens if a third party, such as a bank offering creditor life insurance (one of the few types of insurance banks are permitted to offer) insists on being named beneficiary of the policy? Upon the death of the key shareholder, will the death benefit, paid from the insurance company directly to the third-party creditor, still constitute an amount received by the corporation through its CDA and therefore be subsequently used to pay out a tax-free capital dividend?

That was exactly the subject of a recent dispute between a corporation, Innovative Installation Inc. ("Innovative"), and the Canada Revenue Agency, which landed in Tax Court late last year (*Innovative Installation Inc. v. the Queen, 2009 TCC 580*).

In 1999, Innovative borrowed $220,000 from RBC and obtained key person insurance from Sun Life Financial on the life of its founder Rod Peacock. Peacock died in 2002. Sun Life paid the $196,000 death benefit directly to RBC, which applied $175,500 to pay off the balance on the loan and directed the balance of $21,422 to Innovative's bank account.

> Under the *Income Tax Act*, for the death benefit from a life insurance policy to be included in a corporation's CDA, the corporation must have received proceeds of a life insurance policy after May 23, 1985 in consequence of the death of any person.

In June 2004, Innovative declared a tax-free capital dividend in the amount of $160,000 and included the amount of the death benefit on the Sun Life insurance policy in calculating the balance of its CDA.

The CRA disagreed and found the dividend in excess of Innovative's actual CDA balance and applied the special penalty tax of 75% under *Part III* of the *Income Tax Act* for an excessive capital dividend election, resulting in a tax bill of $120,000.

Needless to say, Innovative appealed this penalty tax to the Tax Court.

Under the *Income Tax Act*, for the death benefit from a life insurance policy to be included in a corporation's CDA, "the corporation must have received proceeds of a life insurance policy after May 23, 1985 in consequence of the death of any person."

The CRA cited its own Interpretation Bulletin IT-66R6, Paragraph 6, subparagraph (d), which states the CDA includes "the net proceeds of a life insurance policy received after May 23, 1985 by the corporation as beneficiary under the policy." The CRA maintained that since RBC was the beneficiary of the policy, it "received" the death benefit and therefore no amount can be included in the calculation of Innovative's CDA balance.

The judge found the CRA's position "defies common sense and natural justice." He observed the *Tax Act's* definition of the CDA does indeed require Innovative to receive the insurance proceeds but concluded that Canadian tax jurisprudence has held that the word "receive" in the *Act* refers to the party that receives the benefit of the insurance proceeds. Innovative clearly derived the benefit of the insurance payout since it had its loan paid off and its net worth increased.

As a result, the judge concluded that Innovative received the proceeds within the *Act's* definition of "capital dividend account" and thus was entitled to add the proceeds of the death benefit to its CDA and pay a $160,000 tax-free capital dividend without being subjected to the punitive *Part III* tax. The decision has been appealed by the CRA. Stay tuned. AER

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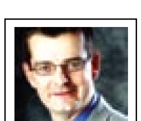
INSURANCE

BY DAVID G. TOMPKINS

Insuring expat employees

For many reasons, the only solution for Canadian expatriates is a group expatriate benefit plan.


TOMPKINS

Terminating work agreements with employees who have been sent overseas represents a huge investment and responsibility for many employers. It's been estimated the cost of a failed overseas assignment for a high-level expatriate employee can cost a company as much as $500,000.

And expatriate employers bear some responsibility for the well-being of their expatriate employees, who often feel more vulnerable when posted overseas.

If your corporate clients are typical, more and more of them are sending employees abroad as expatriates for long-term positions. And if the client is putting those expatriate employees on their domestic Canadian group insurance plans, overseas claims may be denied or mishandled as such policies are not designed for expatriates (Canadian group insurance plans are generally only for Canadian residents, especially the extended health insurance coverage).

Canadian domestic health coverage is primarily extended to cover what the provincial governments do not cover; so for workers in Canada the provincial government coverage is required.

If a Canadian company is sending employees overseas for long periods of time, their provincial coverage will usually end after six or 12 months and many domestic group travel insurance plans only cover up to three months outside of Canada per trip.

Also, Canadian domestic plans usually don't have the ability to pay disability, dental or health claims directly to a medical facility overseas except for short-term travel medical insurance claims.

For these and many other reasons, the only solution for Canadian expatriates is a group expatriate benefit plan.

Group expatriate plans vary across the market from basic to deluxe, but in my opinion only a large global carrier can really meet a multinational corporation's expat group insurance requirements. That essentially leaves employers with three choices:

1. an extension to existing Canadian group insurance plan;
2. a Third Party Administrator (TPA) expatriate plan; or
3. a large global expatriate insurance plan.

Domestic solutions

Some Canadian insurers have recognized the needs of Canadian companies that send employees overseas and have added expatriate coverage as an extension of existing domestic group insurance plans.

Unfortunately, they have developed policies that only partially meet the needs of Canadian multinationals. I have found that Canadian group expat insurance plans usually are not able to cover third-country nationals (TCN) and key local nationals (KLN).

Third-party plans

The other choice for Canadian companies with expatriates is Third Party Administrator (TPA) plans.

> **Many expat insurance brokers feel a TPA expat benefit carrier generally will not have the resources to provide a level of coverage and service most multinationals require or deserve.**

Essentially, a TPA lets a Canadian company administer a group insurance plan that's backed up by one, or several different, insurance companies that may or may not be based in Canada. The TPA handles the marketing, administration and claims. By virtue of its very structure, smaller size and limited resources and reliance on a variety of insurers, a TPA is not my professional choice for a multinational corporate client. The TPA usually leverages someone else's insurance paper and someone else's network, particularly in the United States.

Further, the TPA usually has no control over the network or the paper itself, so they may be at the mercy of their insurance partners, which may withdraw their support from the administrator. The TPA probably doesn't have a large network outside of North America where expats can get direct payment to medical providers, and most TPAs do not have the resources to be compliant in Gulf State countries such as Saudi Arabia and UAE.

Many expat insurance brokers feel a Third Party Administered expat benefit carrier generally will not have the resources to provide a level of coverage and service that most multinationals require or deserve. Some TPA plans are

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