Canada Life™

Tax and planning

Life insurance

Corporate accounting for permanent life insurance

Many business owners have their corporation as the owner and beneficiary of a permanent life insurance policy. There can be many reasons for, and benefits to, owning a permanent life insurance policy within a corporation, including:

- use of lower after-tax corporate dollars to pay premiums
- business loan protection
- key person coverage and buy-sell funding at death
- tax-deferred wealth accumulation
- supplementing executive compensation and retirement funding
- funding for capital gains taxes and estate equalization at death of the shareholder

Whatever the need, there is associated accounting entries.

Annual accounting entries required

1) Payment of premium

For accounting purposes, the entry to record premiums ($25,000 for example) paid during the year is:

DR	Life insurance premium (expense)	$25,000	
CR	Cash (asset)		$25,000

The life insurance expense is separated from other expenses to differentiate the life insurance premium from other on-going business operation expenses.

The $25,000 premium is added back to the financial statement income on the T2 corporate tax return Schedule 001 in the calculation of net income for tax purposes. Life insurance premiums are generally not deductible for income tax purposes unless the insurance is collaterally assigned to a financial institution for a business or investment loan on which the interest cost is deductible. If so, a portion of the premium expense may be deductible for tax purposes. The calculation of the deductible amount of the premium in the case of a collaterally assigned policy is beyond the scope of this article.

2) Change in cash surrender value

The change in the cash surrender value of the life insurance policy is recorded for accounting purposes. The cash surrender value, in the case of a universal life insurance policy, equals the account value less any surrender charge that applies if the policy is surrendered in early years after issue. A surrender charge only applies if the policy is surrendered, but otherwise has no impact on the account value. Generally speaking, surrender charges become nil after the ninth policy year for a universal life insurance policy, after which the account value and cash surrender value are equal. There are no surrender charges for a participating life insurance policy.

For accounting purposes, the entry to record the change in the cash surrender value ($10,000 for example) during the year is:

DR Life insurance cash surrender value (asset) $10,000

CR Increase in life insurance cash surrender value (income) $10,000

This accounting journal entry records the value of the asset on the balance sheet of the corporate financial statements. The increase in life insurance cash surrender value is separated from other income to differentiate this notional income from other income of on-going business operations.

The increase in the cash surrender value (income entry) would be deducted from the financial statement income on the T2 corporate tax return Schedule 001 in the calculation of net income for tax purposes. The increase in cash value is not subject to income tax while inside a life insurance policy that qualifies as an "exempt life insurance policy" under Canada's income tax rules.

Accounting for proceeds received as a consequence of death

Assume the death of the insured occurs at a time when the total death benefit is $2.5 million, the cash surrender value on the balance sheet is $1 million, and the adjusted cost basis of the life insurance policy at the time of death (provided by the insurance company) is $200,000.

For accounting purposes, the entry to record the life insurance death benefit proceeds is:

DR Cash (asset) $2,500,000

CR Life insurance cash surrender value (asset) $1,000,000

CR Mortality gain on life insurance (income) $1,500,000

The $1.5 million mortality gain would be deducted from the financial statement income on the T2 corporate tax return Schedule 001 in the calculation of net income for tax purposes. Life insurance proceeds received by the corporation as a consequence of the death of the life insured is not treated as a disposition of the policy and therefore the death benefit proceeds are not subject to income tax.

The capital dividend account is a notional tracking account, for tax purposes, of a private corporation resident in Canada. This account is part of the integration of Canada's corporate and personal income tax system, and allows tax-free amounts received by the corporation (added to the corporation's capital dividend account) to flow through to shareholders also tax-free. The credit to the account is the excess of the death benefit proceeds received by the corporation over the adjusted cost basis of the policy immediately before death, or $2.3 million in this example. While the full $2.5 million is received tax-free by the corporation, $2.3 million is available, to the extent of the balance in the capital dividend account, to the shareholders as tax-free capital dividends. The remaining $200,000 is taxable as an ordinary dividend at distribution from the corporation to its shareholders. For more information on the capital dividend account, please see our *Tax & Planning* article *The capital dividend account*.