The Intergenerational Wealth Transfer of Life Insurance Policies (Cascading Policies)

This document will review the tax issues associated with "Cascading Policies." This is the terminology used to describe arrangements where life insurance policies are transferred for no consideration to the policyholder's "child." Special provisions of the Income Tax Act (ITA) come into play, so that a tax-free rollover occurs where the life insured is either a child of the policyholder or a child of the transferee (i.e., recipient). Thus, wealth may be transferred from one generation to another on a tax-effective basis through the use of life insurance.

This issue of *Taxing Issues* will provide information on the various requirements that must be met for these rollovers to occur, as well as provide examples of situations in which these might be considered.

I. Brief Overview of the Legislation

Let's start by looking at the legislation. The relevant legislation is brief and is contained in subsection 148(8) of the ITA:

> "Notwithstanding any other provision in the section, where
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> a) an interest of a policyholder in a life insurance policy (other than an annuity contract) has been transferred to the policyholder's child for no consideration, and
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> b) a child of the policyholder or a child of the transferee is the person whose life is insured under the policy,
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> the interest shall be deemed to have been disposed of by the policyholder for proceeds of disposition equal to the adjusted cost basis of the policyholder of the interest immediately before the transfer, and to have been acquired by the person who acquired the interest at a cost equal to those proceeds."[1]

While the legislation is brief, to understand its applications, and the opportunities provided, we need to have a closer look. We have to understand who is considered a "child," which transfers are considered transfers at no consideration, who's life may be insured, etc. We also highlight additional tax considerations that you should be aware of.

Where the transfer is in accordance with the above legislation, the transferor (i.e., the person transferring the interest) will be deemed to transfer the interest at his or her adjusted cost basis (ACB) and the transferee (i.e., the person receiving the interest) is deemed to acquire the interest (i.e., have a cost) equal to the ACB. The transferor will have transferred the interest in the policy on a tax-free basis.

II. Detailed Review of the Legislation

Where we have an in-depth understanding of the legislation, we will be better able to appreciate the application of this provision. We will also be able to avoid missteps, that is, minimize the likelihood of making errors in the application of these provisions.

(a) How "child" is defined

In order to understand the application of the "cascading policies" legislation, we need to understand how "child" is defined. The insurance provisions of the ITA contain a specific definition of "child" when referring to a "child of a policyholder."[2] Here, we see that "child" includes:

a) a child of the taxpayer's child;

b) a child of the taxpayer's child's child, and;

c) a person who, at any time before the person attained the age of 19 years, was wholly dependent on the taxpayer for support and of whom the taxpayer had, at that time, in law or in fact, the custody and control.[3].

[1] See subsection 148(8) of the Income Tax Act (ITA).
[2] See definition of "child" contained in subsection 148(9) of the ITA.
[3] See subsection 70(10) of the ITA

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In addition to the above specific definition, the ITA contains an extended meaning of "child" which applies throughout the ITA. The current legislation provides that extended meaning of "child" includes:

a) A person of whom the taxpayer is the legal parent;
b) A person who is wholly dependent on the taxpayer for support and of whom the taxpayer has, or immediately before the person attained the age of 19 years had, in law or in fact, the custody and control;
c) A child of the taxpayer's spouse or common-law partner;
d) [Repealed]
e) A spouse or common-law partner of a child of the taxpayer.[4]

We note that part of the definition of extended meaning of "child" is a repeat of the more specific definition (e.g., reference to wholly dependent children who had not attained age 19). In general, however, there is an extension of the definition (e.g., to include step-children, daughters- and sons-in law, etc.).

In order to understand the reach of the above definition, it may be necessary to make reference to yet more definitions. For example, where there are references to "spouse," it is necessary to look at the extended definition of "spouse."[5]

Canada Revenue Agency (CRA) has stated that on a child's divorce (whether a natural child, adopted child, step-child, etc.), the child's former spouse ceases to be the child's spouse and is no longer a child of the taxpayer.[6]

When we look at what happens at death, CRA (in the context of the medical tax credits) had stated, "it is our general view that where two persons have been connected by marriage, it is considered that this connection continues to exist when the marriage has been dissolved by death."[7] Here, CRA has extended an administrative practice that existed for certain other tax credits. It is not clear whether this administrative practice would be extended to subsection 148(8) transfers. Hence, taxpayers in this situation are urged to contact CRA for clarification.

(b) Whether the "child" needs to be the "same child"

We note that there are multiple references to "child" in subsection 148(8). Paragraph 148(8)(a) of the ITA requires that the transfer be to "*the policyholder's child*." Paragraph 148(8)(b) requires that "*a child of the policyholder or a child of the transferee* is the person whose life is insured." This leads to the question of whether for the rollover to be permitted the child needs to be the same child for purposes of both paragraphs 148(8)(a) and (b).

Let's look at a straightforward example. A grandfather has taken out a life insurance policy on the life of his son. From a reading of the legislation, it should be clear that this policy could be gifted by the grandfather to his son since: (1) the transfer would be from the grandfather to his son (i.e., his child), and; (2) the son (i.e., a child of the policyholder) is the insured.

When we look at the Technical Notes issued by the Department of Finance (Finance) in 1991, we see that transfer is consistent with Finance's interpretation of the legislation. It would appear that Finance's expectation was that the "child" be the same child for purposes of both paragraphs 148(8)(a) and (b). As stated in the Technical Notes then issued (i.e., at the time of the introduction of subsection 148(8.1), which carved out transfers to spouses from subsection 148(8)):

> "Subsection 148(8) permits the transfer of a life insurance policy to the policyholder's spouse or child, where *the* spouse or child is the life insured under the policy, on a tax-deferred basis …"[8]

Let's look at another example. A grandfather has taken out a life insurance policy on the life of his son, as his daughter is not insurable. He plans to transfer this policy to his granddaughter (i.e., daughter's daughter). We have to ask ourselves whether the conditions contained in paragraphs 148(8)(a) and (b) would be met. This appears to be the case since the first paragraph requires that the transfer be to the policyholder's child (which the granddaughter is) and the second paragraph requires that either: a child of the policyholder or a child of the transferee be the life insured (which the son is).

Thus, from a careful reading of the legislation, it should be clear that the child need not be the same child. CRA, when asked whether the child described in subparagraph 148(8)(a) of the ITA needed to be the same child, as described in subparagraph 148(8)(b) of the ITA, confirmed the following:

[4] See extended meaning of "child" contained in subsection 252(1) of the ITA.
[5] See subsection 252(3) of the ITA.
[6] See paragraph 4 of Interpretation Bulletin IT-419R2 – Meaning of Arm's Length.
[7] See Technical Interpretation # 2004-0063331E5, dated May 3, 2004.
[8] See Department of Finance Technical Notes released in May, 1991, at time of amendment to subsection 148(8) of the ITA.

"You also enquired whether the "child" to whom the policy is transferred must be the same child whose life is insured under the policy. It is our general view that the words of paragraph 148(8)(b) of the Act provide that the life insured under the policy could be any child of the policyholder, or any child of the transferee. "Child" for purposes of section 148 of the Act is defined in subsection 148(9) of the Act, and subsection 252(1) of the Act provides an extended meaning of "child" which applies for purposes of the Act."[9]

(c) Permissible Transfers

For the rollover to be permitted, the transfer must be to the policyholder's child for no consideration. In the discussion that follows we will focus on what a transfer for no consideration would be.

The most common transfers contemplated by subsection 148(8) include:

- Gifts, and
- Transfers of ownership resulting from successive owner designations.

When we look at the legislation, we see that the transfer must be to the policyholder's "child." An easy trap to fall into would be to transfer the policy to the child pursuant to the terms of a will and then seek to have the rollover provisions apply. CRA has held that the rollover would not apply:

"… Whereas the transfer referred to in paragraph 148(8)(a) is that of an interest in a life insurance policy from the policyholder to his child, in the situation described above [i.e., transfer pursuant to the terms of a will], the interest in the policy passes from the policyholder (the parent) to the estate, and then to the child. The first transfer, from the parent to the estate, is not a transfer from the policyholder to his child, and the second transfer, from the estate, now the policyholder, to the child, is not a transfer to the policyholder's (i.e., estate's) child. Insofar as subsection 148(8) would not apply in such a situation, it is our view that the provisions of subsection 148(7) would apply …"[10]

The taxpayer receiving the above correspondence from CRA then approached CRA with a new proposed course of action. Instead of transferring ownership at death via a will, the ownership would be transferred by designating the child as the successive owner (i.e., contingent owner) in the event of death. Under the provincial insurance legislation (Ontario in this case), the designation could be made in the insurance policy contract or in an agreement in writing between the policyholder and the insurer. With such a designation, the interest in the policy does not form part of the policyholder's estate at his or her death. CRA accepted that the requirements of paragraph 148(8)(a) would be met in this case.[11] Hence, the tax-free rollover would apply, provided the other requirements of subsection 148(8) were met.

In an earlier request for a technical interpretation, a taxpayer had asked whether the requirements of paragraph 148(8)(a) would be met if the policy were transferred to any type of trust. The taxpayer specifically queried transferring the policy to a trust established solely for the benefit of a minor child. CRA expressed an opinion, which was entirely consistent with their position on transfers via wills: subsection 148(8) would not apply since the transfer was not to the child.[12] CRA expressed a similar conclusion about transfers to a bare trust as the settlor must, by definition, be the beneficiary of such a trust and that therefore there is no disposition of the policy to the child.[13]

(d) Number of Lives Insured

When we read paragraph 148(8)(b) of the ITA, we see that the reference is to "*the* life insured." This, of course, raises the issue of whether transfers of joint-life policies would be permissible.

CRA, at the 2004 CALU Conference, was asked whether the application of the *Interpretation Act* (IA) would allow for more than one life to be insured. (CRA was asked whether using the IA would allow words in the singular to include the plural, the words in the plural to include the singular.) CRA stated:

"Subsection 148(7) of the *Income Tax Act* provides that as a general rule, transfers of life insurance policies to non-arm's length persons are taxable dispositions at the value of the policy … Subsections 148(8) to (8.2), provide for transfers at the adjusted cost basis of a life insurance policy in specific non-arm's length circumstances. Since subsection 148(8) is, in our view, intended to provide an exception to the general rule, it would be contrary to the

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[9] See CRA document # 2005-0137151E5, dated December 12, 2005.
[10] See CRA document # 9433865, dated February 15, 1995.
[11] See CRA document # 9618075, dated September 3, 1996.
[12] See Technical Interpretation # 9826715, dated January 19, 1999.
[13] See 12 above.

intention of the provisions to apply subsection 33(2) of the *Interpretation Act*, in order to expand the exception to the general rule."[14]

CRA went on to state that this position was consistent with that taken by it in 2000 for multi-life policies for purposes of subsection 70(5.3) of the ITA.[15] More importantly, however, CRA stated:

"The Department of 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. It is our view that a legislative amendment would be required to provide for the application of subsection 148(8) to multiple life policies …"[16]

Thus, it is clear that a joint-life policy cannot be transferred at a time when both insureds are alive. This leads to the question of what happens at death of one of the insureds. At the 2005 CALU Conference, CRA was asked whether subsection 148(8) could apply where there was a joint-last-to-die policy, with the child and one of the child's parents being the only lives insured under the policy. The child was also the contingent owner of the policy. CRA stated:

"If the child receives the interest of the parent policyholder in the last-to-die policy for reason only that the child is the contingent owner of the policy within the meaning of 199(1) of the *Insurance Act (Ontario)* and the parent has died, it is our view that the child is the only life insured under the policy at the time that the parent's interest in the policy is transferred to the child. Provided that the child acquired his interest without consideration, it is our view that subsection 148(8) would apply to the transfer of the policy from the parent to the child …"[17]

While the above opinion dealt specifically with successive (i.e., contingent) owner provisions of Ontario's insurance legislation, it does stand for the proposition that with joint-last-to-die policies, only one life remains once the first insured has passed on. Hence, a transfer pursuant to subsection 148(8) of the ITA could occur.[18]

CRA did, in fact, in a recent Technical Interpretation confirm the following:

"You asked whether a policy that insured the lives of two persons at the time it was issued, would qualify for the tax deferred transfer under subsection 148(8), where one of the lives insured under the policy has died prior to the policy being transferred. It is our general view that the fact that there was more than one life insured under the policy when issued, will not preclude the policy from being transferred at its adjusted cost basis pursuant to subsection 148(8) of the Act, provided that at the time the policy is transferred, there is only one life insured under the policy."[19]

CRA is consistent in its view that there may only be one life insured at the time of the transfer. We are aware of a Technical Interpretation in which CRA was asked whether subsection 148(8) would apply where one of the lives covered under a multiple-life policy was dropped. CRA confirmed that so long as there was only one life insured at the time of the transfer, it would be permissible. (CRA also expressed a caveat with respect to other possible tax consequences resulting from removing a life under a multiple life policy.)[20]

(e) Transfer of Rider

As discussed above, paragraph 148(8)(b) allows for there to be only one life insured under the policy. This leads to the question of what happens if a rider to a policy is to be transferred.

A taxpayer sought advice from CRA in a situation where a rider insuring a child was added to a policy that insured the parent of the child. CRA indicated that it is a question of fact whether: (1) adding a rider to policy results in an income inclusion at the time that this is done, and; (2) there are separate policies in place. CRA indicated that where a policy was silent with respect to the addition of a rider, the addition of a rider would likely be viewed as a policy amendment, and that this would likely result in a deemed disposition of the policy. (Thus, there could be an income inclusion under subsection 148(1) of the ITA.) CRA went on to say that where a policy at the time of its issue provides that a rider may be added at some future time, it is not expected that there would be a deemed disposition at the time this is actually done. Hence, there should not be an income inclusion at that time.[21]

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[14] See CRA document # 2004-0065441C6, dated May 4, 2004.
[15] See 14 above.
[16] See 14 above.
[17] See CRA document # 2005-0116681C6, dated May 3, 2005.
[18] See CRA documents # 5-8204[A], and # 5-8204[B], both dated July 11, 1989, which affirmed that where there were two insured lives, the conditions described in paragraph 148(8)(b) were not met.
[19] See CRA document # 2005-0137151E5, dated December 12, 2005.
[20] See Technical Interpretation # 2005-0125391E5, dated August 29, 2005.
[21] See CRA document # August 1991-285, dated August 1991.

CRA reiterated that subsection 148(8) would only permit the rollover of the rider on the child from the parent to the child if there were one life insured under the policy. The critical issue was whether the rider could be viewed as a separate policy.[22] If the rider cannot be viewed as a separate policy, there are two lives insured under the policy (i.e., the parent and the child), and subsection 148(8) could not apply.

(f) Whether an Interest May be Transferred

When we look at the language in subsection 148(8), we see that it is "an interest of a policyholder" which is being transferred. It is permissible to "cascade" just a portion (i.e., interest) in a policy.

(g) Subrogated Policies in Quebec

At the CRA Tax Roundtable at the 2005 APFF Conference, CRA was asked whether the provisions of subsection 148(8) would apply if the interest of the policyholder is transferred to the policyholder's child as the subrogated policyholder pursuant to Article 2446 of Quebec's Civil Code.

Three scenarios were posed to CRA. CRA confirmed that subsection 148(8) would apply where the interest is transferred to a child on the condition that a third party administers it. (Here the designation of the subrogated policyholder could be made in either the policy or in another document submitted to the insurer.) Subsection 148(8) would also apply where the subrogated policyholder is designated in a will. However, subsection 148(8) would not apply where the subrogated policyholder is a testamentary trust created for the benefit of the child.[23]

(h) Income Attribution Rules

A person who has not attained the age of majority does not have legal capacity, under either common or civil law, to enter into contracts. However, the insurance laws in the common law provinces allow a minor aged 16 or over to enter into a contract of life insurance as an owner, on their own life or on the life of anyone else in whose life they have a financial interest. The minor can exercise all rights under the contract, whether entered into by him or her or assigned to him or her, as if he or she had reached the age of majority. (The only exception relates to giving valid discharge as a beneficiary under a contract owned by someone else.) While the minor may make a contract of life insurance, he or she may not collect the insurance money as a beneficiary.

In Quebec, parents or "tutors" represent persons who are not competent to make a contract (e.g., minors). (Minors can, however, obtain full civil rights by court order, or upon marriage.)

Where the contract is transferred to someone considered a minor for income tax purposes, there is a need to consider the impact of the income attribution rules contained in the ITA. Under these rules, income earned will be attributed back to the transferor.[24] Thus, the benefits of the transfer would be nullified. These tax rules will apply until the taxation year during which the child attained age 18. If, for example, the child turned 18 on June 1st, 2005, none of the income earned from January 1st to December 31st of 2005 would be attributed back to the parent, since the child turned 18 during 2005.

When we examine how this would affect transferred life insurance policies, we see that the attribution rules would come into play if the minor were to do a surrender (or partial surrender) of the policy, or take a taxable policy loan. Any policy gain arising in such a situation would be attributed back to the transferor. (The attribution rules only apply when such a policy gain arises.) It should be noted that the subsection 148(8) transfer in and of it self would be tax-free.

III. Transfers not Qualifying As Subsection 148(8) Transfers

There are a number of provisions in the ITA that could come into play where a transfer does not fall under subsection 148(8). Subsection 148(7) deals with transfers for no consideration and transfers to non-arm's length parties. Where such a transfer does occur, the transferor is deemed to receive proceeds equal to the Cash Surrender Value (CSV) of the interest in the policy. To the extent that the proceeds exceed the ACB of the interest, a policy gain will have to be reported. The transferee is deemed to have acquired the interest in the policy with an ACB equal to its CSV.

Where consideration is received or the transfers are to arm's-length parties, subsection 148(7) will not apply, and other tax rules should be consulted. These are beyond the scope of this document.

[22] See 21 above.
[23] See Question #8, 2005 APFF Financial Products Round Table, October 2005.
[24] See subsection 74.1(2) of the ITA.

IV. Additional Planning Points

In many instances policies are cascaded because of the significant tax advantages. The advantages are magnified where there is a significant tax-deferred build-up within the policy and the transferee can access this whilst paying minimal taxes.

Cascading of policies is attractive when we look at the possibilities of income splitting. It is also attractive when the child needs to withdraw the funds (perhaps there are educational expenses), and the funds can be withdrawn at a minimal tax cost.

In order to maximize the tax-deferred build up within a policy, the planner will need to have a good understanding of the "exempt test" and how this affects the cash value that can be built up within the policy. For example, where the insured is a minor, it may be very difficult to build up significant cash values. For this to happen, you would want to have a significantly older insured (e.g., have the parent as the insured and the grandparent as the owner).

When we are looking at ownership of the policy, we need to consider the situation of the older policyholder since the higher the age of the policyholder, the higher the risk of mortality. Thus, where the cascading provisions are to be used, it may be appropriate to have a contingent owner (e.g., the spouse of the parent). With this set up, subsection 148(8) could come into play by having the grandfather gift the policy to the grandchild. Subsection 148(8) would also come into play where the grandfather dies and the contingent owner to whom the ownership is transferred is a "child." There could then be a subsequent transfer of the policy from the spouse of the parent to the grandchild.

V. Summary

The "cascading policy" provisions provide considerable tax advantages, and well-informed advisors will structure transfers that meet their clients' financial and estate planning needs. We hope that our outlining of the detailed requirements of these provisions will assist advisors in properly structuring these transfers and avoiding the traps that await the unwary.

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