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Overview of Canadian taxation of life insurance policies

Life insurance plays an increasingly important role in financial planning due to the growing wealth of Canadians. Besides the traditional role of protecting families when a parent dies prematurely, many affluent individuals use life insurance to protect their wealth against taxes arising on death. Others use exempt life insurance to provide retirement and other executive benefits.

Advisors often ask for income tax implications based on either the ownership of a policy or for a pending transaction. This bulletin provides a non-technical summary of these tax issues.

New tax legislation for life insurance policies

On December 16, 2014, new life insurance policy exempt test legislation received Royal Assent. It is generally focused on implementing changes that relate to the underlying actuarial assumptions and reserve calculations for the exempt test regime and certain related policyholder tax matters.

One of the most significant changes in the legislation involves modifying the benchmark policy and related regulations used to determine maximum funding room available within the tax-exempt environment of life insurance policies. This will typically result in a decrease to the total amount of funding room available over the lifetime of a policy. While changes will be needed to accommodate the new rules, all life insurance product lines, including universal life, will continue to provide clients with tax-preferred protection solutions.

The effective date for these changes is January 1, 2017. Policies issued before that date will be generally be “grandfathered” from the proposed rules and the current exempt test rules will continue to apply to them. Previous amendments to the rules regarding the tax treatment of life insurance policies also included grandfathering provisions. As a result, the manner in which the rules apply depends on the date on which an interest in the policy was last acquired and, in some cases, the date of issuance of the policy.

Generally, grandfathering would be lost if there is a change to the policy that requires medical underwriting. The following rules summarize grandfathering in respect of the accrual taxation rules and exempt testing for life insurance policies:

Policy Acquisition/Issue Date	Income Tax Treatment
Policies issued before 2017 an interest in which was last acquired before December 2, 1982.	Exempt from accrual taxation unless prescribed premium is paid and certain other conditions met. If grandfathering is lost, annual or triennial accrual applies depending upon taxpayer and whether policy is an exempt policy. If grandfathered status is lost after 2016, exempt policy status determined as though policy were issued after 2016.
Policies issued before 2017 an interest in which was last acquired after December 1, 1982 and before 1990.	Annual or triennial accrual taxation depending upon taxpayer, unless policy is an exempt policy, as determined under rules applicable to a policy interest last acquired after December 1, 1982 and before 1990. If grandfathered status is lost after 2016, exempt policy status determined as though policy were issued after 2016.
Policies issued before 2017 an interest in which was last acquired after 1989.	Annual accrual taxation, unless policy is an exempt policy, as determined under rules applicable to policies an interest in which was last acquired after 1989. If grandfathered status is lost after 2016, exempt policy status determined as though policy were issued after 2016.

All the information below is based on the current rules and does not reflect changes to the legislation that will take effect January 1, 2017.

Exempt vs. Non-Exempt

Under the Income Tax Act (ITA), the internal growth of the cash value of policies issued today is not subject to accrual taxation (i.e. annual taxation on cash value growth), provided the policy growth falls within the parameters of a prescribed test policy. The test policy is a 20 payment endowment at age 85. Policies that meet this test annually are considered 'exempt' (i.e. exempt from accrual taxation).

Virtually every policy issued in Canada today is exempt and contractual or non-contractual measures are generally in place to ensure the policy can remain exempt year over year (e.g. via increase in death benefit or cash withdrawals within 60 days after the policy anniversary). The annual increase in death benefit is limited to 8% of the total death benefit at the previous policy anniversary.

All comments and examples that follow assume the presence of an exempt life insurance policy.

Individually owned policies premiums/deposits

Generally, premiums are not deductible to individuals. There are two exceptions to this general rule for individuals.

1. Where a registered charity is the owner and beneficiary, the premium paid by the taxpayer is considered to be a charitable donation eligible for a charitable tax credit, subject to the usual restrictions on amounts.

2. A portion of the premium may be deductible where the policy is required as collateral by a lender that is a 'restricted financial institution' (e.g. a chartered bank, trust company or credit union) and the interest on the loan would otherwise qualify as a deduction. The amount deductible is the lesser of the Net Cost of Pure Insurance (defined on page 3) and the actual premium payable, prorated by the ratio of the loan balance to the total policy death benefit.

Investment income tax

The Income Tax Act imposes a corporate tax called the Investment Income Tax (IIT) to the insurer. The IIT rate is 15% of net investment income. It is not a tax directly payable by the policyholder.

But, IIT effectively reduces the rate of internal growth in the policy and requires an appropriate premium adjustment to fixed premium, fixed value policies. It is usually reflected in the administrative costs with a universal life policy or is included in the premium amount for a fixed premium policy.

Policy dividends

There are numerous rules in the ITA about taxing of dividends from participating life insurance policies. Indeed, most of the ITA that applies to life insurance was crafted with participating insurance in mind, before the days of universal life. Where dividends are received in cash or paid out of the policy but left to accumulate with interest, all or a portion of the dividend may be taxable in the hands of the policyholder. Any interest earned on accumulated dividends will also be taxable each year.

Today, most buyers of participating life insurance policies select dividend options that redirect the dividend to buy paid-up insurance or term insurance. This avoids these tax consequences.

Death benefit

The beneficiary receives the death benefit of a Canadian life insurance policy tax-free. There are a very limited number of exceptions to this general rule. Following are the two principal exceptions:

1. A 'non-exempt' policy is subject to taxation on the growth in cash value in excess of the growth in adjusted cost basis (ACB) of the policy ('accrued income') from the last reporting date to the date of death. The remainder of the death benefit would be tax-free.

2. A policy registered as a Retirement Savings Plan is subject to taxation in the year of death on the greater of the sum of premiums paid or the cash value. Such policies are rarely issued in Canada.

Adjusted cost basis (ACB)

The cost of an insurance policy for tax purposes is the Adjusted Cost Basis (ACB). There are numerous factors that increase or decrease the ACB. The most common are premiums and the Net Cost of Pure Insurance (NCPI-see below). ACB is increased by the total of all premiums paid and decreased by the annual NCPI. Other factors that increase the ACB include interest paid on a policy loan, previously taxed policy gains (e.g. accrued income on non-exempt policies) and certain policy loan repayments (see below).

NCPI generally increases year over year to the point where it exceeds the premium or deposit, if any, being paid for that year. For this reason, the ACB of a policy generally increases in the early policy years and then declines to zero after a number of years.

Once the ACB reaches zero, then every dollar of cash withdrawn from the policy, by whatever means, will be taxable.

Net cost of pure insurance (NCPI) for policies issued after December 1, 1982

NCPI for a given policy year equals the net amount at risk (essentially total policy death benefit minus total cash value) multiplied by the prescribed mortality rate for the life insured's current age. The NCPI is equal to the mortality charge for the pure insurance element of the policy.

Access to cash values by a policyholder

When cash is withdrawn from a policy by the policyholder, there is the potential for taxation. The amount taxable is defined as a 'policy gain' and 100% of the policy gain is included in the taxable income of the policyholder. The amount of the income inclusion will be different for a withdrawal than it would be for a policy loan.

Policy surrender

When a policy is surrendered or 'cashed in', there will be an income inclusion for the policyholder equal to the cash surrender value less the ACB.

Partial surrender (withdrawal) of cash surrender value

In the case of a partial surrender, the amount of the withdrawal that is taxable is proportional to the ratio at which the total cash surrender value would be taxable on surrender.

Policy loan

Loan proceeds are first received from the ACB of the policy and then from the gain portion of the cash value. This means that amounts up to the ACB can be borrowed without any tax consequences. When policy loans are repaid, the policyholder is eligible for a tax deduction up to the amount of taxable income previously included in income.

Corporate owned policies

The same rules apply to corporate owned policies that apply to individuals for premiums/deposits, investment income tax and policy dividends. Death benefits however have a special set of rules.

Capital dividend account (CDA)

Like individuals, a corporation that is the beneficiary of a life insurance policy will receive the death benefit free of tax. To allow for proper tax integration, Canadian private corporations can use a notional account called the Capital Dividend Account to flow tax-free receipts through to shareholders on a tax-free basis. On death of the life insured:

1. Where the corporation is both owner and beneficiary, the difference between the death benefit received by the corporation and the ACB of the policy is credited to the CDA. This applies even when the policy has been collaterally assigned to a lender.

2. Where the corporation is the beneficiary, but not the owner of the policy, an amount equal to the entire death benefit is credited to the CDA. However, if an operating company owns and pays the insurance premiums, and the death benefit is payable to a holding company, subsection 15(1) of the Income Tax Act (ITA) will apply, and the CRA will assess a shareholder benefit equal to the premium paid. As a result, the holding company will have to include in income the value of the premiums the operating company pays, and pay tax on that amount.

The corporation may then pay a dividend or trigger a deemed dividend equal to the balance in the CDA and file an election to cause that dividend to be a tax-free capital dividend in the hands of the recipient.

A more detailed Financial *Advisor* bulletin is available on this topic. See Corporate Owned Life Insurance Policies Structures

Partnership owned policies

Essentially the same rules apply to policies owned by a partnership. A similar mechanism to the capital dividend account exists for the death benefit received by a partnership. The cost base for tax purposes of the partnership interest is increased by the difference between the death benefit and the policy's ACB.

Trust owned policies

A trust, as owner of a life insurance policy is taxed in the same manner as an individual owner on death benefit and policy dispositions.

Generally a life insurance policy owned by at trust can be rolled out to a beneficiary of the trust at cost (ACB), meaning no tax would be payable until a subsequent disposition.

Non-resident owned policies

There is a significant distinction to be made between a Canadian resident who purchases a policy and subsequently becomes non-resident and a non-resident who purchases a policy from a Canadian insurer.

Similarly, there is a significant difference depending upon whether the life insured was resident in Canada at the time the policy was issued.

Where a 'life insurance policy in Canada' (i.e. a policy whereby the person whose life was insured was resident in Canada at the time of issue) is disposed of by a non-resident, the insurance company must withhold 50% of the entire proceed, unless the insurer received a clearance certificate from the CRA.

Where a non-resident purchases a life insurance policy on a person who is also non-resident at the time of issue, there is an argument for the proposition that there are no Canadian tax implications at the time of a subsequent policy disposition. However, some Canadian insurers, in view of the aggressive nature of this interpretation and concerns about the capacity of selling a policy to a non-resident, are erring on the side of treating these policies as 'life insurance policy in Canada'. That is, they are withholding tax on the gain at time of disposition.

Policy transactions

Ownership transfers

The taxation on the transfer of ownership depends on the relationship between the transferor and the transferee. In the case of some non-arm's length transfers, the intent of the two parties may also be a factor.

As a general rule, a transfer of ownership is a policy disposition. The original owner will include the policy gain (transfer price less the ACB) in their taxable income for that year.

The transferee will be deemed to acquire the policy with an ACB equal to the transfer price at the time of acquisition, i.e. there will be an increase in the policy ACB

There are several exceptions to the general rule. Automatic rollovers on the transfer of an interest in a life insurance policy to a child, spouse or former spouse are available in specific situations. Where the rollover applies, the proceeds of disposition and the acquisition price will equal the ACB.

A more detailed Financial *Advisor* bulletin is available on this topic. See Tax Implications of a Life Insurance Policy Transfer.

Employee/shareholder benefits

Where ownership of a policy is transferred from a corporation to an employee or shareholder, not only will the corporation have to include any applicable policy gain from the deemed disposition of the policy, but there may also be a taxable benefit inclusion in the income of the transferee.

The amount of the benefit inclusion will be the fair market value of the policy at the time of the transfer. This will generally equal the cash surrender value or the accumulating fund of the policy but in cases where the life insured is in poor health, may be a larger actuarially calculated amount, which could be as near to the death benefit.

Similarly, if a business is paying premiums on a policy, where the employee/shareholder or their family are the owner or beneficiary, there will be a taxable benefit equal to the premium included in the income of the employee/shareholder.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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