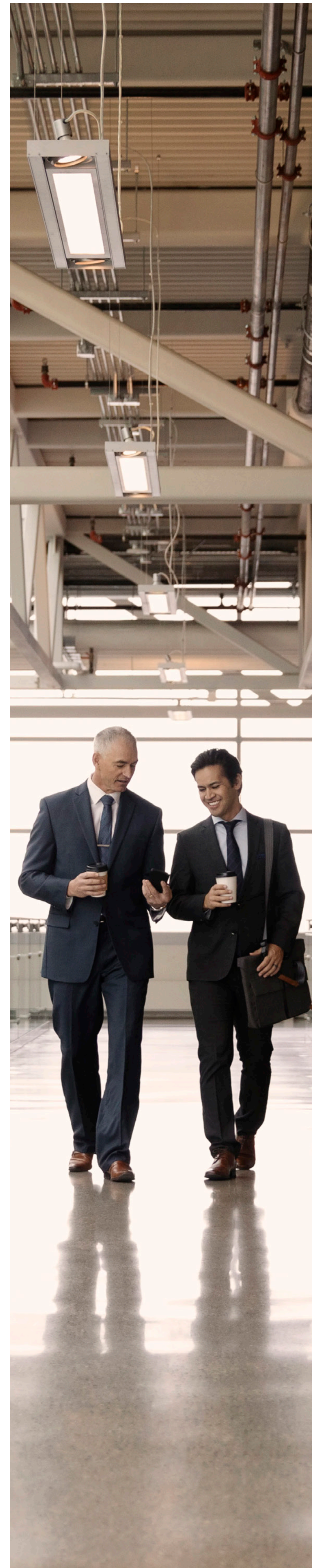

BOOKING THE INSURANCE TRANSACTION

ACCOUNTING FOR CORPORATE-OWNED PERMANENT POLICIES

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A POWERFUL TOOL

Canadian businesses are learning the benefits of corporate-owned permanent life insurance. Not only does it help protect shareholders and business continuity, it can also bolster the balance sheet as an asset that generates corporate value.

That makes it a powerful tool. And to unlock its potential, business owners often turn to accounting professionals.

But there's a problem.

The accounting standards used in Canada – International Financial Reporting Standards (IFRS) and Canadian Accounting Standards for Private Enterprises (ASPE) – do not contain comprehensive guidelines for the treatment of corporate-owned life insurance. Instead, these standards refer accountants to the American standards, which provide more detailed guidance as to how you should record the financial presentation of a corporate-owned life insurance policy.

This lack of clear guidance leaves Canadian business owners at a disadvantage, and accountants at a disadvantage when working with them.

The good news is: whether a corporation owns universal life, participating whole life, non-participating whole life, or even term life insurance, there are still recommended practices for booking insurance transactions and recording the financial statement presentation of a corporate policy.

Provided here are guidelines for recording the typical transactions encountered with corporate-owned permanent life insurance – guidelines that will help you get insurance on the books, and display its value as a corporate asset. In all examples, the corporation is both the owner and the beneficiary of the policy, a common setup in Canada.

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The commonly-referenced Canadian accounting standards, including Accounting Standards for Private Enterprise (ASPE) and International Financial Reporting Standards (IFRS), do not specifically prescribe how policyholders should account for life insurance policies. However, Canadian accounting guidance (including the CPA Canada "Model Financial Statements") refers to the American accounting standards, particularly Financial Accounting Standards Board (FASB) Technical Bulletin 85-4. We believe this paper reflects accounting standards most frequently applied in common practice, however individual cases may vary and involve additional factors that must be considered. Every effort has been made to reflect best-practice standards as of January 2020.

RECORDING PAYMENTS AND POLICY VALUE

Permanent life insurance policies typically contain a savings component, or "cash value." Booking these policies requires attention to the payments made into them, as well as to their cash surrender value (CSV) – their cash value net of any charges incurred through surrender. When booking a payment of premiums, the difference between the insurance payment and the increase to the CSV is allocated to the balance sheet and income statement according to the example below.

These policies may also let policyholders make additional payments in excess of required premiums, thereby accelerating the growth of the cash value. Book these additional payments the same way as a payment of premiums. Focus on the payment and the change in the CSV, as the example shows.

For accounting purposes, measure the carrying value of a corporate policy as an asset. In most cases, the recorded value of a policy is its CSV. That means that accounting for the payment of the insurance premium is typically an exercise in accurately capturing the value of the CSV on the balance sheet. For tax purposes, life insurance premiums are typically a non-deductible business expense. Reverse out any insurance expense recorded on the income statement using Schedule 1 of the T2 Corporate Income Tax Return.

Things to know:

- CSV is the realizable value of a policy. It's the policy's cash value, net of any charges levied in the event the policy is surrendered early. Contact the insurance provider to obtain the CSV of a policy.
- Surrender charges are unique to each insurance product.
- Record differences between yearly policy premiums and changes in CSV on the income statement.
- In the early years of a policy, the annual premiums paid will likely be greater than any increase to the CSV. If this occurs, record an insurance expense on the income statement. This expense should equal the amount by which the premiums paid exceeds the CSV debited to the balance sheet.
- If the increase to the CSV exceeds the annual premiums paid, record an amount equal to the excess increase in CSV as "insurance income" or "insurance gain" on the income statement.
- CSV growth within a tax-exempt life insurance policy does not generate annual taxable income as long as it stays within the limits set by the Maximum Tax Actuarial Reserve (MTAR).
- Insurance premiums that do not align with a corporation's fiscal year may require recording a prepaid asset.

PAYMENT INTO A POLICY

TRANSACTION	DEBIT	CREDIT
Component of insurance payment that generates an increase to CSV	CSV (Balance Sheet)	Cash Account or Accounts Payable (Balance Sheet)
Component of insurance payment in excess of the increase to CSV	Insurance Expense (Income Statement)	Cash Account or Accounts Payable (Balance Sheet)

When are corporate-owned life insurance premiums deductible?

Both for individuals and corporations, there are only a few places in the Income Tax Act where life, health or disability insurance premiums are deductible. It's best to assume that the premiums are not deductible until you consult with a tax professional.

Accounting for policy dividends

If a corporate-owned policy pays dividends, record the dividend as an increase to the cash account on the balance sheet. You can then either:

1) record a credit to dividend income on the income statement, or

2) record a credit to the insurance expense on the income statement.

SKIPPING PREMIUM PAYMENTS

Permanent life insurance policies may offer policyholders the option to use accrued CSV to skip premium payments. Doing so, however, is likely to require adjustment to the CSV figure recorded on the balance sheet. How much that figure changes depends on the policy's ongoing costs, as well as any returns within the policy itself.

If the CSV has decreased, you can book this transaction by crediting the CSV figure on the balance sheet, and recording an insurance expense on the income statement. Then, for income tax purposes, reverse the insurance expense on Schedule 1 of the T2 Corporate Income Tax Return.

If the CSV has increased, debit the CSV figure on the balance sheet, and record insurance income on the income statement. Then, reverse the insurance income as "non-taxable income" on Schedule 1 of the T2 Corporate Income Tax Return.

Things to know:

- If CSV is used to pay ongoing insurance costs, it's important to keep an eye on the long-term viability of any planning strategies that rely on policy values. Be sure to plan using minimum guaranteed rates and values, and consult your insurance professional to review potential outcomes.
- It's always important to confirm the year-end CSV figure with the insurance provider.

SKIPPING A PREMIUM PAYMENT

TRANSACTION	DEBIT	CREDIT
No cash transaction - CSV reduces	Insurance expense (Income Statement)	CSV (Balance Sheet)
No cash transaction – CSV increases	CSV (Balance Sheet)	Insurance Income (Income Statement)

Don't forget the illustration

Policy growth is often projected in a policy illustration. If a policyholder skips a premium payment, it's a good idea to obtain a new in-force illustration from the insurance provider, particularly if the policyholder is planning to pay the total cost of the policy within a set number of years.

PARTIAL POLICY SURRENDER

A partial policy surrender occurs when a policyholder withdraws funds from a policy. It typically results in reduced coverage for the beneficiary – often greater than the cash withdrawn – and it permanently alters the policy. It's best to consult your insurance professional before proceeding, especially if you're dealing with a grandfathered policy. Grandfathered policies may be subject to tax rules that have since changed, and a partial surrender could expose them to new taxation.

For accounting purposes, a partial surrender reduces the CSV of a policy. Be sure to reflect this change on the balance sheet. However, the money received by the corporation will likely differ from the reduction in CSV. If the money received exceeds the reduction, record insurance income on the income statement. The income amount should equal the funds received in excess of the reduction to the CSV. As with an insurance expense, reverse out this income on Schedule 1 of the T2 Corporate Income Tax Return.

For income tax purposes, treat a partial policy surrender as a partial disposition. Paragraph 56(1)(j) of the Income Tax Act requires a policyholder to include income from the disposition of an interest in a life insurance policy as determined under subsections 148(1) & 148(1.1). The amount of income to include – also called the "taxable policy gain" – is the amount by which the proceeds of the disposition exceed the adjusted cost basis (ACB) to the policyholder. Any taxable policy gain arising from the surrender should be included on a T5 slip provided by the life insurance company. Report the gain on Schedule 7 of the T2 Corporate Income Tax Return. If the disposition does not exceed the ACB, enter zero as the amount.

Things to know:

- A policy gain always generates a T5 slip.
- The ACB of a policy will change following a partial surrender.
- A partial surrender typically reduces the CSV of a policy.
- While a realized policy gain is taxable income, the policyholder can't deduct a realized policy "loss" from taxable passive income. A loss could happen, for example, if a policyholder cancels a policy before it earns more in CSV than it has cost in premiums.

WITHDRAWING FUNDS

TRANSACTION	DEBIT	CREDIT
Cash withdrawal	Cash Account	CSV (Balance Sheet)
Cash withdrawal – proceeds exceed the reduction in CSV	Cash Account	CSV (Balance Sheet) Insurance Income (Income statement)

How to determine the adjusted cost basis of a policy

Several factors contribute to the monthly calculation of the ACB of a policy, including payments, the taxable portion of any withdrawals or even loan interest. To determine the ACB for a specific policy, contact the insurance provider.

RECEIVING THE DEATH BENEFIT

There are three steps to accounting for a corporate policyholder's receipt of the death benefit:

1. Determine the policy's CSV at the time of death. Credit an equal amount of the death benefit to the balance sheet, thereby removing the CSV asset.
2. Credit the remainder of the death benefit proceeds as insurance income on the income statement. The offsetting debit – the total received death benefit funds – will be to the cash account on the corporation's balance sheet.
3. The business will receive the full death benefit tax-free, so reverse the insurance income off the income statement using Schedule 1 of the T2 Corporate Income Tax return.

Things to know:

- As per paragraph 89(1)(d) of the Income Tax Act, the corporation will need to update its capital dividend account (CDA) to reflect the increase related to the death benefit (sometimes called the CDA credit).
- The CDA credit available to a corporate policyholder equals the death benefit less any policy loans, minus the ACB.
- To pass the death benefit funds to shareholders as tax-free capital dividends, there must be sufficient positive room in the corporation's CDA.

RECEIVING THE DEATH BENEFIT

TRANSACTION	DEBIT	CREDIT
Total Death Benefit Proceeds	Cash Account (Balance Sheet)	
Portion of Death Benefit represented in the CSV balance		CSV (Balance Sheet)
Amount of Death Benefit in excess of the CSV balance		Insurance Income (Income Statement)

The capital dividend account and health insurance

It's important to understand the type of insurance policy held by a business because not all death benefits function the same way. For instance, a critical illness insurance policy might feature a return of premium on death option. This optional benefit, just like the base critical illness coverage itself, does not generate a credit to a corporate policyholder's CDA.

The capital dividend account and multi-life insurance policies

Multi-life insurance policies can prove challenging when it comes to tax planning because even though a multi-life policy covers more than one insured life, it only has one ACB. It's important to discuss insurance needs with a qualified insurance professional who also understands the planning needs of a corporate policyholder.

USING CASH VALUE FOR LIQUIDITY

There are several ways corporations can use the CSV of a policy to access liquidity:

1. **Policy loan:** A policy loan is issued by the insurance provider. Easy to obtain, these loans don't affect the growth of the CSV within a policy. Additionally, loans equal to or less than the policy's ACB are not taxed. Loan amounts that exceed the ACB are taxable, but clients can equally deduct loan payments that repay the taxable portion. The insurer will issue a T5 slip to report any taxable gain.

   Note: A policy loan reduces the death benefit and ACB of a policy. It's considered a disposition as per paragraph (b) of the definition of "disposition" in subsection 148(9) of the Income Tax Act. Taking a policy loan may therefore affect the CDA credit available to the beneficiary, or the amount of tax payable when the death benefit is paid out to shareholders. In some scenarios, it may even affect both. If a policy loan is outstanding at the time of death, the policy's CDA credit will reduce by the amount outstanding.

2. **Policy withdrawal (partial surrender):** Policyholders can surrender part of the cash value of a policy, but they may incur a tax obligation in doing so. If 40% of a policy's cash value is tax-free, then typically only 40% of the withdrawal will be tax-free. More importantly, a withdrawal permanently modifies the insurance policy, reducing the death benefit by an amount equal to or greater than the amount withdrawn. To determine the percentage of cash value that is tax free, contact the insurance provider.

3. **Third-party loans:** A third-party lender, such as a bank, issues this type of loan. Unlike policy loans, third-party loans do not create income, and typically do not affect the CDA credit at death. If a policy is used as collateral for a loan taken to earn taxable corporate income, the policyholder may be able to deduct the loan interest from their corporate income. They may also be able to deduct the lesser of premiums payable and the net cost of pure insurance (NCPI). Still, it's best to review the outcomes of this type of loan before proceeding. Speak with your insurance professional.

Net cost of pure insurance (NCPI)

NCPI is an annual charge – federally regulated – and it reduces the ACB of a policy by an equal amount. When using NCPI in calculations, it's important to remember that the fiscal year of the corporation may not reflect the calendar year of an insurance policy.

CSV AND INSURANCE FUNDING: OTHER CONSIDERATIONS

In some instances, business owners will require permanent life insurance, but won't require a policy to provide any ongoing liquidity. In fact, they may want to minimize corporate asset values – or the market value of some assets – to ensure their corporation's shares remain qualified small business corporation (QSBC) shares, and therefore eligible for the lifetime capital gains tax exemption.

For shares to qualify as QSBC at the time the business owner sells them or dies, a condition is that at least 90% of the fair market value of the corporation's assets must be used in carrying on an *active* Canadian business. The problem is, life insurance is a *passive* asset and its value is included in this 90% test. According to subsection 70(5.3) of the Income Tax Act, if the business owner is the person insured, the fair market value of a policy is its CSV.

As a result, corporate business owners may find it advantageous to hold a permanent life insurance policy with little to no CSV - for which they would pay only the base cost of insurance. Such a policy still provides permanent insurance protection, but can avoid the risk of a tax obligation a high CSV can carry.

NEXT STEPS

As a CPA, your clients look to you for multi-dimensional planning that addresses their business needs both pre- and post-mortem. By viewing life insurance as an asset that can both contribute to a corporation's balance sheet and further a client's estate planning goals, you have an opportunity to enhance the strategic support you offer your clients.

A framework for accounting for insurance transactions can help yield the full benefits of corporate-owned life insurance. What we've offered here is progress towards a clear method for booking corporate insurance transactions. As you continue to work with corporate clients there are additional resources to help you. Insurance providers offer resources on everything from when premiums are deductible, to how to plan for business succession. To learn more, connect with your insurance professional.

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