TAX TOPICS

Accounting For Corporate Owned Life Insurance and Critical Illness Insurance

Introduction
A corporation may own a life insurance policy for any number of reasons including funding a buy/sell agreement, collateral for a loan or covering the loss of a key employee. Critical illness insurance may be owned to cover losses incurred if a key employee or shareholder becomes critically ill. The financial statements of the company must reflect the financial effects of the policy.

This Tax Topic reviews the appropriate accounting treatment applicable to corporate owned life insurance and critical illness insurance. It also discusses the differences between the treatment of life insurance for accounting and income tax purposes. For a discussion of the tax treatment of corporate owned critical illness insurance, refer to the Tax Topic, "Taxation of Stand-Alone Critical Illness Insurance in the Corporate Context".

Authoritative Support
For fiscal years beginning on or after January 1, 2011, "publicly accountable enterprises" are required to report using International Financial Reporting Standards ("IFRS"). Publicly accountable enterprises are all reporting entities other than private, not-for-profit, and public sector enterprises. Private enterprises (essentially defined as profit-oriented enterprises that are not publicly traded and are not banks, credit unions, mutual funds, securities broker/dealers, or insurers) are allowed to choose to adopt IFRS. Alternatively, they may use a different set of standards called "Accounting Standards for Private Enterprises" ("ASPE").

Neither IFRS nor ASPE specifically address accounting for life or critical illness insurance but do provide a general framework for recording assets, income and expenses. The framework gives guidance on the accounting treatment when specific IFRS or ASPE sections are not available. In addition, where IFRS and ASPE are silent on an issue, international accounting standards can provide guidance.

U.S. Guidance on Accounting for Life Insurance
In the United States, the Financial Accounting Standards Board ("FASB") released a statement on the appropriate financial reporting treatment for life insurance (Technical Bulletin 85-4). The FASB bulletin states that an asset should be recorded on the financial statements at the amount that could be realized under the insurance contract at the financial statement date. In determining the

expense or income to be recognized for the period, the premiums paid are adjusted for the change in the cash surrender value.

Generally, when IFRS or ASPE guidance is silent on a particular transaction, U.S. accounting standards can be considered persuasive in Canada. Therefore, the general concepts from IFRS/ASPE and the FASB statement can be used to determine the appropriate accounting treatment for life insurance.

Purchase of Life Insurance

Permanent cash value life insurance combines an investment component with insurance protection. If the life insurance contract is surrendered, the policyholder is entitled to receive the cash surrender value in the policy. The cash surrender value is the total balance of the accumulated value in the policy reduced by the charges that apply if the policy is cancelled in the early years of coverage. Term life insurance provides only insurance protection and does not build up a cash surrender value. If a term insurance policy is allowed to lapse, the policyholder is not entitled to receive any value from the contract.

IFRS and ASPE standards indicate that a company will only recognize an asset on its financial statements where an economic resource is controlled by the company because of past transactions and will potentially provide a future economic benefit. A company obtains control of a life insurance policy when it purchases the policy as the owner and deposits premiums into the contract. The death benefit proceeds could be considered a future economic benefit although receipt is contingent on the contract remaining in force and the death of the life insured. The cash surrender value of a life insurance policy provides a future economic benefit as it is the amount that can be realized by the company if the policy is surrendered.

Therefore, it is the cash surrender value of the life insurance contract that is recorded as an asset on the corporate balance sheet. Each year the change in the cash surrender value changes the asset on the balance sheet. The difference between the premiums paid in the year and the increase in the cash surrender value is recorded as the net insurance expense on the income statement. In the later years of the policy, the increase in cash surrender value may exceed the premiums paid in the year. The excess is recorded as income on the income statement. See attached Appendix A for an example of the accounting treatment. Since term insurance does not have a cash surrender value, the entire premiums paid for term life insurance are recorded as an expense on the income statement.

Where a company purchases a policy that is already in force there may be an argument to record the policy at its fair market value (based on an actuarial valuation) as opposed to cash surrender value or a value between cash surrender value and fair market value. There may also be an argument to record the policy at a value greater than cash surrender value where the policy has been paid up (i.e., premiums have been pre-paid and the policy is unlikely to lapse).

The retained earnings (or deficit) of a company will be affected by the ownership of a life insurance policy due to the reporting of the income generated and expense incurred. This may be a factor in determining a company's ability to claim the small business deduction and an individual shareholder's ability to claim the lifetime capital gains exemption. See the Tax Topic entitled, "Corporate Owned Life Insurance – Tax Considerations" for details of the impact of corporate-owned life insurance on these tax items.

Disclosure in the notes to the financial statements should be made if the life insurance policy has been pledged as security for bank indebtedness.

Generally, the payment of a life insurance premium is not a deductible expense for income tax purposes. Therefore, the portion of the premium expensed is added back in the calculation of the company's taxable income. Similarly, where the increase in cash surrender value exceeds the premiums paid in the year, the income is deducted in the calculation of the company's taxable income.

Death of the Life Insured
On the death of the life insured, the company will receive the proceeds of the life insurance policy. The life insurance asset on the balance sheet will be eliminated. The excess of the life insurance proceeds received over the amount recorded as an asset is reported as income on the income statement. This income may be disclosed as a separate item.

The company will receive the death benefit proceeds of the life insurance policy tax-free. Therefore, the insurance death benefit proceeds recorded as income must be deducted in the calculation of the company's taxable income.

Attached in Appendix A is an example of the accounting for corporate-owned life insurance.

Accounting for Corporate Owned Critical Illness Policies
The main question with respect to accounting for any insurance contract is whether the payment of premiums results in the acquisition of an asset that should be reflected on the financial statements. Under IFRS and ASPE, an asset must embody a future benefit, the entity must be able to control access to the benefit and the transaction or event that gives rise to the benefit must have already occurred. In addition, an asset must be reasonably measurable and cannot be contingent on a future event. If the payment of insurance premiums results in the acquisition of an asset, then all or a portion of the premium should be capitalized on the balance sheet. If no asset is acquired, then the premiums should simply be expensed as they are paid.

An important factor in determining the accounting for a corporate owned critical illness policy is the nature of the premium refunds accompanying the policy. Stand alone critical illness policies may expire when the individual reaches a specified age or continue for the life of the insured. Policies may come with a guarantee that all or a percentage of the premiums will be refunded at death if no claim has been made under the policy (return of premium on death or "ROPD"). For policies with an expiry age, a rider may be purchased to provide a refund of the premiums (or a portion of the premiums) if the contract expires without the payment of a critical illness benefit (return of premium at expiry or "ROPX"). A rider may also be purchased providing a refund of premiums (or a portion of the premiums) if the policy is surrendered (return of premium with early surrender option ("ROPS")). The ROPS rider usually requires that the critical illness coverage and ROPS rider have been in effect for a specified period of time (i.e., 15 years). The key question is whether the contract, as a result of these "return of premium" features, meets the definition of an asset (as outlined above).

The critical illness insurance benefit will only be received if the individual contracts a critical illness as defined in the contract. The refund of premium at death is typically received only if the policy remains in force until death and if no critical illness benefit was paid on the contract. In the case of a critical illness policy with an expiry age and a return of premium at death, it is pretty clear that an asset cannot be set up since there is a possibility that no payment will ever be received.

When a ROPX or ROPS rider is purchased, or if the policy is a permanent contract (intended to be in force for the life of the individual) the situation is a little different. The policyholder is paying an identifiable cost to ensure payment of either the insurance benefit under the policy or a recovery of expenses at a future determinable date. As a result, it is likely that there will be a recovery of all or some of the premiums. Arguably, an asset could be set up to recognize that the premiums will be recovered. However, the receipt of a future benefit out of the policy is still contingent upon some future event(s) – either the insured contracting a critical illness or the corporation continuing to pay the premiums in order to keep the policy in force. Since there are future events that must occur in order to guarantee a payment, it is difficult to argue that the "transaction or event giving rise to the benefit" has already occurred. As a result, in most cases no asset should be recorded on the financial statements of a corporation that owns a critical illness insurance contract. Rather, the premiums paid on the policy should generally be expensed as incurred and any benefits received under the contract recorded as income when received.

There may be an argument that payment of premiums for life, to surrender or expiry are sufficiently certain so that it is justifiable to set up an asset for a policy with a ROPX or ROPS rider or for a policy with no expiry. In this case, as the premiums are paid, all or a portion of the premiums would be recorded as an asset. The accounting value of the asset should never exceed the lesser of the critical illness benefit or the return of premium benefit. Once this value is reached, all remaining premiums would be expensed. When the critical illness benefit or return of premium benefit is received, the asset would be written off and the difference between the benefit and the asset recorded as income. This accounting treatment is justified only if there is persuasive evidence that the policy will almost certainly be kept in force and that a benefit will be received.

Consider the example of a critical illness policy that has a ROPD rider and a ROPS rider allowing the policy owner to request the return of premiums when the policy has been in effect for 15 years. Once the policy has been in effect for 15 years, the owner is guaranteed to receive either the return of premium on surrender, the critical illness benefit (if the insured experiences one of the covered illnesses) or the return of premium on death.

Conclusion

The financial statements of a company must reflect the ownership of a life insurance or critical illness insurance policy. IFRS and ASPE do not specifically address the issue although guidance is provided by the FASB in the United States in the case of life insurance.

The ownership of a cash value life insurance policy affects the corporate balance sheet, income statement, retained earnings and possibly the notes to the financial statements. In general, where a corporation owns a critical illness insurance policy the premiums will be expensed on the income statement and no asset in respect of the policy will be reflected on the balance sheet; however, there may be exceptions.

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Appendix A

Example of Accounting for Corporate Owned Life Insurance

Life Insurance Policy Information:

$500,000 initial coverage, Face plus Universal Life insurance policy
Assuming Death at the beginning of year 15

	Life Insurance Policy			Financial Statement Impact		
				Balance Sheet	Income Statement	
Policy Year	Annual Deposit	Cash Surrender Value*	Death Benefit*	Insurance Asset	Insurance Expense	Insurance Income
1	15,000	11,728	511,728	11,728	3,272	-
2	15,000	24,159	524,159	24,159	2,569	-
3	15,000	37,337	537,337	37,337	1,823	-
4	15,000	51,305	551,305	51,305	1,032	-
5	15,000	66,441	566,441	66,441	-	136
6	15,000	82,563	582,563	82,563	-	1,122
7	15,000	99,736	599,736	99,736	-	2,172
8	15,000	118,027	618,027	118,027	-	3,291
9	15,000	137,509	637,509	137,509	-	4,482
10	15,000	158,260	658,260	158,260	-	5,751
11	-	164,706	664,706	164,706	-	6,446
12	-	171,571	671,571	171,571	-	6,865
13	-	178,884	678,884	178,884	-	7,313
14	-	186,673	686,673	186,673	-	7,789
15	-	-	-	-	-	500,000

* These values are end of year values

Note: The figures presented in this example are for illustrative purposes only and do not represent actual or projected policy values.