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U.S. persons and Canadian life insurance

The U.S. tax system imposes income tax on both its residents **and** its citizens, regardless of where they live in the world – even Canada. This means the thousands of U.S. persons living in Canada need to consider both Canadian and U.S. income tax issues in their overall planning. This article examines three major U.S. tax issues that U.S. persons living in Canada encounter when purchasing life insurance from Canadian insurers, including some planning tips.

For tax purposes, a U.S. person is a U.S. citizen, a green card holder or a resident of the U.S. Three major U.S. tax issues affecting U.S. persons owning a Canadian life insurance policy include:

1. U.S. estate tax (and the related gift tax)
2. U.S. exempt test for insurance policies
3. U.S. federal excise tax on premiums for non-U.S. insurance policies

U.S. estate tax and gift tax

The estate tax is an insurance-planning concern as a policy's death benefit may impact a U.S. person's estate-tax liability. The gift tax is a concern for a U.S. person funding a policy on their life while it's owned by someone else or another entity (which is often done as a planning measure for the estate tax). Let's look at each in more detail.[i]

Estate tax

The death benefit of a life insurance policy owned by a U.S. person may be subject to U.S. estate tax. This is the case whether the policy is issued by either a Canadian or U.S. insurer. There are generous exemptions and planning measures available to eliminate or reduce a U.S. person's estate tax exposure.

Where the estate tax applies

U.S. estate tax is levied on the taxable estate of a deceased U.S. person. The taxable estate is generally the fair market value of all the assets in the deceased's estate (called the gross estate), less certain allowable deductions. The gross estate also includes:

Life insurance proceeds payable to the estate.

1. Life insurance proceeds of a policy owned by the deceased or where the deceased had "incidents of ownership," either alone or in conjunction with any other person/entity. This includes the right of the insured or the estate to its economic benefits; to change the beneficiary; surrender or cancel the policy; assign the policy or revoke the assignment; pledge the policy for a loan; or obtain a policy loan.[ii]

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2. In the case of a corporate-owned life insurance policy on the life of a deceased U.S.-person shareholder, the death benefit received by the corporation would increase the value of the corporation, and consequently, the value of the shares they owned. As a result, the death benefit, or part of it depending on the ownership interest, is effectively included in a U.S. person's gross estate. There may be instances where a U.S. person who's a majority-interest shareholder would have the death benefit directly included in their estate, particularly where the corporate policyowner isn't the beneficiary.
3. The value of certain property, including a life insurance policy, transferred by the deceased within three years of death.

The allowable deductions generally include funeral expenses, debts of the deceased, the marital deduction (the value of property that passes to a surviving U.S.-citizen spouse), certain charitable deductions and state death taxes.

Estate tax exemptions

The U.S. tax rules provide a basic exemption from estate tax where the taxable estate is less than $11,580,000 USD (in 2020), annually indexed to inflation. Under the current legislation, this exemption amount will be reduced to $5,000,000 USD (indexed to inflation) on January 1, 2026.

The exemption can be used to shelter tax on the estate **and** tax on annual gifts in excess of an annual exclusion amount (discussed later). As a result, if the taxable estate exceeds the exemption amount available (i.e., the total exemption amount less amounts already used to shelter gifts from gift tax), estate tax is payable. When the estate tax is payable, its rate starts at 18 per cent and climbs to 40 per cent when the value of the deceased's taxable estate reaches $1 million USD.

If the deceased has a surviving spouse who inherits the estate and who is also a U.S. citizen, the couple can use the marital deduction that permits a deferral of U.S. estate tax until the death of the second spouse. If certain elections are made in the estate's tax return, the survivor can use the unused portion of the deceased's exemption amount. This effectively brings the total exemption amount for a couple to $23,160,000 USD (in 2020).

If the surviving spouse who inherits the estate isn't a U.S. citizen, the couple can defer paying the U.S. person's estate-tax liability by using a Qualified Domestic Trust (QDOT). A QDOT is a trust established under specific U.S. rules. The estate tax payable on the properties transferred to a QDOT is deferred until either the trust's capital is distributed to the surviving non-U.S.-citizen spouse or upon the surviving spouse's death. Alternatively, the Canada-U.S. Tax Treaty provides a marital credit against U.S. estate tax if certain conditions are met, which effectively results in the couple being able to double the amount of assets that may be transferred to a non-U.S.-person's spouse free of U.S. estate tax ($23,160,000 USD in 2020).[iii]

Gift tax

The U.S. gift tax applies to properties gifted by a U.S. person to another person, subject to certain notable exceptions like those to a U.S.-citizen spouse or to a charity. An annual exclusion amount of $15,000 USD (in 2020) applies to each person to whom a gift is made. In the case of a non-U.S.-citizen spouse, this exclusion is increased to $157,000 USD (in 2020). The amount of a gift in excess of the annual exclusion amount is subject to the gift tax. Any gift tax payable may be sheltered using the U.S. estate-tax exemption amount discussed previously – which in turn reduces the overall exemption that may be available at death.

U.S. exempt test

Generally, life insurance policies issued by Canadian insurers are designed to meet the Canadian exempt test rules so the growth accumulating inside the policies isn't subject to annual taxation in Canada. The U.S. has its own version of exempt test rules. If a Canadian insurance policy doesn't comply with the U.S. exempt test rules, the annual growth in the policy may become subject to annual taxation in the U.S.

This U.S. income tax issue exists whether the insurance policy is owned directly by the U.S. person or through a corporation. For a corporate-owned policy with a U.S.-person shareholder, growth in the policy is taxed differently depending on whether the corporation is considered a "Controlled Foreign Corporation" (CFC)[iv] or a "Passive Foreign Investment Company" (PFIC)[v] for U.S. tax purposes.

- If the corporation is considered a CFC, the U.S. person may have to include their respective share of the annual growth in the life insurance policy in their personal U.S. income tax return on an annual basis (referred to as "subpart F" income).
- If the corporation is considered a PFIC, the U.S. person may be subject to a special tax and interest upon receipt of certain distributions (referred to as an "excess distribution") from the PFIC. Alternatively, the U.S. person may elect to include the amount in income on an annual basis – regardless of whether the PFIC makes a distribution in that year.

Similar U.S. rules apply where a Canadian trust is a policyowner and a U.S. person is a beneficiary of the trust. The rules relating to trusts, CFAs and PFICs are complex; clients dealing with them should consult their U.S. legal and tax advisors.

U.S. premium excise tax

The U.S. imposes a one per cent federal excise tax on premiums paid on life insurance policies, sickness or accident insurance policies and annuity contracts on the life or health of a U.S. person that's purchased from a foreign insurer (i.e., a non-U.S. insurer). Generally, the person who pays the premium pays the excise tax and files the related tax return. If this person fails to pay the tax, the U.S. Internal Revenue Service considers the tax to be recoverable from the policyowner, broker, advisor, life insured and the insurer.[vi]

Planning tips

These planning tips are for informational purposes only and should not be taken as tax or legal advice. Any of the following planning tips should be considered by the client's U.S. legal and tax counsel.

Rely on the basic U.S. estate-tax exemption – If the U.S. person's estate, including the death benefit of a policy on their life that they own (or has incidents of ownership of) is less than $11,580,000 (in 2020), they'll have no U.S. estate taxes payable. This amount is exemption amount is doubled where either the marital deduction is available under U.S. tax laws or the marital credit is available under the Canada-U.S. Tax Treaty. This of course assumes that the exemption wasn't already used to shelter gift taxes. This exemption will protect the vast majority of U.S. persons, but it doesn't address the U.S. exempt test and excise tax issues.

Non-U.S.-person ownership – Arrange for a non-U.S. person to be the owner of the policy, like a non-U.S.-person spouse, if it makes sense. This addresses both the estate tax and U.S. exempt test issues, but not the excise tax issue. If possible, ensure the policy doesn't transfer to the U.S.-person life insured if the non-U.S.-person policyowner dies first (this may result in a policy gain for Canadian tax purposes). In cases where the life insured is a U.S. person by virtue of residency (i.e., they're not a U.S. citizen or green card holder) and

plans to return to Canada in the foreseeable future, consider having a non-U.S.-person parent own the policy. The policy could be transferred back to the life insured at a later date under the Canadian intergenerational rollover rule when they're back in Canada and no longer a U.S. person. A U.S. person funding a policy can take advantage of the annual exclusion amounts from U.S. gift tax, discussed above.

In the corporate context, there aren't many opportunities to have a corporate policyowner where a U.S. person is, or might be, a shareholder – particularly since Canadian capital dividends are not tax-free for U.S. tax purposes. In many cases, using an irrevocable life insurance trust is the best option.

Use an Irrevocable Life Insurance Trust (ILIT) – An ILIT may be setup in Canada to purchase the insurance policy, ideally as the original owner. The ILIT would be the owner, payor and beneficiary of the policy. The death benefit would be paid to the ILIT and if structured properly it wouldn't be included in the estate of the deceased U.S. person. ILITs don't address the excise tax issues. They also don't address the exempt test issue which would apply where the ILIT has U.S. beneficiaries.

If a U.S. person funds the ILIT to pay the insurance premiums, ensure the annual payments are within the annual exclusion limits for gifts discussed previously. Each trust beneficiary is factored into the calculation of the total amount that may be transferred to the ILIT within the annual exclusion limit. For example, if the ILIT has three beneficiaries, the U.S. person may transfer up to $45,000 USD to be within annual gift tax exclusion limit. Also, to take advantage of the gift-tax-exclusion limit, the ILIT must have "Crummey powers." These powers give its beneficiaries the opportunity to withdraw their share of the annual trust contributions. From a Canadian tax perspective, the 21-year deemed disposition rule won't apply to the insurance policy.

The following table covers the benefits and considerations of using an ILIT:

Reasons to use an ILIT	Reasons not to use an ILIT
• Removal of life insurance proceeds from the U.S. taxable estate (subject to three-year rule) • Reduction of U.S. probate costs • Added creditor protection • Estate can achieve liquidity by selling assets to the ILIT or from receiving a loan from the ILIT	• ILITs are irrevocable trusts, meaning they can't be undone • Life insured has no control over the policy (they can't be the trustee or beneficiary) • The policy can't be used to borrow against • ILITs may attract trustee and professional fees to set up and maintain • If U.S. persons are beneficiaries, a policy that is non-exempt for U.S. tax purposes may generate U.S. income

Conclusion

Anytime a U.S. person is the proposed policyowner, a shareholder of the proposed policyowner or the life insured, at least one of the three U.S. tax issues identified in this article will be an issue. The issues are very complex and there are planning options that may facilitate a life insurance solution. In all cases, the client's U.S. legal and tax counsel should be involved with the planning.

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[i] For more information, refer to Internal Revenue Service (IRS) publication (i) 559 Survivors, Executors, and Administrators (ii) Instructions for Form 706, and (iii) Instruction for Form 709.

[ii] Internal Revenue Code Regulation 20.2042-1(c)(2)-(6)

[iii] Those conditions are:

- (i) the individual was, at the time of death, a citizen of the United States or a resident of either Canada or the U.S.;
- (ii) the surviving spouse was, at the time of the individual's death, a resident of either Canada or the U.S.;
- (iii) if both the individual and the surviving spouse were residents of the U.S. at the time of the individual's death, one or both was a citizen of Canada; and
- (iv) the executor of the decedent's estate elects the benefits of the marital credit and waives irrevocably the benefits of any estate-tax marital deduction that would be allowed under the law of the U.S. on a U.S. federal estate-tax return filed for the individual's estate by the date on which a QDOT election could be made under the law of the U.S.

[iv] Generally, a CFC is any foreign corporation (i.e., non-U.S.) that is more than 50 per cent owned (directly, indirectly, or constructively under section 958(b) of the Internal Revenue Code [IRC]) by U.S. persons who are U.S. shareholders. A U.S. shareholder is any U.S. person who owns 10% of the stock of a CFC, both by votes or by value, effective for taxable years of foreign corporations beginning after Dec. 31, 2017.

[v] A foreign corporation is a PFIC if it meets either the income or asset test. (i) Income test: 75 per cent or more of the corporation's gross income for its taxable year is passive income (as defined in section 1297(b) of the IRC). (ii) Asset test: at least 50 per cent of the average percentage of assets (determined under section 1297(e) of the IRC) held by the foreign corporation during the taxable year are assets that produce passive income or that are held for the production of passive income.

[vi] For more information, refer to IRS publication 510 Excise Taxes and the instructions for Form 720. This tax doesn't apply if a tax treaty between U.S. and the foreign country provides for an exemption. Unfortunately the Canada-U.S. Tax Treaty doesn't contain this exemption.

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