

Policy Loans

Many insurance contracts (for example, Universal Life policies) let policyholders make contributions to a tax-deferred investment component of the account. When the policyholders require funds, they can access the investment component in a number of ways (e.g., partial or full surrenders of the contract, policy loans, etc.)

Policy loans are attractive because they let policyholders access the Cash Surrender Value (CSV) of the contract without withdrawing an amount from the CSV or surrendering the policy. They may also let policyholders deduct the related interest charges and thus realize tax savings—another attractive feature.

This document discusses the tax issues related to policy loans. We touch upon interest deductibility briefly. For a detailed discussion of interest deductibility, please refer to the companion piece in this series, which is entitled *Interest Deductibility* [PC 6141].

While policy loans are available for Whole Life participating policies, this document will focus primarily on policy loans under Universal Life (UL) policies.

I. General Discussion

Life insurance contracts that contain a policy loan feature provide policyholders who are looking for financing with a prospective source of funds. Of course, the same policyholders would also be able to pledge the policy to a financial institution as an alternate method for obtaining funds. Thus, policyholders with contracts that allow for policy loans have greater flexibility than policyholders with contracts without the policy loan feature. This latter group would be limited to pledging the policy to a financial institution.

A policy loan feature is good news from a tax perspective. A policyholder who needs money can take out a policy loan. In very general terms, no tax will arise so long as the amount of the loan is less than the adjusted cost basis (ACB) of the policy. Thus, this is a much more tax-efficient way of accessing funds than is a partial surrender of the policy.

Anyone thinking of buying an insurance policy should discuss all policy features with their insurance advisor, so that they have a complete understanding of all of the policy features. When a policy loan feature is available, the prospective purchaser would want to know whether the terms (amount of loan available, when the policy loan feature may be used, interest rate, etc.) are specified in the contract, or whether the insurer will specify the terms at the time that the loan is applied for.

Even if contracts have a policy loan feature, there may be other features of the contract that have a direct bearing on whether or not applying for a policy loan is a good idea. For example, many insurers now use the Ultimate Net Cost of Insurance (NCPI) method for calculating mortality charges where the policy has an issue age of 71 or higher. In such a case, the high NCPI charges will quickly reduce the ACB of the contract, with the result that the amount of a tax-free policy loan may be minimal, or even zero, even in the early years of the contract. Thus, the insurance advisor should review all relevant contract features.

A prospective policyholder may purchase an insurance policy because he anticipates using the policy loan provisions to obtain funds for investing in a business or property. However, many insurers also offer “compassionate benefits” as a contract feature or as a non-contractual benefit. Here, where an insured suffers from a terminal illness, the policyholder may be able to obtain an advance of the death benefit. Such advances may also be treated as policy loans. The prospective insured will also want to understand how this feature works.

II. Tax Considerations

(a) Policy Loan Definition

The Income Tax Act (Canada) (ITA) contains a brief definition of “policy loan.” It “means an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of the life insurance policy.”¹

In essence, a policy loan actually represents an advance of an entitlement under the policy. Thus, a policy loan is dissimilar from a commercial loan, say from a bank.

In 2001, CRA stated that even though a withdrawal from a policy may not be referred to as a “policy loan” in an insurance policy, the definition is broad. CRA has taken the position that it is a question of fact whether a withdrawal from a policy is a “policy loan.” It would be necessary to examine the policy and consider its terms and conditions before coming to a decision.²

Since the policy loans are considered advances, the policyholder has the option to repay all or a portion of the amount, without being capped at the maximum deposit otherwise permitted by the ITA.

(b) Receipt of Policy Loan

Taking a policy loan after March 31, 1978 is considered a disposition of a life insurance policy.³ As with any disposition of a life insurance policy, a policy gain (if any) will have to be calculated. Thus, we would calculate the amount by which the proceeds of disposition exceed the Adjusted Cost Basis (ACB) of the policy.⁴

For policy loans made after March 31, 1978, the ITA contains a unique definition of “proceeds of disposition.” Under this definition, the proceeds of disposition are deemed to be the lesser of the following two amounts:

- The amount of the loan (except an amount that is immediately applied to pay a premium under the policy, as provided for under the terms and conditions of the policy), and
- The amount, if any, by which the CSV of the policy immediately before the loan was made exceeds the total of the balances outstanding of all policy loans made under that policy.⁵

Let’s assume that Mr. Smith has a UL policy with a CSV of \$200,000, and an ACB of \$75,000. He is contemplating taking a policy loan of \$40,000. This would be his first policy loan.

¹ See subsection 148(9) of the Income Tax Act (Canada) (ITA).

² See Canada Revenue Agency (CRA) document # 2001-0072777, dated May 8, 2001.

³ See part (b) of the definition of “disposition” contained in subsection 148(9) of the ITA.

⁴ See subsection 148(1) of the ITA.

⁵ See part (b) of the definition of “proceeds of disposition” contained in subsection 148(9) of the ITA.

In Mr. Smith's case, the proceeds of disposition are deemed to be the lesser of: \$40,000 (that is, the amount of the loan), and \$200,000 (that is, the CSV immediately before the loan was taken minus outstanding policy loans, which in this case are NIL.)

To determine whether a policy gain arises, compare the proceeds of disposition of \$40,000 with the ACB of the policy. Since the ACB of the loan is \$75,000, no taxable gain arises. (Mr. Smith could in fact have taken a policy loan of up to the full amount of the ACB of the policy on a tax-free basis.)

(c) ACB of the Policy

The ITA contains specific rules relating to the calculation of the ACB of the policy.⁶ While a detailed discussion of all of the items entering into this calculation is beyond the scope of this document, the two primary components of the calculations are the premiums (these increase the ACB), and the NCPI charges (these decrease the ACB where a policy is last acquired after December 1, 1982).

However, taking policy loans does impact the ACB calculation. Policy-loan related items that would increase the ACB are:

- Any previous policy gains (including any policy gains arising from earlier policy loans)
- Certain (generally non-deductible) interest payments on the policy loan
- Policy loan repayments in excess of amounts previously included in income.

Policy-loan related items that would decrease the ACB are:

- Proceeds of disposition calculated for previous policy loans.

(See (f) below for a discussion of Automatic Premium Loans and the impact on ACB.)

This is perhaps best illustrated by again looking at Mr. Smith's situation. Let's assume that a year has elapsed and Mr. Smith now wants to take an additional policy loan of \$40,000. In the last year he made additional deposits of \$25,000 into the contract, and also paid interest of \$4,000 on the policy loan. The NCPI charges were \$30,000. The CSV increased to \$240,000.

If we did not look at the components of the ACB calculation relating to the policy loan, we would calculate Mr. Smith's new ACB as the opening ACB (\$75,000), plus the additional deposits (\$25,000), less the NCPI (\$30,000). We would arrive at \$70,000.

We would then make further adjustments for the components relating to the policy loan. Thus, we would deduct the proceeds of disposition for the previous policy loan (\$40,000) and add the interest actually paid (\$4,000). This results in an ACB of \$34,000. (See (e) below for a discussion of circumstances in which interest may be added to the ACB.)

Mr. Smith does not want to have a taxable policy gain. Thus, we need to compare the deemed proceeds of disposition with the ACB. His proceeds of disposition are deemed to be the lesser of: \$40,000 (that is, the amount of the second loan), and \$200,000 (that is, the CSV immediately before the loan was taken of \$240,000 minus outstanding policy loans of \$40,000.) If Mr. Smith took out the second policy loan of \$40,000, he would realize a policy gain of \$6,000 (that is, the deemed proceeds of \$40,000 less the ACB of \$34,000). Thus, he should limit his policy loan to \$34,000.

If Mr. Smith proceeded to take a second policy loan of \$40,000, the \$6,000 taxable gain that he realizes would be added to the ACB.

⁶ See definition of "adjusted cost basis" in subsection 148(9) of the ITA.

Most policyholders would not want to take out policy loans that result in a taxable policy gain. However, there may be unique circumstances where a taxpayer may want to do this. This would typically occur where a taxpayer wants to “manage” his net or taxable income. For example, the policyholder may have tax losses that he or she could apply, or could have significant tax credits that he or she could use. Thus, the appropriate decision depends upon the taxpayer’s particular circumstances.

It is very important to note that non-taxable policy loans will typically be available in the early years of the policy (assuming of course that there is sufficient CSV). This is because of the NCPI charges grind down the ACB of the policy. (Remember here that non-taxable policy loans are capped at the ACB.)

It is important to understand how NCPI is calculated. NCPI charges are distinct from the “cost of insurance” charges. The ITA specifies how to calculate NCPI. Briefly, the insurer calculates this amount by taking the net amount at risk under the policy and multiplying it by a mortality rate. The mortality rate must be taken from a specific table (the 1969-1975 mortality tables issued by the Canadian Institute of Actuaries (CIA)).⁷ All insurers use these same tables.

The CIA prepared these tables for issue ages to 70. Thus, insurers take different approaches when calculating NCPI for issue ages over 70. There may also be some variances as to how NCPI is calculated for joint life policies. For issue ages over 70, some insurers use what is referred to as Select NCPI, whereas others use Ultimate NCPI. Using the Ultimate NCPI method (available only for issue ages over 70) results in significantly higher NCPI charges, and hence a rapid grind down of the ACB to nil. As a result, non-taxable policy loans may only be available for a few early years of the policy.

Prospective policyholders and their advisors should understand how the insurer calculates NCPI, as this has a significant bearing on the availability of policy loans.

(d) Policy Loan Repayments

As stated above, a policy loan could result in a taxable gain, with this taxable gain then being added to the ACB. This being the case, it would make sense for some amount of deduction to be available when the loan is repaid, with some adjustment also being made to the ACB.

This is in fact the case. Of course, the deduction that the taxpayer will have in the taxation year in which he or she made the repayment is limited to policy gains previously included in income (including policy gains in that same year).⁸ To the extent that the taxpayer cannot deduct the entire repayment, the amount will be added back to the ACB of the policy.⁹

Let’s assume that Mr. Smith did take a second policy loan of \$40,000 in the preceding year and chose to repay \$10,000 in a subsequent year. Since Mr. Smith will have included only \$6,000 in income, that is all he will be able to deduct in the year of repayment. Of course, the remaining \$4,000 will be added back to the ACB.

Canada Revenue Agency (CRA) has issued a Technical Interpretation dealing with whether a taxpayer could take a deduction for a “repayment” at the time of death. That is, whether the reduction in the death benefit payable by the insurer for the amount owing by the taxpayer could be considered a “repayment.” CRA does not accept that a “repayment” has occurred.¹⁰ (Remember here that the life insurance death proceeds are non-taxable in their entirety.)

⁷ See component L of the definition of “adjusted cost basis” in subsection 148(9) of the ITA. Also, Income Tax Regulation 308.

⁸ See subsection 60(s) of the ITA.

⁹ See component E of the definition of “adjusted cost basis” in subsection 148(9) of the ITA.

¹⁰ See Technical Interpretation # 9909075, dated June 17, 1999.

(e) Payment of Interest on the Policy Loan

A taxpayer may seek to deduct the interest on the policy loan. Assuming that the interest is otherwise deductible, it may only be deducted if the appropriate CRA form is completed.

The taxpayer and the insurer must jointly complete form *T2210 – Verification of Policy Loan Interest by the Insurer* (T2210).¹¹ (A separate T2210 must be completed for each policy loan.) Where the taxpayer is claiming the interest on the policy loan as an expense incurred for the purpose of gaining or producing income from a business or property, the insurer uses this form to verify that this amount is not being added to the ACB of the policy. (We note that taxpayers resident in Quebec need to file a separate form for Quebec tax purposes.¹²)

The ITA contains rules relating to interest deductibility. A discussion of these rules is beyond the scope of this document. Please refer to the companion piece in this series, which is entitled *Interest Deductibility* [PC 6141].

The logic behind this provision appears to be that if a taxpayer deducted the interest for tax purposes, and also added the amount to the ACB, tax savings could be achieved twice. Tax savings would be realized in the year in which the taxpayer deducted the amount. Tax savings could be achieved by virtue of the increase in the ACB, as this would reduce any policy gains.

Thus, where the taxpayer is not seeking to deduct the interest (perhaps the loan was taken for personal purposes), the T2210 should not be completed. The insurer will automatically add the interest to the ACB.

The form does contemplate situations in which the taxpayer is seeking to deduct only part of the interest. In this case, the taxpayer would complete Part I of the T2210 to indicate what amount they are actually seeking to deduct for tax purposes. In Part II the insurer would then certify that this amount is not being added to the ACB.)

The taxpayer should complete the form on a timely basis. CRA requires that the insurer verify the amount of the non-capitalized interest no later than the due date for the tax return for the year in which the taxpayer is seeking to deduct the interest.¹³ (Individual taxpayers must generally file their personal tax returns no later than April 30th of the following year. Self-employed individuals and their spouses are required to file their tax returns no later than June 15th of the following year. Corporations must generally file their tax returns no later than 6 months following the end of their fiscal period.)

CRA considers the interest to be paid at the time the interest is added to the ACB.¹⁴ This would generally be the policy anniversary date. Where a taxpayer uses the accrual method for calculating income from a business or property, the interest can be deducted in the year of accrual if it is subsequently verified.¹⁵

(f) Capitalization of Interest on Policy Loans (or Automatic Premium Loans (APLs))

A policy could provide that policy loan interest is not to be paid and will instead be capitalized. In these circumstances, the interest is considered a new policy loan. A premium is considered to have been paid at the same time.¹⁶

¹¹ See subsection 20(2.1) of the ITA.

¹² For Quebec tax purposes, form TP-163.1-V should be completed.

¹³ Income Tax Regulation 4001.

¹⁴ See paragraph 5 of *Interpretation Bulletin IT-355R2 – Interest on Loans to Buy Life Insurance Policies and Annuity Contracts, and Interest on Policy Loans*, issued August 26, 1994 (now archived).

¹⁵ See above.

¹⁶ See part (a) of definition of “premium” in subsection 148(9) of the ITA.

When we look at the tax implications of the APL, we need to consider the impact on the proceeds of disposition and on the ACB. When we looked at the unique deemed “proceeds of disposition” for policy loans (in (b) above), we saw that there was an exclusion for amounts that are immediately applied to pay a premium under the policy, as provided for under the terms and conditions of the policy. The proceeds of disposition for this type of policy loan are nil.

When we look at the definition of ACB, we also see that there is a specific exclusion.¹⁷ Thus, the ACB is not increased on account of the APL feature.

Thus, where the proceeds of disposition are nil, and there is no impact on ACB, the net effect is that no taxable income results from the APL feature.

(g) Surrender of the Contract

A policy gain will have to be calculated where all or part of a contract is surrendered. If the contract is surrendered in its entirety, the gain will be calculated by taking the excess of the proceeds of disposition over the ACB of the contract.

The ITA provides that the “proceeds of disposition” will be calculated as the CSV less the amount of the policy loan payable at that time.¹⁸ (The CSV is calculated without any reference to policy loans.¹⁹) Thus, if we look at what would happen to Mr. Smith if he surrendered his contract immediately after taking the first policy loan of \$40,000, his proceeds of disposition would be calculated by taking the CSV of \$200,000 and subtracting the policy loan of \$40,000 that the insurer would essentially “recover” at this time. Thus, his proceeds are \$160,000. His ACB would be the \$75,000, which would be reduced by the deemed proceeds of disposition of \$40,000 for the first loan. Thus, the ACB used in this calculation is \$35,000.

Using the proceeds of disposition of \$160,000 and the ACB of \$35,000, we arrive at a policy gain of \$125,000. (Had Mr. Smith not taken the first loan, and had instead surrendered the policy, the policy gain then computed would have been calculated by taking the CSV of \$200,000 and subtracting the ACB of \$75,000, or \$125,000.) Thus, these calculations provide that when Mr. Smith surrenders his policy he will be taxed on this policy loan.

(h) Partial Surrender of a Contract

There appear to be anomalies in the ITA when we are dealing with partial surrenders in situations in which there have been policy loans.

Let’s look closely at paragraph (a) of the definition of “proceeds of disposition”. We see that component A used in this definition looks at the CSV of the *interest* in the policy. However, component C refers to the entire amount of the policy loan.²⁰ This does not appear appropriate where there is in fact a partial surrender.

CRA dealt with partial surrenders in a Technical Interpretation issued in 2001. We are not sure whether CRA’s analysis was correct. (It interpreted the legislation as providing that on a partial disposition, the CSV of the entire interest is used in calculating component A, not just the partial interest.) CRA confirmed that “this result may not be appropriate in policy terms, we will be bringing this matter to the attention of the Department of Finance for their consideration.”²¹

¹⁷ See component B of the definition of “adjusted cost basis” in subsection 148(9) of the ITA.

¹⁸ See components A and C of the definition of “proceeds of disposition” in subsection 148(9) of the ITA.

¹⁹ See definition of “cash surrender value” in subsection 148(9) of the ITA.

²⁰ See components A and C of paragraph (a) in definition of “proceeds of disposition” in subsection 148(9) of the ITA.

²¹ See Technical Interpretation # 2001-0100255, dated November 6, 2001.

It is not possible to anticipate when the Department of Finance will revisit these provisions of the legislation and correct this anomaly. Industry practice is to generally take the logical view that the anomaly is unintended, and thus to prorate the entire transaction. Hence, we urge policyholders who are contemplating doing a partial surrender of a policy in situations in which policy loans are outstanding to seek independent tax advice.

(i) Tax Consequences at Death

At death, the insurer will offset the loan (and any accrued interest) against the death proceeds otherwise payable. Hence, the life insurance death proceeds paid to the beneficiaries will be reduced. However, the life insurance death proceeds represent a non-taxable receipt.

III. Other Considerations

(a) Share Value at Time of Death

It's also important to consider the impact of a policy loan on the valuation of a corporate-owned life insurance policy. Let's assume here that a shareholder died, and that a policy loan was taken out on a corporate-owned policy on his life.

The ITA contains specific rules governing the valuation of deceased's shares.²² The CSV of the corporate-owned policy is to be used. Policy loans do not reduce the CSV.²³ This was confirmed by CRA in a Technical Interpretation issued in 2003.²⁴ In this same Technical Interpretation, CRA was asked whether the policy loans could be treated as a corporate liability for purposes of valuing the shares. CRA's response was that "ordinary valuation principles" would be applied.²⁵ Presumably the terms of the policy would determine whether the policy loan is a liability of the company.

(b) Capital Dividend Account (CDA) Considerations

Private corporations can take advantage of the CDA mechanism. Life insurance death proceeds (net of the ACB of the contract) can be added to the corporation's CDA and paid to shareholders resident in Canada as tax-free capital dividends.

Where there is a policy loan, the life insurance death proceeds payable by the insurer will be reduced by the amount of the policy loan, plus any accrued interest. At the same time, the ACB of the policy will have been reduced by the amount of the policy loans. The net of these two amounts is added to the CDA.²⁶

First let's assume that we do not have any policy loans. We simply have a life insurance contract providing a death benefit of \$1,000,000, with this contract having an ACB of \$250,000. In this example, \$750,000 would be added to the CDA account.

Now let's fold in a policy loan of \$50,000. Since the insurer would reduce the life insurance death proceeds by \$50,000, our life insurance death proceeds become \$950,000. We would also reduce the ACB by the proceeds of disposition for the loan. Hence the ACB becomes \$200,000 and we arrive at the same \$750,000.

For additional information on the CDA, please refer to *The Capital Dividend Account* [PC 5674].

²² See subsection 70(5.3) of the ITA.

²³ See definition of "cash surrender value" in subsection 148(9) of the ITA.

²⁴ See Technical Interpretation # 2003-0004335, dated June 9, 2003.

²⁵ See above.

²⁶ See CRA document # RCT A-0579, dated December 12, 1984.

(c) Donations of Life Insurance Policies

A taxpayer may make an absolute assignment of a life insurance policy to a registered charity. CRA has stated that the donor will be entitled to a tax credit (within the limits provided by the ITA) for the value of the gift, provided that the charity has also become the registered beneficiary of the policy.²⁷ The value of the gift is to be calculated as the CSV of the policy (less any policy loans outstanding at that time), plus any dividends and interest that are also assigned at that time. Where the policyholder later repays any policy loans, these repayments also qualify for the tax credit.²⁸

A prospective donor should of course realize that the absolute assignment referred to above also represents a disposition of the policy. Hence, the appropriate policy gain will have to be calculated.²⁹

(d) Compassionate Benefits

Many insurers provide “compassionate benefits” to policyholders. Here, terminally ill policyholders will be able to receive an amount from the insurer prior to their death. Different insurers employ different methods for providing these amounts.

CRA takes the position that these compassionate benefits could be structured as policy loans. This would be the case where a loan is provided under the terms and conditions of the life insurance policy.³⁰

Some insurers may provide funds to the terminally ill policyholder by making a loan from their general funds. Here, the policyholder would assign the life insurance policy to the insurer. CRA takes the view that a disposition of the policy will not arise where there is no amendment to the policy.³¹

This is consistent with the definition of “disposition”, as used in an insurance policy context. There is a specific exclusion for assignments of policies.³²

IV. Summary

The policy loan is an attractive feature offered by many insurance contracts. Policies with significant investment components represent an attractive source of financing for these policyholders. Policyholders requiring funds for investing in property or a business may also be able to realize tax savings where they obtain policy loans and are able to deduct the interest charges. Of course, policyholders should have a thorough understanding of how this policy loan feature works, so that it can be used to its best advantage.

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.

²⁷ See paragraph 1 of *Interpretation Bulletin IT-244R3 – Gifts by Individuals of Life Insurance Policies are Charitable Donations* (IT-244R3), dated September 6, 1991.

²⁸ See paragraph 3 of IT-244R3.

²⁹ See subsection 148(1) of the ITA.

³⁰ See CRA document # 2002-013889, dated February 25, 2003.

³¹ See above.

³² See part (f) of the definition of “disposition” contained in subsection 148(9) of the ITA.