PPI Advisory

TAX TALK

THE ADVISOR'S GUIDE TO LIFE INSURANCE TAXATION 2020

Life insurance helps Canadians manage risk, provides security for their families and businesses, and is an important component of estate planning. While the rules related to the taxation of life insurance have changed in recent years, its special tax attributes remain. This guide will assist you in answering the on-the-spot questions clients may have when it comes to insurance taxation.

Information in this guide was last updated July 2020. To the best of our knowledge, the information in this guide is accurate and up-to-date. It is highly recommended that clients seek independent accounting, legal and taxation advice with regard to the use of life insurance in their business and estate planning.

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THE BASICS OF LIFE INSURANCE TAXATION

Life insurance can be owned by an individual, a trust or a corporation, and in all cases the beneficiary receives the benefit tax-free upon the death of the insured. Ownership decisions are based on many factors, only one of which is income tax.

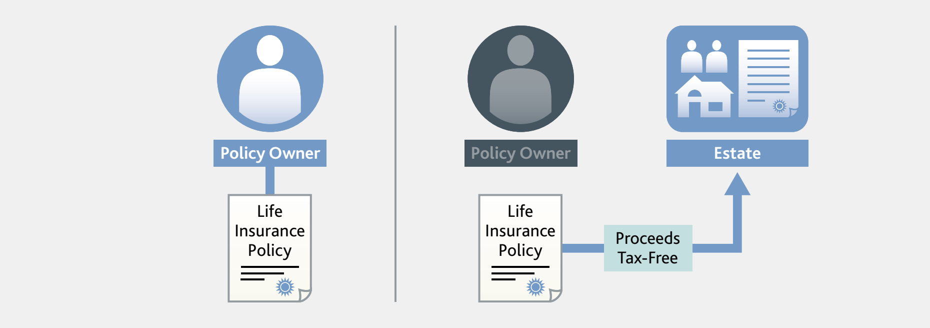
Most, if not all, insurance policies sold today are 'exempt' policies, which means that the funds accumulating in the plan qualify for preferential rules under the Income Tax Act (Act). The Exempt Test rules allow for additional deposits into the policy beyond the basic death benefit premium, within certain limits. The growth on the additional deposits (often referred to as the accumulation fund) receives preferential tax treatment as it is not subject to accrual taxation. The tax-free receipt of proceeds on death applies not only to the death benefit but also to the amount accruing in the accumulation fund of the policy. (*See page 6 for more about the Exempt Test.*)

Notwithstanding the exempt status outlined above, certain policy transfers and withdrawals, as well as policy loans, may be taxable depending on the circumstances. (*See page 9 for more information on when there is a disposition of a life insurance policy.*)

TO LEARN MORE about the concepts in this booklet, please contact your local PPI office to connect one-on-one.

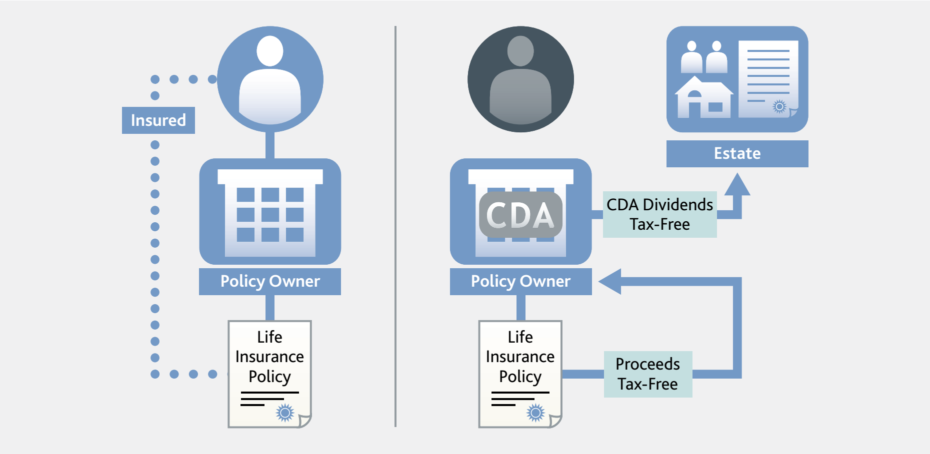
Personally-owned Life Insurance

When insurance is owned by an individual, all of the general taxation considerations outlined on the previous page apply.



Corporate-owned Life Insurance

In general, the same rules apply to insurance owned by a corporation. However, there are also special rules for corporations that allow insurance proceeds to be distributed to shareholders tax-free, through a mechanism called the Capital Dividend Account (CDA – *see page* 5). Dividends paid from the CDA are tax-free to a shareholder, and are an important estate planning tool that can reduce or even eliminate tax on the death of a shareholder.



TERMS AND CALCULATIONS YOU SHOULD KNOW

When it comes to the taxation of life insurance, you need to know about:

Adjusted Cost Basis (ACB)

	Cumulative Premiums
–	**Cumulative Net Cost of Pure Insurance (NCPI)**
–	**Policy Loans**
+	**Policy Loan Repayments**
	ACB*

**Formula is more complex but these are the main components.*

The ACB is used:

- to determine the gain when there has been a disposition of a policy (*see page 9*)
- in calculating the CDA (*see page 5*)

The ACB is calculated by the insurance company through a complex formula. Various policy actions impact the calculation of the ACB, such as:

INCREASES ACB	DECREASES ACB
Premiums paid by or on behalf of the policyholder	Proceeds of disposition including policy loans
Policy gains included in policyholder's income	Net Cost of Pure Insurance
Interest paid on policy loan (unless interest deducted for business or investment purpose)	
Most policy loan repayments	

Net Cost of Pure Insurance (NCPI)

	Net Amount at Risk
x	**Mortality Factor**
	NCPI

The NCPI was first introduced for policies acquired after December 1, 1982. The NCPI increases each year because mortality risks increase with age. The Income Tax Regulations govern the calculation of NCPI and differ according to the date the policy was issued. For policies issued after 2016, the NCPI will generally be lower, which reflects improved mortality experience over recent decades.

IMPLICATIONS OF A LOWER NCPI FOR POST 2016 POLICIES
The ACB remains positive for a longer period of time (since NCPI is deducted from ACB). This is beneficial for policy loans and dispositions but not for the calculation of the CDA (*see page 5 for discussion on CDA*).
For policies issued after 2016, the deduction of the NCPI (*see question: Are insurance premiums deductible? on page* 9) for tax purposes, which is available under certain collateral assignments, will generally be lower than in previous years.

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Capital Dividend Account (CDA)

	Non-taxable portion of Capital Gains*
+	**Capital Dividends received from other companies**
+	**Life Insurance Proceeds****
–	**Capital Dividends paid in prior years**
	CDA

Net of Capital Losses.
**Net of ACB and special adjustments for pre-March 22, 2016 transfers from shareholders.*

Life insurance proceeds (*net of ACB – outlined on page 3*) are added to the CDA of a private corporation, from which dividends can be paid tax-free to shareholders.

For more information on the tax issues to be aware of with life insurance and the CDA, *see page 27.*

Cash Surrender Value (CSV)

Cash surrender value of a life insurance policy is the amount that is available to the owner of the policy if the policy is surrendered. It is calculated by the insurer without regard to any policy loans (*see page 10*). For term insurance policies, the CSV is nil.

Refundable Dividend Tax On Hand (RDTOH)

There are two separate refundable dividend tax on hand accounts: eligible (ERDTOH) and non-eligible (NERDTOH). A Canadian controlled private corporation pays refundable tax on its investment income (other than dividends) at a rate of 30.67% which is added to the NERDTOH. Dividends are subject to Part IV tax at a rate of 38.33% and are added to the NERDTOH unless the dividend is an eligible dividend and then it is added to the ERDTOH. When taxable dividends are paid, a refund of the RDTOH account is received: $1 for every $2.61 taxable dividend paid to the extent of the RDTOH account balance. Only the payment of non-eligible dividends can generate a refund out of the NERDTOH account. RDTOH is a factor to consider in post mortem planning (*see page 24*).

Exempt Test

Growth in policy accumulation fund is tax-free
if amount < benchmark "Exemption Test Policy"

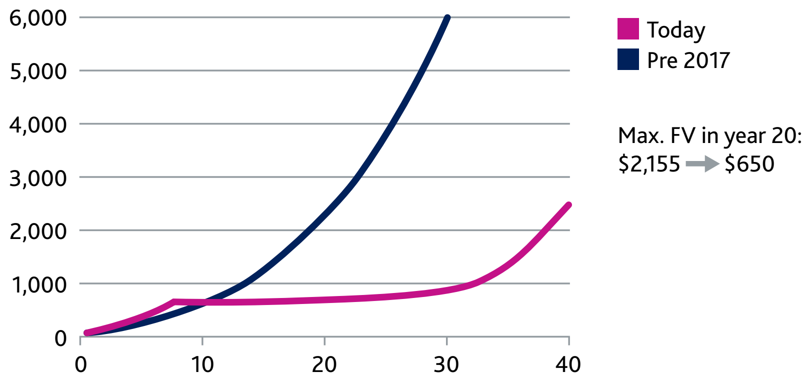
These regulations, updated as of January 1, 2017, distinguish policies that are primarily insurance from those that are primarily investment-oriented. Insurance companies monitor policies to ensure that they maintain their exempt status. With respect to tax-deferred accumulation, new rules significantly affect Level Cost of Insurance (LCOI) Universal Life (UL) insurance policies by reducing the amount that can be deposited to the policy in excess of the insurance charges.

Grandfathered status for policies issued prior to 2017 can allow for significant extra accumulations, especially for LCOI policies (*see chart below*).

Grandfathering may be lost if:

- Term insurance issued prior to 2017 is converted to permanent life insurance after 2016
- Insurance that requires medical underwriting is added to the policy after 2016

Maximum FV per $1,000 of LCOI Face | Male 50 NS



Fair Market Value (FMV)

The determination of the FMV of an insurance policy requires actuarial input and review, and is based on a variety of qualitative and quantitative factors including:

- Policy face amount and cash value
- Replacement value of policy
- Health and life expectancy of insured
- Future premiums payable
- Type of policy – Permanent or Term
- If Term, conversion features available

Proceeds of Disposition

The disposition of an interest in a life insurance policy can arise in a number of circumstances (*see page 9*). The proceeds (or deemed proceeds) of disposition are the amount that the transferor is considered to receive for tax purposes on a disposition.

Proceeds of Disposition for arm's length transactions = consideration received

Proceeds of Disposition for *most* non-arm's length transactions* = greatest of FMV of consideration received, CSV and ACB

There are exceptions where a policy is transferred to a spouse or child under certain circumstances (*see page 10*).

**The rules that apply to determine the proceeds of disposition on non-arm's length transfers also apply where a policy is transferred:*

- *as a gift or bequest,*
- *as a distribution from a corporation to any person,*
- *by operation of law to any person.*

Policy Gain

If Proceeds of Disposition > Policy ACB*, the gain is fully taxable as an income gain, *not* a capital gain
If Proceeds of Disposition < Policy ACB*, a loss *cannot* be claimed for tax purposes

**In the case of a partial surrender, the ACB is prorated.*

Investment Income Tax (IIT)

The IIT is a 15% tax payable by insurance companies on their earnings from the investment of accumulation funds in exempt policies. It represents an indirect tax on the tax-deferred growth within an exempt policy. The new Exempt Test rules for policies issued after 2016 result in a higher IIT for certain types of policies, such as LCOI policies. Although IIT is usually passed on to policyholders through higher charges or lower investment returns, there are some policies that offer an IIT refund on the surrender of a policy.

THE QUESTIONS WE HEAR MOST OFTEN

Are insurance premiums deductible?

Insurance premiums are generally not a deductible expense since they are capital in nature. However, in certain circumstances, a deduction for the lesser of the NCPI and premium is allowed. In order to qualify for the deduction, the owner of the policy and the borrower must be the same taxpayer and the following conditions must be met:

- The insurance policy is assigned to a restricted financial institution (which includes all the major banks and credit unions) in the course of borrowing from that institution;
- The interest on the loan must be deductible (*see page 23 for when interest is deductible*); and
- The assignment of the life insurance policy is required as collateral for the borrowing.

When the amount of the insurance assigned as collateral for the borrowing exceeds the amount of the loan, the amount of the deduction must be prorated.

When is there a disposition of a life insurance policy?

A disposition of a life insurance policy will result in an income gain for tax purposes if the proceeds of disposition exceed the policy's ACB. Any gain would be included in aggregate investment income for purposes of the passive investment income rules (*see page 11*).

INCLUDES
The surrender of a policy, either full or partial
A policy loan made after March 31, 1978
Disposition by operation of law (such as a transfer to a trustee in bankruptcy)
A change of ownership of the policy

EXCLUDES
The death benefit paid under an exempt life insurance policy
Payment under a policy for a disability benefit
The collateral assignment of a policy as security for a loan

What are the rollover rules for life insurance?

A tax-deferred policy rollover is permitted:

- If the transfer of the policy is to the policyholder's spouse or common law partner (no rollover is available on a transfer to a spousal or common law partner trust) or to former spouse as part of separation agreement
- If the policy is transferred to a child (including grandchildren and great grandchildren) for no consideration, where a child of the policyholder or a child of the transferee is the person whose life is insured under the policy (only one life can be insured under the policy)

A corporate rollover is not permitted:

- Unlike most kinds of other property, a life insurance policy cannot be transferred to a corporation on a tax-deferred basis

For rollovers, the transferor is deemed to have disposed of the policy for an amount *equal* to its ACB, and the transferee is deemed to acquire it for the *same* amount

What is a policy loan?

A policy loan is an amount advanced by an insurer to a policyholder in accordance with the terms and conditions of a life insurance policy. A policy loan results in a disposition.

Policy Loan must be < CSV

If Policy Loan > ACB, then there is an income gain

What are the tax consequences of transferring a corporate-owned policy to a shareholder or employee?

Proceeds of Disposition = greatest of FMV of consideration received, CSV and ACB

- Any gain is an income gain and treated like interest income to the corporation
- If shareholder or employee does not pay FMV for the policy, a taxable benefit can arise
- The shareholder benefit rules are punitive and result in double tax

For additional information on the tax consequences of transferring life insurance policies please *see page 29*.

Is the growth in an exempt life insurance policy subject to the passive investment income rules?

The passive investment income rules were introduced in the 2018 federal budget. The rules result in a reduction in the small business deduction (SBD) if the corporation (or associated corporations) has "adjusted aggregate investment income" (AAII) that is greater than $50,000 in the previous year. AAII is basically passive investment income. The SBD is reduced $5 for every $1 of passive income over the $50,000 threshold resulting in the elimination of the SBD at $150,000 of passive income. The growth in an exempt life insurance policy is not included in AAII. However, any income gain arising from the disposition of a policy would be included in the AAII calculation. Ontario and New Brunswick decided not to follow the federal rules so there is no reduction to the SBD for provincial purposes for passive income in these provinces.

Is life insurance planning affected by the Tax on Split Income (TOSI) rules?

The TOSI rules that were implemented in 2018 do not affect life insurance planning directly. The TOSI rules do not apply to capital dividends (only taxable dividends). In general terms, the TOSI rules expanded the "Kiddie Tax" rules to adult family members unless certain exclusions are met. There are special deeming rules for shares received on death and care must be taken when completing post mortem planning (*see page 23 for a refresher on post mortem planning alternatives*) to ensure that the tax attributes are maintained.

How are segregated funds taxed and what are the differences between a mutual fund and a segregated fund?

A segregated fund is a deferred annuity contract offered by a life insurance company that combines the growth potential of a mutual fund with the security of a life insurance policy. The segregated fund contract is a life insurance contract between the policyholder and the insurance company. The annuitant under the contract is the person upon whose life the contract is based. In most cases, upon death of the annuitant, the policy terminates and any death benefit guarantee becomes payable to the beneficiary designated for the contract. Segregated funds are a good option for those approaching or in retirement or business owners who like the security of guarantees and potential creditor protection.

VISIT www.thelinkbetween.ca/passive-investment-income-calculator to explore the potential impact the passive investment income rules have on your client's business.

The following is a comparison of segregated funds and mutual funds:

	SEGREGATED FUND	MUTUAL FUND
Diversified selection of investments	✓	✓
TFSA and RRSP/RRIF eligible	✓	✓
Potential for capital growth and investment returns	✓	✓
Managed by professional portfolio managers	✓	✓
MERs	✓	✓
Guarantee fees	✓	
Fund protected against insolvency of the issuer	✓	N/A
Death benefit and maturity guarantees of typically 75%-100% of initial investment • Possible market value guarantee resets	✓	
Bypass probate if beneficiary is designated (other than estate)	✓	
Possible creditor protection	✓	
Taxed as an inter-vivos trust	Yes, but not an actual trust	✓
Income allocated to unit holders from the trust	Yes, amounts deemed allocated, but not distributed	Yes, amounts must be distributed
Capital losses can be allocated to investor from trust	✓	
Capital gain or loss will result if the owner sells/redeems	✓	✓
Company tracks ACB of unit holder and reports gain or loss from redemption of units by holder on T3 slip	✓	Investors must track and report capital gains/losses

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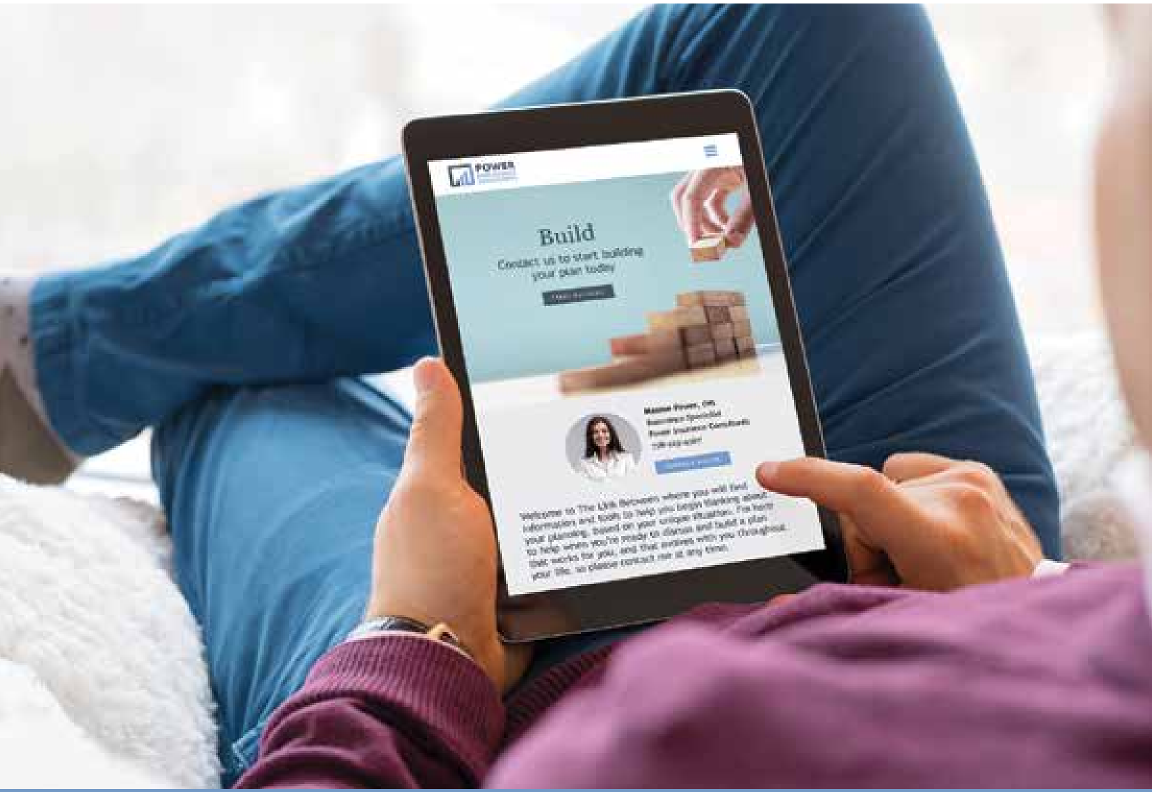

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Is insurance subject to U.S. Estate Tax?

Unlike in Canada where only the appreciation in the value of assets is taxed on death, the U.S. has an estate tax that is payable on the gross value of the deceased's estate. Life insurance proceeds are included in the gross value if the proceeds are payable to the estate or if the deceased had "incidents of ownership" in the policy. Estate tax applies to U.S. citizens and U.S. residents but can also apply to Canadian residents who are not U.S. citizens if they own U.S. situs property. The lifetime exclusion from estate tax for 2020 is US$11,580,000 – therefore there is no estate tax if your estate does not exceed this amount. The exclusion is set to return to US$5,000,000 after 2025.

For Canadian residents that are not U.S. citizens, if the value of your U.S. assets is less than US$60,000, you are not subject to estate tax. If your U.S. assets exceed US$60,000 and your worldwide estate exceeds US$11,580,000 then you may be subject to estate tax. Canada's tax treaty with the U.S. allows a prorated amount of the unified credit up to $4,574,100 for 2020 (U.S. estate tax on $11,580,000 of assets) to be used to offset the estate tax liability. The deceased's estate is entitled to a credit of the greater of US$13,000 and the amount determined by the formula:

US$4,574,100 × deceased's gross estate situated in the U.S.
÷ value of the deceased's worldwide gross estate

While life insurance is generally not a U.S. situs asset, the FMV of the policy will be included in the value of the deceased's worldwide estate for determining the proration of the unified credit.

It is important to review the terms of life insurance policies to determine if the deceased had incidents of ownership whether the deceased is a U.S. citizen or is a Canadian resident non-U.S. citizen that has U.S. situs assets.

ALWAYS KEEP IN MIND Clients should consult a U.S. tax expert before any planning is undertaken.

Incidents of ownership can include:

- any legal ownership interest in the policy
- being a beneficiary of the policy
- having the right to surrender or cancel the policy
- having the right to borrow against the policy
- making a determination with respect to the policy including whether or not to pay premiums and whether or not to increase coverage
- the right to change beneficiaries
- an option to acquire the policy

There is a three-year look back rule that will include life insurance in the deceased's estate if the individual dies within three years of severing all incidents of ownership. Life insurance payable to a corporation will increase the value of the corporation for purposes of U.S. estate tax. Unlike in Canada, capital dividends are taxable in the U.S. when paid to U.S. residents and U.S. citizens.

An Irrevocable Life Insurance Trust (ILIT) is often used to remove "incidents of ownership" so the life insurance proceeds are not subject to U.S. estate tax. The ILIT would own the policy and be the beneficiary. The settlor can fund the premiums and if the settlor is a U.S. citizen, certain gift tax exclusion amounts can apply.

What is a Graduated Rate Estate (GRE) and why is it important?

A GRE is an estate that is eligible for certain income tax advantages that are unavailable to other testamentary trusts. There can only be one GRE per deceased individual and the designation must be made in the trust's first tax return after death. A GRE can last for a maximum of 36 months, during which time it is eligible for the graduated tax rates that are available to individual taxpayers. Unlike other estates, a GRE is also eligible for a number of post mortem tax planning strategies, including the carry back of capital losses and the use of insurance proceeds to redeem shares under a tax savings strategy often called the "50% solution" (*see page 25*). In addition, a GRE allows the executor more flexibility in claiming donations upon death: the donations can be claimed by the estate or by the deceased. In order for an estate to qualify for the nil capital gains inclusion rate for donations of publicly listed securities, ecological and cultural property the estate must be a GRE.

How does corporate-owned insurance affect share valuation?

This answer depends on the circumstances. Here are two common examples:

	CAPITAL GAINS EXEMPTION	VALUE ON DEATH
What is the issue?	There is a capital gains exemption available on the disposition of qualifying small business corporation (QSBC) shares. The exemption was $800,000 in 2014 and has been indexed annually since that time (2020 exemption is $883,384).* One required test is that 90% of the FMV of the assets of the corporation must be used in active business. Generally, life insurance is not an active business asset.	An individual is deemed to dispose of capital property for proceeds equal to FMV, and where the individual owns shares in a corporation, the shares must be valued.
How is life insurance valued for determining share value?	CSV of the life insurance is included. This applies to all insurance owned by the corporation on the shareholders, not just the insurance on the shareholder using the capital gains exemption. Life insurance that the corporation owns on a non-shareholder employee must be valued at FMV.	Valued at CSV if owned by the corporation on the life of the deceased shareholder or any individuals not dealing at arm's length with the deceased shareholder. However, life insurance the corporation owns on any other shareholders/employees must be valued at FMV.

**There is also an exemption for farming and fishing properties, and life insurance may affect the amount available. In addition, the tax on split income rules will apply to capital gains unless the shares qualify for either the QSBC or farming and fishing exemption.*

How are disability and critical illness insurance taxed?

The taxation of disability and critical illness insurance depends on who is paying the premiums:

	DISABILITY	CRITICAL ILLNESS*
Premiums paid personally	Benefit not taxable	Benefit not taxable
Premiums paid by employer and employee is the beneficiary	Benefit taxable	Benefit not taxable but amount of premium paid by employer is a taxable benefit

**Some critical illness policies are sold with return of premium riders. The taxation of the rider is case dependent. Please contact your local PPI office to discuss.*

What are the ways to donate life insurance to a charity?

A policy can be donated directly to a charity, or the charity can be named as the beneficiary of a life insurance policy.

	POLICY DONATED TO CHARITY	CHARITY NAMED AS BENEFICIARY
Disposition for tax purposes?	Yes. Proceeds for tax purposes equal the greatest of: FMV of consideration given, CSV and ACB. There is no consideration on a gift so there will only be an income gain if CSV is greater than ACB.	No disposition where a charity is named beneficiary of an existing policy.
Control	Control lost as policy must be absolutely assigned to the charity.	No loss of control as beneficiary can be changed at any time.
Amount of the donation receipt	FMV* of the policy on the date of gift plus additional receipts if premiums paid by the donor in future.	Donation receipt for the amount of the insurance paid at the time of death.
Anti-avoidance rule	Special rules that treat the value of the gift as lesser of policy's FMV and ACB if insurance owned (i) less than 3 years or (ii) less than 10 years if acquired with intent to donate.	N/A
Who receives donation receipt?	Used by taxpayer in year of donation or can be carried forward for 5 years. Net income limit is 75%.	Received by the estate but can be claimed in estate, carried forward 5 years or claimed in date of death return of deceased or return immediately preceding death if estate is a GRE (*see page 16*). If not GRE then claimed in estate. Net income limit is 100% for date of death and preceding year of death but 75% for estate or carry forward.

**There is a planning opportunity for donating life insurance policies that are no longer needed as the FMV of the policy can be greater than its CSV. The donation receipt would be equal to the FMV but proceeds of disposition is the CSV.*

How can insurance be used to enhance donations?

As discussed on the previous page, if the charity is designated as a beneficiary then the estate will receive a donation receipt for the proceeds received which can be used to offset the taxes arising on the date of death return (if the executor chooses to and the estate is a GRE – *see page 16*). Instead of designating the charity as a beneficiary, the taxpayer could donate publicly listed securities while they are alive and use the insurance to replace the capital to the estate. The amount of the taxable capital gain is nil but the donation receipt is equal to the FMV of the securities on the day the securities are transferred to the charity and can be used to offset other taxable income of the taxpayer (subject to the 75% limit) or carried forward for 5 years. This strategy can also be used on death if the estate is a GRE.

A similar strategy can be used by corporations with the added benefit that the full amount of the capital gain (that would otherwise have been recognized) is added to the corporation's capital dividend account that can be paid out to the shareholders on a tax-free basis.

In addition, preferred shares of private corporations can also be donated to charities and the life insurance used to fund the redemption of the shares held by the charity.

What is an Insurance Trust?

An insurance trust is typically created through a beneficiary designation on an insurance company form, in a will or in a separate document. Before the introduction of the GRE rules in 2016, insurance trusts were taxed at graduated income tax rates. They are now taxed at the highest marginal rate (like inter-vivos trusts) since they are not GREs, and there is no grandfathering available. However, an insurance trust can qualify as a qualified disability trust (QDT) which is taxed at graduated tax rates.

Despite the loss of the tax savings, insurance trusts are still beneficial for the following reasons:

- Protection for minor/spendthrift beneficiary
- Protection from family law and dependants' relief claims
- Control of funds (e.g. for education)
- Sprinkling of income and capital amongst beneficiaries
- Secure inheritance for children of first marriage where significant portion of estate passes to second spouse

- Avoiding probate fees/estate administration tax
- Potential protection from creditors
- Privacy (if designation not in probated will)
- Not subject to will challenges/variations

Why separate ownership of the insurance from the beneficiary?

Despite the change to the CDA calculation referred to on page 5, there are still important reasons to have one corporation, such as a holding company (Holdco), as the owner, and another corporation (Opco) as the beneficiary of a life insurance policy:

- The policy value may be protected from the creditors of Opco
- If the shares of Opco are sold to a third party, the insurance policy can remain in Holdco, thus avoiding the tax consequences of a policy transfer. The beneficiary designation would need to be changed, but this is not a taxable event. (*The tax consequences to transferring a policy out of a corporation are discussed on page 29.*)

What are probate fees and are insurance proceeds included?

All the provinces have some form of probate fees. Probate fees are fees paid to the court to prove the validity of the will and are generally calculated based on the fair market value of the assets held in the estate. Receiving the grant of probate informs others that the executor has the authority to deal with the assets in the estate. If someone dies intestate (without a will) the court will grant similar authority to the appointed administrator. Not all assets are subject to probate. If a beneficiary, other than the estate, is designated under a life insurance policy, the proceeds are not subject to probate. The same applies to designations for RRSP/RRIFs. In addition, assets that transfer by right of survivorship to a joint tenant are not subject to probate. The use of multiple wills is also another method to remove certain assets from probate. Before any probate fee planning is completed, professional advisors should be consulted.

Quebec does not charge probate fees. However, wills other than notarial wills must be probated before the Superior Court of Quebec, which involves a minimum fee.

What are the key aspects of beneficiary designations?*

Benefits of designating a beneficiary	• Avoid probate fees (*see page 20 for information on probate fees*) • Not part of public record • Potential creditor protection • Immediate payment of funds with fewer concerns about estate litigation or other delays in estate administration
What is the difference between revocable and irrevocable beneficiary?	If irrevocable, the policy owner needs consent of the beneficiary before certain changes are made to the policy
Why use irrevocable designation?	Examples include creditor protection, family support orders and certain shareholder agreements
Concerns with irrevocable designation	• If beneficiary is a minor, can't make changes until age of majority • If beneficiary becomes incapacitated, consent can be difficult
Is there another way to get creditor protection other than an irrevocable designation?	Yes, if beneficiaries are from a "protected class": • Spouse, child, grandchild or parent of the life insured (not necessarily the policy owner) • In Quebec, where the designate beneficiary of the insurance is the married or civil union spouse, descendant or ascendant of the policyholder or of the participant, the rights under the contract are exempt from seizure
Is creditor protection absolute?	No, fraudulent conveyance legislation and dependants' relief claims may override
Why have a contingent beneficiary?	In case primary beneficiary predeceases the life insured – otherwise proceeds go to policy owner's estate
If multiple beneficiaries designated, what does policy owner need to be aware of?	• If no stated allocation – default is to share equally • If no contingent beneficiary designated, proceeds go to surviving beneficiaries • If no surviving beneficiary, proceeds go to estate
When should policy owner update designation?	• Divorce or other change in personal circumstances • Death of the beneficiary • If future event revokes will and designation is in the will
Do both owners need to sign a beneficiary change form if policy is joint ownership?	Yes
Can a person acting under a power of attorney change a beneficiary designation?	No
If there is a designation in the will and on the insurance policy, which is used?	The latest made valid designation

**Comments are general in nature and there are differences in provincial legislation.*

ACCESSING CASH VALUE FOR INVESTMENTS OR OTHER PURPOSES

A life insurance policy owner can access a policy's CSV in one of three ways:

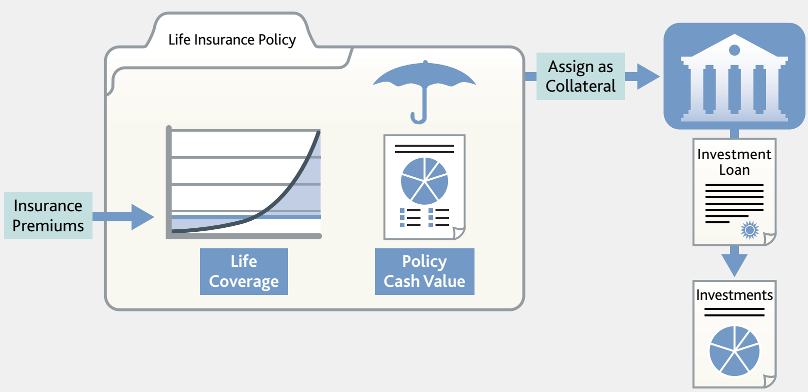
1. Withdrawing the CSV of the policy by either a partial or full surrender of the policy;
2. Obtaining a policy loan; or
3. Assigning the CSV as collateral for a loan

The first two options result in a disposition and an income gain may result if the proceeds of disposition are in excess of the policy's ACB (in the case of a partial surrender, the ACB is prorated).

The collateral assignment of a life insurance policy does not result in a disposition.

The general structure of such a leveraging arrangement is:

1. Determine that life insurance is required to meet individual's estate, succession or business planning objectives
2. Deposits made into permanent life insurance policy to cover required mortality premiums, plus additional deposits invested in accumulation fund subject to exempt test limits
3. Life insurance policy is used by borrower to secure collateral loan
4. If certain requirements are met, interest expense should be deductible for income tax purposes (*see page 23*)
5. In cases where owner of life insurance and borrower are the same, a deduction may be allowed for the lesser of the premium and the NCPI (*see page 9 for conditions of when insurance premiums are deductible*)
6. Where borrower is shareholder or employee and life insurance policy is owned by corporation, shareholder or employee benefit may result unless guarantee fee is paid
7. On death of insured, loan must be repaid; in most circumstances, portion of death benefit payable under the policy must be used to first repay loan, and shareholder or employee benefit may arise unless additional agreements in place



Interest Deductibility

The requirements for loan interest deductibility include the following:

1. Interest is paid or payable in the year it is deducted
2. Interest is paid pursuant to a legal obligation
3. Borrowed money is used for the purpose of earning income from a business or property (such as an investment portfolio)
4. The amount must be reasonable

The tax and legal issues relating to the use of leveraging must be reviewed with independent legal and accounting professionals.

POST MORTEM PLANNING – A QUICK REFRESHER

Post mortem planning is completed to avoid double taxation on death where the deceased has private corporation shares. Life insurance is an effective way to reduce the double tax since it creates CDA (*see page 5*) in the corporation.

How double (or triple) tax can arise:

- There is a deemed disposition on death at FMV which results in a capital gain
- When shares are redeemed or corporation wound up, a taxable dividend can arise
- Potential taxable gains on disposition of corporate assets

Capital loss carry back planning and pipeline planning are the most common post mortem planning alternatives to remove the double tax. The method used will depend on the facts of each situation and the two methods can be used in combination.

TAX CONSIDERATIONS associated with each post mortem planning method should be discussed with independent tax, legal and accounting advisors.

The key aspects of the two methods are outlined in the following table:

CAPITAL LOSS PLANNING
Effectively trade capital gains rate for dividend rate • Effective if corporation has significant CDA (including life insurance proceeds) or Refundable Dividend Tax On Hand (RDTOH – *see page 5*)
Redeem shares or windup corporation in first year of estate (must be GRE – *see page 16*)
Deemed dividend and capital loss arises on redemption or windup
Elect to carry back loss from estate to offset the capital gain on death • Time sensitive election – 1st taxation year of a GRE • Watch capital dividend stop loss rules (*see below*) that may reduce amount of loss

PIPELINE PLANNING
Retains capital gains rate
Estate transfers shares (Subco) to a new corporation (Newco) and takes back a promissory note equal to the FMV of the shares
Subco winds up into the Newco – with potential use of "bump" planning to increase ACB of corporation's assets and reduce or eliminate third layer of tax
Often completed if no CDA or RDTOH
Not generally time sensitive but need to meet Canada Revenue Agency's (CRA) administrative positions to avoid potential deemed dividend treatment

Capital Dividend Stop Loss Rules

Prior to April 27, 1995, it was possible to use a life insured corporate redemption strategy to completely eliminate the tax arising on the deemed disposition of private corporation shares held by a deceased shareholder. The capital loss realized by the estate was carried back to offset the capital gain on the deceased's date of death return, and the resulting deemed dividend was a tax-free capital dividend.

'Capital dividend stop loss rules' were introduced in 1995 to reduce the amount of the loss available to be carried back; however they do not apply if the deceased's shares are grandfathered under one of the following rules:

- Shares are redeemed pursuant to an agreement made before April 27, 1995, or
- A corporation was the beneficiary of a life insurance policy on April 26, 1995, and it is reasonable to conclude that a main purpose of the policy on that date was to fund a redemption of shares owned by the taxpayer or the taxpayer's spouse

Grandfathering provides the best tax result to the estate and deceased. It is important that transactions regarding the shares and the shareholders' agreement be reviewed on a case by case basis to determine if grandfathering is available. The pre-existing insurance test is the most generous of the grandfathering rules. In order to meet this test, it is not necessary to establish that the sole purpose, or the primary purpose, of the insurance was to redeem shares, only that this was a main purpose. The issue is proving a main purpose – documentation is important. The purchase of new or additional insurance or the replacement or conversion of existing policies will not alter the grandfathered status under either of the grandfathering tests. However, CRA has stated that grandfathering will be lost if the agreement is "altered or modified in any way".

Alternatives when grandfathering is not available

Roll and Redeem Solution – achieves a similar result to the grandfathered situation. Shares are rolled to the spouse on death at ACB, then later redeemed under special put and call provisions contained in the shareholders' agreement. This results in a tax-free capital dividend being paid to the spouse. There is no capital loss created so the stop loss rules are not relevant. The agreement must be carefully drafted and provide alternative buyout arrangements in case there is no surviving spouse.

100% Solution – the full CDA is paid to the estate and the stop loss rules apply. This results in no tax to the estate and a 50% reduction in the capital gain realized in the year of death. This can be a tax-effective result for the estate but "wastes" 50% of the available CDA credit.

50% Solution – avoids the stop loss rules so the capital gain on death is eliminated, but there is a taxable dividend in the estate. Since dividends are currently taxed at a higher rate than capital gains in every province, the 50% solution results in more tax than the 100% solution but leaves 50% of the CDA available for future use.

The following example illustrates the differences between the solutions:

Assumptions: $10 M insurance, top marginal tax rate 50%, dividend rate 45%

	PIPELINE	GRANDFATHERED	ROLL AND REDEEM	50% SOLUTION	100% SOLUTION	PIPELINE AND CDA
Capital Gain	$10 M	$10 M	$0	$10 M	$10 M	$10 M
Capital Loss	$0	($10 M)	N/A	($10 M)	($5 M)	$0
Capital Dividend	$0	$10 M	$10 M	$5 M	$10 M	$0
Taxable Dividend	$0	$0	$0	$5 M	$0	$0
Tax Payable by Deceased	$2.5 M	$0	$0	$0	$1.25 M	$2.5 M
Tax Payable by Estate	$0	$0	$0	$2.25 M	$0	$0
CDA Remaining	$0	$0	$0	$5 M	$0	$10 M

ASK YOUR LOCAL PPI OFFICE about the new Post Mortem Planning section on the Professional Resource Centre that provides detailed information on each of the planning alternatives. In addition, Technical Strategies are available that walk through the details of grandfathering, Roll and Redeem, the 50% Solution and the 100% Solution.

CAPITAL DIVIDEND ACCOUNT – TAX CONSIDERATIONS

The capital dividend account ("CDA") is a notional account that exists to maintain a fundamental part of the tax system in Canada – that proceeds of life insurance (and the non-taxable portion of capital gains net of capital losses) should be received tax-free whether they are received by an individual or a corporation.

As was noted on page 5, the life insurance proceeds in excess of the policy's adjusted cost basis is added to the CDA and can be paid to shareholders on a tax-free basis.

The following are some points to consider regarding the CDA:

- For policies issued after 2016, NCPI (*outlined on page 4*) is now lower which results in a positive ACB for a longer period. As a result, the addition to the CDA could be lower than expected and if the full amount of the life insurance proceeds is to be paid to the deceased shareholder's estate, a taxable dividend may have to be paid equal to the ACB of the policy. (*See page 23 for discussion on post mortem planning.*)
- Prior to the 2016 federal budget, the ACB of a policy would only reduce the CDA credit where the beneficiary was also the policy owner. Where insurance proceeds are received after March 22, 2016, the ACB will reduce the CDA credit whether or not the beneficiary is a policy owner and in the case of multiple beneficiaries the full ACB will reduce the credit for each beneficiary. Where there are multiple beneficiaries, this will result in double counting of the ACB as can be seen in the following example:
  - Holdco is the owner of the life insurance policy and the beneficiary of the accumulation fund ($1 million)
  - Opco is the beneficiary of the death benefit ($3 million)
  - ACB of the policy at death of shareholder is $500,000

	HOLDCO	OPCO
Proceeds	$1,000,000	$3,000,000
ACB	($500,000)	($500,000)
Addition to CDA	$500,000	$2,500,000

The Department of Finance is aware of this issue and hopefully there will be a legislative change. In the meantime, other planning alternatives should be considered rather than the use of multiple beneficiaries. Contact your local PPI office to discuss.

- The CDA calculation is cumulative and a negative balance in one component of the calculation generally will not affect the overall positive CDA balance from the other component (for instance, if the capital gains net of capital losses is negative at the time of the calculation and life insurance proceeds net of ACB of $1 million is received, the $1 million can still be paid out to the shareholder's estate tax-free). However, an issue can arise if a capital dividend has been paid previously and capital losses arise after the capital dividend was paid and before the life insurance proceeds are received. This is best illustrated with an example:
  - Opening CDA is nil, $500,000 capital gain in 2019, pay $200,000 capital dividend in 2019
  - End of 2019: capital dividend account is $50,000
  - Life insurance proceeds of $500,000 received in early 2020
  - Capital dividend balance $550,000: full amount of life insurance can be paid out tax-free
  - What if losses of $200,000 were incurred in 2020 before life insurance proceeds were received?

	2020 (NO LOSSES)	2020 (LOSSES)
Tax-free portion of capital gain in excess of losses	$250,000	$150,000
Capital dividend paid	($200,000)	($200,000)
Insurance proceeds	$500,000	$500,000
Capital dividend balance	$550,000	$450,000

  Because of the losses in 2020, the full amount of the insurance proceeds cannot be paid out tax-free; therefore, it is important for the corporation's tax advisor to determine the balance of the CDA.

- If the corporation has a critical illness policy on a shareholder, the proceeds are not added to the CDA and therefore cannot be paid as a tax-free dividend.
- Prior to March 22, 2016, a shareholder was able to transfer a life insurance policy to a corporation and receive consideration equal to the FMV of the policy while only being taxed on the amount by which the CSV exceeded the ACB of the policy. Under the 2016 federal budget, where an individual benefited from these rules under a transfer made after 1999, there will be a reduction in the corporation's CDA credit when the individual dies. In most cases the reduction will equal the FMV of consideration given by the corporation in excess of the greater of the policy's CSV and ACB at the time of the transfer, although other technical adjustments are possible.

CONSEQUENCES OF TRANSFERRING LIFE INSURANCE

Advance planning is the best way to avoid what can be onerous tax consequences when transferring a life insurance policy from an individual or a corporation.

Ideally, a life insurance policy should not be owned in an operating corporation (Opco) but in a holding corporation (Holdco), perhaps with Opco as the beneficiary. This approach not only avoids having to transfer the life insurance policy if the Opco shares are sold but also potentially removes the insurance from the reach of Opco's creditors.

As noted on page 10, when a policy is transferred to a shareholder or employee, there is a disposition of the policy for proceeds equal to the greatest of CSV, ACB and FMV of any consideration given. An income gain (not a capital gain) will arise when the deemed proceeds exceeds the ACB. There are no tax deferred rollovers for the transfer of life insurance to or from a corporation.

An additional issue arises when a corporate owned policy is transferred to a shareholder or employee: a taxable benefit may arise if FMV is not paid to the corporation by the shareholder or employee. In the absence of FMV consideration, a taxable benefit may also arise where the recipient is a "sister company" or other corporation that is not a shareholder of the transferor.

The following are some common examples of the tax consequences of transferring life insurance policies to non-arms' length parties:

1. **Corporation transfers life insurance to a shareholder**
   - If the policy has a CSV of $100,000, ACB of $50,000 and a FMV of $200,000 the following will result:

	NO FMV CONSIDERATION PAID BY SHAREHOLDER	FMV PAID BY SHAREHOLDER
Income gain to corporation	$50,000	$150,000
Taxable shareholder benefit	$100,000	$0

Note that double taxation will arise when a shareholder benefit is assessed as the corporation would not receive a deduction for the amount of the benefit and therefore this result should be avoided. The income gain is subject to refundable tax and will be added to the NERDTOH account (*see page 5*) and would be included in the calculation of adjusted aggregate investment income (and possibly reducing access to the small business deduction – *see page 11*).

2. **Transfers of life insurance from a corporation to its Holdco**

- The same results as noted on the previous page will occur except it is possible to avoid the shareholder benefit by paying the life insurance policy as a dividend-in-kind. A dividend-in-kind results in a disposition to the transferor of the policy (at the greater of CSV and ACB as no consideration is being received), but there is no shareholder benefit to Holdco since the dividend is equal to the policy's FMV. The dividend should be tax-free to Holdco as long as the transferee corporation has sufficient "safe income". Safe income is a complex calculation that basically approximates retained earnings of the corporation adjusted for tax purposes and should be determined by the corporation's tax advisor.

3. **Shareholder transfers life insurance to their corporation**

- There is no requirement for the shareholder to receive FMV consideration on the transfer; therefore, consideration can be restricted to the greater of CSV or ACB. Let us consider the following examples:

CSV	ACB	CONSIDERATION RECEIVED BY SHAREHOLDER	INCOME GAIN TO SHAREHOLDER	ACB TO CORPORATION
$100,000	$75,000	$100,000	$25,000	$100,000
$75,000	$100,000	$100,000	$0	$100,000

4. **Amalgamations and windups**

- There are special provisions that will apply to the transfer of policies where corporations are amalgamated or wound up. For amalgamations, the policies are transferred on a tax-deferred basis. For windups, there are different results depending on the type of windup. For a windup of a subsidiary into a parent corporation, there is a tax-deferred transfer of the policy; however, for other windups, the policy is deemed to be disposed of at FMV.

For considerations when donating a life insurance policy to a charity *see page 18* and for the rollover rules available between individuals *see page 10*.

SHAREHOLDERS' AGREEMENTS – DON'T MISS THE INSURANCE PROVISIONS

Agreements should fully outline terms and conditions relating to ownership and use of life insurance:

1. **Ownership and Beneficiary designations**
   - Identify the owner and beneficiary of each policy used in buy/sell funding.
   - Ensure the policies reflect content of Agreement.
   - Corporation and/or shareholders should have right to purchase additional insurance.
2. **Payment of premiums**
   - Identify who is responsible (usually the policy owner).
   - Affected parties who are not policy owners should have right to confirm policy status.
3. **Consent to medical exams**
   - Shareholders whose lives are to be insured are obligated under the Agreement to undergo necessary medical examinations and cooperate regarding other underwriting requirements, for current and future insurance needs.
4. **Future changes in ownership**
   - Contemplate possibility of an ownership change of the life insurance policies acquired for buy/sell purposes.
   - Provide for an agreed price, for example, the greater of $1 and CSV.
5. **Restrictions on ownership rights**
   - Insurance policies acquired for buy/sell funding should not be used for other purposes.
   - Restrict ownership rights of parties, i.e. should not be allowed to transfer policies or assign them as collateral without consent of all parties.

6. Flow of funds / declaration of capital dividend

- Describe the flow of funds that follows the payment of the life insurance proceeds, e.g. where the beneficiary is the corporation itself, the proceeds may be paid to the estate of the deceased shareholder in the course of a share redemption. In most cases, the corporation should be required to declare a capital dividend in these circumstances.

7. Valuation

- Provide method to determine purchase price for shares bought and sold under the agreement. The price should typically be the shares' FMV as agreed by the parties or determined by an independent business valuator.
- CSV of corporate owned insurance may be included as corporate asset for these purposes, but death benefit proceeds should not be included.

8. Excess or deficiency of life insurance proceeds

- Stipulate which party (often the policy owner) is entitled to proceeds in excess of the purchase price.
- If proceeds are less than the purchase price, stipulate how the remaining purchase price is paid (usually by installments over a period of up to five years).

FOR MORE INFORMATION about shareholders' agreements, please contact your local PPI office to connect one-on-one.

CHECKING THE NUMBERS

For a current list of personal and corporate Tax Rates, OAS, CPP and Probate Fees please visit the following websites:

KPMG
https://home.kpmg/ca/en/home/services/tax/private-company-tax-kpmg-enterprise.html

Ernst & Young
https://www.ey.com/en_ca/tax/tax-calculators

Government of Canada
www.canada.ca/en/services/benefits/publicpensions/cpp/old-age-security/payments.html#tbl1

www.canada.ca/en/services/benefits/publicpensions/cpp/cpp-benefit/amount.html

TaxTips.ca
www.taxtips.ca/willsandestates/probatefees.htm

ACRONYMS

ACB – Adjusted Cost Basis

CDA – Capital Dividend Account

CSV – Cash Surrender Value

ERDTOH – Eligible Refundable Dividend Tax On Hand

FMV – Fair Market Value

FV – Fund Value

GRE – Graduated Rate Estate

IIT – Investment Income Tax

LCOI – Level Cost of Insurance

NCPI – Net Cost of Pure Insurance

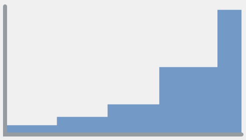
NERDTOH – Non-Eligible Refundable Dividend Tax On Hand

RDTOH – Refundable Dividend Tax On Hand

TOSI – Tax On Split Income

UL – Universal Life

QUICK REFERENCE FOR INSURANCE PRODUCT TYPES

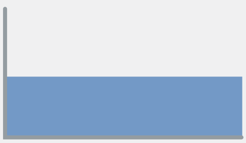


Term Insurance

Most term insurance policies are inexpensive at the start. However, the premiums can increase on renewal and, in most instances, the policy will expire before the client's life expectancy.

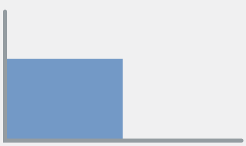
Term to 100 Insurance

"Term to 100" is a permanent policy that allows for level insurance rates through the client's lifetime. Term to 100 policies guarantee that as long as premiums are paid, the policy will pay a death benefit at the client's death.



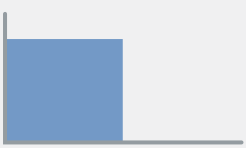
Permanent Whole Life Insurance

Whole life policies offer a guaranteed level premium and guaranteed cash values that are based on conservative assumptions for mortality, expense projections and investment returns. When any of these components experience better than anticipated performance, excess funds are returned to the policyholder in the form of dividends. Because the components of whole life are not specifically defined in the policy, the level of declared dividends is not based on a disclosed formula. In a whole life policy, the dividends paid can be used in a number of ways, including the purchase of paid-up additions, permanent coverage that increases the total face amount of the policy and has a cash surrender value.



Permanent Universal Life Insurance

Universal life insurance policies offer level rates and minimum lifetime premiums, as well as the flexibility to deposit funds in excess of the minimum premium. These additional funds can be deposited into a selection of fixed rate and equity style investments available inside the policy and any growth on these investments is not subject to taxation unless withdrawn. The growth can be used to pay future mortality charges, creating a very efficient method of funding the insurance coverage.



Permanent Hybrid Life Insurance

Like universal life, a hybrid life insurance policy offers a level cost of insurance, lifetime minimum premiums, and the flexibility to deposit and use excess funds in tax-deferred investment accounts, including a smoothed investment account. Like whole life, a hybrid policy offers guaranteed cash values, and returns excess earnings to policyholders in the form of a bonus. The bonus is based on a guaranteed formula linked to the gross return of the smoothed investment account. Hybrid also provides policyholders with the ability to purchase paid up additions. With hybrid however, there are two ways to purchase this additional guaranteed paid up coverage: with the bonus, and with a portion of the additional deposits made to the policy.

PROFESSIONAL RESOURCE CENTRE
A LIBRARY OF HIGH NET-WORTH SOLUTIONS

Have questions about what happens on the death of a taxpayer who owned shares in a private corporation and how insurance can help fund the tax liability? Need to transfer a life insurance policy? Looking for a shareholders' agreement that utilizes the 'roll and redeem' strategy?

We are pleased to introduce the refreshed **Professional Resource Centre** (PRC) from PPI Advisory, your online resource for advanced planning with insurance, and the new planning section: Post Mortem Planning. The site provides exclusive access to PPI's extensive library of tax and estate planning educational materials, technical strategies and fact finders – and now it's mobile-friendly too!

The content in the Professional Resource Centre is developed by PPI Advisory's cross-disciplinary team of Planning Specialists and is focused on sharing the knowledge and skills that top advisors use to differentiate themselves in the marketplace.

TO LEARN MORE about the Professional Resource Centre website, contact your local PPI office.

YOUR LOCAL PPI SUPPORT

Contact any one of our local offices to learn more. Our team is eager to help you build your business. For locations and contacts, please visit www.ppi.ca.

	PPI Advisory	**PPI Benefits**
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Halifax	Halifax	Montréal
Québec City	Montréal	Kitchener
Brossard	Toronto	Toronto
Montréal	Winnipeg	Calgary
Laval	Edmonton	
Ottawa	Calgary	
Toronto	Vancouver	
Mississauga		
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