Impact of the 2013 Federal Budget on Life Insurance Planning for Individuals and Private Companies

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Introduction

Life insurance is an important tool in tax, estate and business succession planning. For individuals, life insurance death benefits can provide funding for traditional needs for capital at death such as: supporting dependents; preserving the estate by paying down debts, tax liabilities and other estate costs; ensuring an equitable distribution of estates as between beneficiaries; leaving a legacy to charity, to name a few.

In the private company context, life insurance may provide funding to continue business operations on the loss of a key person; pay down business debt; carry out buy-sell obligations, fund tax liabilities arising from a deemed disposition of private company shares at death and facilitate post-mortem tax planning in the family business context. In these contexts, the use of life insurance is facilitated by the existence of the capital dividend account ("CDA") and more particularly, the credit derived from life insurance proceeds received by a private corporation[1] .

The main advantageous tax attributes of "exempt" life insurance[2] - tax-free death benefits and tax-sheltered cash value accumulation - remain with some proposed modifications[3] . These modifications are meant to modernize the regime of taxation for exempt life insurance and are proposed to take effect in 2016.

Commonly, life insurance, with or without cash values, is used as collateral security to cover business debts. This is referred to as "collateral insurance" and provided the requirements of the Act are met all or a portion of the premium in respect of the policy may be deductible.[4] Life insurance policy cash values may provide a source of collateral security for loans. This is referred to as "leveraged life insurance". Often, cash values accumulate over time and, for example, in retirement the policy's cash values are leveraged to supplement personal income in retirement, fund dividends or corporate redemption of shares at retirement or provide funding for a living buy-out of another shareholder in a corporation. Life insurance may also be purchased for required capital at death and funded to the maximum extent permissible under the exempt test rules[5] such that there are significant immediate cash values that are used as a source of collateral security for a borrowing.

Two significant but narrowly focused measures were introduced in the 2013 Federal Budget[6] to "improve the integrity and fairness of the tax system" by "acting to eliminate multiple and unintended tax benefits relating to certain leveraged life insurance arrangements" - **10/8** plans[7]

(ii) the maximum amount of an investment account in respect of the policy is determined by reference to the amount of the borrowing or policy loan, as the case may be, described in paragraph (a)"[26] .

The definition encompasses **10/8** plans structured as collateral loans[27] or as policy loans. The key element is that either the rate credited on the special investment account is tied to the rate of interest on the borrowing or the maximum amount of the special investment account is determined by reference to the amount of the loan.

Policyholders of **10/8** policies would have to repay the loan with external funds, refinance or surrender the policy's cash values to repay the loan to no longer meet the definition of a **10/8** policy. A relieving provision[28] is contained in the Final Draft Legislation that allows a policyholder of a **10/8** policy to claim an offsetting deduction against any income inclusion resulting from a partial or complete surrender of the policy after March 20, 2013 and before April 2014. Claiming this deduction would amount to **10/8** policyholder self-identification to the CRA.

Related to this, it is unclear whether these measures will halt CRA audit activity for taxation years before 2014. The Budget made the following statement: "The Government is challenging **10/8** arrangements under existing income tax provisions. Since these challenges are both time-consuming and costly, the Government is also acting now to introduce legislative measures to prevent **10/8** arrangements from being used in the future."[29] In verbal remarks at a recent CRA Roundtable[30] , it was indicated that the CRA would continue to apply the current law while the Budget proposals are pending and will review its approach to auditing **10/8** arrangements once the Budget proposals receive legislative approval. The main areas of concern expressed in prior CRA statements relating to **10/8** plans involved reasonableness of loan interest and the potential application of the general anti-avoidance rule ("GAAR").

A final word of caution from the Budget is worth noting. The Budget materials stated as follows: "The Government will monitor developments in this area and, if structures or transactions emerge that undermine the effectiveness of the measure, evaluate whether further action is warranted, with possible retroactive application."[31] This statement is indeed unsettling and hard to ignore. Will taxpayers seek rulings from the CRA or comfort letters from the Department of Finance when undertaking replacement strategies?

At least one replacement strategy has emerged since the release of the Draft Legislation for existing **10/8** policyholders. It provides a policy loan or collateral loan from the insurer at a rate that is at a guaranteed spread within a range of 1.5-2% above the rate of a designated investment account. However, it does not require that there be a borrowing so the maximum amount in the designated account is not limited by the amount of the loan. The rate credited to the designated account is guaranteed for the first 4 years and will vary thereafter based on the performance of the designated account. This does not fall within the definition of "**10/8** policy" because the link is from the investment account rate to the loan rate and not the other way around. The main question is, will this be viewed as something that the Department of Finance's warning would be