

Converting Retained Earnings to Capital Dividend Account

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We have recently completed a transaction for a client that illustrates a unique aspect of corporate-owned life insurance. I thought it might be interesting to summarize it here.

As you know, retained earnings may be paid out as taxable dividends to a shareholder. Currently, the tax rate on dividends in Ontario is 31.7% to 34.5%. As business owners (and owners of holdco's) get into their 60's or older, they may come to the realization that they will not likely draw all of their retained earnings out as taxable dividends during their lifetime.

The new concern then becomes, "how can I best reduce or eliminate the tax on those retained earnings in my estate?"

Here are two very effective ways to do that:

- 1)** Purchase a corporate-owned life insurance contract. Premiums are not deductible (or taxable to shareholder) but they do reduce retained earnings. The eventual death benefit is received tax free by the company and most or all of the proceeds go into the Capital Dividend Account. It may then be paid out to the shareholders tax free as a capital dividend. To the extent premiums have been paid, those amounts have been converted to tax free capital dividends.
- 2)** In the appropriate circumstances, the company can purchase an annuity as an investment. At the same time, a life insurance policy is purchased by the company in the amount of the annuity premium.

The annuity pays an income to the company, partially taxable, partially a "return of principal". However, on death, the annuity ceases and has no value; this reduces the retained earnings by the amount of the annuity premium that was originally paid.

The life insurance death benefit however is then received by the company tax free and, as noted, goes into the Capital Dividend Account. As in **1)**, it may be paid out tax free to the (new) shareholders.

In most cases, the value of the company will also have been reduced for capital gains purposes.

These are simple strategies that may be used with or without leverage, depending on a client's situation.