Managing a Portfolio of Life Insurance Policies

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Important considerations

♦ This material is for information purposes only and should not be construed as legal or tax advice. Every effort has been made to ensure its accuracy, but errors and omissions are possible.

♦ All comments related to taxation are general in nature and are based on current Canadian tax legislation for Canadian residents, which is subject to change. Persons who are not residents in Canada or who are resident in Canada but are citizens of another country, may be subject to different tax rules.

♦ For individual circumstances, consult with legal or tax professionals.
Agenda

Managing life insurance policies can sometimes involve a transfer of ownership of the policy, which can have significant tax implications, sometimes good, sometimes bad.

♦ Transfers of Ownership
  – Rules, exceptions, planning checklist

♦ Change of Beneficiary
Insurance is ...

- **TAX**: ... a tax planning tool
- **WEALTH**: ... a wealth tool
- **PROTECTION**: ... a hedge against risk
Managing Policies

- Life insurance is a unique planning tool
- Life insurance is used to facilitate/enhance overall tax, business and estate planning
- Life insurance policies require on-going monitoring and management
- Transferring an interest in a life insurance policy can have tax implications for both the transferor and the transferee
Types of Transfers

- Spouse to spouse
- Parent/grandparent to child/grandchild
- Shareholder to company
- Company to shareholder or employee
- Company to company
- Taxpayer to trust
- Deceased taxpayer to estate
- Estate to beneficiary
- Trust to beneficiary
- Donor to charity / foundation
General rule

A transfer of ownership

- is a disposition for income tax purposes
- Can result in a policy gain
- Policy gain = proceeds – adjusted cost basis
- If proceeds > ACB, taxable policy gain
- If proceeds < ACB, non-deductible policy loss
- A taxable policy gain is fully included in income
Adjusted Cost Basis
CSV versus ACB

No Accrued Gain  Accrued Gain
Exceptions
Exception - 148(8.1) &(8.2)

- Transfer to spouse is a tax-free rollover
  - Inter vivos or testamentary
Spousal Rollover
Exception - 148(8.1)&(8.2)

- Transfer to spouse is a tax-free rollover
  - Inter vivos or testamentary
- Rules
  - No consideration
  - Settlement of rights arising out of marriage
  - Automatic but can elect out
  - Both spouses must be resident in Canada
- Transaction deemed to occur at ACB
Exception - 148(8)

- Inter vivos transfer to child is a tax-free rollover

- Rules
  - No consideration
  - Transferred to the policyholder’s child
  - Life insured is a child of the policyholder or the transferee
  - Automatic provision

- Transaction deemed to occur at ACB

- Testamentary if child named as successor owner
Exception - 148(8)

Examples

♦ Dad owns policy on son and later transfers the policy to his son
♦ Granddad owns policy on grandson and later transfers the policy to his grandson
♦ Granddad owns policy on his son and later transfers the policy to his grandson.
Intergenerational Transfer
Exception - 148(7)

- A gift
- A distribution from a corporation
- A transfer by operation of law to any person
- A transfer to anyone NAL to the policyholder
- Examples
  - Gift of insurance policy to charity/foundation
  - Transfers to/from corporations and between related corporations
- Transaction deemed to occur at CSV
Exception - 148(7)

Rules

- **Transferor**
  - Proceeds = “value” (typically CSV)
  - Policy gain = CSV − ACB

- **Transferee**
  - New ACB = CSV

*But ... exception can be over-riden*
Exception - 148(7)

Transfer to corporation by shareholder

– Actual proceeds = greater of FMV and CSV
– Excess of FMV over CSV tax-free to transferor
– Excess of FMV over CSV does not impact ACB
– CRA not happy with this result

✦ Third party valuation a must
✦ Planning considerations
Exception - 148(7)

Example - Transfer to corporation by shareholder

- Policy is a $1m T-100 policy
- CSV = $0; ACB = $20,000
- FMV = $600,000 (based on third-party valuation)
- Corporation pays $600,000 to shareholder
- Deemed proceeds = CSV = $0
- No policy gain on transfer, no tax on $600,000
- New ACB to new owner = CSV = $0
Exception - 148(7)

- Transfer to shareholder by corporation
  - SS 148(7) applies
  - But SS 15(1) also applies
  - Shareholder benefit = FMV – amount paid
  - Third party valuation should be considered
Exception - 148(7)

- Transfer to employee by corporation
  - Subsection 148(7) applies
  - Subsection 6(1) applies - EE benefit = FMV
  - Third party valuation should be considered
Exception - 148(7)

- Transfer to charity by donor
  - Transferor includes policy gain in income
  - Policy gain = CSV – ACB
  - Donation receipt based on FMV of policy (subject to the three-year look-back rule)
  - Valuation a must
Fair market value only applies when you’re selling.
Fair Market Value - FMV

- *Fair market value of a life insurance policy?*
  - **Paragraph 40 of Information Circular 89-3**
    - (a) cash surrender value
    - (b) the policy's loan value
    - (c) face value
    - (d) state of health of the insured
    - (e) conversion privileges
    - (f) other policy terms, such as term riders
    - (g) replacement value
Exceptions to the Exceptions
Exceptions to the Exceptions

- Subsection 107(2) transfers
  - Transfer to beneficiary by personal trust is a tax-free rollover
  - SS107(2) takes precedence over SS 148(7)
Planning Checklist

- What are the policy details (FMV / CSV / ACB)?
- Who is the transferor (current owner)?
- Who is the transferee (new owner)?
- What is the relationship between the parties?
- Does the general rule apply or one of the exceptions?
- What are the tax issues? Transferor? Transferee?
- When do we need to make the transfer?
- Why do we need to transfer the policy?
Conclusions

- A transfer of ownership of a life insurance policy can have tax implications for both the transferor and the transferee.
- Understanding the tax implications is important to be able to properly advise clients and manage expectations.
Another requirement in managing a life insurance portfolio is beneficiary designations and declarations.
Naming a Beneficiary

To my spouse
Current spouse?

To my minor child
$ to court

To my children
Issues

In trust for:
Terms of trust?

To John Doe, trustee,
issues

To predeceased
$ to estate
Irrevocable Beneficiary

- Policy-owner cannot deal with contract
- Beneficiary must consent to changes

- Issues
  - Minor child
  - Incompetent beneficiary
  - Former spouse
Named Beneficiary

- Not part of “estate”
- Excluded from probate calculation in Ontario
- Creditor protection
- Privacy (?)
Declaration

SS 190(1) – Policyholder can designate a beneficiary by a “declaration”

SS 171(1) – Def’n of declaration

An instrument signed by the insured,

(a) with respect to which an endorsement is made,
(b) that identifies the contract, or
(c) that describes the insurance or insurance fund or a part thereof,

in which the insured designates, or alters or revokes the designation of a beneficiary

And, “instrument” includes a will
Declaration – Why?

Allows insurance proceeds to be paid to a trustee, to hold in trust for beneficiaries on specified terms

- For minors can extend Trusteeship past age of majority, and give powers to Trustee
- For spouse can control capital distribution
- For disabled or “spendthrift” beneficiary
- For tax planning
Declaration in a Will

- If prepared properly, likely not part of estate for probate purposes

- 2 Saskatchewan cases:
  - Carlisle Estate, 2007 SKQB 435
  - Sun Life Assurance Co. of Canada v. Taylor, 2008 SKQB 403
Carlisle and Taylor cases

♦ Carlisle – Court included proceeds in estate for probate purposes
  – Designation in Will wasn’t to a “named beneficiary”
  – Trustees of insurance proceeds must be someone other than the Executors
  – > Uncertainty!

♦ Taylor – named children as beneficiaries + spouse as “administrator” of the funds
Declaration in a Will

- Separate provision
- Revoke prior designation
- Appoint “Insurance Trustees”
  - Different from the Estate Trustees?
- Identify the beneficiaries
- Set out terms of the trust(s)
- Separate trust on same terms as provided for residue of estate, or on the following terms…
- Confirm that Declaration is made pursuant to the provincial Insurance Act and the proceeds don’t form part of estate
Declaration in a Will

- Include policy number
- Cannot be irrevocable
- Includes only the policies in force at the time the Will is made
Declaration outside Will

- Private
- As an Insurance Declaration
  - Similar to a Will
- As an Insurance Trust
  - Similar to an inter vivos trust
  - But to ensure it is a testamentary trust, be careful that it isn’t funded until death
    - Tech. Interp. 9238555 (Feb. 4, 1993)
Caveats

- Consider creditor protection issues
- Joint owners
  - Declaration cannot be in a Will
  - One owner cannot unilaterally revoke
- Must be in writing, signed
    - Doesn’t need to be witnessed
- Advise the insurer of new designation
  - S. 207 of the Ont. Insurance Act
  - Send in only the relevant provisions
Caveats

- Attorney under POA cannot make a designation
  - Re Richardson Estate, 2008 CarswellOnt 7180
  - Pending B.C. Wills, Estates and Succession Act – court may authorize Attorney to make a designation in a “Benefit Plan” (as long as not in a Will)
Family law issues

♦ Marriage revokes Will, but not beneficiary designations
♦ On divorce, Will construed as if spouse predeceased, but not beneficiary designations
♦ Separation agreement may be a revocation, but only if refers specifically to insurance, pension designations
  – Re Richardson Estate, 2008 CarswellOnt 7180
Planning Checklist

♦ Who are the current beneficiaries and/or declarations?
♦ Who are the trustees of any trust?
♦ Does the current facts reflect the client’s current situation and wishes?
Questions?