



LEVERAGING A LIFE INSURANCE POLICY

A GUIDE FOR LAWYERS, ACCOUNTANTS
AND INSURANCE ADVISORS

Using life insurance as collateral for personal and business planning

This guide is intended to be a source of information on the leveraging process, but not a substitute for independent legal, tax, accounting or other professional advice. While the leveraging concept can be beneficial to both individuals and businesses, there are risks involved in such a strategy and the issues can be complex. No person or business should undertake a leveraging strategy without a thorough review of the financial risks as well as the potential legal, tax and accounting implications that apply to their situation.

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LIFE INSURANCE – A FLEXIBLE FINANCIAL PLANNING TOOL

Life insurance policies with a cash value component, such as universal life and permanent life policies, can be flexible financial planning tools – for both individuals and businesses. While term life insurance provides temporary protection, permanent life insurance provides lifelong protection and most permanent policies also create an opportunity to build cash value.

A cash value policy provides an excellent means of deferring tax on the interest earned, most often for use in retirement. It can play an integral role in business succession planning by providing tax-efficient funding for the purchase of a business owner's interest or funding for the owner's retirement income. While the purchaser usually has a specific planning objective when buying a permanent life insurance policy, the flexibility of these policies can help purchasers achieve their original goal as well as new objectives and needs that may arise over time.

In many cases, access to the cash value of the policy during the lifetime of the insured is an integral part of the planning strategy.

There are three main ways to do this:

- › withdraw funds from the policy
- › take out a policy advance or policy loan¹ from the insurance company
- › take out a loan from a financial institution, using the policy as collateral

While we briefly discuss policy loans and withdrawals in the sections that follow, this guide focuses on the third method of accessing a policy's cash value – leveraging the policy by using it as collateral for a loan from a financial institution.

WHY BUY LIFE INSURANCE WITH CASH SURRENDER VALUES (CSV)?

Both individuals and businesses can take advantage of a permanent life insurance policy. While there are no restrictions on the use of an insurance policy's cash value, an increasing number of people use these funds as an additional source of retirement income. They can purchase a policy during their high-income earning years, make significant payments and earn tax-deferred interest. Of course, while building the cash value of their policy, they also enjoy the ongoing life insurance protection that the policy provides.

When their income decreases at or near retirement, these individuals can access the cash value of the policy in one of the three ways described previously (withdrawal, policy loan or loan from a financial institution) to supplement their retirement income.

There are a number of ways businesses can benefit from the purchase of permanent life insurance on the lives of one or more employees, partners or shareholders. Benefits include:

- › providing collateral for a business loan
- › covering anticipated business losses if a key employee or an owner-manager dies or retires
- › providing tax-free funds to finance a buyout or redemption of a deceased shareholder's interest

¹ See glossary for more details.

- › accumulating tax-deferred funds to buy out a retiring partner's or shareholder's interest
- › funding retirement income for an active shareholder

Some of these strategies are discussed in more detail in the section entitled "Key leveraging strategies for corporations and their shareholder."

ACCESSING CASH VALUE DIRECTLY – POLICY WITHDRAWALS OR POLICY LOANS

There are two ways a policy owner can directly access the cash value of the policy – through policy withdrawals or a policy loan.

POLICY WITHDRAWALS

Most cash value policies allow for ongoing policy withdrawals. However, there are tax implications to consider with any withdrawal.

First, all withdrawals are final and may not be repaid to the insurer. This means that any subsequent payments are considered a new premium and must meet the conditions set out in the insurance contract and the Income Tax Act (ITA) to maintain their tax-exempt status.

Second, all or a portion of the withdrawal may be taxable under section 148 of the ITA. Whenever the cash surrender value (CSV) of a policy exceeds the adjusted cost basis (ACB) of the policy, withdrawals will trigger taxation. The taxable portion of each withdrawal is the proportion of the amount withdrawn to the total policy fund value times the total gain on the policy at the time. For example, if 30 per cent of the total CSV is comprised of non-taxable ACB, and 70 per cent of the total CSV is taxable, then 30 per cent of the withdrawal will be treated as a withdrawal of non-taxable ACB, and 70 per cent of the withdrawal will be taxable.

Ultimately, the ACB of the life insurance policy will reach zero and when that happens 100 per cent of a withdrawal will be taxable.

POLICY LOANS

Most cash value policies also allow the policyholder to take out a policy loan from the insurer against the cash value of the policy. While most people refer to this approach as a policy loan, in reality it is an advance against the death benefit paid under the terms of the insurance policy. So, while terms like "policy loan" and "borrow" are used to describe this method of accessing the cash value of a policy, the legal requirements and obligations of this arrangement are different from when a person uses a cash value policy as collateral for a loan or line of credit from a financial institution.

Policy loans taken in amounts that do not exceed the policy's ACB will be tax free, and will reduce the policy's ACB. If the policy loan exceeds the policy's ACB, the amount borrowed in excess of the policy's ACB will be fully taxable.² There is no proportional taxation as is the case with policy withdrawals.

Unlike a policy withdrawal, amounts borrowed can be repaid. If the original loan was not taxable, the repayment will merely increase the policy's ACB. If the original loan had a taxable portion, the amount repaid will be deductible from the policyholder's income up to the previously taxed portion. The repayment less the deductible portion will increase the policy's ACB.

² See section 148(9) of the ITA.

ACCESSING CASH VALUE INDIRECTLY – BORROWING FROM A FINANCIAL INSTITUTION (LEVERAGING)

The third method of accessing the cash value of a life insurance policy is to use the cash value of the policy as collateral for a loan from a financial institution. This is often referred to as “leveraging” the life insurance policy.

The primary advantage of this approach is that under current tax laws, the loan proceeds can be received tax free. In addition, loan interest may be deductible if the loan proceeds are used to generate income from business or property. Where the policy is assigned to the financial institution as a condition of the loan, a portion of the insurance costs may be deductible. The amount deductible is based on the lower of the premium paid and the net cost of pure insurance (NCPI) as outlined in ITA paragraph 20(1)(e.2).

The loan agreement with the financial institution will provide the conditions for the loan repayment. In some cases, the borrower may have to make interest or capital payments on the outstanding balance. This and other risks associated with leveraging are discussed in the “Risks of leveraging” section of this guide, on page 17.

Remember, cash value life insurance remains one of the best ways of achieving long-term growth – whether your client leverages or not. In most cases, your client’s decision to make a policy withdrawal, borrow from the policy or leverage won’t be made for many years. A renewed assessment of the risks can be made at that time. Whatever decision is made, the tax-deferred growth within the policy remains available for your client’s benefit, as does the tax-free payment of the death benefit.

Whether leveraging is used in a personal or business context, the basic structure is the same. At the time of the loan application, the financial institution will issue a line of credit or a loan to the policy owner, taking the insurance policy as collateral either through a collateral assignment or, in Quebec, a movable hypothec.

The maximum amount that can be borrowed is based on a specified percentage of the CSV, usually 50 to 90 per cent depending on the investment options chosen by the policy owner. In most cases, the more conservative the investments, the higher the borrowing limit. Interest may be paid annually or added to the loan balance, depending on the lender and the terms of the loan. Because the rate earned within the policy may be less than the financial institution’s lending rate, it is possible that the loan balance will exceed the CSV. If so, the financial institution may require additional collateral or a partial repayment of the loan (see “Risks of leveraging” on page 17).

Providing additional collateral may also become a risk if the deduction of the life insurance NCPI is a component of the financial value of the strategy. Excess collateral is not directly relevant to the life insurance premium deduction. However, excess collateral may cause the limitation or the denial of the deduction if the Canada Revenue Agency (CRA) doubts the assignment of the policy is a “genuine requirement” of the borrowing.

Providing additional collateral may also impact the deduction of insurance costs under ITA paragraph 20(1)(e.2). The deduction available is prorated by the amount of the insurance coverage as a percentage of the loan amount. When additional collateral is required, this proportion would be reduced.

Upon the death of the insured, the financial institution has first claim on the proceeds of the policy. After the loan is fully repaid, the excess of the death proceeds, if any, will flow to the designated beneficiary, the policy owner, or the estate if there is no designated beneficiary.

LEVERAGING – A CLOSER LOOK AT HOW IT WORKS

A QUICK-STEP APPROACH TO THE LOAN CALCULATION

When a financial institution calculates the loan amount, the calculation is designed to ensure that the loan balance never exceeds the maximum allowable percentage of the CSV before the estimated date of death.

Here are the key steps:

- › An estimated date of death for the insured is determined, based on actuarial assumptions that the insurer would be able to provide. However, the financial institution is not compelled to use the insurer's assumptions, and is free to develop its own.
- › The cash value of the policy at the time of death is projected, based on an assumed date of death and on assumed future returns. Generally, a policy illustration may be used for this purpose. However, given the uncertainties involved in predicting anyone's death and in projecting future returns, several illustrations using a range of estimated dates of death and rates of return should be used.
- › The financial institution calculates the maximum loan amount by applying a percentage to the projected cash value (typically 50 per cent of the policy cash value if the cash value is invested in equity subaccounts, and up to 90 per cent if the policy cash value is invested in guaranteed subaccounts).
- › The annual loan amount is then calculated using a projected average long-term interest rate on the balance of the loan.

Many of the risks associated with leveraging arise from the fact that assumptions are used in the loan calculation that could later prove inaccurate – such as the projected interest rates or estimated date of death of the insured.

For example, mortality tables are based on average or median life expectancies. Approximately 50 per cent of the population will die before reaching life expectancy and 50 per cent will outlive life expectancy. If the insured outlives life expectancy, the outstanding loan balance may exceed the percentage of the policy cash value that the bank agreed to accept as collateral. If that were to happen, the bank could require additional collateral, failing which it could require repayment of all or part of the loan. Family history can help when assessing the risk of outliving assumed life expectancy.

DISTINCTION BETWEEN A COLLATERAL ASSIGNMENT AND A MOVABLE HYPOTHEC

In all Canadian provinces except Quebec, the use of a life insurance policy as collateral for a loan involves the policy owner executing a collateral assignment. As assignee, the financial institution does not become the owner of the policy. It can, however, prevent any action under the policy that would diminish its security interest. If the borrower defaults on the loan while the insured is alive, the lender has remedies it can exercise, including a surrender of the policy for its cash value, in order to recover the amount it has lent. The lender also has a right to the proceeds of the policy up to the loan balance at the time of the insured's death if the loan remains outstanding at death.

In Quebec, the use of a life insurance policy as collateral involves the use of a movable hypothec. Like a collateral assignment, the movable hypothec does not involve the transfer of policy ownership. Rather, it provides security for the loan by giving the lender rights in the policy to the extent of the loan balance.

One concern, in the past, with using the movable hypothec was that the CRA held the view that the debtor corporation was not allowed to post to its capital dividend account (CDA) the part of the death benefit that went to pay off the loan at the insured's death. However, the CRA has reversed this position, and now allows the debtor corporation a credit to its CDA for the entire death benefit (minus the policy's adjusted cost basis).³

LEVERAGING IN ACTION – TWO EXAMPLES

Let's look at two examples of how leveraging might work with a personal life insurance policy. As you consider the examples below, bear in mind that the amount of money your client may access is only one concern – just because a withdrawal may offer more money than borrowing does not mean that a withdrawal is always the best choice. Also consider that small changes in the assumptions used can produce large changes in the results. Provide your client with several illustrations using a variety of rate of return and life expectancy assumptions. Consider also how changes to the way in which the product is offered (for example, level death benefit versus death benefit plus fund) can affect the comparison. Finally, remember that it's also important that the client has the right amount of life insurance in place, in a policy that meets their needs. Accessing policy values through loans or withdrawals is something the client may or may not do, but they will still need to have the right death benefit at an affordable cost.

We'll look at our example and compare the income from two different scenarios:

1. The insured makes an annual withdrawal from the policy.
2. The insured leverages the policy and receives an annual loan from a financial institution (where loan interest is not deductible).

³ CRA Views Technical Interpretation 2002-0122944F.

Assumptions

Insured	Male, non-smoker, age 50
Life insurance	SunUniversalLife \$1,000,000, level insurance amount plus fund,* investment bonus selected
Exempt status	Increase insurance amount and reverse, apply non-exempt allocation to service account**
Cost of insurance	Level term
Policy payments	\$50,000 for 15 years (not guaranteed)
Policy interest rate	5% (not guaranteed)
Life expectancy at age 65	82
Supplementary retirement income need	Maximum income for 10 years from age 66 through age 75
Loan interest rate	7% (2% above policy interest rate)
Maximum loan ratio	90% of cash surrender value
Marginal tax rate	45%

* Assuming a level insurance amount plus fund with this strategy produces higher death benefits, but slightly lower policy cash values than assuming a level insurance amount.

** Money in the service account earns taxable interest.

Note: See page 18 for important information on financial risks.

EXAMPLE #1

The client lives to statistical mortality. After policy payments stop, withdrawals or loans as the case may be, are taken for the next ten years, after which no more money is withdrawn from the policy or borrowed against the policy's cash values. What are the projected financial results for the client and their estate?

Average mortality from age 65 (age 82)

	1. Annual withdrawals	2. Annual loan
After-tax income	\$75,545	\$79,832

Estate value at age 82

	1. Annual withdrawals	2. Annual loan
Death benefit	\$1,114,211	\$3,105,729
Loan balance	0	\$1,895,152
Net estate benefit	\$1,114,211	\$1,210,577

Note: Annual withdrawals are illustrated after-tax. Annual loans are taken from a financial institution and are not taxable. However, if the policy had to be surrendered to repay the loan balance, the difference between the policy's cash value and its adjusted cost basis would be taxed as income to the client.

As previously discussed, statistical mortality means that 50 per cent of clients will live beyond that age. If the client received annual loans from a financial institution, and lives beyond age 82, the client would have to provide additional collateral in order to keep the loan in good standing.

EXAMPLE #2

One way to address the risk of the client living beyond life expectancy and having to provide additional collateral, is to illustrate the concept with an assumed longer life expectancy, resulting in lower annual loans. Let's see the effect of a change in the assumed life expectancy of the insured, in this case all the way to age 100. All other assumptions remain the same.

Above-average mortality (age 100)

	1. Annual withdrawals	2. Annual loan
After-tax income	\$75,545	\$58,161

Estate value at age 100

	1. Annual withdrawals	2. Annual loan
Death benefit	\$1,001,553	\$6,185,141
Loan balance	0	\$4,666,666
Net estate benefit	\$1,001,553	\$1,518,475

Conclusion

In example #2, the policy owner maintains the same after-tax income from withdrawals over the same period of time as they did in the first example. The increased life expectancy assumption does not affect their ability to withdraw in this example (although it could if we altered the assumptions). Even after stopping policy payments and withdrawing money from the policy, enough policy cash value remains to maintain a reduced death benefit until the insured reaches age 100.

However, you can see that the assumed date of death makes a significant difference in the amount of money they can borrow against the policy. By extending the assumed date of death to age 100, the maximum annual loan amount decreases significantly (from \$79,832 to \$58,161).

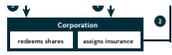
There are at least three reasons for this. First, loan interest is not being paid, but is instead being added to the outstanding debt. Since the insured is expected to live much longer in the second example than in the first, annual loans must be kept lower to keep the total loan balance from exceeding 90 per cent of the policy cash value before the insured reaches age 100. Second, as the insured grows older, mortality charges increase, reducing the policy cash value more than at earlier ages. Again, in order to protect the bank's collateral, annual loans must be kept lower. Third, the loan is assumed to be growing at a rate that is two per cent higher than the assumed rate of cash value growth within the policy (even before mortality charges are considered). If, contrary to the assumption, loan interest rates were lower than the policy cash value growth rate, annual loans could be higher.

The above discussion should not be used to conclude that taking cash withdrawals is "better" than leveraging the policy cash values (or vice versa). Instead, the examples should be used to show how a leveraging strategy works, and the impact of different approaches used to mitigate some of the risks inherent in a leveraging strategy. The client will need to determine whether they want to access policy cash values, and if so, which strategy best suits their needs and risk tolerance.

KEY LEVERAGING STRATEGIES FOR CORPORATIONS AND THEIR SHAREHOLDERS

Here is an overview of the main ways a business can make use of a leveraging strategy.

Living buyout



Buy out a partner or shareholder

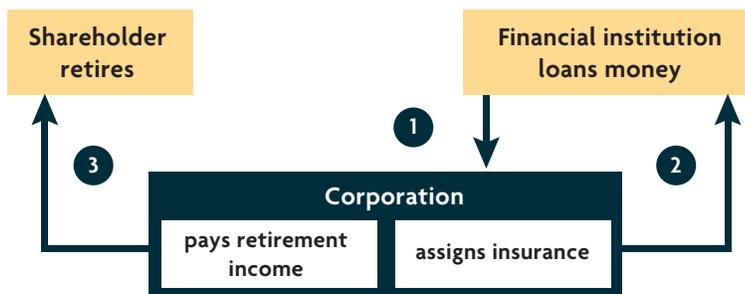
The cash value of a life insurance policy can provide the necessary funding to buy out the interest of a retiring or disabled business partner, or to purchase the shares of a principal shareholder of a private corporation. When a business partner or shareholder dies, the policy death benefit can be used to purchase that person's interest or shares.

In a leveraging situation:

1. The business would take out a loan from a financial institution.
2. It would use the policy as collateral.
3. The loan proceeds would be used to fund the buyout. The loan would then be repaid with the policy death benefit when the insured partner or shareholder dies.

To the extent that the death benefit exceeds the policy's adjusted cost basis, the excess can be credited to an eligible corporation's CDA. This enables the corporation to pay a non-taxable dividend to its remaining shareholders. While there is no CDA for partnerships, the tax treatment is equivalent.

Living pension payment



Provide an ongoing pension to a shareholder

The cash value of a life insurance policy can also be used to provide ongoing retirement income to a retired shareholder.

In a leveraging situation:

1. The corporation would receive a loan from a financial institution.
2. It would use the policy as collateral.
3. The corporation would then pay retirement income to the shareholder from the proceeds of the loan.

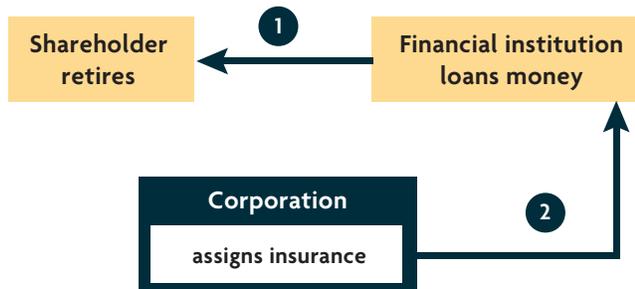
While the payments would be taxable to the shareholder, there is security in knowing that the business would have the resources to fund the retirement income.

When the shareholder dies, the loan is repaid with the proceeds from the policy. Any death proceeds from the policy in excess of the loan balance at death, will be paid to the corporation.

There is a risk that this strategy could be deemed to be a retirement compensation arrangement (RCA). See page 22 for more information.

Personal loan with corporate policy

Personal loan with corporate policy (during income period)



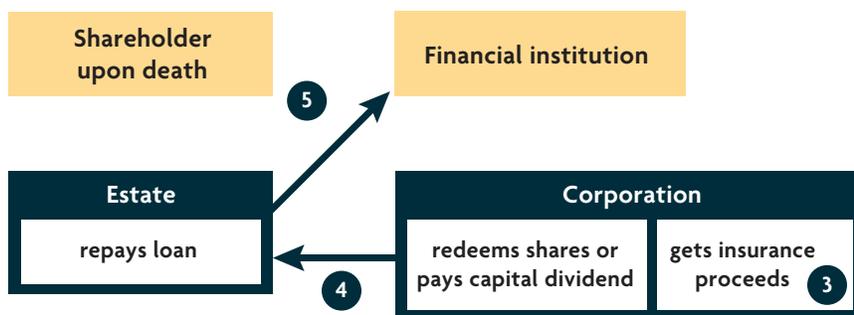
Personal loan using the corporate policy as collateral

In a leveraging situation:

1. When an insured shareholder retires, they would take out a personal loan from a financial institution. The amount would be received by the shareholder on a non-taxable basis.
2. The corporation would assign the policy on the life of the insured shareholder as collateral for this personal loan.

A word of warning – this structure will usually result in a taxable shareholder benefit, based on either the interest rate savings that the borrower achieves by having the corporate guarantee, or a benefit that's equivalent to a guarantee fee that would otherwise be charged. This risk may be reduced by having the borrower pay a guarantee fee to the corporation. However, the facts of each case should be carefully examined to ensure the structure is tax-effective.

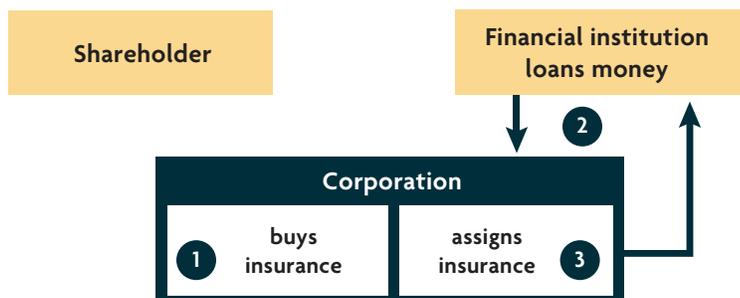
Personal loan with corporate policy (after death)



- When the shareholder dies, the corporation would receive the proceeds from the insurance policy.⁴
- These assets would be used either to pay a tax-free capital dividend to the shareholder's estate from the CDA, or buy out the shareholder's interest with a payment to the estate.
- The estate would then retire the loan with the funds paid to it from the corporation.

Immediate leverage for premium

Immediate leverage for premium (during income period)



- The corporation would purchase a policy on the life of a shareholder.
- After the policy has been issued, the corporation would borrow money from a financial institution to add to its working capital. The corporation will pay the premiums, while the line of credit or loan would be used to replenish the working capital.
- The life insurance policy would be assigned as collateral for this loan or line of credit. While the cash surrender value would be used as collateral for the loan or line of credit, other collateral would likely be required by the financial institution.

⁴ As indicated above, the collateral assignment (movable hypothec) gives the financial institution the first claim on the life insurance policy death proceeds. Usually the financial institution is reluctant to renounce this right without additional guarantees provided to secure the loan. But if the death proceeds flow directly from the life insurance company to the financial institution to repay the shareholder's loan, the loan reimbursement may be treated as a shareholder benefit and taxed accordingly under subsection 15(1) ITA. Advisors must pay special attention to the issues related to this type of arrangement and make sure the implementation will not trigger negative tax consequences, since the repayment of the loan would have been otherwise done using a capital dividend that is non-taxable by definition.

Immediate leverage for premium (after death)



4. Upon the death of the shareholder, the corporation will receive the insurance proceeds.
5. The corporation will use the insurance proceeds to repay the loan or the line of credit. Any death proceeds from the policy in excess of the loan balance at death will remain with the corporation.
6. The balance of the proceeds will then be used to buy out the shareholder's interest.

There are risks to this strategy in that loan interest is not deductible if the loan is used to pay insurance premiums or to replace capital used to pay premiums, and the structure could be deemed an RCA. Care must be taken in structuring the arrangement to minimize these risks.

RISKS OF LEVERAGING

When an individual or business purchases a cash-value life insurance policy, access to the policy's cash value is often not needed for many years. And while the policy owner will always benefit from the insurance protection and the policy's tax-deferred growth during this time, there are risks to relying on and eventually making use of the leveraging option.

The good news is that, with careful planning and the proper legal and tax advice, these risks can be effectively managed. And ultimately, the greatest risk neutralizer is the fact that a policy's cash value is always available for withdrawal, even if the leveraging option is considered and then rejected as a strategy.

Here are the key risks associated with the leveraging of a cash-value life insurance policy.

MORTALITY RISKS

When a life insurance policy with cash values is used to secure a loan (or line of credit) the maximum loan amount will be capped, just as when a loan is supported with any other form of collateral. The loan will be structured so that, based on certain financial assumptions, the outstanding loan amount will not reach that cap until the projected date of death. If interest payments are being added to the loan amount (which is commonly the case where interest is not deductible) smaller loan advances will be available than if the interest is not being capitalized.

The mortality risk is realized if the insured lives longer than the projected date of death. Mortality tables indicate the median life expectancy, meaning 50 per cent of the people will outlive the mortality assumption. In these situations, the loan balance will begin to exceed the maximum allowable percentage of the policy's cash value. When this occurs, the policy owner must either provide additional collateral or pay off a portion of the loan balance. If the policy owner is unable to do so, the financial institution may force the surrender of the policy.

This could be disastrous to the policy owner since they are liable for the tax payable on the taxable gain (cash surrender value minus adjusted cost basis), if any. A significant amount of the cash value, or all of it in some cases, will be used to repay the loan. There may not be funds left over to cover the tax liability triggered by the policy gain, which may in turn force the policy owner to liquidate other assets.

Of course, the policy owner can take steps to avoid a surrender of the policy before the death of the insured. The owner can assign additional assets to secure the loan, repay a portion of the loan with funds from another source, or simply repay a portion of the loan interest each year. As noted previously, these options will be available to the policy owner only if enough other assets or income sources exist.

To minimize the mortality risk from the start, it's important to make a conservative assumption when projecting the date of death. If life expectancy is used, it should be based on the age of the insured when the loan is arranged, not when the policy was first purchased. Even then, life expectancy is a mathematical mean, leaving a significant possibility that the insured will outlive the projection. Using a higher projected date of death, such as age 100, can be an effective method of reducing the mortality risk associated with leveraging.

FINANCIAL RISKS

In addition to the mortality risks described above, there are also financial risks to consider before leveraging a life insurance policy.

Widening of spread between loan interest rate and policy interest rate

The key financial risk is the potential for a widening spread between the loan interest rate and the policy interest rate.

When the loan is negotiated, assumptions are made about the loan interest rate and the policy interest rate. A typical assumption will have the loan interest rate one to three per cent above the expected policy investment return. If higher interest costs or lower returns cause this spread to widen, the accumulated loan balance will “catch up” to the cash surrender value of the policy at a faster rate than projected. The greater the spread between rates, the faster this will happen.

If the accumulated loan exceeds the maximum allowed by the financial institution, the financial institution may ask for additional collateral, require payments on the loan, or force the surrender of the policy to have the loan repaid. Conservative estimates on both the rate of return and interest rates can minimize this particular financial risk.

The financial institution may require the borrower to invest the policy fund value in guaranteed interest accounts or investment accounts that provide for more stable rates of return after the loan is issued. A negative rate of return on an investment account may jeopardize the leveraging strategy and cause the loan or line of credit to be recalled much earlier than expected.

Change in business practice of financial institution

While many financial institutions are in the business of making loans using cash value life insurance as collateral, there is no guarantee that these institutions will still be pursuing this line of business when it comes time to negotiate a loan. If financial institutions decline such loan applications in the future, policy owners may need to rely on policy loans or withdrawals to fund their ongoing financial needs.

Change in loan requirements of the financial institution

A policy owner must still qualify for a collateral loan under the financial institution’s normal lending requirements. There is no guarantee that a policy owner who would qualify at the time an insurance policy is initially purchased will qualify years later, as the financial institution’s lending requirements or the policy owner’s financial situation may have changed. For example, ongoing financial problems, a poor credit history or a previous bankruptcy can disqualify a policy owner’s loan application.

In addition, the financial institution may ask for a periodic re-qualification of any loan or line of credit already provided. This could require the policy owner to pay off the loan in full, provide additional collateral, or make interest or capital payments. Another option is to change the lender. However, this can also mean additional fees and potentially important changes to the terms of the loan.

TAX RISKS

There are several tax risks associated with a leveraging strategy.

An ever-changing tax environment

Tax laws change frequently. If past history is any indication, many tax laws will be different in 20 years time. The tax treatment applicable to loans, interest deductibility and life insurance policies may change over time without any grandfathering provision. Indeed, over the past decade, and after several court decisions, the federal Department of Finance tried, unsuccessfully, to change the interest deductibility rules. The last effort was in 2003. Finally, the CRA released IT-533 representing its position on the various issues raised by interest deductibility.

General anti-avoidance rules (GAAR)

In addition, the CRA could decide to invoke the GAAR in section 245 of the ITA.

Specifically, subsection 245(3) defines an avoidance transaction as any transaction “that but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.”

The concern is that in circumstances where it determines that it is appropriate to do so, the CRA could use the GAAR to characterize a collateral loan as a policy loan. Any money received from a policy loan is tax-free to the extent the borrowed funds do not exceed the policy’s ACB, and taxable to the extent they do. Money received from a collateral loan is not taxable at all.

However, the CRA has also been careful to say that it does not believe that all collateral loans should automatically be treated as policy loans:

Ordinarily the pledging or assignment of a life insurance policy as collateral for a loan from the insurer, or a corporation related to the insurer, would not, by itself, cause us to conclude that a policy loan has been made. Nevertheless, a determination of whether a particular loan is a policy loan can only be made after a review of the terms and conditions governing the particular policy.⁵

Clients should carefully document the reasons for taking a collateral loan and should discuss the transaction with their tax advisor.

⁵ CRA document 9606425, dated April 9, 1996

RETIREMENT COMPENSATION ARRANGEMENT RISK

The use of leveraged life insurance in some corporate situations might also invoke the RCA rules. This can occur when an employer takes an interest in a life insurance policy that is considered to be acquired to fund an employee's retirement benefits. The RCA rules require that a 50 percent refundable tax be paid on all contributions and all income earned by the RCA.

Because of the RCA rules, the use of corporate-owned life insurance to fund the retirement income of key employees is not advisable unless the business wishes to establish the arrangement as an RCA. In most other situations, such as providing retirement income to a shareholder, a properly structured arrangement can avoid the deeming of these onerous RCA rules. If a key employee will require retirement income, then a personally owned policy or a shared benefit arrangement such as Sun Life Financial's Executive Retirement Account concept could be used.⁶

⁶ Refer to Sun Life Financial's guide, "Sharing Interests in a Life Insurance Policy – A guide for lawyers and accountants" (810-3300)

GLOSSARY

Adjusted cost basis (ACB)

The ACB of a life insurance policy is calculated using a complex formula that takes into account all payments into, withdrawals or loans from, dividends and the net cost of pure insurance charges of a policy. ITA subsection 148(9) defines a life insurance policy's ACB.

An oversimplified definition for the vast majority of policies, and assuming no cash withdrawals, cash dividends or loans from the policy, looks something like this:

Policies issued before Dec. 2, 1982

Total premiums paid

Policies issued Dec. 2, 1982 or later

Total premiums paid

Less: Net cost of pure insurance

ACB is increased by the total of all premiums paid and decreased by the annual net cost of pure insurance (NCPI). NCPI generally increases year over year to the point where it exceeds the premium or payment, if any, being paid. For this reason, the ACB of a policy generally increases in the early years after a policy is issued and then declines to zero after a number of years. Once the ACB reaches zero, every dollar of cash withdrawn from the policy, by whatever means, will be taxable.

Canada Revenue Agency (CRA)

The CRA is in charge of administering tax laws for the Government of Canada and for most provinces and territories. It also administers various social and economic benefit and incentive programs delivered through the tax system.

Capital dividend account (CDA)

The capital dividend account is a notional tax account, part of the tax integration mechanism, into which certain capital receipts of a corporation and life insurance proceeds can be credited. This enables a corporation to pay a non-taxable capital dividend to its shareholders.

The CDA is available only to private corporations that are resident in Canada. Here are some key criteria for determining if a corporation qualifies for a CDA, although final determination rests with the client's legal, taxation and accounting advisors:

- › The corporation must be a private corporation. This means that the corporation is not controlled directly or indirectly by one or more public corporations (see subsection 89(1) of the ITA).
- › The corporation must be resident in Canada, though it does not have to be Canadian controlled.
- › The corporation must receive non-taxable money, such as the non-taxable portion of a capital gain minus the non-deductible portion of any capital loss, which it credits to the CDA. When a corporation receives a life insurance policy death benefit, the death benefit minus the policy's ACB is credited to the CDA.
- › If the policy was transferred to the corporation by a shareholder before March 22, 2016, that part of the death benefit equal to the value the corporation paid to the shareholder for the policy minus the policy's cash surrender value at the time of the transfer may not be posted to the corporation's capital dividend account.

A private Canadian corporation may elect to pay a capital dividend to its shareholders (see subsection 83(2) ITA). To the extent of the CDA credit, the dividend is not taxable to its Canadian resident shareholders and is not included in computing those shareholders' incomes. This favourable tax treatment applies only to Canadian resident shareholders. Capital dividends paid to non-resident shareholders will be subject to a 25 per cent withholding tax.

Cash surrender value (CSV)

When cash value life insurance is surrendered during the lifetime of the person whose life is insured, the cash surrender value is the amount that the policy owner receives after any outstanding policy loan, interest and other surrender charges have been paid. The CSV is a taxable income receipt to the extent that the CSV exceeds the policy's ACB.

Cash value life insurance policy or cash value policy

Permanent life insurance can provide life insurance coverage and cash value growth within the contract. For the purposes of this guide, "cash value life insurance" and "cash value policy" refer to life insurance policies that are exempt from annual accrual taxation of the growth in cash value under the provisions of the ITA.

Collateral assignment

In the common law provinces and territories, the owner of a life insurance policy can use the policy as collateral for a loan or line of credit. The owner cannot sell or dispose of the policy without either first getting the lender's consent or paying off the loan or line of credit. This process is sometimes called a "partial assignment".

Income Tax Act (ITA)

This is the Federal statute that governs taxation of the income of individuals, corporations, partnerships, trusts and estates in Canada. The provinces and territories also levy income tax. The ITA is amended on a regular basis.

Leveraging

A policy owner assigns a life insurance policy to a financial institution as collateral for a loan or line of credit. In the common law provinces and territories, the legal mechanism is a "collateral assignment." In Quebec, the assignment is done through a "movable hypothec."

Movable hypothec

In Quebec, the owner of a life insurance policy can use the policy as collateral for a loan or line of credit. A "movable hypothec" is a charge on one or more specific eligible properties that include a life insurance policy to secure a loan.

Net cost of pure insurance (NCPI)

NCPI is calculated based on a prescribed mortality charge applied to the amount at risk (i.e. the total death benefit less the accumulating fund of the policy). It is a separate calculation for tax purposes and need not bear any relationship to the actual cost of insurance assessed under the policy.

Policy advance or policy loan

Cash value life insurance contracts can permit the policy owner to receive an advance against the death benefit payable under the terms of the policy. Most people (advisors and clients alike) refer to this arrangement as a policy loan and consider this to be a form of borrowing.

While terms like “policy loan” and “borrow” are used to describe this method of accessing the cash value of a life insurance policy, the legal requirements and obligations of this arrangement are different from when a person uses a cash value policy as collateral for a loan or line of credit from a financial institution. Like a loan from a financial institution, interest on the advance is charged. The policy advance is taxable to the extent that the amount borrowed exceeds the policy’s ACB. For convenience, we will refer to this arrangement as a “policy loan” and will use the term “borrow” to describe the action of accessing the cash value of the insurance policy.

Policy withdrawal

Cash value life insurance contracts can permit the policy owner to make a permanent withdrawal of part of the policy’s cash value. Withdrawals may result in a reduction in the amount of life insurance coverage and some or all of the amount withdrawn may be taxable.

Retirement compensation arrangement (RCA)

An RCA is a plan or an arrangement made by an employer or a former employer that is used to provide retirement income or benefits to an employee or a former employee. Under the ITA, 50 per cent of all payments to the RCA and 50 per cent of all income and gains realized on the RCA’s investment must be paid to CRA, which holds them in a refundable tax account (RTA). Once the employee begins to receive retirement income from the RCA, a refund of \$1 from the RTA for every \$2 paid to the employee is then available. The RCA rules in the ITA deem an RCA to exist when an employer is under an obligation to provide retirement income and acquires a life insurance policy to fund the benefits in contemplation of the employee’s retirement.

The CRA can determine that an RCA exists years after the structure was set up, which can result in a significant overdue tax liability.



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