Collateral life insurance deduction

Life insurance premiums are not deductible for tax purposes, but in certain circumstances a policyowner may claim the collateral life insurance deduction set out in paragraph 20(1)(e.2) of the *Income Tax Act* (Canada) (the "Act"). This article will help you understand how this deduction works and where it plays a role in life insurance strategies.

Criteria for the collateral insurance deduction

A borrower may claim the collateral life insurance deduction if:

1. A premium is payable under the policy in respect of the year;
2. The assignment of the life insurance policy is required by the lender under the terms of the loan agreement;
3. The lender is a "restricted financial institution" as defined in the Act; and
4. The interest payable on the loan is deductible for tax purposes.

If these criteria are met, the amount of the deduction may be limited in two ways:

First, the deduction may not be more than the lesser of the:

a. Premiums payable under the insurance contract for the year, and
b. Net cost of pure insurance ("NCPI").

Second, of the lesser of these two amounts, the deductible portion is that which may reasonably be considered to relate to the amount owing from time to time during the year by the taxpayer.

Let's look at some of the criteria in more detail.

1. Premiums payable under the insurance contract in respect of the year

The requirement for "premiums payable" creates an interesting difference between participating whole life insurance policies that are on offset and overfunded universal life insurance policies, where the policyowner is no longer making out-of-pocket premium payments.

In the context of a universal life insurance policy, the CRA confirmed that the "premiums payable" requirement corresponds with the premiums the policyholder chooses to pay the insurer under the terms of the policy and the "amounts the insurer withdraws from the accumulation account to cover the costs of insurance and related fees do not constitute premiums."[1] This means in the case of universal life insurance, there is only a "premium payable" in the years where the policyowner makes an out-of-pocket payment into the policy.

In contrast, for participating life insurance products, the amount of each premium is specified in the contract, resulting in a basis for claiming that there is a premium payable in a year that the policy is on offset. In addition, the CRA has also stated that the method by which the premiums are paid does not determine the amount deductible, which also supports

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the position that premiums paid using policy dividends or through the surrender of paid-up additions may qualify for the collateral life insurance deduction.[2]

2. Assignment of the life insurance policy is required by the lender

This is a strict requirement that the lending terms must specifically reflect the lender's requirement that the borrower assign the life insurance policy as collateral for the loan. Even though a lender may accept a policy from one entity as security for a loan given to another entity, the policyowner and the borrower must be the same person or entity, as the case may be, for the collateral life insurance deduction to be available.[3]

3. Restricted financial institution

A restricted financial institution is a defined term in subsection 248(1) of the Act and generally means a bank, trust company, credit union, insurance corporation and a corporation whose principal business is arm's length lending. This requirement prevents the collateral insurance deduction from being claimed in situations involving loans from shareholders and their family members.

4. Interest payable on the loan is deductible

The loan secured by the life insurance policy must be used for business or investment purposes for the interest on the loan to be deductible pursuant to paragraph 20(1)(c) of the Act. The CRA has stated that this element is satisfied where only a portion of the interest is deductible – this could arise where, for example, the loan was used to buy an annuity and subparagraph 20(1)(c)(iv) of the Act limits the interest deduction.[4]

5. Reasonably be considered to relate to the amount owing

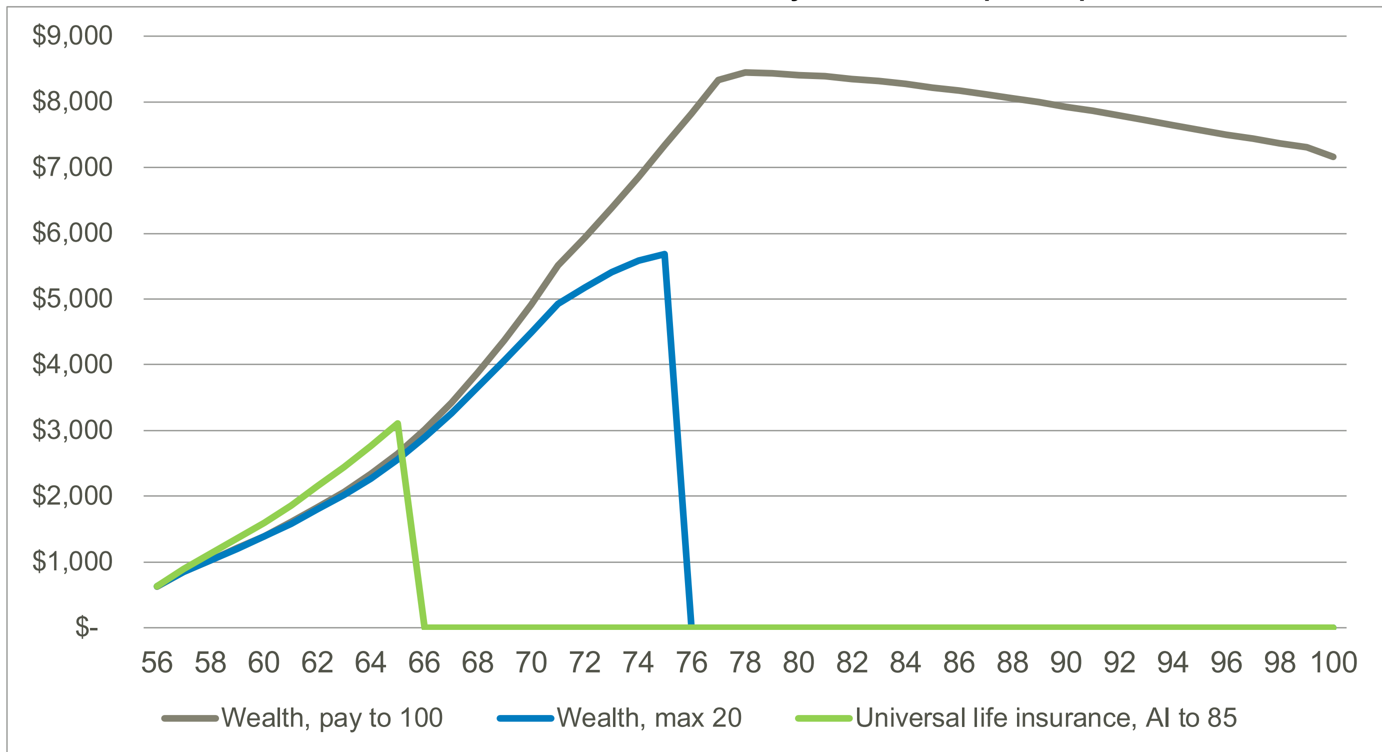
This last element generally means the deduction is proportionate to the amount of the outstanding loan balance to the life insurance policy death benefit. For example, if the insurance death benefit is $1,000,000 and the loan is $100,000, then only 10% of the lesser amount of the premiums payable and the NCPI is deductible under paragraph 20(1)(e.2). This proration method based on the death benefit as the main variable applies to policies both with and without cash value.[5]

The collateral insurance deduction in leveraging strategies

There are generally two categories of strategies which involve collateral loans. The first category is referred to as back-end leveraging, which involves assigning the policy as collateral to a bank loan several years after the policy is settled. In this context, the collateral insurance deduction will not be available to the policyowner unless the loan is used for an eligible use to obtain the interest deduction (and of course the other criteria in paragraph 20(1)(e.2) are met). Our *Asset efficiency* and *Corporate Asset efficiency* illustrations may be used to show this strategy and do not show the collateral insurance deduction.

The second category is referred to as front-end leveraging, which involves a business or investor using its own funds to pay the life insurance premiums and receiving bank loans to be made whole. The bank loan is used for business or investment purposes and it's secured by the policy's cash value and other assets as temporary collateral (until the policy's cash values are sufficient). The tax savings from the interest and collateral insurance deductions help offset the costs of this strategy which is mainly the ongoing interest costs to the bank. This strategy is more popularly known as the immediate financing arrangement ("IFA"). The collateral loan deduction is a key element in this strategy, particularly in the life insured's later years when the NCPI amount becomes more significant.

The following graph shows the collateral loan deduction in three polices each having a $50,000 total annual premium that's paid out-of-pocket for 10 years on a 55-year-old male, non-smoker, standard risk. Assume the business loan throughout the duration of the graph is $500,000.



- Participating life insurance, Wealth, pay to 100, $50,000 total annual premium, max additional deposit option of $29,267 annually for 10 years, basic coverage amount of $603,064, paid-up addition dividend option, 2022 dividend scale.
- Participating life insurance, Wealth, max 20, $50,000 total annual premium, max additional deposit option of $22,652 annually for 10 years, basic coverage amount of $555,186, paid-up addition dividend option, 2022 dividend scale.
- Universal life insurance, $50,000 annual premium, annually increasing to age 85 cost of insurance, level death benefit, insurance amount of $983,000, 1.5% return in account value.

The example provided is not complete without the Canada Life illustration, including the cover page, reduced example and product features pages all having the same date. Read each page carefully as they contain important information about the policy.

Collateral loans involve risk. They should only be considered by sophisticated investors with high risk tolerance and access to professional advice from a lawyer and accountant. The terms of future availability of collateral loans cannot be guaranteed. The loan or line of credit must be negotiated between the policyowner and the lender. It is subject to the lender's financial underwriting and other requirements. The policyowner should have enough income and capital to cover the interest and loan repayment, as well as the insurance premium.

[1] 2007 APFF Conference, question 3, CRA document 2007-024191, Oct. 5, 2007.

[2] 2007 APFF Conference, question 3, CRA document 2007-024191, Oct. 5, 2007.

[3] See CRA document 2007-0219601E5, March 14, 2007.

[4] 2005 CALU Annual General Meeting, question 4, CRA document 2005-0116651C6, May 3, 2005.

[5] 2006 CALU Annual General Meeting, question 1, CRA document 2006-0174781C6, May 9, 2006.

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