

## Interest deductibility in back-end leveraging strategies

Our strategy illustrations that show collateral loans give the user the option of selecting “loan interest is deductible”; this means the interest expense from the collateral loan generates tax savings. This feature increases the amount of cash flow from the collateral loan, but the assumptions involved when using this illustration option are different than those involved where interest deductibility is not shown.

This article discusses the general rules applicable to interest deductibility, the particular rules affecting interest deductibility in a collateral loan strategy illustration<sup>i</sup>, and the assumptions built into a strategy illustration showing interest deductibility.

### The 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.

In most back-end leveraging cases that show interest deductibility, the focus 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”). To a lesser degree, the ‘paid in the year’ or ‘payable in respect of the year’ test can be a relevant consideration as strategy illustrations typically show interest as capitalized. Clients would use an arm’s length financial institution to obtain a loan secured by their life insurance policy so the legal and reasonable elements are generally not an issue.

### Personal loans and loans made directly to a shareholder

In many cases, back-end leveraging illustrations show the client that they can access their policy’s cash value in their later years and, therefore, how the policy can provide a supplemental source of retirement income. This personal use of borrowed funds is not an eligible use, so interest on the collateral loan would not be deductible. In these types of situations with collateral loans, the client needs to ensure the direct use of the borrowed funds is for business or investment purposes. For example, the interest could be deductible if the client liquidated some investments instead, used the sale proceeds to supplement his or her income and repurchased the investments with the loan. In this scenario, the loan is used to buy investments, which is generally an eligible use of borrowed funds for obtaining the interest deductibility.

A similar planning scenario would also need to take place in a case with a corporate-owned policy that secures a loan made directly to a shareholder (as opposed to being made to the corporation). Again, for the interest to be deductible, the shareholder could liquidate investments and repurchase them using the loan proceeds. In each case, there may be both tax and non-tax related costs to liquidating the investments.<sup>ii</sup>

This method of planning that involves some reorganizing of assets, is similar to the planning seen in *The Queen v. Singleton*, 2001 SCC 61. In this case, a lawyer withdrew capital from his law partnership to purchase a house, and then took a bank loan of an equal amount to recapitalize the partnership. If he used the loan to buy the house directly, the interest would not be deductible, but, as found by the Supreme Court of Canada, using the loan to re-establish the equity in his law firm was an eligible use and the interest was therefore deductible. The *Singleton* case shows the direct use of loan proceeds is important. If a policyowner is seeking interest deductibility, he or she should be prepared to show a direct link between the borrowed money and the eligible use. It's recommended that clients consult a tax professional if they're considering this type of transaction.

### Loans to corporations

In most cases with corporate-owned policies, the loan is made to the corporation and paid as a dividend to the shareholder. This scenario is not, on its face, an eligible use of the borrowed funds. Fortunately, the Canada Revenue Agency ("CRA") has an administrative position that could help make the interest deductible.

As noted, the direct use of loan proceeds is important, however, the CRA permits exceptions to this rule in corporate cases where the loan is used to redeem shares, return capital or pay dividends<sup>iii</sup>. 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've 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"<sup>iv</sup>.

The CRA refers to this as the "fill-the-hole" concept, and it's an important assumption made in our *Corporate asset efficiency* strategy illustration when interest deductibility is illustrated with the loan made to the corporation (as opposed to the shareholder) and paid out as a dividend. If the loan is made to the corporation, and not paid out as a dividend, then the normal purpose test would apply. In these cases, interest deductibility could be achieved if, for example, the loan proceeds are invested in the corporation's business or used to purchase investments.

### Other assumptions in strategy illustrations

There are three other key assumptions relating to interest deductibility shown in a back-end leveraging strategy illustration.

First, each year the tax savings from the interest deduction are applied to reduce the loan balance; this is how an illustration that shows interest deductibility generates more cash flow in comparison to an illustration that doesn't show interest deductibility. For example, refer to a 45-year-old male non-smoker, standard risk using a Canada Life Estate max 20 participating life insurance policy with a \$25,000 annual premium (assuming paid-up additions dividend option). Assume the annual loan income starts in year 21 and continues each year for 15 years. The interest rate charged by the bank is 5%, the margin ratio on the cash value is 90%, which is reached at age 99. The policyowner's tax rate is 51% and the loan amounts shown are based on the current dividend scale interest rate<sup>v</sup>. Where interest from the loan is deductible, the illustration shows \$61,100 as the annual cash flow. Where interest deductibility is not selected, that amount is \$40,750. As the table below shows, if the tax rate is lower and the tax savings are less, the difference between the two numbers would be less.

	Interest deductibility		No interest deductibility
	51% tax rate	16% tax rate	
Annual cash flow from years 21-35	\$61,100	\$49,615	\$40,750

Second, the illustration assumes the policyowner has a sufficient amount of income to be able to use the interest deduction in each year. This assumption may become particularly important in the policyowner's later years when total loan and associated interest costs could become large. In the case of personal and trust policyowners in Quebec, if the loan is used to buy investments, the interest is an investment expense and the deduction would be limited to the policyowner's income from passive sources in the year.

Third, strategy illustrations showing interest deductibility also assume the interest is paid every year. 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 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's paid, which in the case of a back-end leveraging strategy illustration, is typically at the death of the life insured.

### Important information

There are financial risks associated with leveraging and clients should not purchase life insurance only for the future possibility of obtaining a collateral loan.

Collateral loans involve risk and should generally only be considered by an investor with high risk tolerance, and access to professional advice from a financial advisor, lawyer and accountant. They should also have sufficient other income and capital to cover interest payments or potential tax liability should it be necessary to surrender the policy and repay the loan.

There are many circumstances under which a lender could demand repayment of a loan. For example, a lender could demand repayment if a loan exceeds, or is close to exceeding, the maximum percentage of collateral the lending institution requires. This is more likely to occur when the loan interest is capitalized. If the lender demands repayment of the loan, the corporation/individual may have to surrender the life insurance policy. This surrender may trigger tax, and the policy may not have enough cash surrender value to pay the tax.

Additionally, once a policy is surrendered, an insured may not be able to obtain replacement insurance or may have to pay much more for it.

<sup>i</sup> For example, Canada Life's Asset efficiency and Corporate asset efficiency strategy illustrations.

<sup>ii</sup> See Canada Life's *Tax and Planning* article titled, "Backend leveraging: loan to shareholder vs. loan to corporation" for a in-depth discussion on the tax issues associated with a corporate owned life insurance policy securing a loan from a bank directly to the shareholder.

<sup>iii</sup> *Income Tax Folio*, S3-F6-C1, "Interest Deductibility," paragraph 1.48-1.52.

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<sup>iv</sup> *Income Tax Folio*, S3-F6-C1, paragraph 1.50.

<sup>v</sup> Assuming the policy maintains a 5.10 per cent dividend scale interest rate.