



Split Dollar Life Insurance – Applications

Introduction

This Tax Topic is a continuation of our examination of the Split Dollar concept, which started with the Tax Topic entitled “Split Dollar Life Insurance”. This Tax Topic will explore a number of different situations where the Split Dollar concept is used as a creative alternative to solve complex problems. The situations explored range from more traditional applications of the concept to the most current planning techniques.

Review of Split Dollar Basics

The Split Dollar concept is an arrangement where the benefits and costs associated with a life insurance policy are shared between two or more parties. The concept recognizes that separate interests can be identified within a single life insurance policy. The particular interests in the policy can be matched to the parties that most require the benefits provided by the interest.

Applications of the Split Dollar Concept

The Split Dollar concept can be used in any situation where different parties wish to share the obligations and benefits associated with a life insurance policy. Examples of situations where the concept is used are:

- * Executive Life Insurance Planning
- * Funding Shareholder Agreements
- * Key Person Insurance
- * Collateral Insurance Planning
- * Funding a Retirement Compensation Arrangement
- * Family Insurance Planning
- * Charitable Giving – to more than one charity

Executive Life Insurance Planning

One of the more traditional applications of the Split Dollar concept is in situations where an employer is interested in providing an employee with a supplementary benefit package. Supplementary benefit packages are often used by employers as a means of attracting executives. These packages offer a wide assortment of benefits that may include affordable life insurance protection. The life insurance protection ensures that upon death the dependents of the executive receive an inflow of capital that can be used to cover funeral expenses, education costs, reduce debt, and provide a future stream of income.

A Split Dollar arrangement can be used to provide the affordable life insurance protection to the executive as well as achieve the investment goals of the employer. The benefits of a permanent life insurance policy are split between the employer and the executive. The life insurance policy is jointly purchased by the executive and the employer with the executive as the life insured. The arrangement is structured so that the executive pays for and owns a level

(or increasing) death benefit amount and the employer pays for and owns the remaining interests in the policy (generally the cash surrender value).

The employee must pay a reasonable cost for the life insurance protection received. Often the employer pays the entire life insurance premium and the portion of the premium related to the executive's interest is reported as a taxable benefit on the employee's Statement of Remuneration Paid (T4 Supplementary Slip). It is important that the amount reported on the T4 slip represents a reasonable cost for the benefit received. It is Canada Revenue Agency's (CRA) stated position that an employee benefit under paragraph 6(1)(a) of the Income Tax Act (the "Act") may be assessed if the employee pays a premium that is less than the cost of comparable rights available under a separate insurance policy. Neither party should subsidize the costs of the other party.

The application of the Split Dollar concept, in the executive/employer situation, allows the executive to obtain affordable life insurance protection and allows the employer to benefit from an investment opportunity that offers tax-deferred growth.

Funding Shareholder Agreements

Another application of the Split Dollar concept is in the business context for funding a shareholder agreement. A shareholder agreement generally contains buy-sell provisions, which allow for the orderly transfer of shares in the event of retirement, disability and death of a shareholder. It is common for buy-sell agreements to provide that on the death of a shareholder, the corporation agrees to redeem the shares of the deceased. Refer to the Tax Topic entitled "*Buy/Sell Agreements – Corporate Redemption Method*" for a detailed discussion of this topic.

A Split Dollar arrangement can be used as a cost-effective alternative to provide the funds required to facilitate the redemption of shares on death as well as provide the shareholder with a tax-deferred investment vehicle. Under this arrangement a life insurance policy is jointly purchased by the corporation and the shareholder with the shareholder as the life insured. The corporation pays for and owns a level death benefit sufficient to fund the share redemption. The shareholder pays for and owns the remaining interest in the policy (generally the cash surrender value).

It is important that the portion of the premium paid by the shareholder is a reasonable amount for the benefit received. If a reasonable amount is not paid CRA could assess a shareholder benefit under subsection 15(1) of the Act. As the cash surrender value owner, the shareholder is generally given the power to direct the investment options within the life insurance policy. To facilitate dealing with the policy, a power of attorney may be executed, allowing the shareholder to carry out investment transactions on behalf of the corporation. This allows the executive to create an investment portfolio that matches his/her level of risk tolerance. At a point in the future, when cash value has accumulated in the policy, the shareholder may wish to supplement retirement income by taking policy withdrawals or by using the cash value as collateral security for a bank loan or series of bank loans.

By using the Split Dollar concept in this situation the corporation is provided with the buy-sell funding that it needs and the shareholder is provided with access to a tax-deferred investment vehicle that can ultimately be received tax free if held until death.

Key Person Insurance

The Split Dollar concept can be used effectively to fund a key person insurance need and provide the key person with a vehicle for tax-deferred investment growth. In many business situations, the genesis and success of the business is built around the talents, skills, expertise, financing and vision of either the owner, a key person or both. Businesses often purchase

corporate-owned life insurance on the lives of their key people in order to protect the corporation from losses triggered by the death of these key people. The proceeds of the life insurance policy are received tax-free and can be used to meet expenses, repay debts, fund the cost of hiring and training a replacement or meet immediate working capital needs. In conjunction with this corporate need for insurance protection, the life insured (key person) may have funds available for investment. A Split Dollar life insurance arrangement provides the structure to meet the needs of both parties.

A life insurance policy is jointly purchased by the corporation and the key person with the key person as the life insured. The corporation pays for and owns a level death benefit on the life of the key person and the key person pays for and owns the remaining interest in the policy (generally the cash surrender value). By investing in the cash surrender value component of the policy, the key person gains access to a tax-deferred investment that can ultimately be received tax-free if held until death.

In all corporate key person scenarios, the need for corporate-owned life insurance expires when the key person retires or leaves the company. The corporation may agree to transfer the death benefit portion of the policy to the key person, who will then own the entire life insurance policy. A number of issues must be considered if this transfer of ownership is contemplated. First, while the corporation owns the level death benefit component of the policy, the portion of the premiums paid by the corporation must be reasonable in the circumstances. If it is known that the key person is going to retire at age 65 and the death benefit will be transferred, the equivalent premium for a Term to 65 life insurance policy may be a reasonable allocation of the premium to the corporation. Second, a transfer of ownership of an interest in a life insurance policy is considered a disposition for tax purposes. A disposition may result in a taxable policy gain that must be included in the income of the transferor. The proceeds of disposition depend on the relationship between the transferor and the recipient of the interest in the policy. Refer to the Tax Topics entitled "*Transfer of an Insurance Policy From a Corporation to a Shareholder*" and "*Transfers of Personally-Owned Life Insurance*" for a discussion of transferring ownership of an interest in a life insurance policy. The third issue that must be considered if an interest in the policy is transferred is whether a taxable benefit has been conferred on the key person. A taxable benefit may be assessed under paragraph 6(1)(a) of the Act for an employee or under subsection 15(1) of the Act for a shareholder if the fair market value of the interest in the policy is greater than the amount of consideration paid by the key person for that interest.

By using the Split Dollar concept in this situation the corporation is provided with key person insurance coverage for the appropriate period of time and the key person is provided with a tax-deferred investment vehicle.

Collateral Insurance Planning (Policy shared between three parties)

An innovative use of the Split Dollar concept can be used for a closely-held private corporation with a need for collateral insurance. Many lending institutions require the active owners of closely-held businesses to insure their lives as collateral security for a corporate loan. CRA views the cost of the life insurance used for collateral security as a legitimate business expense and therefore allows a deduction if the requirements under paragraph 20(1)(e.2) of the Act are met. Private corporations are often owned through a holding company. Holding companies generally have excess funds and look for tax efficient investment vehicles. The shareholder of the holding company may also have a need for personal insurance. The requirement for collateral insurance in the operating company and for personal insurance by the shareholder can be linked to the holding company's need for a tax efficient investment using the Split Dollar concept. The holding company, operating company, and shareholder jointly purchase a life insurance policy with the shareholder as the life insured. A Split Dollar life insurance arrangement is structured so that the operating company pays for and owns a

level death benefit, the shareholder pays for and owns a level death benefit and the holding company pays for and owns the remainder of the policy (generally the cash surrender value). The amount payable by each company and the shareholder for its interest in the policy must be reasonable in the circumstances or a shareholder benefit may arise.

Where two private corporations are beneficiaries under a life insurance policy, each receives a credit to the capital dividend account (CDA) upon the death of the life insured. In this application of the Split Dollar concept both the operating company and the holding company receive a CDA credit upon the death of the shareholder. The amount credited to the CDA equals the proceeds received upon the death of the life insured less the adjusted cost basis (ACB) of the policy immediately before death. Each corporation has an ACB for their interest in the life insurance policy. The ACB of an interest in a policy is defined in Subsection 148(9) the Act and is subject to a number of adjustments, but is essentially the premiums paid less the net cost of pure insurance (NCPI). NCPI is defined in Regulation 308 of the Act as the net amount at risk multiplied by a mortality factor. The net amount at risk is equal to the excess of the death benefit over the cash value of the interest in the policy. Regulation 308 refers to the 1969-75 mortality tables of the Canadian Institute of Actuaries for purposes of determining the mortality factor in respect of a policy.

Each corporation should calculate and track the ACB for its interest in the policy. The following example provides an overview of how each corporation may calculate their ACB:

The facts:

Insured – Male 45 non-smoker

Life insurance policy – universal life, \$1,000,000 initial death benefit, \$20,000 annual premium for 20 years.

<u>Split of policy benefits</u>	ABC Opco owns \$1,000,000 level death benefit XYZ Holdco owns the remaining interests in the policy (i.e. cash surrender value)
<u>Split of policy premium</u>	ABC Opco premium \$8,680 (For this example Term-100 insurance costs have been used. The reasonableness of using Term 100 insurance costs must be based on the facts of the case.) XYZ Holdco premium \$11,320

ACB Calculation – End of year 1

Formulas

NCPI = Net amount at risk x mortality factor (from CIA 1969-75 mortality tables)

ACB is approximately equal to Premium – NCPI

ABC Opco

$$\begin{aligned}
 \text{NCPI} &= \$1,000,000 \times 0.00104 \\
 &= \$1,040 \\
 \text{ACB} &= \$8,680 - \$1,040 \\
 &= \mathbf{\$7,640}
 \end{aligned}$$

XYZ Holdco

$$\begin{aligned}
 \text{NCPI} &= \$0.00 \times 0.00104 \\
 &= \$0.00 \\
 \text{ACB} &= \$11,320 - 0.00 \\
 &= \mathbf{\$11,320}
 \end{aligned}$$

Note: In the above example ACB Opco owns a \$1,000,000 level death benefit and XYZ Holdco owns the remaining interests in the policy. If the policy has any riders or death benefit enhancers, these benefits are paid for and owned by XYZ Holdco. The increased coverage amount applicable to riders impacts the net amount at risk applicable to XYZ Holdco, which impacts the calculation of ACB.

Funding a Retirement Compensation Arrangement

The Split Dollar concept can be used to fund a Retirement Compensation Arrangement (RCA). Many businesses believe that competent and satisfied executives are key to its success. In order to maintain executive satisfaction, many businesses are offering executives alternative compensation packages including supplemental executive retirement pensions (SERPs). Such a pension is designed to provide the executive with a top-up to their retirement income. It is often based on what the executive would have qualified for under the company pension plan if the plan wasn't subject to the pension "cap" imposed by federal legislation. Life insurance is an efficient vehicle for an RCA used to fund a SERP. Also, it is often common for the business to own a key person life insurance policy on the life of the executive. In this situation a Split Dollar life insurance arrangement can address both of these insurance needs.

A life insurance policy is jointly purchased by the employer and the RCA trust with the executive as the life insured. The corporation pays for and owns a level death benefit that will provide key person protection. To fund the SERP the corporation establishes an RCA trust. The RCA trust owns and pays for the remaining interests in the policy (generally the cash surrender value).

Contributions made by the corporation to the RCA trust are subject to 50% refundable tax. The total amount contributed to the RCA trust is fully deductible by the corporation for tax purposes. The refundable tax is refunded on the basis of \$1 for every \$2 of benefit paid out of the RCA trust. Refer to the Tax Topic entitled "*Retirement Compensation Arrangements*" for a detailed discussion of RCA's.

At retirement a number of choices are available to the RCA trust to fund the executive's supplemental pension. Provided the RCA trust document provides the trustee with the power to do so, the trustee may (1) withdraw funds from the policy, (2) collaterally assign the cash value to the bank and borrow against the cash value of the policy, or (3) pledge the cash value as security for loans taken by the corporation which in turn makes the pension payments to the executive. In situations where the RCA trust borrows against the cash value of the policy, it is important to note that the death benefit owner will also be required to collaterally assign the death benefit to the bank. In situations like this, at death the cash value owned by the RCA trust will be used to repay the debt. If the cash value is not sufficient to pay the debt, then the bank will look to the death benefit owned by the corporation to make up the shortfall.

In any situation where the benefits of a life insurance policy are split between a corporation and an RCA trust, the initial ownership of the policy must be structured in a way that ensures the level death benefit portion of the life insurance contract is not considered property of the RCA trust.

If the RCA trust applies for and owns the life insurance policy initially and then transfers the death benefit interest in the policy to the corporation this may be considered a distribution from the RCA trust. The value of the distribution would be taxable to the corporation.

If, on the other hand, the corporation applies for and owns the life insurance policy initially and then transfers the cash value interest in the policy to the RCA trust, the RCA trust may be deemed to be established at the time the life insurance policy is issued under subsection 207.6(2) of the Act. The entire policy, including the interest in the level amount of death benefit, may then be considered property of the RCA trust. As a result, the portion of the premium paid by the corporation may also be subject to refundable tax. Further, the entire life insurance proceeds receivable on the death of the life insured may be considered to be received by the RCA trust and taxable upon distribution to the corporation. Also, the corporation may not receive a credit to the capital dividend account. To avoid these potential problems, it may be advisable to have the policy owned jointly from inception. In the insurance application, ownership would be indicated as joint tenants. If the RCA deeming provisions are a moreover concern, the "other" category can be indicated on the application with a notation of "co-ownership".

In the RCA situation, a Split Dollar arrangement is a flexible method of meeting the funding needs of the RCA trust and allowing a level death benefit to be received tax-free outside of the trust.

Family Insurance Planning

A Split Dollar arrangement may facilitate the purchase of permanent life insurance in certain family situations. Many young families are burdened by heavy debt-loads. They are trying to save for their children's education, repay car and student loans and deal with a home mortgage. The loss of a breadwinner could be devastating to the financial well being of the family. Term insurance is often used as a safeguard to protect against this significant problem. Where there is a need for family protection, a parent or grandparent could play a key role in ensuring the protection is put in place. It is common to have circumstances where parents or grandparents have funds to invest and their children's family have a large life insurance need but limited cash flow.

A solution is to purchase a life insurance policy jointly by the parent/grandparent and the child(ren). The child/grandchild pays for and owns a death benefit equivalent to their term insurance need and the parent/grandparent pays for and owns the remaining interests in the policy (generally the cash surrender value). To determine the allocation of the premium it may be reasonable to use an equivalent term insurance cost (i.e. 5 or 10 Year Term, Term to 65, Term to 100). The parent/grandparent may help the child with their premium obligation by gifting funds to the child/grandchild (to pay the premium related to the death benefit). The attribution rules will not apply to the gift if the child/grandchild is 18 years of age or older. The benefit to the parent/grandparent is that they own the cash surrender value (savings) portion of the policy, which accumulates on a tax-deferred basis. At a point in the future when value has accumulated in the policy, the parents/grandparents can use the value to supplement retirement income needs.

The Split Dollar arrangement allows the parent to help their children meet their life insurance needs and gain access to a tax-deferred investment vehicle.

Charitable Giving

Most charities are highly dependent on annual gifts from a large number of donors in order to fund their initiatives. A great deal of effort is put into these fund raising efforts, which takes valuable resources away from the actual running of their charitable activities. A charity's reliance on new donations also makes it difficult to budget for new initiatives they may want to undertake. A planned gift involving life insurance helps reduce the charity's reliance on annual fundraising activities.

A Split Dollar arrangement can be an effective way to give a gift to more than one charity. A life insurance policy is purchased by an individual with the individual as the life insured. When the life insurance policy is issued, the individual absolutely assigns the policy to two or more charities. The assignment constitutes a change in ownership of the policy. The charities become joint owners of the policy and their interest in the policy is determined at the time of transfer by the individual making the gift. Even though the policy is jointly owned by the charities, the annual policy premium is paid direct to the insurance company by the individual. The payment of the policy premium is considered a charitable gift for tax purposes. Each charity will confirm with the life insurance company that the premium has been paid and issue a charitable receipt to the individual in an amount equal to the portion of the premium paid that applies to their interest in the policy.

A Split Dollar arrangement is a creative approach to charitable giving that provides current tax relief to the individual and a larger gift for each charity upon the individual's death.

Some of CRA's older interpretations (for example #9335905 dated June 6, 1994) indicated that split dollar arrangement could not be used in a situation where the benefits of a life insurance policy are split between an individual and a charity. They took this position because some of the policy's benefits are also accrued to the donor. Interpretation Bulletin IT 244R3, entitled "Gifts by individuals of life insurance policies as charitable donation", states "in order for the gift of a life insurance policy to represent a bona fide charitable gift, no right, privilege, benefit or advantage can accrue to the donor as a result of the gift".

However, the release of the December 20, 2002 Technical Bill and December 24, 2002 Technical News No. 26 heralded a change in policy regarding charitable giving. This change regarding split-receipting opened the way for gifts even where the donor receives some element of benefit. Since the change in policy, a couple of interpretations have been raised that involve the possibility of receiving a charitable donation receipt with respect to an interest in a life insurance policy that is the subject of a split dollar arrangement (See CRA Interpretation Letters #2003-00043 and #2003-0004115). Although short on specifics, the CRA is now open to there being a donation in these circumstances. In Interpretation Letter #2003-00043 CRA offered the following comments:

To determine whether in a particular situation any portion of the premiums paid by an individual would qualify as a charitable gift, it would be necessary to demonstrate that the charity has a premium obligation under the policy and that this premium relates exclusively to the benefits under the policy that will accrue to the charity. Also, since there may be some cost reduction by virtue of having a single policy from what would be the premium obligation if two separate policies were issued, it would seem that this saving should be taken into account. Therefore, absent a review of the particular arrangement, we are not in a position to confirm that the calculation of the amount of the gift, if any, is simply the excess of the annual premium over the cost of pure insurance for the year.

While the CRA is open to allowing split dollar arrangements to qualify for some type of charitable gift, it will be necessary to submit all the documentation – the policy, the split-dollar arrangement and any other information relevant to the arrangement – to get a more definitive answer on what the actual amount would be on the donation receipt. This is a difficult issue because determining the premium split under split dollar arrangements is more of an art than a science, and the CRA has not provided much guidance in determining what is a reasonable split in their previous commentary.

Conclusion

Split Dollar arrangements are a flexible method of sharing the costs and benefits of a permanent life insurance policy. It applies to numerous situations and is a creative way to solve problems for two or more parties.

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