

# ADVANCING *Issues*

Winter 2003 • Published quarterly by Corporate Planning Associates • Vol. 10, No. 3

## Getting Money Out of Your Holding Company Tax Free!

*By David Vicic, Senior Vice President, Corporate Planning Associates.*

In our last newsletter, we discussed a fixed income strategy called a “back to back” or Insured Annuity. This strategy, which combines a life annuity and a life insurance policy, can be an attractive investment vehicle for individuals over the age of 65. The Insured Annuity concept should be looked at by those whose income is generated by interest bearing investments as it can produce better after-tax cash flow for the individual.

The purpose of this article is to describe a variation of the Insured Annuity concept that will be of interest to those individuals who are shareholders of a holding company:

- With significant investment assets;
- Where a large portion of the investment assets are in cash or near cash;
- Where shareholders have assets in a holding company that they want to transfer to their beneficiaries; and

- Where shareholders face the prospect of incurring substantial capital gains on their deaths.

### Corporate Insured Annuity

This version, called a Corporate Insured Annuity, uses the traditional life annuity and life insurance combination in conjunction with a leveraged structure. When implemented, this concept can provide at least an equal and in many cases, a positive cash flow to that generated by the cash/near cash assets currently held. In addition, there can be significant benefits in the event of the shareholder's death that could allow assets to be paid tax-free to the beneficiaries by virtue of the corporation's Capital Dividend Account (CDA). The CDA mechanism recognizes the fact that amounts received tax-free by a corporation which in turn are distributed to shareholders should

not be taxed in the shareholders' hands as these amounts would not have been taxed if received directly.

We will attempt to outline the steps required to implement the strategy along with some of its benefits and risks.

**Step 1:** The holding company (“Holdco”) determines how much of its cash/near cash assets it wants to commit to this strategy.

**Step2:** Holdco then purchases either a Term-to-100 or a minimum funded universal life policy on the life of the shareholder with a death benefit equal to the amount of funds determined in Step 1. Holdco is the owner (i.e. pays the premium) and beneficiary of the policy.

**Step 3:** Once the life insurance is in place, Holdco uses the funds (as determined in Step 1) to purchase a life annuity on the life of the shareholder. The annuity is non-prescribed, i.e. has a taxable

*continued on page 2*

# Getting Money Out of Your Holding Company Tax Free!

continued from page 1

interest component that is higher in the earlier years of the annuity and decreases over time, and payable as long as the shareholder is alive. Annuity payments are made to Holdco.

**Step 4:** Holdco obtains a loan from the bank equal to the funds committed to the annuity purchase. These funds are invested in a portfolio thereby making the interest paid on the loan deductible.

**Step 5:** As security for the loan, the bank requests that the life insurance policy be assigned as collateral. This will allow a tax deduction equal to the lesser of the life insurance premium paid or the net cost of pure insurance.

To summarise, the Corporate Insured Annuity concept has the following affect on cash flow:

## **Cash Flow Into Holdco:**

- Annuity payments
- Tax savings due to loan interest deductibility
- Tax savings due to insurance cost deduction

## **Cash Flow Out of Holdco:**

- Life insurance premium
- Loan interest
- Tax on interest portion of annuity

## **Net Cash Flow Position:**

- In most cases, positive cash flow comparable to that which could be earned by cash/near cash assets if not used for Corporate Insured Annuity concept.

As noted earlier, the Corporate Insured Annuity can generate significant benefits on the death of the shareholder.

When a shareholder dies, he is deemed to have disposed of the shares immediately prior to his death at fair market value. In the case of a shareholder who has employed the Corporate Insured Annuity concept, the following assets and liabilities of Holdco would contribute to the value of those shares:

## **Investment portfolio**

- Based on market values

## **Life annuity**

- A life only annuity will have no value as it stops on death

## **Life insurance policy**

- Since the value of Holdco is done immediately before death, the life insurance proceeds have not yet been paid. In addition, the life insurance purchased has little or no cash value. As a result, the life insurance policy adds little or no value to the value of Holdco

## **Bank Debt**

- The value of the bank loan will reduce the value of Holdco

To illustrate this, let us assume that Holdco's investment portfolio is currently worth \$2 million; insurance in place is \$2 million and the bank loan totals \$2 million. At death, the value of the company is as follows:

Portfolio	\$2,000,000
Bank Debt	(\$2,000,000)
Value of Shares	\$ 0

At this point, we can see that the shares of the company have no value for tax purposes, therefore no capital gains taxes will be paid on the disposition of the shareholder's shares.

Immediately after the shareholder's death, the life insurance policy is paid to the bank to retire the debt, leaving the \$2 million portfolio in Holdco intact. But how do you get those funds out tax-free? Here's how:

## **Withdrawing the HoldCo Funds – Tax Free**

When the life insurance is paid out, an amount is credited to the Capital

continued on page 4

# RESP Planning for your children's future

By: *Duncan McEachran, Senior Vice President, Corporate Planning Associates*

**W**ith the demise of Grade 13 (OAC) in Ontario this year, this fall marks the time students graduating from both Grades 12 and 13 compete together for acceptance to post secondary education. With these double cohort students and their parents worrying about whether there will be sufficient space to meet the huge demand, the financial considerations for those accepted might seem less significant. Equally worrisome, however, are the costs these fortunate students and their parents face.

Current estimates place the cost of a four-year undergraduate program at a Canadian university, while living away from home, at about \$60,000.

What financial alternatives are available for families whose children have some time before they face their own entrance challenges? Potential student grants and/or loans may be available when the student is at school. Part-time employment during the summers and the school year could provide for some expenses. Excess parental cashflow may be available at the time, allowing for a pay-as-you-go plan. One of the most compelling options, however, continues to be saving for the future using an RESP.

## **RESP Benefits**

An RESP provides an immediate government grant of 20% of the

contribution, to a maximum of \$400.00 for a \$2,000 contribution. The annual contribution limit is \$4,000, however, generally only the first \$2,000 is eligible for the government grant. These plans allow for the accumulation of funds on a tax-free basis, to cover any expenses a student incurs while attending a qualifying post secondary institution. Tax is only paid as funds are withdrawn, and then, only in the student's hands. Those institutions that qualify include a very wide range of schools, including public and private universities, colleges and vocational schools in Canada and abroad. A complete list of qualifying schools can be viewed at [www.canlearn.ca](http://www.canlearn.ca)

## **Investment Options for your RESP**

RESPs can be either a self-directed (as to investment choice) plan for particular beneficiary(ies) or a pooled plan providing for a large group of individuals. Both of these types of RESPs have been available for many years. It was the introduction of the 20% government grant in 1998 that significantly increased their popularity, particularly the self-directed type. For those who weren't able to contribute in the past to take advantage of the grants (a maximum of 5 years of eligibility has passed, depending upon the child's age) the good news is those "unused grants" are still available. As the maximum

annual contribution is actually \$4,000, there are provisions to allow the "first" \$2,000 as a current year contribution for the grant purposes, and also allow the "second" \$2,000 (for a total of \$4,000 annual contribution) as a previously unused grant year's contribution. In this manner, the maximum of 5 years of unused grants, could be "recovered" in 5 years.

Are there risks? Yes. Investment performance in self-directed plans will depend on the particular investment choices, whereas the pooled plans are directed by the plan sponsor, and are limited to guaranteed investments. There is also the risk of a child not attending a qualifying institution, which can be mitigated somewhat by using a family plan. In this case, any one of the named (but related) beneficiaries can access all the funds in the plan. If no one attends a qualifying institution, the funds can be transferred to the contributor and taxed as income in their hands, plus a 20% penalty. Still, this net outcome is not significantly worse than had a contributor simply saved funds for their own account.

With proper planning, the financial considerations of post secondary education can be a little easier to manage, leaving more effort to focus on meeting the challenge of being accepted to the student's program of choice.

# Getting Money Out of Your Holding Company Tax Free!

continued from page 2

**Dividend Account.** The amount credited to the CDA is equal to the life insurance proceeds less the adjusted cost basis of the policy. In many cases, the cost basis will be equal to zero, meaning that 100% of the life insurance proceeds are credited to the CDA. You will recall that values credited to the CDA can be paid out tax-free to shareholders and in this case, the estate of the deceased shareholder. A capital dividend would be paid out to the beneficiaries with the funds coming from the portfolio. At this point, the company can be wound up and the deceased shareholder has succeeded in transferring funds from the Holdco to his beneficiaries without paying any tax.

When entering into the Corporate Insured Annuity concept, there are risks that one must be willing to accept:

- The use of the strategy should fit in with an overall estate plan. There should be a need for life insurance in order to solve liquidity issues on death.
- There is interest rate risk involved – the interest rate on the bank loan is variable while the interest rate used in the annuity is fixed. Cash flow could be impacted when interest rates rise more than expected.
- The shareholder should only commit discretionary funds to this concept due to the inflexible nature of the arrangement.
- CCRA, otherwise known as Canada Customs and Revenue Agency. If they feel that a particular arrangement is too abusive, CCRA has the potential of invoking the GAAR or General Anti-Avoidance Rule. This could lead to a denial of the

interest expense deduction, or the inclusion of the annuity in the value of the Holdco, for example.

There is another variation of the Corporate Insured Annuity that can be utilised when both a husband and wife are shareholders of the corporation. This version uses a life annuity that is paid until the first death of the spouses as well as a joint and first to die life insurance policy. The benefits of this arrangement are potentially bigger than when only one life is insured and more importantly, CCRA may not be able to attack the arrangement by invoking the GAAR.

The Corporate Insured Annuity could be considered an aggressive strategy. This arrangement is complicated and not applicable to all. It is important to get the proper financial advice to determine whether or not this strategy is for you.

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*Subscription price: \$100 per year*