The New GAAR and Its Impact on Insurance Planning: Reassessing the Viability of Financing Premiums

In the realm of high-net-worth insurance planning, Immediate Financing Arrangements (IFAs) have emerged as a popular strategy. These arrangements allow policyholders to purchase life insurance while simultaneously obtaining a loan to cover the premium payments, with interest payable on the outstanding loan until death. The key attraction of IFAs is the ability to deduct the interest on the loan from income, effectively reducing the interest payment by up to 53% (more if a partial premium is also being deducted). This significant reduction can lower the overall interest cost of the strategy, whether the interest is collateralized or paid out of pocket, making it appear highly attractive. However, recent amendments to the General Anti-Avoidance Rule (GAAR) have introduced considerable challenges to the viability of IFAs, particularly regarding the deductibility of interest. This article explores the intricacies of IFAs, the critical role that interest deductibility plays in their effectiveness, and how the new GAAR amendments are poised to disrupt this strategy. This article represents my personal opinion and interpretation of the recent changes to the GAAR and their potential impact on insurance planning strategies, anyone contemplating an IFA should consult with their tax advisors first.

Understanding IFAs and the Role of Interest Deductibility

An Immediate Financing Arrangement is structured to provide life insurance coverage while minimizing the policyholder's out-of-pocket expenses. The arrangement works as follows: the policyholder takes out a significant life insurance policy, and instead of paying the premium out of pocket, they secure a loan from a financial institution to cover the premium payments. The loan is secured against the cash value of the policy, and possibly additional collateral, and the policyholder is required to make annual interest payments on the loan. Upon the policyholder's death, the policy's death benefit is used to repay the outstanding loan, with any remaining amount going to the estate or beneficiaries.

The financial appeal of an IFA is deeply tied to the tax deductibility of the interest payments on the loan. In Canada, interest on borrowed money used to earn income from a business or property is generally tax-deductible under paragraph 20(1)(c) of the Income Tax Act. However, the Act explicitly excludes interest on borrowed money used to acquire a life insurance policy from this deduction. Despite this, IFAs have historically leveraged a workaround where the policyholder first pays the premium out of pocket and later replenishes their capital by taking out a loan for business purposes. This maneuver creates the appearance that the loan is unrelated to the insurance policy, thus allowing the policyholder to claim the interest deduction.

The effectiveness of IFAs hinges on the ability to deduct interest payments from income. Without this tax deductibility, the strategy would likely be too costly and unattractive to most policyholders, as the cost of maintaining the loan would outweigh the benefits of the insurance coverage. It is crucial to emphasize that the interest deduction must be claimed every year until death, regardless of whether the premium payments have ceased. For the IFA to function as intended, the loan must be maintained, and interest must be paid annually until the policyholder's death. This long-term requirement provides the CRA with ample opportunity to challenge the validity of the interest deductions. The ability to deduct interest payments (and, in some cases, a portion of the premium) is not merely an advantage but a necessity for making IFAs financially viable.

The Legal Framework: Interest Deductibility Under Scrutiny

The Income Tax Act is clear on the matter of interest deductibility related to life insurance policies. Paragraph 20(1)(c) permits the deduction of interest on borrowed money used for earning income from a business or property. However, it explicitly denies this deduction for interest on borrowed money used to purchase a life insurance policy. This legal stance was reinforced in a CRA communication (J. P. Dunn, 2000-005146), where the CRA confirmed in writing that interest on funds borrowed to purchase a life insurance policy is not deductible:

> "*We are writing in response to your correspondence in which you had requested the views of Canada Customs and Revenue Agency with respect to the deductibility of interest on funds borrowed which are used to purchase a universal life insurance policy.*
>
> *The deductibility of interest for income tax purposes is governed by paragraph 20(1)(c) of the Income Tax Act which allows a deduction for interest on borrowed money used for the purpose of earning income from a business or property. Specifically excluded from eligibility for deduction, however, is interest on borrowed money used to acquire a life insurance policy. Accordingly, if money is borrowed to purchase a life insurance policy, the interest paid or payable on those borrowed funds is not deductible for income tax purposes."*

Given this clear legal framework, the tax deductibility of interest in an IFA is not permissible when the loan is directly used to pay the insurance premiums. However, as described above, many policyholders have sought to circumvent this rule by structuring their transactions in a way that separates the loan from the policy by first paying the premium out of pocket and then taking out a loan purportedly for business activities, thereby replenishing the capital that was used to pay the premium, something we will call the “replenishment strategy”. This indirect connection between the loan and the insurance policy has, until now, allowed many to claim the interest deduction under the guise of a business expense.

This approach, while technically distinct from directly borrowing to pay the premium, fundamentally undermines the intent of the tax law. The reality is that without the insurance policy, the need for the loan would not exist in many cases. Therefore, the loan and the policy are intrinsically linked, making the interest deduction questionable. This type of arrangement has been tolerated to some extent in the past, but the new GAAR amendments are likely to bring this to an end.

The New GAAR: Tightening the Noose on Tax Avoidance

The recent amendments to the General Anti-Avoidance Rule (GAAR) represent a significant tightening of Canada’s tax avoidance rules, particularly concerning strategies like IFAs. The new provisions introduce several changes that make it more difficult for taxpayers to justify the deductibility of interest in such arrangements.

1. **Economic Substance Rule**:
    - **Provision**: The GAAR has been updated with a new rule that considers a transaction that significantly lacks economic substance abusive.
    - **Application**: In the context of an IFA, the CRA can argue that the replenishment loan lacks genuine economic substance because its primary purpose is to enable a tax deduction rather than to serve a legitimate business need. Since the loan is effectively replacing the funds used to pay the insurance premium, it lacks the necessary economic substance to justify an interest deduction.

2. **"One of the Main Purposes" Test**:
    - **Provision**: The threshold for an avoidance transaction has been lowered from a "primary purpose" to "one of the main purposes" of the transaction being to obtain a tax benefit.
    - **Application**: This provision makes it easier for the CRA to classify the replenishment loan in an IFA as an avoidance transaction. Even if the loan has some business purpose, if one of the main purposes is to obtain a tax benefit by deducting interest, the GAAR can apply to deny the deduction.

3. **Penalty and Extended Reassessment Period**:
    - **Provision**: The GAAR now includes a 25% penalty on the tax benefit amount and extends the reassessment period by three years for transactions subject to GAAR.

  - **Application**: This increases the financial risk for policyholders using IFAs. The extended reassessment period gives the CRA more time to scrutinize these arrangements, while the penalty acts as a deterrent.

4. **Mandatory Reporting of Transactions**:
   - **Provision**: Transactions that could be subject to GAAR must be disclosed to the CRA.
   - **Application:** The possibility that IFAs could be required to be disclosed as reportable transactions makes it easier for the CRA to identify and challenge these strategies. This increased transparency reduces the likelihood that such arrangements will go unnoticed.

Conclusion

The new GAAR amendments pose a substantial challenge to the viability of Immediate Financing Arrangements. By tightening the rules around economic substance, lowering the threshold for avoidance transactions, and increasing penalties and reporting requirements, the CRA has made it much more difficult to justify the tax deductibility of interest in IFAs. The days of relying on replenishment loans to circumvent the prohibition on interest deductibility for life insurance policies may be over. Insurance professionals and their clients must reassess their use of IFAs in light of these changes. The risks have increased significantly, and the potential for the CRA to deny interest deductions and impose penalties is now higher than ever. Moving forward, it is crucial to consider alternative strategies that do not rely on aggressive tax planning techniques and are more likely to withstand scrutiny under the new GAAR framework. Proactive adaptation to these changes will ensure optimal financial outcomes for clients. If you are still considering an IFA, make sure to insist on an illustration that shows the costs of the strategy where the tax credits are denied.

As outlined in my previous article, a decreasing policy Adjusted Cost Base (ACB) can make exiting a mature IFA strategy costly, as funds can no longer be withdrawn fully tax-free. Additionally, from an estate planning perspective, there is a significant risk that the policy may not perform as expected over the policyholder's lifespan. This could leave the estate exposed to taxes upon the policyholder's death, potentially with insufficient or no life insurance coverage.

Imagine being offered a 'zero-cost' parachute for a helicopter ride with your family. The catch is that although it's 'free,' it may or may not open when needed. Would you take it? Probably not.