Policy dividends: uses and taxation

Owners of participating whole life insurance policies have the potential to receive policy dividends in the form of cash payments, paid-up additions or term insurance enhancements. Policyowners may also apply to use their dividends either to pay the policy's premium or repay a policy loan. They're different from the dividends paid by corporations to their shareholders, and their tax treatment is different as well.

Policy dividends

Participating policyowner premiums go into a separate account called the participating account. Canada Life™ manages this account and invests its assets in a diversified portfolio of bonds, mortgages and equities, including real estate. Earnings arise when the actual experience of the participating account is more favourable than the assumptions used when pricing the products. Experience factors that influence earnings may include, but aren't limited to:

1. Investments
2. Mortality
3. Expenses, including taxes
4. Other factors

Each year, Canada Life may distribute some of these earnings, if any, in the form of policy dividends, as approved by the board of directors. The amount to be distributed as policy dividends is influenced by considerations such as the need to retain earnings as surplus and to reduce short-term volatility in dividends. Some years, a policy may not receive a dividend – for example, if the dividend grouping of policies to which it belongs is considered to have made no contribution to participating account earnings.

Taxation of policy dividends

A policy dividend has the potential to trigger a taxable policy gain.[i] Whether it does depends on the policy's adjusted cost basis (ACB) and how the policy dividend is used. The policyowner may use the dividend in a number of ways. Canada Life offers new participating life insurance policyowners three dividend options:

1. Cash payment
2. Purchase of paid-up insurance: paid-up additions (PUAs)
3. Purchase of one-year term coverage: enhanced coverage option (ECO)

A policyowner may apply to use their dividends in the following two additional ways:

4. Payment of the policy's contractual premium (premium offset)
5. Repay a policy loan

Cash payment

Under this option, the policy dividend is paid in cash to the policyowner. If the payment exceeds the policy's ACB, then the excess is a policy gain and the policyowner will receive a tax slip from the insurer reporting the taxable income. Policy dividends paid in cash also reduce the policy's ACB on a dollar-per dollar basis. As a result, if the cash payment is less than the policy's ACB, then there wouldn't be a policy gain. Policy gains increase the policy's ACB.

The following table illustrates how these rules work using a Canada Life participating whole life insurance policy with $100,000 of coverage on the life of a 35-year-old male, non-smoker, standard risk. The policyowner chose the cash payment dividend option and the policy has a 5.5 per cent dividend scale interest rate. The policy's net cost of pure insurance (NCPI) reduces a policy's ACB and is shown below for a more complete picture of the ACB calculation.

Male, 35 years old, non-smoker, standard risk, Canada Life participating life insurance, pay-to-100, basic coverage $100,000

Age	Opening ACB	Premium paid (↑ACB)	Cash dividend (↓ACB)	Policy gain (↑ACB)	NCPI (↓ACB)	Closing ACB
71	7,940	1,992	2,681	-	1,064	6,187
72	6,187	1,992	2,731	-	1,145	4,304
73	4,304	1,992	2,783	-	1,230	2,282
74	2,282	1,992	2,834	-	1,319	121
75	121	1,992	2,863	750	1,411	0
82	0	1,992	2,956	2,956	2,093	0
83	0	1,992	2,993	2,993	2,188	0

Some notable points from the table:

- Ages 71 to 73 – the cash payment is less than the policy's ACB. As a result, the cash payment just reduces ACB.
- Age 75 onwards – the cash payment is more than the policy's ACB. Consequently, the cash payment results in a taxable policy gain equal to the difference and the policy's ACB is increased by the same amount.
- Age 82 onwards – the entire amount of the policy dividend is treated as a policy gain.[ii]

Internal policy transactions

Policy dividends used to purchase PUAs, ECO, repay a policy loan or to pay premiums are called internal policy transactions and don't result in a policy gain for the policyowner. In all of these cases, the policy dividend is a disposition for tax purposes; however, a rule in the *Income Tax Act* (Canada) deems the proceeds to be reduced by the portion of the dividend used either to pay a premium or repay a policy loan. Using a policy dividend for purchasing PUAs, ECO, paying most types of policy premiums or putting a policy on premium offset are payments of a "premium" for the purposes of this rule.[iii] Premiums paid by policy dividends aren't included in calculating a policy's ACB.

Paid-up additions

Under the PUA dividend option, the policy dividend is used to purchase additional paid-up life insurance coverage at the single premium rate in effect at that time. As noted, a policy dividend applied to purchase PUAs will not result in policy gain because the proceeds of the disposition are deemed to be nil. As a result, there's no policy gain and no impact on the policy's ACB. Key features of PUAs include:

- They add cash value and coverage to participating life insurance policy.
- They contribute to the total policy dividend.
- When surrendered to pay premiums, they're not subject to taxation (PUAs surrendered for their cash value may be subject to taxation depending on the policy's prorated ACB).

Enhanced coverage option (one-year term insurance)

Under the ECO dividend option, policy dividends buy one-year term insurance up to a maximum enhanced coverage amount available at issue. After paying the one-year term insurance cost for the upcoming year, the remaining policy dividend purchases PUAs. As noted, a policy dividend which purchases ECO will not result in policy gain because the proceeds of the disposition are deemed to be nil. Key features of ECO include:

- It can significantly increase the policy's total death benefit in the short to medium term without increasing insurance costs.
- The enhanced coverage amount may be guaranteed on either a 10-year or lifetime basis.
- Since a portion of a policy dividend may be used to buy PUAs, the policy's total death benefit may surpass the original enhanced coverage amount in later policy durations.
- One-year term coverage purchased under this option in the year of conversion may also be converted to any permanent life insurance policy available at the time of conversion.

Premium offset

Premium offset uses policy dividends to pay all or a portion of the policy's annual premium. Full premium offset may be available after the policy has been in force for several years. In cases where the policy dividend is lower than the annual premium, PUAs may be surrendered for their cash value to make up the difference. If the policy dividend and PUA cash value are insufficient to pay the annual premium, then the policyowner can pay the premium out-of-pocket or consider non-forfeiture options such as reduced paid-up. Changes in the dividend scale may impact the supportability of premium offset.[iv] Premium offset is an internal policy transaction and the proceeds of the disposition are deemed to be nil.

Policy loan repayment

A policy loan is made by an insurer pursuant to the policy's contractual terms, provided the policy's cash value is large enough to cover the loan. A policy gain generally arises if the policy loan exceeds the policy's ACB. Any policy loan amount that exceeds policy ACB is treated as a policy gain. As noted, the proceeds of the disposition of a policy dividend used to repay a policy loan are deemed to be nil. Generally, a policy loan repayment in excess of the portion of the policy loan that was previously taxable, if any, is added to the ACB of the policy. A policy's ACB isn't increased where the loan is repaid using a policy dividend.

Conclusion

The potential for receiving policy dividends is an important feature of participating whole life insurance policies. These participating policyowner dividends may be used in different ways to help a client achieve their financial and estate planning objectives – through additional cash flow, increasing insurance coverage and/or the elimination of out-of-pocket premium costs.

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[i] A policy gain is taxed as regular income, not like a capital gain. A policy gain realized by a corporation is treated as passive income.
[ii] From age 82 onward, the entire policy dividend is a treated as a policy gain because in each year the sum of the cumulative premiums and the prior year's cumulative policy gains are less than the sum of the prior year's cumulative policy dividends and the prior year's cumulative NCPI.
[iii] For a policy issued before 2017, the premiums paid for accidental death benefits, disability benefits, substandard risk, conversion rights or guaranteed insurability are not considered "premiums" for the purposes of this rule.
[iv] The dividend scale represents the current dividends credited to policies based on the participating account's experience from the investment, mortality, expense and other components.