Corporate Insured Annuity

I. Introduction

An “insured annuity” or “back-to-back” structure is a very familiar concept to most financial planners and tax practitioners. It involves the acquisition of two separate financial products – a life annuity and a life insurance policy. In the right circumstances, this arrangement can result in enhanced investment returns and increased estate values. Where the arrangement is at a corporate level, it may be possible to reduce in the capital gains tax liability arising at the death of the shareholder (at which time there is a deemed disposition of his or her shares). This can translate to lowering the income taxes payable at death. Furthermore, corporations with significant balances in the Refundable Dividend Tax on Hand (RDTOH) account may be able to accelerate recoveries of these amounts.

Insured annuity structures are often set up on a personal basis. However, this paper focuses on structures established in a corporate environment. The structure will be discussed in some detail, as will the tax issues. The document ends with a section devoted to additional considerations (possible financial risks, etc.).

II. Description of the Arrangement

As stated above, the corporation would acquire two products. First, it would purchase a life insurance policy, with it being the beneficiary. Typically, either a term to 100 (T100) or universal life (UL) policy would be acquired. The policy would be acquired for the purpose of guaranteeing that the capital invested in the annuity is “protected,” that is, it will be available at the death on the insured(s). The life insurance should be applied for and be issued before the annuity is purchased because the life insured must qualify medically for the life insurance and the annuity cannot be unwound once it is purchased.

If the corporation seeks only to protect the amount of capital that it originally invested in the annuity, it would purchase T100 coverage with minimal or no cash values. If the corporation has excess funds, it should consider acquiring a UL policy. In addition to protecting the initial capital, this structure provides the opportunity to tax shelter additional funds in the investment component of the policy. If tax sheltering is not required, the UL policy can be minimum funded at approximately the same cost as T100.

Private corporations would typically enter into these arrangements, as only these corporations can take advantage of the beneficial tax treatment of life insurance proceeds payable at death (i.e., the ability to flow all or a portion of the death benefit through the Capital Dividend Account, or CDA).[1]

As noted above, the non-registered annuity should only be acquired after the insurance has been put in place. Often, the amount used to purchase the annuity is reduced by the amount of the first year’s premium for the insurance coverage. Alternately, the first year’s premium may be payable out of other cash flow. The annuity payments are based on the life of the shareholder, with the corporation being the holder of the annuity. The annuity will usually not have a guarantee period because: (1) guarantee periods reduce the annual annuity payments, and (2) insurance coverage has been put in place to protect the initial capital that was used to acquire the annuity.

The arrangement might be structured with either a single life or joint lives. If joint lives are used, this may serve to enhance the returns by lowering the cost of the life insurance policy.

1 Subsection 89(1) of the Income Tax Act (Canada) (ITA) should be referred to for information regarding the calculation of amounts that are credited to the Capital Dividend Account (CDA).

The corporation would commence to receive the annuity stream. Income tax would be paid on the taxable portion of the annuity. This payment stream would also be used to pay the insurance premiums. If the shareholders require an income stream, the corporation could pay dividends to the extent of the after-tax funds (i.e., the annuity stream less the tax on the taxable portion less the insurance premium), as adjusted for any RDTOH that it will recover.[2] The RDTOH calculations only apply where the corporation is a private corporation.

III. Taxation of Corporate Insured Annuities

Since the structure involves the acquisition of two separate financial products, each will be discussed separately. We will also discuss how these products are valued at the time of the death of the shareholder, and the possible tax savings that may arise.

(i) Annuity

This annuity is subject to accrual taxation.[3] For life insurance policies (including annuity contracts) last acquired after 1989, the income must be reported annually, unless specific exceptions are met. Note that prescribed annuities are an exception to these rules.[4]

Corporate-owned annuities cannot be prescribed annuities. Subparagraph 304(1)(c)(iii) of the Regulations stipulates that the holder of a prescribed annuity must be an individual, a testamentary trust, a spousal trust or other trust described in paragraph 104(4)(a) of the ITA.

Since the annuity is not a prescribed annuity, it does not enjoy the beneficial tax treatment that these annuities receive (e.g., levelized taxable income for the entire period the contract is held). Instead, the insurer will report a varying taxable portion for each year. The taxable income will generally decrease from one year to the next, as more capital is being returned to the holder in each successive year. It is common to have the taxable portion for the first year be less than that reported for the subsequent year, as the insurer is able to offset certain administrative costs against the income that it must report.

The taxable income will be reported as at each "anniversary day" of the policy, even if no annuity payment was actually received at that time.[5] Thus, the first annuity payment will typically be no later than 12 months after the acquisition date since the accrual rules would require an income inclusion at that time in any event. A percentage (26.67%) of the taxable portion of the annuity income will increase the corporation's RDTOH account if the owner is a private corporation. The RDTOH can be recovered at a rate of $1 for every $3 of taxable dividends paid by the corporation.

Let's assume that the non-prescribed annuity was acquired June 1, 2006. The first anniversary day would be May 31, 2007 (i.e., one year less a day after the acquisition). The next anniversary day would be exactly one year after that (i.e., on May 31, 2008). Insurers issue tax slips for the non-prescribed annuities on a calendar year basis, but the amount reported is the accrual to the anniversary day occurring in the year. The corporation will have to be aware of the contract anniversary. If the corporation had an April 30th year-end, the income for the first anniversary day of May 31, 2007 would only be reported on the corporate tax return for the year ending April 30, 2008.

Where the corporation's year-end (May 31) occurs after the contract anniversary, the corporation may need to request the accrual amount from the insurer. This is because the prescribed time for the issuance of the tax slip may be too late to ensure timely filing of the corporate tax return. Here let's assume that the contract was acquired May 1, 2006. The first anniversary day would be April 30, 2007. The corporation would have to report the appropriate income on its tax return for the year ending May 31, 2007. Since the insurer would only be required to issue the tax slip for the 2007 accrual in early 2008, the insurer needs to be contacted.

Even if the non-prescribed annuity were to have monthly payments, the corporation would follow the same process (i.e., it would report the income in the taxation year in which the anniversary date fell.)

---

2 Section 129 of the ITA should be referred to for the Refundable Dividend Tax on Hand ("RDTOH") calculations.
3 Subsection 12.2(1) of the ITA should be referred to here
4 Annuities last acquired before 1989 are subject to different rules. Section 12.2 of the ITA should be referred to.
5 See definition of "anniversary day" contained in subsection 12.2(11) of the ITA.

For additional information on non-prescribed annuities, we refer to our separate *Taxing Issues* document: The Taxation of Personally Owned Non-Registered Non-Prescribed Annuities [PC 6000].

(ii) Insurance

The corporation would acquire a permanent insurance policy (UL, T100 policy or other permanent plan).

With the UL policy, premiums are paid for two components – the insurance component, as well as an investment fund component. In most cases, the premiums are not deductible for tax purposes. Upon the death of the life insured, the proceeds of the policy will generally be received by the policyholder (i.e., corporation) on a tax-free basis. Where the corporation is a private corporation, the CDA mechanism comes into play. Here, the corporation will be able to credit the CDA for the excess of the life insurance proceeds over the adjusted cost basis (ACB) of the policy. If there is a positive balance in the CDA, the corporation will be able to declare a dividend and elect it to be a tax-free capital dividend. Where the ACB is relatively small, a significant portion (or perhaps even all) of the life insurance proceeds will be credited to the CDA. In this case, the proceeds will be available for payment to the shareholder(s) as a non-taxable capital dividend. The corporation will typically pay an amount equal to any ACB as a taxable dividend, as this amount cannot be flowed through the CDA. A discussion of the proposed changes to the taxation of dividends is included in (iii) below.

Take care when declaring capital dividends. The CDA has a number of components, of which life insurance death proceeds is just one. A company could inadvertently fall into the "capital dividend account trap" and declare an excess capital dividend, with the result that significant penalty taxes could arise. For a detailed discussion of the CDA, we refer you to our *Taxing Issues* item on this topic: The Capital Dividend Account [PC 5674].

If a UL policy is being used as part of this arrangement, the advisor should establish how the insurer is calculating the Net Cost of Pure Insurance (NCPI). Remember here that the NCPI is a deduction in arriving at the ACB. The lower the ACB, the greater the capital dividend that may be paid. Insurers may take different approaches for issue ages over 70, including for joint-life cases. If the insurer chooses to use "Ultimate NCPI" rather than "Select NCPI," this will result in a higher NCPI. Thus, the ACB will be reduced to nil earlier than would generally be the case if Select NCPI were to be used.

Where a UL policy is acquired, the insurer generally undertakes to ensure that the policy maintains "tax exempt" status. Thus, it will monitor what portion of premiums may be deposited to the tax-exempt portion of the policy, as these will be able to grow on a tax-deferred basis. With an insured annuity arrangement, there is typically no intention to withdraw amounts from the policy during the lifetime of the life insured(s). If, however, amounts were withdrawn from the policy, or policy loans were taken, income taxes may be payable. This would only be applicable if the corporation deposited excess funds into the investment component of the UL policy.

With a T100 policy, the tax consequences are largely the same: life insurance proceeds on death will be credited to the CDA, to the extent that the amount exceeds the ACB. T100 policies may in later years have a cash value. Some insurers may allow access to the cash value through policy loans. The tax aspects of doing so will have to be considered. The death benefit will be reduced by the amount of any outstanding policy loan. These cash values will also increase the value of the shares on the shareholder's death and the corresponding tax liability from the deemed disposition of those shares and, therefore, decrease the estate's value.

(iii) Impact of the Proposed Changes to the Taxation of Dividends

On June 29, 2006, the Department of Finance (Finance) released draft legislation containing new rules governing the operation of the dividend tax credit mechanism.[6] A Canadian-controlled private corporation (CCPC) will have to categorize the taxable dividends it pays as either "eligible dividends" or non-eligible dividends.[7] Finance introduced these new rules to counter the losses in tax revenues that the Canadian

[6] See Legislative Proposals and Explanatory Notes Relating to Income Tax – Dividend Taxation, as released by the Department of Finance on June 29, 2006 (June 29, 2006 Draft Legislation).
[7] See proposed definition of "eligible dividend" in subsection 89(1) of the June 29, 2006 Draft Legislation.

government was suffering as a result of corporations being converted into income trusts. Finance felt that it could reduce the tax advantages relating to these conversions by reducing the effective personal tax rate on dividends received from Canadian corporations. Depending upon the jurisdiction, Finance anticipated that the top marginal combined tax rate could fall by as much as 10%.

"Eligible" dividends will be subject to a 45% (rather than 25%) gross up under the new rules.[8] The dividend tax credit at the federal level will be 18.96% (rather than 13.33%) of the grossed-up dividend.[9] CCPCs will only be able to pay "eligible" dividends to the extent that they have income that was subject to the general corporate tax rate. A CCPC will have to calculate its General Rate Income Pool (GRIP) (the proxy for the income that was subject to the general corporate) and will be able to pay "eligible" dividends only to the extent of the balance in its GRIP.[10]

The definition of GRIP is complex, and contains multiple components. Let's look at the two components that are relevant in the case of the corporate insured annuity. First, we see that component "D" (the corporation's taxable income for the year) is an inclusion. Then we see a deduction for component "F" ("the corporation's aggregate investment income"). A 68% factor is actually applied to these two components in order to take into account the assumed taxes. [11]

With the corporate insured annuity, the corporation would include the taxable portion of the non-prescribed annuity in its taxable income. Since the proposed rules specifically require that "aggregate investment income", i.e., this same amount, be deducted in calculating GRIP, no portion of the income from the annuity remains in the GRIP. The corporation would also receive life insurance death proceeds. This amount is tax-free to the corporation. Hence, as a starting point, this amount is not even included in the GRIP. Therefore, under the proposed rules, taxable dividends paid from amounts received under the corporate insured annuity arrangement would not be "eligible" dividends.

Note that Finance has invited the public to submit comments on the draft legislation. The impact of the new rules will only be known once the final legislation has been enacted. Furthermore, the provinces will also have to decide whether they will adopt parallel measures.

(iv) Valuation of Company Shares Upon Death of a Shareholder

There are specific provisions in the tax legislation that deal with the valuation of a company's shares at the time of the death of the shareholder.[12] Since the shareholder will typically be the life insured/annuitant under the corporate insured annuity arrangement, it is essential that the application of the rules be understood.

The tax legislation contains specific rules, which provide that there is a deemed disposition of all capital assets owned at death.[13] Since the corporation will have held an interest in each of an annuity contract and a life insurance contract, the Fair Market Value (FMV) of these two contracts will have an impact on the value of the corporation's shares, and hence on any tax liability relating to capital gains arising at that time.

The Canada Revenue Agency (CRA) has published general principles that apply in valuing insurance contracts held on the lives of shareholders other than deceased shareholders.[14] However, these general guidelines do not apply in valuing the shares held by the deceased shareholder. In valuing the insurance held on the life of the deceased the cash surrender value (CSV) becomes the appropriate measure.[15]

Thus, it is clear, except in the case of multiple-life and joint-life policies, that the CSV is to be used in valuing either a T100 or UL contract at the time of death. It is for this reason that T100 or UL policies with minimal cash values are usually used in corporate back-to-back strategies.

---

8 See proposed paragraph 82(1)(b) of the June 29, 2006 Draft Legislation.
9 See proposed subsection 121(b) of the June 29, 2006 Draft Legislation.
10 See proposed definition of General Rate Income Pool (GRIP) in subsection 89(1) of the June 29, 2006 Draft Legislation.
11 ibid
12 Subsection 70(5) of the ITA should be referred to.
13 Subsection 70(5) of the ITA should be referred to for a discussion of these rules.
14 See paragraphs 40 and 41 of Information Circular IC-89-3 – Policy Statement on Business Equity Valuations.
15 Subsection 70(5.3) of the ITA should be referred to.

Interests in multiple-life contracts are problematic. In 2000, CRA expressed the view that where there is a multiple-life policy, subsection 70(5.3) could not be relied on to provide that the CSV was the appropriate measure, as the legislation made specific reference to "the person whose life was insured", that is, it contemplated only one life insured.[16] The insurance community had hoped that the March, 2001 amendments to subsection 70(5.3), where the reference to "the person whose life was insured" was changed to "a person whose life was insured", would have allowed the CSV to be used as the measure of FMV where there was a policy on more than one life.

Unfortunately, this is not the case. In a Technical Interpretation issued in May, 2004, CRA stated that in fact "Finance confirmed that at the time subsections 70(5.3) and 148(8) were enacted there was no tax policy intention to have the provisions apply to life insurance policies under which more than one life is insured".[17] CRA then went on to state that it was CRA's view that an amendment would be required to subsection 148(8) of the Act so that it would contemplate multiple-life policies.[18] It is our understanding that this item is not necessarily high on Finance's legislative agenda and may have to wait until Finance completes its overhaul of section 148. Unfortunately, this is another instance in which the tax legislation lags product developments within the insurance industry.

In situations where subsection 70(5.3) does allow the CSV to be used in valuing contracts, the CSV will be readily ascertainable. With T100 policies, any CSV may be minimal, except perhaps in later years. For UL contracts, the CSV may be much larger, especially where the policyholder has made extra deposits to take advantage of the tax-exempt room that is available.

What is also subject to debate is how the tax authorities might value an interest in an annuity contract. Depending upon the specifics of the annuity contract, in certain circumstances it might be argued that the FMV of the annuity is nil, and hence the investment in the annuity contract should not be included in calculating the FMV of the deceased's shares. Factors supporting this argument would be: (a) the lack of any guarantee features for the annuity, (b) the inability to commute the annuity, and (c) the non-transferable nature of the annuity.

When we look at the definition of "life insurance policy" contained in the tax legislation, we note that this definition "includes an annuity contract".[19] Hence, this may serve to support the argument that since the annuity cannot be surrendered, the cash surrender value is nil. As a result, the interest in the annuity contract is excluded in valuing the deceased's share. CRA and the provincial taxation authorities may, however, contend that the above argument is not appropriate. In a technical interpretation issued in 1993, CRA (then Revenue Canada, Taxation) stated that the CSV measure (i.e., nil) may not be used since the legislation allows this approach to be taken for "a life insurance policy, under which the particular individual (or any other individual not dealing at arm's length with the particular individual at that time or at the time the policy was issued) was a person whose life was insured …".[20]

The taxation authorities appear at various times to have communicated different positions on the "life insured" issue. Another technical interpretation issued in 2000 deals with joint-last-to-die policies and whether the first person to die was a "life insured." CRA stated that subsection 148(9) (specifically paragraph (j) of the definition of "disposition") was drafted before multi-life policies were introduced. However, CRA found that this provision contained "broad language" and held that the payout at first death was not a "disposition of the policy," with the result that the payout was not taxable.[21]

It is interesting to note that some provisions of the tax legislation, which deal with life insurance policies, specifically exclude annuities.[22] However, annuities are not carved out from the provision allowing a deceased shareholder to use CSV as the measure of FMV. If the "life insurance policy" definition includes annuities, might the taxpayer's representative reasonably conclude that there must be a life insured?

[16] See CRA's Technical Interpretation # 2000-0014245 dated March 28, 2000.
[17] See CRA's Technical Interpretation # 2004-0065441C6 dated May 4, 2004.
[18] See above.
[19] Subsection 138(12) of the ITA.
[20] See CRA's Technical Interpretation # 931275 dated September 20, 1993.
[21] See CRA's Technical Interpretation # 2000-0033885 dated September 11, 2000.
[22] See subsection 138(12) of the ITA as well as subsection 148(8).

If the taxation authorities do not allow the CSV to be used as a measure of FMV for annuities, they may choose to apply the general principles enunciated in their Information Circular.[23] Alternatively they may look at a different approach, for example, calculating the present value of the expected future stream of the annuity payments.

It is apparent that if one could successfully argue that subsection 70(5.3) was applicable and this allowed the annuity to be assigned a FMV of nil at a time when the carrying value on the books was substantially more, this would serve to decrease the value of the deceased shareholder's shares, especially when compared to the FMV that may have resulted had the corporation continued to hold conventional investments such as GICs, government bonds, etc.

It is not possible to anticipate what the taxation authorities would do in a situation such as a tax audit, where they have to specifically address these situations. Taxpayers and their advisors should consider the tax consequences of not being able to sustain this position.

Note that in the appropriate circumstances, entering into a corporate insured annuity arrangement will produce significantly enhanced investment returns and estate values. These financial advantages will in and of themselves justify entering into such an arrangement. Hence, any reduction in taxes relating to the deemed disposition at death will not be the motivation for entering into the arrangement.

(v) Potential for Additional Recoveries of RDTOH

Corporations with significant opening balances in their RDTOH account may benefit from implementing a corporate insured annuity, as this may accelerate refunds of this RDTOH.

This result occurs because RDTOH increases each year by amount equal to 26.67% of the investment income (i.e., only the taxable portion of the annuity), yet RDTOH is refunded at the rate of $1 for every $3 of taxable dividends paid. The corporation is able to pay a dividend to the extent of its after-tax cash flow from the arrangement (the total annuity income (i.e., total capital and taxable portions), less the insurance premiums, less the taxes on the taxable portion of the annuity income,) plus anticipated recoveries of the RDTOH for the year.

While this after-tax cash flow varies by year, for purposes of this discussion let's look at an example where the net after-tax cash flow for the year is $10,000, and the corporation has $50,000 in its RDTOH prior to the payment of the taxable dividend. Let's further assume that the taxable portion of the annuity payment was $2,000, so only $533 (26.67% of $2,000) would have been added to the RDTOH in the year. In this situation, the corporation could pay a taxable dividend of $15,000, since it has the $50,000 in its RDTOH, and would receive a $5,000 refund of RDTOH. If the corporation were limited to only the RDTOH created in the year, the taxable dividend would be the net after-tax cash flow from the year plus $533. In our example, it would be for $10,533.

When we look at paying a taxable dividend of $15,000 versus $10,533, we still need an additional source of cash. Part of the source will be the taxes that the corporation would otherwise pay on the taxable portion of the annuity. Thus, a source of cash is really only needed for the balance pending receipt of the RDTOH refund.

IV. Additional Considerations

(i) Permanence of Arrangement

Back-to-back arrangements should be considered permanent (i.e., they cannot be unwound). Annuities without guarantee periods do not have a commuted value. Thus, the owner cannot have a lump-sum return of the capital invested in the annuity, except at death where the life insurance proceeds come into play. The insurance policy must be kept in force for life (i.e., must not have lapsed) for this to happen. Therefore, the client must have sufficient liquidity on an on-going basis for the continued payment of the life insurance premiums either from the after-tax annuity payments or from some other source.

---

[23] See 14 above.

The long-term interest rate climate will have a significant bearing on the annuity stream. Anyone contemplating the acquisition of an annuity should consider whether it is appropriate to acquire an annuity in a low-interest rate environment, as it will not be possible to unwind the arrangement at a later time.

These arrangements are most appropriate for those who will find the kind of payment stream these arrangements provide sufficient for the remainder of their lives. Many financial advisors will in fact recommend that only a portion of the client's non-registered funds should be allotted to this strategy. These arrangements do not suit all taxpayers. The arrangement has to be consistent with the client's overall financial needs.

(ii) Acquisition of Separate Products

The taxation authorities have held that in certain circumstances such arrangements might be viewed as the acquisition of a single contract, with the result that the taxpayer would be considered to have acquired a non-exempt life-insurance policy. Here, the taxation authorities are concerned about whether the two products would have been issued on a stand-alone basis.[24] It is therefore critical that the taxpayer be considered to have acquired two separate financial products, including being viewed as having been separately underwritten for each product. If the taxpayer cannot sustain the position that the contracts would have been issued on a stand-alone basis, the taxation authorities may consider applying the General Anti-Avoidance Rule (GAAR) provisions and deny inappropriate tax benefits.[25]

Some taxpayers address this possible risk by acquiring the insurance contract and annuity contract from separate insurers. Alternately, a taxpayer could choose to first be underwritten for the insurance coverage. Once that policy is issued, the taxpayer would then apply for the annuity from the same insurer. The insurer would want to be sure that each of the two contracts would have been underwritten on their own merits. This second approach also avoids the potential problem of having the taxpayer acquire an annuity first, and then find that he or she is uninsurable and cannot obtain life insurance.

If the annuity and insurance contracts are acquired from the same insurer, the broker could also substantiate the fact that the two products should be considered to have been separately underwritten by obtaining an annuity quote on a fictitious individual and an insurance quote on a second fictitious individual, each having the same date of birth, sex and smoking status. Of course, the timing of the submission of the application on the fictitious individuals should coincide with the submission of the actual application.

(iii) Financing Costs

An insured annuity might be structured so that there is a third component, i.e., a bank loan. Here, the aim is to be able to realize additional tax savings through a deduction for financing costs. Such arrangements are referred to as "triple back-to-back" arrangements. In such a situation, operating funds will have been used to acquire the interest in the life insurance policy. These funds are then replenished by taking out a bank loan.

As a general rule, interest charges should be deductible where the borrowed funds are used to earn income from a business or property and if the interest is reasonable in the circumstances.[26] However, taxpayers considering such loans should review the proposed legislation that the Department of Finance introduced on October 31, 2003. While two recent Supreme Court of Canada cases had created what many view as a generally permissive environment regarding the deduction of financing costs, the Department of Finance is seeking to introduce much stricter legislation. This "reasonable expectation of profit" test that Finance proposed will make it increasingly harder for many taxpayers to deduct financing costs. This may be especially true for investment holding companies that hold other than common shares.[27]

---

[24] See CRA's Technical Interpretation # 7M12851 dated May 10, 1986.

[25] See CRA's Technical Interpretation # 931275 dated September 12, 1993. Also see CRA's Technical Interpretation # 9606425 dated April 9, 1996.

[26] On October 31, 2003, CRA published Interpretation Bulletin IT-533 – Interest Deductibility and Related Issues. This bulletin incorporates two significant Supreme Court of Canada cases (Singleton and Ludco).

[27] In the news release that accompanied the draft legislation of October 31, 2003 (News Release # 2003-055 – Department of Finance Releases Draft Proposals Regarding the Deductibility of Interest and Other Expenses), the Department of Finance announced that the administrative practices for investments in common shares will continue unchanged, that is, financing costs should generally be deductible.

In the 2005 Federal Budget, the Department of Finance indicated that:

> "… Many commentators expressed concern with the [October 31. 2003] proposals' structure … Finance has sought to respond by developing a more modest legislative initiative that would respond to those concerns while still achieving the Government's objectives. The Department will, at an early opportunity, release that alternative proposal for comments.[28]

At the date this document was written, the alternative proposal had not yet been released. It is important that the borrowed funds be considered to have been used to replace operating capital. If the funds have been used for the direct purchase of an annuity, the deduction for the interest would be limited to the taxable portion of the annuity.[29]

Even if the taxpayer were to contend that the borrowed funds were used to replenish operating funds, the taxation authorities might invoke GAAR and contend that the essence of the transaction was to acquire an annuity, with the result that a large portion of the tax savings associated with the interest deduction would evaporate!

Where interest on a loan is deductible, it may also be possible to achieve a deduction for a portion of the insurance costs. Where a lender requires that the life insurance policy serve as collateral for the loan, the borrower will have a deduction for the lesser of premiums paid and the "net cost of pure insurance" (NCPI).[30]

It's always important to make sure that any triple back-to-back arrangement will withstand any challenge from CRA. CRA has stated that if the terms of the annuity contract, insurance policy and loan agreement were such that any of the products would not have been issued on a stand-alone basis, this would be a factor in determining the deductibility of life insurance premiums and interest paid or payable.[31] In the same Technical Interpretation, CRA goes on to state that even if the stand-alone test were met, "consideration would be given as to whether the structure of the arrangement is designed to conceal the true purpose of the borrowing, which was to acquire an interest in a life insurance policy, in which case interest would not be deductible".[32]

Summary

A corporate insured annuity arrangement offers many benefits – such as enhanced cash flows and enhanced estate values – in the right situation. To this might be added: the tax savings that result upon a deemed disposition at death that result from not having to include the FMV of the annuity in valuing the deceased's shares in a corporation and accelerated recoveries of RDTOH.

Shareholders of private corporations who have specific characteristics (i.e., a desire to retain their capital, prefer conservative investments, have attained a higher age, etc.) would do well to investigate this strategy.

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.

[28] The Budget Plan – Supplementary Information and Notices of Ways and Means Included, page 410, as released by the Department of Finance on February 23, 2005, should be referred to.
[29] See subparagraph 20(1)(c)(iv) of the ITA.
[30] See paragraph 20(1)(e.2) of the ITA.
[31] See CRA's Technical Interpretation # 9606425 dated April 9, 1996.
[32] See above.