A question of ownership – Who should (or should not) own the policy? – Part 2

Part 1 examined some of the issues surrounding corporate ownership of a life insurance policy. This bulletin examines some of the issues surrounding personal ownership of a life insurance policy.

In some situations there are advantages to an individual, rather than a corporation, owning a life insurance policy. Generally speaking, if the need for insurance is permanent or if non-shareholder family members will require money at the insured’s death, the policy should be personally owned.

Personal ownership is sometimes critical to achieving tax or legal objectives, but there are still issues to consider. This bulletin explores some of the issues and drawbacks of personal ownership that you should be aware of. It is important to note that many of these problems are not solved by corporate ownership.

Avoid personal ownership by “United States persons”

Generally, the United States Internal Revenue Code (IRC) defines a “United States person” as an individual who lives in the United States or has U.S. citizenship or permanent residence – regardless of where they live. Canadians with dual U.S./Canadian citizenship are considered U.S. persons, as are green card holders. Under American law a green card holder is a permanent U.S. resident (and therefore a U.S. person) even if he or she does not live in the United States.

The estates of U.S. persons are subject to estate tax at death. Not only are all their assets subject to tax, but also the death benefits of any life insurance policies they own on their lives at death. The tax rates can be as high as 60%.† For a fuller discussion of this question see our bulletins, “Unique estate risks of ‘U.S. person’ clients” and “U.S. taxes for Canadians with U.S. assets”. If a U.S. person needs life insurance, he or she should speak with a tax or legal advisor experienced in U.S. transfer tax law regarding some of the strategies that can be used to deal with U.S. estate taxes.

† Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA), there is no estate or generation-skipping tax for persons dying in 2010. The gift tax remains, however. EGTRAA will expire at the end of 2010. For 2011 and future years, the top estate and gift tax rate will revert to its 2001 rate, 60%.
An additional aspect of life insurance taxation is that life insurance policies are subject to different tests in the United States and Canada to determine if the policy cash value is entitled to tax deferral. Policies developed for the Canadian market, and sold in Canada, are designed to satisfy the Canadian rules. Further, Canadian life insurance companies monitor the policies they have sold to make sure that they continue to benefit from tax deferral according to Canadian law. Canadian policies may not satisfy the U.S. rules to remain exempt under American law.

**Continuing ownership after the owner's death**

If someone other than the insured owns a life insurance policy, additional planning is needed. If the owner dies before the insured, the policy remains in force (because the life insured is still alive). If the policy had a contingent owner designation, the contingent owner becomes the new policy owner. From a tax standpoint, the contingent owner must be the spouse or the common-law partner, or a child of the deceased who is the life insured or whose child is the life insured, to avoid triggering a taxable disposition of the policy in the hands of the deceased policyholder. Designating a trust for the benefit of a spouse, a common-law partner or a minor child as the contingent owner will trigger a taxable disposition.

Without a contingent owner designation, the policy becomes an asset of the deceased owner’s estate. If the deceased owner had a will, the will determines where the policy goes, either by wording that specifically deals with the policy, or through language in the will that says who receives the residue of the estate (i.e., all the property owned by the deceased that is not used to pay debts or given as specific gifts). If the deceased did not have a will, and if the policy had no contingent owner designation, then the rules of intestate succession in the province where the deceased resided before death apply. Generally, the court appoints an administrator to administer the deceased’s estate. After paying all the deceased’s debts, taxes and expenses, the administrator divides the deceased’s remaining property among his or her heirs. The rules governing who gets what are rigid, and contemplate passing money, not assets, to the heirs. Therefore, it may be necessary to surrender a policy owner’s life insurance policy for its cash surrender value as the result of his or her intestacy.

**Changing ownership during the owner’s life**

A person may also buy a life insurance policy with a view to changing ownership. In most cases, a change of ownership is treated as a disposition, triggering taxation of the gain to the former policy owner. However, there are exceptions, one of which is to transfer ownership of a policy to a spouse, a common-law partner or a child or grandchild.

Often an adult buys a life insurance policy on the life of a child or grandchild, with a view to transferring ownership to that child or grandchild when the child or grandchild reaches age 18. There are some technical rules to remember when buying a policy with this in mind. Here are a few of them:

- There can be only one life insured under the policy.
- The policy cannot be on the owner’s (i.e., the parent’s or grandparent’s) life – the policy must be on the life of a child or grandchild of the parent or grandparent.
- The transfer of ownership must be to a child or grandchild of the owner, but does not have to be to the insured child or grandchild – the policy could be transferred to another child or grandchild of the owner. For example, a grandparent owning a policy on his or her child could transfer ownership of that policy to his or her grandchild, so that the grandchild would own a policy on the life of his or her parent. Or a parent owning a policy on the life of his or her oldest child could transfer ownership of that policy to his or her youngest child.
- The rules do not allow for a transfer of a policy tax-free to a child or grandchild pursuant to the terms of the policy owner’s will (even if the same transfer during the policy owner’s life would be allowed tax-free). The Canada Revenue Agency's (CRA) reasoning is that the transfer must be from the policy owner to the child or grandchild in order for the tax-free rollover to succeed, whereas at death the transfer is from the policy owner to the policy owner’s estate, and then to the policy owner’s child or grandchild.
- If the child is age 18 or over, and borrows from the policy or takes a withdrawal, the attribution rules will not apply. However, if the child is under age 18, the attribution rules will apply.

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2 See s. 148(8) of the Income Tax Act (ITA).
3 See CRA Views, 9433865 – Disposition of life insurance policy on death.
Creditor protection

Insurance products may enjoy protection from most creditors of the owner if the owner is also the life insured, and if the owner chooses the right beneficiary.

In the common law provinces, the beneficiary must be the spouse, child, grandchild or parent of the life insured, or an irrevocable beneficiary (except the policy owner). It is important to keep the relationships straight. For example, if a husband owns a policy on his wife’s life, and names his father as the revocable beneficiary, there is no creditor protection (because the beneficiary must be a parent of the life insured, not the owner).

In Quebec the relationship between the owner and the beneficiary (rather than the life insured and the beneficiary) determines whether creditor protection is available. The beneficiary must be the spouse (married or civil union), the ascendant or descendant of the policyholder or an irrevocable beneficiary. However, an owner may not designate himself or herself as beneficiary and obtain creditor protection.

The attribution rules

One of the strategies often recommended for dealing with the attribution rules is to have the higher income-earning spouse pay the regular bills (groceries, mortgage, rent, etc.), leaving more money in the lower income-earning spouse’s hands for investment. Any income from these investments is taxed at the lower income-earning spouse’s lower tax rate.

Clients should carefully consider whether to apply this strategy to have the lower income-earning spouse pay life insurance premiums for a policy the higher income-earning spouse owns. The reasoning depends on the fact that life insurance policies are not exempt from the attribution rules, and owners may withdraw or borrow funds from a life insurance policy. If the withdrawal or loan creates a disposition, and if there is gain in the policy, tax will be owed on the gain deemed to have come out of the policy. If the wife earned a higher income than her husband, and paid the premiums for a policy owned by her husband, the wife would have to include in her income the part of the withdrawal or loan treated as gain and pay tax on it.

The right to pay for the policy and get access to policy information

Especially in divorce or marital separations, it may be critically important to keep a policy in good standing, even over the objections of the other spouse. But who can find out if a policy is in good standing? Only the owner or someone with the owner’s permission can find out.

What about paying premiums to keep a policy in force? The owner and beneficiary may pay the premiums, as can a collateral assignee, or someone acting on their behalf. But the provincial insurance acts do not say whether a life insured can pay the premiums. Ownership, including shared ownership, can be very important in having the rights and access to information necessary to properly manage the policy.

Charitable giving

The owner of a life insurance policy on his or her own life may name a charity as a beneficiary. At the owner/insured’s death, the policy owner’s estate will receive the same tax treatment as if the life insurance proceeds had flowed to the charity through the will. This can create a large charitable donation receipt that the executor may use to offset up to 100% of the taxes owed in the year of death and in the previous year. But this benefit applies only if the owner was also the life insured. If instead the policy owner had owned a policy on someone else’s life, the charity would still get the money at the insured’s death, but could not issue a charitable receipt to the policy owner.

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4 S. 118.1(5.1) of the Income Tax Act.
Family law

Life insurance proceeds receive special consideration under matrimonial law. In Ontario for example, a surviving spouse may take what the deceased left to him or her under the will, or may ask a judge to award an equalization payment, as if the spouses had separated. Life insurance policy ownership is crucial in these cases. For example, if John died, owning a life insurance policy on his own life, with his wife Mary as the beneficiary, the proceeds of insurance would be deducted from whatever equalization payment Mary could receive. On the other hand, if Mary had owned the policy, the proceeds of insurance she received at John's death would not affect her claim for an equalization payment.

Advising clients

We often think that the important thing is to have enough life insurance to cover the risk of a loved one’s or business associate’s premature death. Often, though, who owns the policy can have a profound effect on whether the right people get the money, and on how much they get.

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