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Canadian tax alert

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Budget proposes to eliminate tax benefits of certain life insurance products

The 2013 budget introduced measures to discourage the use of certain life insurance products which had traditionally provided extensive tax benefits in certain circumstances. These polices have been particularly attractive for owner-managers who wanted to preserve capital while accessing permitted tax benefits.

The budget focused on two particular strategies:

- Leveraged insured annuities (LIAs), and
- The so-called 10/8 arrangements.

Leveraged insured annuities

LIAs are arrangements under which the owner-managed corporation acquires a life annuity from available corporate assets and an exempt life insurance policy with a death benefit equal to or greater than the premium paid to acquire the annuity. The annuitant corporation receives a guaranteed payment flow from the annuity, which could be distributed as taxable income to the owner-manager, and incurs no net cost because the death benefit from the insurance policy would ensure a return of the premiums paid to acquire the annuity. Subsequently, both policies would be assigned as security for a loan which is used to “replace” the corporate assets used to acquire the annuity.

By virtue of the application of separate provisions of the Income Tax Act (the Act), these arrangements have the following tax attributes:

- The annuity is a prescribed annuity with the result that the corporation is taxed on a set percentage of the annual annuity payments. Further, a portion of these payments are characterized as a non-taxable return of capital.
- The income accruing in the life insurance policy is not taxed on an accrual basis because the policy satisfies the exempt insurance policy requirements. Frequently, the accrued income is distributed to the corporate beneficiary as part of the death benefit, following the death of the owner manager. The death benefit is not taxable in the hands of the corporation.
- For the purposes of the deemed disposition on death rules, the value of the annuity and life insurance policy at death are their cash surrender values. In the case of the annuity, the cash surrender value would be nil.

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- Due to the fact that the policies were assigned to secure borrowings, a portion of the insurance premium is deductible. In addition, any interest paid on the funds borrowed is deductible since the loan was used to purchase investments.
- In the appropriate circumstances, the proceeds on death could increase the corporate beneficiary's capital dividend account.
- The existence of the loan could reduce the value of the shares of the company for purposes of the deemed disposition on death.

In order to address the unintended tax consequences, the budget has introduced new rules regarding the taxation of LIA policies.

An LIA policy will include an insurance policy other than an annuity where:

- There is an agreement that upon the death of the life insured, a lender will be repaid; and
- The lender is assigned an interest in the insurance policy and the life annuity under which payments end with the death of the individual insured under the life insurance policy.

Insurance policies under which all borrowings were entered into before March 21, 2013 would be exempted from this definition.

Where a taxpayer holds an LIA, the Act will be amended with the following consequences, applicable for taxation years ending on or after March 21, 2013:

- The previously deductible portion of the insurance premium will no longer be deductible;
- The fair market value of the annuity upon death will equal the premiums paid under the annuity;
- The capital dividend account will not be increased by any death benefits paid under the life insurance policy; and
- The life insurance policy will cease to be an exempt policy, resulting in the current taxation of the income accruing in the policy.

It should be noted that the government will monitor structures which attempt to circumvent these rules and introduce further measures if considered necessary.

10/8 arrangements

Under a 10/8 arrangement, the taxpayer:

- Acquires a life insurance policy;
- Borrows and pledges the life insurance policy as security; and
- Invests the borrowed funds in income-producing assets.

The key attribute of these arrangements is that the rate of return earned inside the policy is set to be equal to the interest payable on the borrowed funds less a fixed spread, usually 2%.

With a 10/8 arrangement, the taxpayer would deduct both the premiums and interest paid. Further, the income accruing under the insurance policy would not be included in income.

In lieu of continuing to challenge these 10/8 arrangements, the government proposes to amend the Act to prevent their use. Where an insurance policy, other than an annuity, or the investment account of the policy, is pledged as security on a loan and either the rate of interest payable on an obligation held in an investment account in respect of the policy is determined by reference to the interest payable on the amount borrowed, or the maximum amount accruing under the policy's investment account is determined by reference to the principal amount borrowed, the following tax consequences will result:

- The interest paid or payable on a borrowing that relates to a period after 2013 will not be deductible;
- No portion of premiums paid or payable under a policy that relates to a period after 2013 will be deducible; and
- On the death of the life insured after 2013, the capital dividend account will not be increased by the amount of the death benefit unless it exceeds the amount of the loan outstanding at that time.

As a relief measure, the budget provides that if funds are withdrawn from these policies between March 21, 2013 and December 31, 2013 for the purpose of repaying the loans, the policyholder can claim a deduction to reduce and potentially eliminate taxation of that benefit. It should be noted that this measure does not exempt existing plans from these rules; it merely assists in the winding-up of the existing structures.

As with LIAs, the government has indicated that it will monitor structures which attempt to circumvent these rules and will introduce further measures if considered necessary.

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