

Leveraging Life Insurance Policies

Universal life (UL) policies are attractive financial vehicles, since they provide for tax-free death benefits and also allow for a significant tax-deferred accumulation within the policy. Policyholders may want to access the built-up tax-deferred wealth within the contract since they may require funds for either personal or for investment purposes. Options for accessing the built-up wealth include partial or full surrenders of the contract, as well as policy loans, all of which are considered dispositions for tax purposes.¹ Hence, taxes may be payable.

Fortunately, there is a tax-effective strategy for accessing the built-up wealth that policyholders may use. Namely, the policyholder may assign the policy to a financial institution as collateral for a loan or series of loans. This process is widely known as “Leveraging”.

This is an extremely tax-effective method for accessing the built-up wealth, since using a policy as collateral is not considered a “disposition” for tax purposes. In fact, these arrangements are explicitly carved out from the “disposition” definition. Where the proceeds of the loan are used for investment purposes, the taxpayer may realize additional tax savings through being able to deduct the interest costs.² Additional tax savings may be available where the policyholder is able to deduct all or a portion of the premiums because the financial institution has required that, as a condition of granting the loan, the insurance policy is to be collaterally assigned to the financial institution.³

Even if the purpose of the strategy is personal (for example, to supplement retirement income), it can be extremely tax-effective. Given the limits that the rules contained in the Income Tax Act (Canada) (ITA) place on tax-assistance for registered plans, many taxpayers are seeking additional tax-effective strategies.

With this approach there will continue to be a build-up of tax-deferred wealth, as the cash surrender value of the policy will continue to grow. Moreover, any proceeds that are payable at death will remain tax-free, and in the case of a corporate beneficiary, may be credited to the Capital Dividend Account (CDA).

This document discusses the tax and other implications of these arrangements. Readers seeking more information on the taxation of true policy loans should refer to the Taxing Issues item on *Policy Loans* [PC 6140].

I. Description of the Arrangement

As stated above, a UL policy may have a significant investment component. Thus, a policyholder may want to leverage the policy. Typically, the following would occur:

- A UL policy is acquired, with the policyholder maximizing the deposits into the contract for a specified period of time, normally a period of at least 10 years;
- The deposits, together with the investment income earned thereon, accumulates on a tax-deferred basis;

¹ See definition of “disposition” contained in subsection 148(9) of the Income Tax Act (Canada) (ITA).

² See paragraph 20(1)(c) of the ITA.

³ See paragraph 20(1)(e.2) of the ITA.

- The policyholder approaches a financial institution for a loan (or series of loans) and offers the UL policy as collateral security;
- The policyholder and financial institution negotiate the terms of the loan. (Terms to be negotiated include: whether interest and principal are both to be paid (or whether interest is to be capitalized); what is the maximum percentage of the cash surrender value that may be borrowed against; etc.)
- Upon the death of the policyholder, the tax-free life insurance proceeds will be used to pay off the balance of the loan (or series of loans), with the remainder being paid to the named beneficiaries (or estate).

II. Taxation Implications

a) Tax-Free Receipt of Loan Proceeds

When we look at the ITA we see that a disposition of an interest in a life insurance policy does not include “an assignment of all or part of an interest in the policy for the purpose of securing a debt or a loan other than a policy loan”.⁴

For an assignment to not be considered a disposition, the assignment must be a collateral assignment as opposed to an absolute assignment. The Canada Revenue Agency (CRA) discusses these two types of assignments in a Technical Interpretation issued in 2003:

“In *Norwood on Life Insurance Law in Canada* (Third Edition), on page 362, it states that ‘an assignment which transfers the assignor’s interest in the policy leaving no residual is known as an absolute assignment. One which leaves a residual interest with the assignor, even though the assignee’s interest must first be satisfied in full, is known as a collateral assignment.’

Whether a particular life insurance policy is collaterally or absolutely assigned is a question of law. The nature of the assignment will depend upon the intent of the assignee and assignor. Subject to any other evidence of intent, the assignment instrument is key in determining the nature of the assignment since it sets out the specific rights assigned.”⁵

Thus, it is essential that a taxpayer assigning a life insurance policy take the necessary steps in reviewing the nature of an assignment. (While the taxpayer will want to ensure that the assignment is a collateral assignment as opposed to an absolute assignment, the taxpayer will also want to understand the extent to which any of his or her rights under the policy are encumbered.)

b) Deductibility of Borrowing Costs

Taxpayers would typically want to structure their affairs so that interest charges for the borrowings for which the policy has been collaterally assigned are deductible.

The ITA contains specific provisions relating to interest deductibility. There are general rules that specify the criteria that must be met for interest to be deductible, as well as some specific rules that modify the general provisions.

⁴ See part (f) of the definition of “disposition” contained in subsection 148(9) of the ITA.

⁵ See Technical Interpretation # 2003-0029377 issued by the Canada Revenue Agency (CRA) on November 20, 2003.

The specific conditions that must be met for interest to be deductible are as follows:

- The interest must be paid or payable for the year (depending upon the method regularly followed by the taxpayer for computing income);
- There must be a legal obligation to pay the amount;
- The amount must be reasonable, and;
- The borrowed money must be used to earn income from a business or property (other than to earn exempt income or to acquire a life insurance policy).⁶

The rules relating to interest deductibility are discussed in detail in the Taxing Issues item on *Interest Deductibility* [PC 6141].

The last condition is especially important. Two landmark decisions in 2001 (Singleton and Ludco) established that “income” could not be interpreted as “net income” or “profit”. As a consequence of these two decisions, CRA could no longer limit a deduction for interest expense to the investment income (or business income) actually earned. Thus, given the appropriate circumstances, many taxpayers are able to create substantial tax losses, and hence achieve tax savings.

The Department of Finance (Finance) wanted to remedy this situation and on October 31, 2003 proposed the Reasonable Expectation of Profit (REOP) rules. Tax practitioners attacked the proposed rules quite vociferously, with the result that Finance stated that it would modify these proposals. Tax practitioners are still awaiting the release of the new proposals. As a result, it is not possible to state how the rules might be modified, and what the effective date for the application of the modified rules might be.

It is essential that taxpayers seeking to deduct substantial interest costs (and other investment costs) seek independent tax advice.

c) Deduction of Annual Premiums

A policyholder may be able to deduct all or a portion of the life insurance premiums where the policy is used as collateral, provided all of the following conditions are met:

- The policy is assigned to a restricted financial institution (bank, trust company, credit union or insurance company)⁷,
- The interest payable would otherwise (except in certain circumstances) be deductible in computing the taxpayer’s income for the year, and
- The restricted financial institution requires the policy as collateral.⁸

CRA is of the view that giving a movable hypothec is also considered an assignment.

Where these conditions are met, the taxpayer will have to then determine the portion of the premium that is actually deductible. The deduction is capped at the lesser of:

- Premiums payable in respect of the year, and
- The net cost of pure insurance (NCPI), for the year, in respect of the interest in the life insurance policy.⁹

⁶ See paragraphs 20(1)(c)(i), (ii) of the ITA.

⁷ The definition of “restricted financial institution” is defined in subsection 248(1) of the ITA and should be referred to here.

⁸ Paragraph 20(1)(e.2) of the Income Tax Act (Canada) (ITA) should be referred to here. This provision applies for premiums payable after 1989. (Paragraph 20(1)(e) applied to term life insurance premiums payable to secure loans prior to 1990.)

⁹ Income Tax Regulation 308 should be referred to for a determination of the Net Cost of Pure Insurance.

Both of the above will need to “reasonably be considered to relate to the amount owing from time to time during the year under the loan for which the insurance policy has been assigned as collateral”.¹⁰

If, for example, the life insurance coverage under the assigned policy were \$500,000, yet the loan outstanding throughout the taxation year was only \$250,000, the deduction would be capped at the lesser of one-half of the premiums or one-half of the NCPI.

The financial institution may require that other assets be pledged as well, with the result that the total collateral could exceed the loan balance. CRA has stated that a deduction under paragraph 20(1)(e.2) will usually not be denied, unless that lender has imposed the life insurance requirement simply to accommodate the taxpayer. (Of course, it will still be necessary to ensure that a deduction taken under paragraph 20(1)(e.2) is not for insurance coverage that is in excess of the maximum amount of the loan outstanding during the year.¹¹ CRA has stated that “there must be a genuine requirement to provide the specified amount of collateral insurance and the borrower should not, accordingly, have any control over the amount of coverage”.¹²)

It should be noted that “premiums” are not defined in the ITA. In the context of a UL policy, they are generally interpreted by the industry to mean all amounts paid into the policy up to the yearly maximum exempt premium.

In 1999 at an industry event CRA stated that

“... payments made by a policyholder, notwithstanding that they are in excess of specified minimum amounts necessary to cover the risk and administrative charges for a policy year, are treated by the insurer as premiums that are not prepaid premiums. The full amount of the payment is included in the insurer’s income as a premium for the year of receipt, and such a payment is reflected in both the adjusted cost basis and cash value of the policy. Based on this, it is our opinion that such payments are premiums that are payable in respect of the year in which they are made by the policyholder. The fact that mortality and administrative charges in subsequent years may be funded from the build-up in the accumulating fund of the policy is in our view not relevant to the determination of the year to which the premium relates. Unless a portion of the premium paid is in fact prepaid, we see no basis for treating it as other than in respect of the year in which it is paid.”¹³

Also, at a very recent conference, the CRA did in fact confirm that :

“... the CRA is generally of the view that the premiums payable correspond to the premiums the policyholder elects to pay to the insurer under the terms of the policy. Moreover, it is our opinion that the amounts the insurer withdraws from the accumulation fund to cover the costs of insurance and related fees do not constitute premiums.”¹⁴

Policyholders who collaterally assign policies and want to take a deduction pursuant to paragraph 20(1)(e.2) will want to take care in determining the appropriate premium payment stream for the policy. Remember here that the deduction is limited to the lesser of the premiums paid for the year and the NCPI. If, for example, the premiums were being paid on a “quick-pay” basis (i.e., premiums are paid upfront over a limited number of years), the formula would eliminate any deduction for years subsequent to this period given the “lesser of” requirement.

¹⁰ See paragraph 2 of *Interpretation Bulletin* IT-309R2 – Premiums on Life Insurance used as Collateral

¹¹ See paragraph 5 of IT-309R2.

¹² See CRA document # 9204595, dated May 19, 1992.

¹³ See Question # 10 from CRA document Round Table 9980430 – CALU Conference May 1999.

¹⁴ See Question # 3 from the 2007 APFF Conference (Oct. 3 - 5, 2007, Montreal)

Of course, if the loan proceeds were to be put to personal use (e.g., collateralizing a policy personally with the goal of supplementing retirement income), interest charges would not be deductible. Hence, a deduction could not be taken pursuant to paragraph 20(1)(e.2).

(Individuals should be aware that if the interest charged relates to the acquisition of a non-prescribed life annuity that had been purchased to supplement retirement income, interest charges could be deducted. However, the amount that may be claimed in a particular taxation year is capped at the taxable portion of the annuity that is reported for that year.¹⁵)

Readers contemplating assigning a life insurance policy are urged to refer to CRA's *Interpretation Bulletin 309R2 – Premiums on Life Insurance Used as Collateral*, for CRA's views on the application of paragraph 20(1)(e.2).

d) Impact on CDA

Let's assume that Company X has collaterally assigned a policy on the life of Shareholder A to a financial institution. Let's further assume that at the time of A's death, the life insurance death proceeds are \$1,000,000, the amount owing to the financial institution is \$400,000, and the adjusted cost basis (ACB) of the policy is \$50,000. The insurer will pay Company X \$600,000 after the claims of the financial institution have been satisfied.

In 1997 CRA clarified its position on what may be credited to a private corporation's CDA where there has been an assignment of a life insurance policy.¹⁶ It wanted to make sure that both the creditor and debtor did not add an amount to the CDA. In the above situation, where Company X has remained as the beneficiary, CRA deems it to constructively receive \$1,000,000, even though \$400,000 would be paid directly to the creditor. Thus, it will be permitted to credit \$950,000 (i.e., the amount of the life insurance death benefit in excess of ACB of the policy) to its CDA.

(In Quebec, policies that are the subject of a hypothecary claim by a creditor are treated similarly.¹⁷)

CRA has stated that in the above situation the creditor is neither the beneficiary of the policy nor the policyholder, and thus would not be able to credit an amount to its CDA, since the \$400,000 it receives would not be considered the proceeds of a life insurance policy.¹⁸

Now let's look at what would happen where Company Y as policyholder and beneficiary absolutely assigns the policy to the creditor as security. In addition to there being a disposition at the time of the absolute assignment, Company Y will not be able to add an amount to its CDA at the time of the payment of any life insurance (death) proceeds. CRA has stated that since the debtor (Company Y) would not receive, constructively or otherwise, the life insurance proceeds, an amount could not be credited to its CDA.¹⁹

(Of course, if the creditor were the beneficiary or (absolute) assignee of the policy, it would be able to credit its CDA (assuming all the other necessary conditions were met).) This would be the case, irrespective of who paid the premiums.²⁰

For more information on the CDA refer to *Capital Dividend Account* [PC 5674].

¹⁵ See subparagraph 20(1)(c)(iv) of the ITA.

¹⁶ See Income Tax Technical News No. 10 (ITTN 10), dated July 11, 1997.

¹⁷ See paragraph 6 of *Interpretation Bulletin IT-430R3 – Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death (Consolidated)* (IT-430R3), dated December 2, 2002.

¹⁸ See paragraph 6 of *IT-430R3*.

¹⁹ See Technical Interpretation 2002-0166375, dated December 5, 2002.

²⁰ See paragraph 6 of *IT-430R3*.

e) Surrender of Policy

It is possible that the financial institution accepting the life insurance policy as collateral may in certain circumstances call upon its security. Where this happens, the policy will be surrendered. This is in fact a disposition and a policy gain will be calculated in the usual manner. The policyholder will be responsible for paying the appropriate income taxes to the government. Where the full amount of the cash surrender value of the policy has been paid to the financial institution, the policyholder will need another source of funds from which to pay the taxes.

f) Shareholder Uses Corporate-Owned Life Insurance Policy as Collateral

A corporation may guarantee a loan made by a shareholder, or may provide security as collateral. CRA has stated that it has no firm guidelines as to when a (shareholder) benefit will be assessed.

Let's first look at a situation where a shareholder deals at arm's length with the corporation, and there is no evidence that at the time the guarantee was granted the shareholder was unable to repay the loan. In a recent (2006) technical interpretation, CRA confirmed its previous position of not assessing a benefit.²¹

Let's look at another situation. Here, let's assume that the shareholder pays a reasonable fee to the corporate owner of the policy, (presumably because he is dealing on a non-arm's length basis with the corporation). CRA has stated that the granting of the guarantee would not in and by itself give rise to a benefit. If, however, the corporation had to actually pay an amount to the financial institution, a shareholder benefit would arise at that time. The benefit would be equal to the amount by which the amount paid exceeded amounts recovered from the shareholder.²²

There are no set rules for calculating what a reasonable fee would be. CRA has indicated that two possible methods include: (1) Looking at the difference in interest rates charged with and without the collateral security, and (2) Determining what would have to be paid to a third party for a similar guarantee.²³

It is important to realize that CRA is strict in its interpretation of subparagraph 20(1)(e.2)(i). This provision refers to "premiums payable by the taxpayer under a life insurance policy". At a very recent conference CRA was asked whether the Department of Finance (Finance) would consider amending this provision, so that a deduction would also be allowed where a borrower pledges a policy that is not owned by it. (Here, a shareholder might pledge a corporate-owned policy, or a subsidiary might pledge a policy owned by its parent company). In such a situation, the borrower is not the party paying the premium.

Finance was in fact unrelenting and was of the view that "The benefits of this paragraph are appropriately limited to the taxpayer who paid the premium ...".²⁴

Professional advice should be sought whenever a shareholder is considering pledging a corporate-owned policy. It is essential that the shareholder understand the shareholder benefit implications, as well as the loss of any deduction under paragraph 20(1)(e.2).

²¹ See CRA document 2006-0174011C6, dated June 29, 2006.

²² See CRA document 2006-0174011C6, dated June 29, 2006.

²³ See Technical Interpretation 2000-0002575, dated March 29, 2000.

²⁴ See Question # 4 from the 2007 APFF Conference (Oct. 3 - 5, 2007, Montreal)

III. Other Considerations

While a policyholder will want to understand the tax implications of a leveraging strategy, there are numerous other issues that should also be considered.

Insurers prepare illustrations, which are provided to prospective policyholders. A number of assumptions are made during the course of the preparation of these illustrations. Where an assumption varies from actual, this will have a significant bearing on the leveraging strategy. These are discussed below, as are other factors, which affect the implementation (or the success) of this strategy.

a) Creditor Protection and Beneficiary Designations

In the Common Law provinces, if the policy owner has designated a preferred beneficiary (spouse, child, grandchild, parent of the insured) or an irrevocable beneficiary, the policy is generally creditor protected. In Quebec, the rule is different. The policy is generally creditor protected if the policy owner has designated a preferred beneficiary (his spouse, his descendants, his ascendants) or an irrevocable beneficiary. However, we should note that when a beneficiary has been designated to be irrevocable²⁵, the owner's freedom is limited with regards to the policy. Any change that could materially affect the benefit must have the consent of an irrevocable beneficiary. Thus, any pledge of the policy as security for a loan will need the signature of that beneficiary. In situations where the parties are estranged, consent may not always be forthcoming.

b) Investment Performance

The assumptions used for investment performance have a significant bearing on the tax-deferred build-up of the investment component within the exempt policy. Where the performance is less favourable than illustrated, the investment component will be reduced. Thus, less can be collateralized at the financial institution.

Where the policy has actually been collateralized, and subsequent investment performance is less favourable than anticipated, the percentage that the financial institution is willing to lend could quickly be reached, with the result that the policyholder may have to provide additional collateral, or may have to pay off a portion of the loan. In an extreme case the financial institution could actually call the loan, forcing the policyholder to surrender the policy. Since this would result in a policy gain, the policyholder will likely owe taxes.

Financial institutions mitigate the possible reduction in policy values, due to poor performance, by limiting the amount of the outstanding loan(s) to typically 50% of the policy's cash value. Investments in guaranteed accounts such as Term Investment Accounts are treated much more favourably with up to 90% of the policy's fund value being permitted as security.

c) Life Expectancy

A leveraging strategy may contemplate that upon the death of the policyholder the life insurance (death) proceeds will be used to repay the loan. The policyholder may outlive the life expectancy as shown in the original illustration. Thus, in a situation in which interest is not being paid and is instead being capitalized, or there are several years of negative investment performance, the percentage that the loan is of the cash value may be exceeded. Again, the financial institution may require additional collateral, or may ask the policyholder to pay off a portion of the loan. Where this cannot be done, the financial institution may call

²⁵ In the Common Law provinces, (all provinces except Quebec), a spouse, child, grandchild, mother or father designated as a beneficiary before July 1, 1962 will also have to give consent if the contract is to be leveraged.

the loan, forcing the policyholder to surrender the policy. Again, taxes could be payable by the policyholder.

d) Interest Rate Risk

The lending institution will typically not guarantee interest rates for the duration of the arrangement. If lending rates go up, adverse consequences will arise. The policyholder will be responsible for greater-than-anticipated financing costs. This will reduce the overall effectiveness of this strategy. In an extreme case (especially where interest charges are being capitalized rather than being paid), this could result in a surrender of the policy where the policyholder can no longer satisfy all of the conditions imposed by the lending institution.

e) Ongoing commitment of Financial Institution to Leveraging Program

Currently, financial institutions make no commitment that they will continue to make collateral loans secured by life insurance policies in the future. Lending rules may change, with the result that these loans will no longer be available. Furthermore, at the time of renewal, the financial institution may seek to change the terms of an existing loan.

f) Changes in the Tax Laws or Interpretation of Tax Laws

These strategies are attractive based on the current tax laws. Should the tax laws change (e.g., should loan proceeds become taxable, or should the laws relating to interest deductibility change), these arrangements would become less attractive. Whether or not existing arrangements would be “grandfathered” cannot be predicted.

These arrangements are attractive because the loan proceeds are received on a non-taxable basis. This treatment is very different from that accorded to policy loans, where policy loans are only tax-free to the extent of the ACB of the policy. It is presumed that CRA would not contend that the loan proceeds represent a policy loan. Of course, CRA’s actions cannot be predicted.

g) General Anti-Avoidance Rule (GAAR)

The ITA contains a General Anti-Avoidance Rule. Where there is an “avoidance transaction” that directly or indirectly results in a tax benefit, the tax consequences will be determined in a way that denies the tax benefit. (However, GAAR will not apply where a transaction is carried out primarily for bona fide purposes other than to obtain a tax benefit.)²⁶

It may be argued that a leveraging strategy is a legitimate strategy sanctioned by the tax laws (i.e., there are specific tax rules carving out collateralizations from the “disposition” definition), and hence GAAR should not apply.

g) Comfort Level with Collateralization

This strategy is generally appropriate for a more sophisticated investor. The investor has to be comfortable with debt. Moreover, the investor has to understand that illustrations provided by a financial broker contain a number of assumptions, any of which may change.

²⁶ See section 245 of the ITA.

V. Summary

The collateralization of life insurance policies is an attractive strategy from a tax perspective. However, taxpayers should implement this strategy only after they and their advisors understand the tax implications of the strategy and have assessed all inherent risks.

This document is intended for general information only. It should not be construed as legal, accounting, tax or specific investment advice. Clients should consult a professional advisor concerning their situations and any specific investment matters. While reasonable steps have been taken to ensure that this information was accurate as of the date hereof, The Standard Life Assurance Company of Canada and its affiliates make no representation or warranty as to the accuracy of this information and assume no responsibility for reliance upon it.