Accessing cash value from a corporate-owned life insurance policy using collateral loans

There are three ways your corporation can access the cash value from its life insurance policy:

1. **Collateral loan** – assign the policy to a lender as collateral for a loan[i]

2. **Policy loan[ii]** – take a loan from the insurance company based on the policy's contractual terms

3. **Cash withdrawal or partial surrender of coverage** – withdraw cash directly from the policy

This article looks at the considerations and tax implications of using collateral loans as a method of accessing the cash value of a corporate-owned life insurance policy. Also, included is an example showing how collateral loans may help supplement retirement income and enhance estate value.

Considerations

With this method, the corporation collaterally assigns a life insurance policy to a third-party lending institution as security for a loan or line of credit. The maximum collateral loan can be as high as 100% of cash value depending on the type of policy and the lender used[iii].

With a collateral loan, the policyholder is not directly accessing the policy's cash value as it remains within the policy and grows tax-free while inside the policy, subject to government limits. In contrast, this would not be the case if the policyholder withdrew cash directly from the policy as a cash withdrawal or partial surrender of coverage.

A collateral loan is not a disposition for tax purposes. As a result, income tax is not payable by the policyholder when the policy is assigned to a lender. Also, the loan proceeds received are not considered as income for tax purposes[iv]. By contrast, depending on the policy's adjusted cost basis (ACB), there can be tax payable when cash is accessed from a policy via a policy loan or cash withdrawal/partial surrender. For this reason, a collateral loan is generally the most tax effective way of accessing cash value from a life insurance policy.

Once the corporate policyowner has the loan proceeds it can either use the cash for its own purposes or distribute the funds to the shareholder. If it is paid to the shareholder it will be subject to tax, or not, depending on how the transaction is structured. In many cases it will be paid out as either a non-eligible dividend or eligible dividend. These are taxable dividends and they are subject to tax at a lower marginal rate in comparison to regular income. Alternatively, if the shareholder is an employee of the corporation the amount may be paid out as employment income, which would enable the corporation to deduct an equivalent amount from its income for tax purposes.

That said, collateral loans involve risk. Only a policyowner with financial assets significantly over and above the life insurance policy in question and with above average risk tolerance should consider this type of arrangement. Some examples of the risks for consideration are noted below:

- Potential for the lender to demand repayment for the loan, for example, if the loan exceeds the maximum loan to cash value ratio because of capitalized interest.
- Potential taxable policy gain if the policyowner is required to surrender the policy to repay the loan.
- Change in tax laws in respect to the taxation of collateral loans.
- Change in lending practices of lending institution.
- Changes in interest rates, particularly where loan remains outstanding over long period (i.e., until death of insured life) or where the total outstanding loan is significant.
- Client's ability to service the debt may diminish in later years (i.e., retirement years).
- Not having other financial resources sufficient to cover the loan.

Tax implications

As noted above, a collateral loan is not a disposition for tax purposes. Moreover, collateral loan advances are not income for tax purposes. For these reasons, collateral loans generally do not attract any tax consequences. However, there are other tax implications that may be involved with the strategy including tax deductions relating to interest costs and a portion of the insurance premium, the capital dividend account, and loans to shareholder.

Interest deduction

Interest on borrowed money is only deductible for tax purposes if it satisfies the criteria described in paragraph 20(1)(c) of *Income Tax Act* (Canada) (the "Act"). Generally, the interest must be:

1. paid in the year or be payable in respect of the year;
2. paid pursuant to a legal obligation;
3. on borrowed money used for the purpose of earning income from a business or property; and
4. a reasonable amount.

Clients typically use an arm's length lender to obtain a loan secured by their life insurance policy, so the legal and reasonable elements are not an issue. Banks and credit unions will charge a market interest rate which is presumably reasonable for this purpose and they will also ensure that interest is paid regularly (often monthly) pursuant to their documented lending terms. In most collateral loan cases that show interest deductibility, the focus of attention is on the purpose test, meaning whether the loan is used for the purpose of earning income from a business or property (often called an "eligible use").

In many cases with corporate-owned policies, the loan is made to the corporation and used by the corporation in the business or used to purchase investments. In this situation, the interest deduction criteria is commonly satisfied as the borrowed money is used to earn income from the business or property.

In other cases, the loan is made to the corporation and then paid as a dividend to the shareholder. This scenario is not on its face an eligible use of the borrowed funds; however, the Canada Revenue Agency ("CRA") has an administrative position that could help make the interest deductible. In particular, CRA may permit interest deductibility were the corporate loan is used to redeem shares, return capital, or pay dividends: Income Tax Folio, S3-F6-C1, "Interest Deductibility", paras 1.48-1.52. The CRA states that even though the direct use of the borrowed funds is to make a distribution from the corporation, the purpose test is nevertheless met as long as the borrowed money replaces "accumulated profits" that are being used in ways that would have qualified for interest deductibility had the capital been borrowed money or acquired with borrowed money. Accumulated profits are generally the corporation's retained earnings, which are "computed on an unconsolidated basis with investments accounted for on a cost basis": Tax Folio, S3-F6-C1, para 1.50. The CRA refers to this as the "fill-the-hole" concept and it is an important assumption made in our Corporate Asset Efficiency strategy illustrations when interest deductibility is illustrated with the loan made to the corporation and paid out as a dividend.

Collateral life insurance deduction

Premiums payable under a life insurance policy are generally not deductible for tax purposes. However, a deduction is permitted where an insurance policy is required by the bank to be collaterally assigned by the policyholder to secure a loan and the loan is used by the policyholder to earn income from a business or property (i.e., interest is deductible on the loan)[v]. The amount deductible is generally equal to the lesser of premiums payable for the year and the policy's net cost of pure insurance (NCPI) in the year, as it relates to the loan amount outstanding throughout the year. For example, if the life insurance death benefit on the assigned policy is $1,000,000, and the amount owing under the loan throughout the taxation year is $200,000, the amount deductible is limited to 20% of the lesser of the premiums payable and the NCPI for the year.

Collateral loans and a corporation's capital dividend account

Generally, the amount of the death benefit received by a corporation less the policy's ACB, credits its capital dividend account (CDA). A CDA balance allows a private corporation to pay tax-free capital dividends to Canadian resident shareholders. When a corporation owns a life insurance policy, it's also typically the beneficiary of the policy as well for tax reasons. If the policy is used to secure the indebtedness of the corporation, the corporation receives a credit to its CDA on the same basis, even when the death benefit is paid directly to the creditor[vi].

Loans to shareholder

As noted, typically the proceeds from a collateral loan are received by the policyowner (i.e., the corporation) and then paid to the shareholder as a taxable distribution. In contrast, if the loan was instead made directly to the shareholder it would ultimately provide more after-tax cash to the shareholder since the loan proceeds are not considered income for tax purposes. There are, however, several other significant tax issues to consider, which may lead to the conclusion that corporate borrowing can be more advantageous. For more information on this complex topic refer to Canada Life's *Tax and Planning* article titled "Backend leveraging: loan to shareholder vs. loan to corporation".

Example – Comparison of net estate values from corporate collateral loans

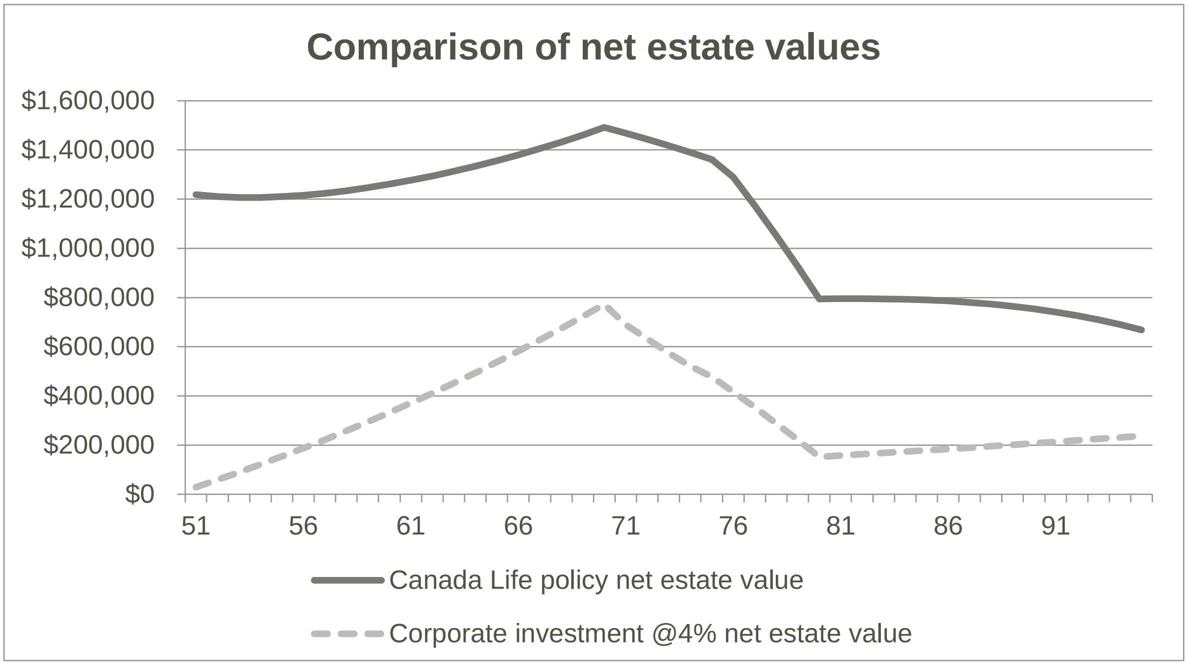
Let's look at an example using a corporate-owned participating life insurance policy.

Suppose the life insured is Michelle, age 50, a non-smoker and standard risk. Michelle has an insurance need based on her capital gains tax liability at death. She owns a company ("MichelleCo") that purchases a Canada Life participating life insurance policy on her life[vii]. MichelleCo pays an annual premium of $50,000 for 20 years and is also the policy beneficiary.

MichelleCo takes collateral loans annually during policy years 21-30 at a borrowing rate of 5%. The total collateral loan equals 90% of the policy's total cash value at age 99. Loan interest is capitalized and assumed to be tax deductible[viii]. At a 5.10% dividend scale interest rate, MichelleCo can obtain $134,100 of loan proceeds annually over this ten-year period. These funds can be distributed to Michelle as a dividend to supplement her retirement[ix].

Assume MichelleCo purchased a guaranteed investment certificate (GIC) having a 4% interest rate with the same premium dollars and also took the same withdrawal amounts to provide Michelle with income (i.e., as a dividend). Compare the net estate values from the GIC and the Canada Life participating life insurance policy. MichelleCo's tax rate on passive income is assumed to be 51% and Michelle's estate's dividend tax rate is 44 per cent.

The net estate value from life insurance at age 90 is $753,873 compared to the GIC at $206,913. The main reasons why the net estate value from corporate-owned life insurance is attractive compared to corporate investments is because the policy's cash value grows tax-free while inside the policy (subject to government limits) and all, or significant portion, of the insurance payout credits MichelleCo's CDA. The CDA credit is generally equal to the insurance payout less the policy's ACB. To the extent MichelleCo has a CDA balance, it can pay out tax-free capital dividends to its shareholder(s) who are residents of Canada. In contrast, the interest income from the GIC is taxed at a high corporate rate and, generally, it's received as a taxable distribution when paid out to its shareholder(s).



The above example is for illustrative purposes only and is not necessarily indicative of future performance. Situations will vary according to specific circumstances.

Summary

Collateral loans from third-party lenders are appealing to corporate policyowners because they are not considered as income for tax purposes. As the example with Michelle illustrates, an income strategy using collateral loans from a corporate-owned life insurance policy is competitive with other corporate investments of a similar risk profile while potentially generating greater net estate values.

[i] 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's 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.
[ii] All reference to policy loan in this article refer to a cash policy loan, not an automatic premium loan.
[iii] Typically the loan amount is less than 100% of the total cash value and depends on the type of policy and lender used.
[iv] It's possible that CRA could argue that the General Anti-Avoidance Rule ("GAAR") applies to the bank loan from the standpoint that it's an attempt to avoid the tax that would be payable on a policy loan and has no other purpose. We would view this as a tenuous argument because it's an established rule of law that taxpayers are entitled to structure their affairs in the most tax-effective manner. However, we can't rule out the possibility of the successful application of the GAAR by CRA. As such, the purpose and the need of the loan must be clearly established.
[v] Pursuant to paragraph 20(1)(e.2) the bank must be a restricted financial institution as defined in section 248(1) of the Act.
[vi] Court rulings have confirmed the corporation only needs to have 'constructively received' the death benefit proceeds and the discharging of the corporate debt qualifies as receiving the death benefit for purposes of the credit to the corporation's CDA. Refer to CRA Income Tax Folio S3-F2-C1, Capital Dividends paragraph 1.67
[vii] Canada Life Wealth max 20 of $1,230,315 with paid-up additions dividend option.
[viii] It assumed that interest is paid every year (i.e., interest is paid and then borrowed back). This assumption is often reflected in reality as many lenders will require the policyowner to pay interest on the total loan balance on a monthly basis and then subsequently draw on their line of credit to be made whole. If the interest was not paid and is simply accrued and added to the total loan amount it would be considered compound interest. Paragraph 20(1)(d) of the Act states that compound interest is only deductible when it is paid. Furthermore, it is assumed that interest is deductible at MichelleCo's general active business rate of 26.5% and the tax savings is used to pay down the loan.
[ix] When one of the possible future uses of the permanent life insurance policy cash values is to fund a retirement income to an owner of the business (or an employee), great care must be taken to avoid the application of the retirement compensation arrangements (RCA) rules under the Act.