

Armstrong

— Financial Services —

US Policy Memo

An "exempt policy" under Canadian tax law refers to a life insurance policy meeting the criteria set out in section 306 of the Income Tax Act ("the Act") Regulations. Notably, it's important to recognize that the issuer of the policy does not have to be Canadian. The policy's exempt status is individually determined through actuarial certification, ensuring such policies are not subject to annual taxes on their internal earnings and are exempt from being considered taxable income upon the receipt of death benefits, in line with the Income Tax Act.

To validate the policy in question's exempt status in Canada and to accurately calculate the Capital Dividend Account (CDA), we will provide the following:

1. **Actuarial validation** by a certified Canadian actuary, confirming the policy's status as an Exempt Policy according to Act subsections 12.2(11) and Regulation 306 of the Income Tax Regulations for all years.
2. **The Net Cost of Insurance** (NCPI) ledger for calculating the annual Adjusted Cost Basis (ACB) in Canadian dollars, as stipulated by subsection 148(9) of the Act.

The policy, issued in the U.S., will have a Canadian Holdco as both the owner and the beneficiary using its Canadian registered address. Additionally, it can be noted that under section 26 U.S. Code § 2105(a), life insurance proceeds for a nonresident who is not a U.S. citizen are not considered U.S. property.

Sincerely,
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Memo: Tax Status of Foreign Life Insurance Policies in Canada

An "exempt policy" under Canadian tax law refers to a life insurance policy meeting the criteria set out in section 306 of the Income Tax Regulations. Exempt policies are not subject to annual taxes on their internal earnings and are exempt from being considered taxable income upon the receipt of death benefits.

The preamble to Income Tax Regulation 306(1) indicates that a life insurance policy that is exempt from accrual taxation must, first and foremost, be a life insurance policy. This Regulation does not reference a "life insurance policy in Canada" as defined in subsection 138(12) of the Income Tax Act, with the result that a life insurance policy issued by a non-resident insurer on the life of a person resident in Canada can be an exempt policy under the Act. Notably, it is important to emphasize that the issuer of the policy does not have to be Canadian.

The following question was presented to Steven Szilagyi, Tax Policy Advisor for the Federal Department of Finance Canada at the 2019 CLHIA (Canadian Life and Health Insurance Association) Round Table:

Will the CRA provide guidance as to how to apply the exempt test to policies that are not "life insurance policies in Canada"?

CRA Response: A life insurance policy is essentially a contract between the policyholder and the life insurance company that issues the policy. While there may be types of policies that are issued in the same form to many policyholders, each policy issued by an insurer is conceivably different from every other policy issued by the insurer. An "exempt policy" for income tax purposes, is a life insurance policy that satisfies certain criteria, set out in section 306 of the Income Tax Regulations ("Regulations"). In general terms, a taxpayer who holds an interest in a life insurance policy that is an exempt policy is not subject to annual accrual taxation under section 12.2 of the Income Tax Act ("the Act") with respect to the income earned within the policy, and will not have an income inclusion under subsection 148(1) and paragraph 56(1)(j) of the Act, with respect to the proceeds received as a consequence of the death of the life insured under the policy.

We acknowledge that the rules for determining whether any particular life insurance policy is an exempt policy under section 306 of the Regulations are themselves complex. The rules in section 306 of the Regulations apply on a policy-by-policy basis and require actuarial calculations and information that only the issuing insurer will possess. The tests in section 306 of the Regulations may be applied at any time but the tests are generally performed by the insurer that issued the policy on each policy anniversary date.

A life insurance policy issued by a non-resident insurer is not specifically precluded from qualifying as an "exempt policy" and thus, such a policy could qualify provided the criteria in section 306 of the Regulations are satisfied. Given that the information to determine the exempt status of a particular life insurance policy is only available in the accounts of the insurer, the onus is on the policyholder to establish that the policy qualifies as an exempt policy. This would include supporting evidence that the life insurance policy satisfies the exempt policy tests in section 306 of the Regulations. The CRA's mandate is to administer the Act and does not include resolving issues between policyholders and their insurer about the terms and conditions of a particular life insurance policy.

As can be seen from this response, a policy's exempt status is a question of fact, based on whether it meets the requirements of the Income Tax Act and Regulations. Evidence to support the exempt status of a policy is to be provided by the policyholder. Given the complexity of this calculation, I, as a Fellow of the Canadian Institute of Actuaries (FCIA) specializing in this field and qualified to perform these tests, am able to make that determination and generate the necessary documentation to validate the test results.

Respectfully Submitted,



Ryan Wall FCIA