

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

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2013 OC 13B: p.1/2/3 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

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 corporation¹.

The main advantageous tax attributes of "exempt" life insurance² - tax-free death benefits and tax-sheltered cash value accumulation - remain with some proposed modifications³. 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 rules⁵ 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 Budget⁶ 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 plans⁷

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and leveraged insured annuities ("LIAs")⁸. What distinguished 10/8 plans from other immediate leveraged life insurance was that the life insurance product and loan from the insurer was structured to maximize tax benefits of immediate leverage of cash values bringing about after-tax positive cash flow. What distinguished LIAs was a combination of products (life insurance, annuity and loan) that when put together gave rise to tax benefits resulting in a positive after-tax cash flow. Draft legislation was released by the Department of Finance which would implement these targeted measures⁹. In the period between the Budget and the Draft Legislation, submissions were made in respect of the proposed measures by interested industry groups.¹⁰ These submissions did not end up significantly influencing the direction or content of the Draft Legislation¹¹ but had some impact on the final proposals tabled on October 18, 2013.¹²

This paper will discuss these arrangements, the impact of the Budget measures on them and, perhaps more importantly, what life insurance strategies that may be somewhat similar to these targeted arrangements have not been impacted by these proposed measures.

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10/8 Plans before the Budget

Generally, 10/8 arrangements involved the purchase of an exempt life insurance policy under which the policyholder makes deposits, often to the maximum permissible under the exempt test rules, in excess of the mortality costs and other charges to keep the policy in force. The excess deposits were put into a special investment account earning a rate of interest (say 8%) linked to and with a guaranteed spread based on the loan rate (say 10%).

The policy containing the special investment account was used to secure a loan which may have taken the form of a policy loan¹³ or a collateral loan¹⁴ from the insurer issuing the policy. The loan amount, in the case of policy loans would be an amount close to 100% of the amount in the special investment account. In respect of collateral loans, 100% of the amount in the special investment account was "leverage-able." The life insurance policy contract would limit the amount permissible in the special investment account to a maximum of that which had been borrowed under the loan. Because a policy loan is a disposition of a life insurance policy, the total borrowed amount would often correspond to the amount of the adjusted cost basis ("ACB") of the policy,¹⁵ but only to the point where the ACB was entirely offset and no further. No such limitation was required with 10/8 plans structured with a collateral loan because a collateral assignment of a life insurance policy does not give rise to a disposition of a life insurance policy.

The borrowed funds would be used to gain or produce income from a business or property. An interest deduction¹⁶ would be claimed in respect of the interest paid or payable in the taxation year. If the requirements were met, a collateral insurance deduction¹⁷ may also have been claimed. The payment of interest each year was handled differently between 10/8 plans structured with policy loans versus those structured with collateral loans.¹⁸

Upon the death of the life insured, the loan would be repaid from the life insurance policy death benefit which would be comprised of the insurance protection amount (i.e. that for which the

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mortality costs were charged) and the amount in the special investment account of the policy. Where the beneficiary of the policy is a private corporation, a CDA credit would be permitted for the full amount of the death benefit less the adjusted cost basis ("ACB") of the policy where the 10/8 plan was structured using a collateral loan.¹⁹ Because a policy loan reduces the death benefit proceeds received by a private corporation as beneficiary, there would be no CDA credit for the policy loan amount in circumstances where a 10/8 plan was structured using a policy loan.

To summarize, 10/8 plans allowed for the purchase of permanent life insurance protection that would fulfill the need or desire for a death benefit (net of the loan repayment). At the same time, 10/8 plans reduced the cash outflow needed to purchase this benefit or create a positive after-tax cash flow through a combination of tax-sheltered growth within the policy, loan advances and tax savings from deductions. Due to the fixed interest rate spread between the loan and the special investment account, this was done, essentially at no commercial risk. This combination of benefits was of concern to the Canada Revenue Agency ("CRA")²⁰ and as we have seen through the Budget measures, the Department of Finance as well.

2013 OC 138; p.5-6 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

The Budget Measures, Draft Legislation and Final Draft Legislation for 10/8 Plans

The stated goal of the Budget measures was to "ensure that unintended tax benefits are not available in relation to 10/8 arrangements."²¹ No grandfathering for existing arrangements was provided other than to postpone the application of the new rules until 2014. For a "10/8 policy"²² after 2013 any interest deduction²³, collateral insurance deduction²⁴ and increase in the CDA by the amount of the death benefit related to the borrowing²⁵ is denied.

The Final Draft Legislation provides that "a '10/8 policy' means a life insurance policy (other than an annuity) where

- (a) an amount is or may become
 - (i) payable, under the terms of a borrowing, to a person or partnership that has been assigned an interest in the policy or in an investment account in respect of the policy, or
 - (ii) payable (within the meaning assigned by the definition 'amount payable' in subsection 138(12) " " ") under a policy loan (as defined in subsection 148(9) " " ") made in accordance with the terms and conditions of the policy, and
- (b) either
 - (i) the return credited to an investment account in respect of the policy
 - (A) is determined by reference to the rate of interest on the borrowing or policy loan, as the case may be, described in paragraph (a), and
 - (B) would not be credited to the account if the borrowing or policy loan, as the case may be, were not in existence, or

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- (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 loans²⁷ 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 provision²⁸ 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 Roundtable³⁰, 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

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applied to?

2013 OC 13B, p.71 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

What life insurance strategies are not impacted by the 10/8 Plan Measures?

Leveraged life insurance - using a life insurance policy as collateral security for a loan from a lender (i.e. where there is no link between the rate credited to the policy and the loan interest rate) was not impacted by the 10/8 policy measures. The cash values within an exempt policy accumulate on a tax-deferred basis. When funds are required, the policyholder applies for a loan from a financial institution. The loan is secured by a collateral assignment of the policy.

There is no linkage between the loan interest rate and the investment return within the policy. This exposes the borrower to the risk that the cash values could grow or decrease at a different rate than the interest rate on the loan. Financial institutions that participate in leveraged life insurance strategies require that the loan balance not exceed a specified percentage of the policy's cash surrender value (generally 50-90% depending upon the underlying investments giving rise to the cash value). Extra collateral would normally be required to be provided if the margin is exceeded.

If the borrowed money is used to gain or produce income from a business or property, interest deductions may be claimed (provided the other conditions of subsection 20(1)(c) " " of the Act are met). If the policy is required by a restricted financial institution as security for the borrowing, a collateral insurance deduction may be claimed (provided the other conditions of subsection 20(1)(e.2) " " of the Act are met).

If the loan does not remain in good standing (for example, the margin is exceeded) this would be treated as any other margin call - the borrower would need to provide additional security, repay or partially repay the loan or the policy could be required to be surrendered for its cash surrender value. In the latter case, as a disposition of the policy, the policyholder would face the potential for tax payable on any gain arising from the disposition.

If the loan remains in good standing, at the death of the life insured the proceeds from the life insurance policy would repay the outstanding loan including any interest which may have been added to the loan amount³². Where the beneficiary of the policy is a private corporation, a CDA credit would be permitted for the full amount of the death benefit less the ACB of the policy.

2013 OC 13B, p.78-91 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

Leveraged Insured Annuities ("LIAs") Before the 2013 Budget

An insured annuity is the combination of a life annuity and a life insurance policy. A capital sum is invested in an annuity which provides a regular payment stream to the investor for the life of the annuitant. A life insurance policy is purchased to ensure the return of the capital expended on the annuity at the death of the life insured.

A portion of each payment to the investor from the annuity is taxable, the remainder, non-taxable. Under the Act non-registered annuities are taxed in two ways: accrual taxation³³ or

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taxation as payments are received.³⁴ The method applied depends on the terms of the particular annuity. Annuities that qualify as "prescribed annuity contracts"³⁵ currently have favourable tax treatment due to each payment having an equal portion considered to be a non-taxable return of capital (with the remainder of each payment constituting income), so as to provide an element of tax deferral as well as a prescribed basis for calculating the capital portion.³⁶ All other annuities are taxed on an accrual basis. Generally, only annuities issued to individuals and certain types of trusts qualify as prescribed annuity contracts.

The life insurance policy in an insured annuity arrangement need not have cash values since its purpose is merely to return the capital sum invested in the annuity. The rationale in purchasing an annuity and life insurance policy in this fashion is to increase cash flow while living and to replace the capital at death. The insurance professional would shop the market to purchase the lowest cost life insurance and annuity policies. This would often mean having different issuing insurers for the annuity and life insurance contracts at any given time based on any given insurer's pricing. Relevant as well would be the health assessment of an insurer of the life insured. If an insurer applies a substandard rating, this would result in a higher cost for the life insurance policy, but the annuity may also be rated which would increase the amount of the annuity payments from the annuity.

A LIA combines and insured annuity with leverage. Generally, a corporation (usually an investment holding company) would purchase the life insurance and the annuity (non-prescribed) on the life of its shareholder using cash or near cash assets. It would then replenish the cash used to make the purchase of the annuity with borrowed funds. The borrowed money would be used to gain or produce income from a business or property.

The lender, a restricted financial institution, would require a collateral assignment of the life insurance policy and the annuity contract for the borrowing. Other assets may also be required as security by the lender.³⁷ Interest would be paid on the borrowing each year. Provided that the interest on the borrowing is deductible³⁸ and the other requirements for deductibility are met, a collateral insurance deduction may also be claimed.³⁹

2013 OC 13B, p.9-10 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

On the death of the shareholder the annuity payments would cease and the life insurance policy's death benefit would be paid to the lender under the terms of the collateral assignment.⁴⁰ Where the beneficiary of the policy is a private corporation, a CDA credit would be permitted for the full amount of the death benefit less the ACB of the policy.

The deceased shareholder is deemed to have disposed of the company's shares at fair market value immediately before death.⁴¹ For purposes of determining this fair market value, the value of the shares would be reduced by the outstanding loan and increased by the assets purchased with the borrowed funds plus any growth thereon. There would be no value attributed to the life insurance policy since the policy would have no cash surrender value immediately preceding death.⁴² Arguably there would be little or no value attributable to the annuity contract.⁴³

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In summary, this structure preserves the capital in the corporation by using a loan to replace the capital invested in the annuity contract. The desired effect of the structure is to generate improved after-tax cash flow to the corporation during life, create CDA at death which can be utilized to distribute tax-free capital dividends (using assets other than the life insurance proceeds used to repay the loan), and potentially reduce the capital gains tax on the personally held shares of the corporation at death. The CRA had expressed some discomfort with these results in particular circumstances and more generally.⁴⁴ Prior to the Budget, there was some indication that LIAs were under scrutiny by the Department of Finance as well.⁴⁵

2013 OC 138; p.10/11/12 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

The Budget Measures, Draft Legislation and Final Draft Legislation for LIAs

The Budget measure proposed to eliminate the "unintended tax benefits by introducing rules for 'LIA policies'."⁴⁶ Unlike 10/8 policies, grandfathering of existing arrangements that would otherwise be LIA policies is available.⁴⁷

"LIA policy" means a life insurance policy (other than an annuity) where

- (a) a particular person or partnership becomes obligated after March 20, 2013 to repay an amount to another person or partnership (in this definition referred to as the "lender") at a time determined by reference to the death of a particular individual whose life is insured under the policy, and
- (b) the lender is assigned an interest in
 - (i) the policy, and
 - (ii) an annuity contract the terms of which provide that payments are to continue for a period that ends no earlier than the death of the particular individual.⁴⁸

As a consequence of meeting the definition of a LIA policy the life insurance policy will be considered a non-exempt policy.⁴⁹ Given that it is not known by the issuing insurer if a policy is being used in a manner that would attract this definition, this is not as easy as it sounds. However, some cognizance of this fact was demonstrated since the Regulations also provide that the insurer is not required to provide tax reporting to the policyholder on the basis that the policy is non-exempt unless it has been notified or reasonably ought to have known that policy is a LIA policy.⁵⁰

Another consequence of meeting the definition of a LIA policy is that the collateral insurance deduction will not be allowed.⁵¹ It is interesting to note that interest deductibility is not denied. The rationale for this is derived from the comparator that the Department of Finance used in determining the base case scenario - which was a corporation which borrows to buy a guaranteed investment certificate.⁵²

Also, the death benefit received in respect of the policy will not increase a private corporation's capital dividend account.⁵³ It is important to note that the full amount of death benefit proceeds are excluded for a LIA policy whether or not the amount borrowed corresponds to this amount.

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For example, if the policy is for \$2 million and the loan is for \$1 million, the entire amount of the death benefit (\$2 million) would not be permitted to be credited to the CDA.

A final consequence of meeting the definition of a LIA policy is that for purposes of the deemed disposition at death of the shares of a corporation holding a LIA policy, the fair market value of the annuity will be deemed to be equal to the total of the premiums paid under the contract (i.e. the purchase price of the annuity contract).⁵⁴ It is interesting to note that this amendment may provide an additional argument that subsection 70(5.3) " " should apply in determining the question of the value of the annuity in a corporate-owned insured annuity situation.⁵⁵

As with 10/8 policies, the Budget also expressed a warning regarding future planning. The Budget materials stated: "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 retrospective application."⁵⁶ As with 10/8 plans, the Government appears to be serious about ensuring the integrity of the measures enacted. One subtle distinction in treatment between the two strategies is the use of the word "retrospective" in respect of LIAs and "retroactive" in respect of 10/8 policies. In either case, the statement is difficult to ignore. Will taxpayers seek rulings from the CRA or comfort letters from the Department of Finance when undertaking any planning involving the purchase of life insurance, annuities and borrowing?

2013 OC 13B: p.12 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

What life insurance strategies are not impacted by the LIA Measures?

Insured annuities are not impacted by the Budget measures since no borrowing is undertaken. Using a life insurance policy as collateral security for a loan that does not involve an annuity also being provided as collateral security also does not meet the definition of a LIA policy.⁵⁷ As well, conversely, using an annuity as collateral security for a loan that does not involve a life insurance policy also being provided as collateral security would similarly not meet the definition of a LIA policy.⁵⁸

What if a corporation holds an annuity, a life insurance policy and borrows money using the life insurance policy as collateral security for the loan? The three separate elements exist in the corporation but the use of the annuity as security is not required by the lender. What will be relevant factors in determining if this would be viewed as something that the Department of Finance's warning would be applied to?

2013 OC 13B: p.12 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

Conclusion

Although the Budget measures are significant, they are targeted at specific leveraged life insurance arrangements. By dealing with strategies which it concluded were providing multiple and unintended tax benefits in this targeted manner, this enables life insurance in many leveraged scenarios to continue to be used. These include the use of leveraged life insurance for supplementing personal income in retirement, payment of dividends or redemption of shares at

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the time of retirement, a living-buy out of another shareholder or as a source of collateral security for business loans or to allow short term cash flow requirements to be met.⁵⁹ The use of life insurance in non-leveraged scenarios is not impacted at all by these targeted measures.

FOOTNOTES

2013 OC 13B Footnote-1 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ¹ Paragraph (d) of the definition of "capital dividend account" in subsection 89(1) of the Income Tax Act, R.S.C. 1985, c.I (5th Supp.) (hereinafter referred to as the "Act") provides a credit for death benefit proceeds less the corporation's adjusted cost basis (defined at subsection 148(9) of the Act) of the policy.

2013 OC 13B Footnote-2 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ² An "exempt" life insurance policy is not subject to annual accrual taxation (per subsection 12.2(1) of the Act. Tax-sheltered accumulation of life insurance policy cash values must remain within limits prescribed by the Income Tax Act Regulations (306-310). Taxation of life insurance policy gains only arise on a "disposition" (also defined at 148(9) of the Act which include transactions such as: absolute assignments (subject to certain rollover provisions - 148(8) " ", (8.1) " ", (8.2) " "); surrenders or partial surrenders of a policy's cash values; policy loans; receipt of policy dividends. Subsection 148(9) " " definition of "disposition" of the Act excludes payments under a policy in consequence of death resulting in tax-free receipt of life insurance policy death benefits.

2013 OC 13B Footnote-3 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ³ Draft Legislative Proposals Relating to the Life Insurance Policy Exempt Test released by the Department of Finance August 23, 2013 (hereinafter referred to as the "Draft Exempt Test Legislation").

2013 OC 13B Footnote-4 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁴ Subsection 20(1)(e.2) " " of the Act generally requires that the assignment of a life insurance policy owned by the borrower be required by a lender, the lender be a "restricted financial institution" and the interest payable on the money borrowed be generally deductible in computing the borrower's income. The amount of the deduction is generally, lesser of the premium paid in the year or the "net cost of pure insurance" as determined in accordance with the Regulations (308) in respect of the interest in the policy that can reasonably be considered to relate to the amount owing from time to time during the year by the taxpayer.

2013 OC 13B Footnote-5 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁵ Supra note 2.

2013 OC 13B Footnote-6 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁶ Jobs, Growth and Long-Term Prosperity, Economic Action Plan tabled in the House of Commons on March 21, 2013 (hereinafter referred to as the "Budget").

2013 OC 13B Footnote-7 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁷ Ibid., Annex 2 - Tax Measures: Supplementary Information and Notice of Ways and Means Motion (hereinafter referred to as the "NWMM") section 40 proposed amendment to subsection 248(1) " " of the Act to define the term "10/8 policy".

2013 OC 13B Footnote-8 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁸ Ibid. section 40 proposed amendment to subsection 248(1) " " of the Act to define the term "LIA policy".

2013 OC 13B Footnote-9 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- ⁹ Draft Legislative Proposals Relating to the Income Tax Act, the Excise Tax Act and the Income Tax Regulations released by the Department of Finance on September 13, 2013 (hereinafter referred to as the "Draft Legislation"). At the time of writing these measures had not received First Reading due to the prorogation of Parliament until October 16, 2013.

2013 OC 13B Footnote-10 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

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- 10 See www.calu.com June 3, 2013 CALU (Conference for Advanced Underwriting) Report, "Budget 2013 - CALU Submissions to Finance re 10-8s and LIAs". The Canadian Life and Health Insurance Association ("CLHIA") also made a submission which is not publicly available.
2013 OC 13B Footnote-11 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 11 On September 19, 2013 CALU made a follow-up submission which it posted on its website on October 8, 2013. The main areas emphasized in the follow-up submission was to allow more time for the transition or wind-up period on 10/8 plans; ensuring that any commentary from the explanatory notes that clarifies the measures is reflected in wording in the draft legislation; and, concern with the difficulty to comply with doing accrual reporting in respect of a LIA policy. It has stated that "while Finance is not in a position to confirm whether additional changes will be made to the final legislation, they have listened closely to the various positions that CALU has put forward."
2013 OC 13B Footnote-12 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 12 Notice of Ways and Means Motion to amend the Income Tax Act, the Excise Tax Act and Other Legislation and Explanatory Notes tabled on October 18, 2013 (hereinafter referred to as the "Final Draft Legislation"). The main areas that were impacted were as follows: 1) Language clarifying that in order for tax benefits to be denied, the policy must be a 10/8 policy at the relevant time - so that a policy which was a 10/8 policy that has taken corrective action, for example, the loan has been repaid, will not forever have tax benefits denied. 2) The period during which a policyholder can claim an offsetting deduction in respect of the surrender of the special investment account was changed to "after March 20, 2013 and before April 2014" (from January 2014). However, the timeframe for the denial of tax benefits was not extended to the same timeframe and remains January 2014.
2013 OC 13B Footnote-13 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 13 Under subsection 148(9) " " a "policy loan" means an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of the life insurance policy. A policy loan is included by paragraph (b) of the subsection 148(9) definition of "disposition".
2013 OC 13B Footnote-14 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 14 A collateral loan - "an assignment of all or part of an interest in the policy for the purpose of securing a debt or loan other than a policy loan" is excluded from the definition of "disposition" in subsection 148(9) by paragraph (f) of the definition.
2013 OC 13B Footnote-15 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 15 "Adjusted cost basis" is defined in subsection 148(9) of the Act. A policy loan reduces the ACB such that, until the ACB is reduced to zero, no policy gain would be reported in respect of the disposition. Subsection 148(1) " " of the Act provides that a policy gain is reported to the extent that the proceeds of the disposition exceed the ACB of the policy. For policy loans, the ACB need not be prorated as is the case in respect of partial surrenders (referred to as withdrawals or partial withdrawals) pursuant to subsection 148(4) " " of the Act.
2013 OC 13B Footnote-16 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 16 Subsection 20(1)(c) " " of the Act.
2013 OC 13B Footnote-17 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 17 Supra note 4. The provision requires that the borrower and the policyholder be the same person. Often 10/8 plans were not leveraged by the policyholder corporation but by the controlling shareholder of the corporation such that this deduction was not available in any event. Issues associated with that structure of borrowing subsection 15(1) " " benefits mainly) were the subject of CRA commentary in #2006-0174011C6 which referenced Q62 and 24 of the 1986 and 1991 CTF Annual Conferences; #2006-017540117; 2001-0112885 and #2000-0002575.
2013 OC 13B Footnote-18 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 18 Because the capitalization of policy loan interest (i.e. the addition of policy loan interest to the loan balance),

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constitutes an additional policy loan, this may result in a taxable policy gain, so as a result, under 10/8 plans structured with policy loans, the interest was generally actually paid each year and not reborrowed. For 10/8 plans structured with collateral loans, the loan was structured so that 8% of the interest cost was serviced using advances from the credit facility and, therefore the policyholder was only out of pocket 2% in respect of the interest. It should be noted that it is arguable that the advanced interest may be considered to be compound interest and only deductible when actually paid pursuant to 20(1)(d) " " of the Act. However, CRA technical interpretations #2004-007034 and #2005-0116661C6 have indicated that when a taxpayer obtains a loan to pay the interest on an earlier loan, the interest on the second loan will be deductible if the simple interest on the loan was. The commentary suggests that the CRA views such interest as simple interest that is deductible under paragraph 20(1)(c) " " of the Act. It is unclear if this is the CRA's position in respect of interest advances in respect of 10/8 plans. Further clarification of the CRA's position was not provided in technical interpretation #2006-0188621E5.

2013 OC 13B Footnote-19 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 19 Supra note 1. The corporation as beneficiary under the policy constructively receives proceeds paid to a lender pursuant to a collateral assignment of a life insurance policy. See archived *Interpretation Bulletin* IT-430R3 " " - Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death at paragraph 6.

2013 OC 13B Footnote-20 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 20 In #2004-0065531E5 the CRA questioned the reasonableness of the loan interest rate. Starting in November of 2008 the CRA also began to indicate an intention to audit 10/8 plans advising that starting in 2009, audits of policyholder tax activities relating to 10/8 plans would commence and that life insurers' tax reporting and documentation would be examined, which it expected would result in policyholder audits and the potential application of the general anti-avoidance rule ("GAAR") in subsection 245(2) " " of the Act. The CRA also made public statements at Canadian Tax Foundation Annual Conference and other conferences raising as issues the reasonability of loan interest and the possible application of GAAR in respect of 10/8 plans. The CRA was prevented from obtaining client lists from insurance carriers offering 10/8 plans pursuant to ex parte orders made under subsection 231.2(3) " " of the Act in *Canada v. RBC Life Insurance Company*, 2013 FCA 50. This subsection has now been amended by Bill C-60, Economic Action Plan 2013 Act, No. 1 which received Royal Assent on June 26, 2013 to require that notice to the third party be given when the CRA seeks a court order from a judge of the Federal Court.

2013 OC 13B Footnote-21 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 21 Supra note 6 at pg. 361.

2013 OC 13B Footnote-22 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 22 Supra note 12 subsection 89(5) of the Final Draft Legislation, proposed definition of "10/8 policy" in subsection 248(1) of the Act.

2013 OC 13B Footnote-23 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 23 Ibid. subsection 11(4) of the Final Draft Legislation proposed subsection 20(2.01) " " of the Act.

2013 OC 13B Footnote-24 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 24 Ibid. subsection 11(2) of the Final Draft Legislation proposed subparagraphs 20(1)(e.2)(ii) " " and (iii) " " of the Act.

2013 OC 13B Footnote-25 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 25 Ibid. subsection 41(1) of the Final Draft Legislation proposed subparagraph 89(1)(d)(iv) " " of the definition of "capital dividend account" of the Act.

2013 OC 13B Footnote-26 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 26 Supra note 22.

2013 OC 13B Footnote-27 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

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- 27 It is interesting to note that the definition encompasses collateral loans advanced by "a person or partnership" and need not be advanced by the insurer. However, in practice, only the insurer would be able to carry out both (a) and (b) of the definition. In addition, a third party lender would have different capital requirements in respect of a collateral loan using a life insurance policy as security than an insurer making such a loan using a policy it issues as collateral security such that a third party lender could not offer such lending on the same terms.
2013 OC 13B Footnote-28 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 28 Supra note 12 subsection 65(1) of the Final Draft Legislation adding subsection 148(5) " " to the Act which provides a deduction for the least of the amount of the policy gain in respect of the surrender relating to the investment account referenced in paragraph (b) of the definition of "10/8 policy", the amount that reduced the borrowing and the amount the policyholder is entitled to receive as a result of the disposition of the special investment account. The first of these would generally be the least amount.
2013 OC 13B Footnote-29 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 29 Supra note 21.
2013 OC 13B Footnote-30 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 30 CLHIA Tax Officers Conference, Finance and CRA Roundtable, dated May 17, 2013.
2013 OC 13B Footnote-31 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 31 Supra note 6 at pg. 362.
2013 OC 13B Footnote-32 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 32 Normally, interest would be added to the loan amount such that the margin is not reached until the life insured's life expectancy. If interest is being deducted, care would need to be taken to avoid characterization as compound interest. Interest would be paid annually out of pocket, but each year a new loan is advanced for the same amount as the interest cost. To ensure the deductibility of interest on the new loans, the loan proceeds from the new loans must be used to produce income. This has the same economic effect as if the interest were capitalized, but for tax purposes the loan balance remains only principal and no compound interest arises.
2013 OC 13B Footnote-33 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 33 Subsection 12.2(1) " " of the Act.
2013 OC 13B Footnote-34 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 34 Paragraphs 56(1)(d) " " and 60(a) " " of the Act.
2013 OC 13B Footnote-35 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 35 The requirements for a prescribed annuity contract are set out in Regulation 304 " " of the Income Tax Regulations and are generally only available to individuals and certain types of trusts.
2013 OC 13B Footnote-36 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 36 Regulation 300(2) " " contains rules for determining the capital portion of payments under a prescribed annuity based on a prescribed mortality table (1971 Individual Annuity Mortality Table). The Draft Exempt Test Legislation, supra note 3, proposes that for annuities issued after 2015, a more recent table (Annuity 2000 Basic Mortality table) be used to calculate the capital portion of prescribed annuity contracts. This newer table which reflects longer life expectancies will result in a higher portion of each payment being taxable under a prescribed annuity contract issued after 2015. However, the Draft Exempt Test Legislation would also allow recognition of substandard ratings, thus allowing for a higher portion of each payment being considered a non-taxable return of capital.
2013 OC 13B Footnote-37 Life Insurance Planning for Individuals and Private Companies (Marino, F.)
- 37 Depending upon the circumstances, the lender may also require additional collateral security such as a general security agreement over the assets of the company, a personal guarantee of the shareholder or that specific additional collateral security be provided (i.e. other assets of the company pledged). This would generally depend on the extent to which the LIA produces a positive cash flow before any tax deductions are applied.

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2013 OC 13B Footnote-38 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 38 It is interesting to note that the CRA has indicated that even if a portion of the interest on the loan is deductible, the entire premium or net cost of pure insurance can be deducted provided the other requirements of paragraph 20(1)(e.2) " " " of the Act are met.. #2005-0116651C6 confirmed that "the condition stated in clause 20(1)(e.2)(i)(B) " " " of the Act is met for the taxation year if part or all of the interest is deductible in the year by virtue of subparagraph 20(1)(c)(iv) " " " of the Act."

2013 OC 13B Footnote-39 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 39 The amount deductible under paragraph 20(1)(e.2) " " " of the Act is the lesser of the premium and the "net cost of pure insurance" under the policy. Of note is that currently, at older ages (generally over age 65), the net cost of pure insurance is not a limiting factor such that the entire premium paid under the policy would generally be deductible after the first few years of the policy being in force. Of interest as well is that the mortality table used to calculate a policy's net cost of pure insurance does not take into account substandard ratings. The Draft Exempt Test Legislation, supra note 3, proposes to update the mortality table used to a more recent table and to recognize substandard ratings for purposes of determining the net cost of pure insurance on policies issued after 2015. Also, see supra note 4 for more discussion of the collateral insurance deduction.

2013 OC 13B Footnote-40 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 40 Generally, the loan agreement in respect of the borrowing would define the life insured/annuitant's death as an event of default which would require the repayment of the loan.

2013 OC 13B Footnote-41 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 41 Subsection 70(5) " " " of the Act.

2013 OC 13B Footnote-42 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 42 Subsection 70(5.3) " " " of the Act.

2013 OC 13B Footnote-43 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 43 The annuity is usually non-commutable meaning it is a permanent contract for the life of the individual and cannot be surrendered for a lump sum cash payment. It may also be non-transferable so that it cannot be transferred to another party, either as a gift or for consideration. Such an annuity has no cash surrender value. Subsection 138(12) " " " of the Act includes annuities in the definition of a life insurance policy such that subsection 70(5.3) " " " when applied would ascribe no value to it. In #9321275 the CRA questioned the application of subsection 70(5.3) to an annuity in these circumstances.

2013 OC 13B Footnote-44 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 44 #2009-344721E5 the CRA stated that GAAR could apply to such an arrangement where the structure involves a subsidiary company ("Subco") borrowing to pay a dividend to a parent company ("Parentco") where Parentco uses the dividend to purchase the annuity. It stated that normally, borrowing to "fill a hole" is an acceptable indirect use of borrowed money, but GAAR could apply to limit the interest deduction to the taxable portion of annuity payments. At that time, CALU was aware of one reassessment on this basis. At the 2011 CALU Associate meeting on October 28, 2011 the CRA stated that it would apply GAAR to Parentco/Subco structures to limit the interest expense to the taxable portion of the annuity contract. The CRA also expressed concern with the tax benefits arising in situations involving these strategies where one corporation purchases the annuity, the life insurance policy and borrows money. At that time, the CRA stated that they had raised this with the Department of Finance.

2013 OC 13B Footnote-45 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 45 At the 2012 CALU Conference, the Minister of Finance made a statement regarding the Federal Government's desire to close down certain tax planning strategies and specifically mentioned LIAs in this context. There was some follow-up with the Department of Finance by CALU regarding this comment with the conclusion that LIAs were "under review".

2013 OC 13B Footnote-46 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

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- 46 Supra note 6 at pg. 359.

2013 OC 13B Footnote-47 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 47 The explanatory notes to the Final Draft Legislation (supra note 12) provide: "The new definition 'LIA policy' describes a leveraged insured annuity arrangement entered into after March 20, 2013. In particular, an LIA policy is one in respect of which funds, borrowed after March 20, 2013 are used in connection with a lifetime annuity and a life insurance policy. An LIA policy does not include a policy in respect of which the amount of borrowings outstanding as of March 21, 2013 does not increase on or after that date...." The Budget materials also made the following statement: "This measure will not apply in respect of leveraged insured annuities for which all borrowings were entered into before Budget Day." Supra note 6 at pg. 360. The final sentence of the explanatory notes from the Final Draft Legislation did not appear in the explanatory notes to the Draft Legislation. This clarification was added as a result of industry groups seeking further information regarding the extent of grandfathering for existing arrangements.

2013 OC 13B Footnote-48 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 48 Supra note 12 subsection 89(5) of the Final Draft Legislation, proposed definition of "LIA policy" in subsection 248(1) " " " of the Act.

2013 OC 13B Footnote-49 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 49 Ibid. subsection 97(1) of the Final Draft Legislation amending Regulation 306(1) " " " to exclude a LIA policy from the meaning of "exempt policy".

2013 OC 13B Footnote-50 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 50 Ibid. subsection 96(1) of the Final Draft Legislation, amending Regulation 201 which imposes a requirement on insurers to make an information return in prescribed form if the life insurance policy is subject to the accrual rules, adding subsection (5.1) that would only require such compliance where the insurer is "notified in writing before the end of the calendar year that the policy is a LIA policy or it is reasonable to conclude that the insurer knew, or ought to have known, before the end of the calendar year, that the policy is a LIA policy."

2013 OC 13B Footnote-51 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 51 Ibid. subsection 11(1) of the Final Draft Legislation amending paragraph 20(1)(e.2) to exclude a LIA policy.

2013 OC 13B Footnote-52 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 52 This base case scenario was expressed at the CLHIA Tax Officers Conference on May 17, 2013, supra note 30.

2013 OC 13B Footnote-53 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 53 Supra note 25.

2013 OC 13B Footnote-54 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 54 Supra note 12 subsection 34(1) of the Final Draft Legislation provides new subsection 70(5.31) " " " of the Act.

2013 OC 13B Footnote-55 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 55 Supra note 43.

2013 OC 13B Footnote-56 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 56 Supra note 6 at pg. 360.

2013 OC 13B Footnote-57 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 57 This is commonly referred to as collateral insurance which may be used to pay down business debts. One of the benefits of collateral insurance is that the collateral insurance deduction under paragraph 20(1)(e.2) " " " and a CDA credit for the amount of the death benefit when a private corporation is beneficiary of the policy would be available.

2013 OC 13B Footnote-58 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

- 58 This is not a common situation but at least is theoretically possible.

2013 OC 13B Footnote-59 Life Insurance Planning for Individuals and Private Companies (Marino, F.)

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- 59 For a discussion of many of these leveraged life insurance applications, see Chapter 4 of "Canadian Taxation of Life Insurance, 6th Edition, Carswell 2012 edited by Florence Marino.

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