iA LARGE CASE **SOLUTIONS**

TAXATION OF LIFE INSURANCE

INTRODUCTION

When used properly, a life insurance policy not only provides financial protection but also serves as a flexible asset with significant benefits during the policyholder's lifetime and after their death. However, careful planning is essential to avoid unintended tax consequences when it comes to life insurance policies. In this article, we will discuss the tax treatment of life insurance policies in Canada, both for individual and corporate owners.

Cash surrender value of a life insurance policy

Generally speaking, the cash surrender value ("CSV") of a life insurance policy represents the maximum amount which the policyholder could receive if the policy were to be surrendered. While a policy's CSV of may not necessarily be equal to its fair market value (see our "Fair Market Value of a Life Insurance Policy"[1] document for commentary on this subject), the CSV of a life insurance policy nevertheless has important implications for tax purposes.

For example, for purposes of evaluating whether shares of a Canadian private corporation would qualify as Qualified Small Business Corporation ("QSBC") shares, which would determine the ability of a shareholder to claim the lifetime capital gains exemption, taxpayers must consider whether an asset within a corporation is "used principally in an active business carried on primarily in Canada".

However, a life insurance policy within a corporation would not typically be considered an "active" asset. Therefore, to determine whether the shares of a corporation would meet the necessary criteria, one must use the CSV[2] of any policies held by a corporation to calculate the value of the aggregate passive assets within the corporation.

Tax treatment of growth of cash value

Generally speaking, the growth of cash value within an insurance policy is not taxable as long as the policy qualifies as an "exempt policy" – which requires the policy to meet certain conditions on an ongoing basis (e.g., the accumulating fund of the policy does not exceed the accumulating fund of the exemption test policies). To ensure the tax-free status of a policy, insurers typically have mechanisms in place to make sure that those conditions are met.

In the event that a policy does not qualify as an "exempt policy", the policyowner would be subject to taxable income equal to the difference between the amount of the accumulating fund and the adjusted cost basis of the policy.[3]

[1] https://files.ia.ca/-/media/files/solutions-cas-avances/pdf/13-1205a_fairmarketvaluelifeinsurance-acc.pdf

[2] ITA, subpara. 110.6(15)(a)(i)

[3] *Income Tax Act* (R.S.C., 1985, c. 1 (5th Supp.)), ss.12.2(1) [ITA]

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POINT OF CONSIDERATION: UNIVERSAL LIFE POLICIES

As the performance of the accumulation fund of a universal life policy is based on the investment profile of the client, there is a risk that the accumulation fund could generate returns greater than the exemption test policy. When that happens, the excessive returns will be transferred to a separate shuttle fund in order to maintain the policy's exempt status. However, such a transfer could generate taxable income to the policyowner based on the amount of the transfer and the adjusted cost basis ("ACB") of the policy.

Tax treatment of policy dividends

For policies with a policy dividend feature[4], the dividend option will determine its tax treatment. If the client chooses to receive the policy dividends in cash, or to deposit them with interest, it will generally be considered a disposition, which could generate taxable income determined by the dividend amount and its prorated ACB.

On the other hand, if the policy dividends were to be used for paid-up additions, or to pay for the premium, the policy dividends would not be considered a disposition and therefore would not generate taxable income.

Adjusted cost basis of a life insurance policy

The adjusted cost basis ("ACB") of a life insurance policy is defined under ss. 148(9) of the Income Tax Act and is determined by a number of factors. The most relevant factors which determine the ACB of a policy are the premiums paid and the net cost of pure insurance ("NCPI") of the policy. NCPI of a policy is generally based on a policy's death benefit minus its cash surrender value, multiplied by the prescribed mortality rate for the insured's age.

Due to the fact that NCPI generally increases year over year, as the insured's mortality risk increases, the ACB of life insurance policies would generally increase in the early years (as premiums are paid into the policy) and decrease in later years (as NCPI continues to grow).

As we will discuss in the coming sections, the ACB of a policy will have important ramifications in situations such as a policy loan, policy surrender and policy transfer.

[4] ITA, para. 148(2)(a)

[5] *Income Tax Regulations* (C.R.C., c. 945), Regulation 308(1)(b) [ITR]

Tax treatment of policy loans

For tax purposes, policy loans made under a life insurance policy are generally treated as dispositions, which may trigger tax consequences. Specifically, where a policy loan is made, there is a deemed disposition which would lead to taxable income to the policyowner equal to the difference of the proceeds of disposition and the ACB of the policy. In this case, the proceeds of disposition would be equal to the lesser of the amount of the loan and the amount by which the CSV of the policy immediately before the loan exceeds the outstanding loan balance[6]. It should be noted that if a policy loan is taken out and the amount is used immediately to pay for the policy's premium, the policy loan amount will not be considered in the proceeds of disposition.

Example
John bought and continues to own a PAR Estate policy. In year 5 he decides to take out a $10,000 policy loan to fund his personal renovation project.

Policy loan amount	$10,000
ACB of the policy	$8,000
Income from disposition	= $10,000- $8,000 = $2,000

From this example, John would have to include $2,000 as taxable income for the year of the policy loan.

If a policy loan is repaid in full or in part[7], a deduction is available in the year of repayment equal to the lesser of the amount of repayment and the amount previously included as income. It should be noted that if a policy's death benefit is paid out before the existing policy loan is repaid, the CRA may not allow any repayment deduction as the amount is directly deducted from the death benefit.

The policy loan as well as the repayment of the policy loan would also affect the policy's ACB. While the policy loan would decrease the policy's ACB, the repayment of the policy loan would increase the policy's ACB, other than the aforementioned portion that was used to deduct against income.

Example
In year 5, John takes out a policy loan. The next year, he receives an inheritance and decides to repay the policy loan amount in full.

After the loan in year 5, the ACB of the policy would be reduced from $8,000 to $0. In year 6, because John repaid the whole amount in full, he can deduct $2,000 from his income, being the lesser amount between the repayment amount and the income inclusion from year 5. The ACB of the policy is also increased by $8,000, which is the amount of repayment ($10,000) minus the income deduction amount ($2,000).

	Policy loan	Repayment	Income inclusion	Income deduction	ACB of the policy
Immediately before policy loan (Year 5)	-	-	-	-	$8,000
Year 5	$10,000	-	$2,000	-	$0
Year 6	-	$10,000	-	$2,000	$8,000

[6] ITA, ss. 148(9), definition of "proceeds of disposition" (b)
[7] ITA, para. 60(s)

Tax treatment of policy surrender

The cash surrender value of a policy represents the amount a policyholder is entitled to if they surrender the policy. However, careful consideration should be given to the tax treatment of a policy surrender. For full surrenders, the policyholder will incur taxable income equal to the difference between the policy's CSV and ACB. For partial surrenders of post-December 1, 1982 policies, the taxable income is calculated as the proceeds from surrender minus the pro-rated ACB of the policy. In a partial surrender, the ACB of the policy would also be decreased by the proceeds of disposition from the surrender, and increased by the amount of policy gain.

Example

Susan is the policyholder of a whole life policy with an ACB of $10,000 and a CSV of $30,000. She wishes to do a partial surrender of $15,000.

	ACB	CSV	Surrender amount	Policy gain (taxable income)
Before the surrender	$10,000	$30,000		
Partial surrender			$15,000	$15,000 - $10,000*($15,000 /$30,000) = $10,000
After the surrender	($10,000- $15,000 + $10,000) = $5,000	$15,000		

Tax treatment of policy transfer

Similar to a policy surrender, a policy transfer would also cause tax consequences to the policyholder based on the proceeds of disposition and adjusted cost basis ("ACB") of the policy. However, unlike surrender, a policy transfer's tax treatment also depends on the relationship between the transferor and transferee. If the parties do not deal at arm's length, the transferor would be deemed to dispose the policy at the highest of three values: the surrender value of the policy, the fair market value of the consideration received or the ACB of the policy.

For more details regarding the tax treatment of policy transfers, we invite you to consult our "Transfer of ownership of a life insurance policy involving a corporation"[8] document.

Capital dividend account and life insurance proceeds for corporate-owned policies

One benefit of corporate-owned life insurance policies is their ability to generate a CDA balance for the corporation (assuming that the corporation is designated as beneficiary of the policy). A capital dividend account ("CDA") is a tax account for Canadian private corporations which allows tax-free dividends to be paid to Canadian resident shareholders. In order to use a corporation's CDA balance, the corporation must have a positive CDA balance and elect the dividend to be capital dividend using the prescribed form. The CDA is made up of different elements, including a corporation's non-taxable portion of its capital gains, non-deductible portion of its capital losses, as well as any capital dividends received and life insurance proceeds (calculated as the policy's death benefit minus its ACB). For details, please consult our "Capital Dividend Account" document.

Furthermore, unlike the CDA balance generated by capital gains, the CDA balance generated by life insurance payments would not be reduced by future capital losses of the corporation.

In the example below, in year 1, the corporation added $100,000 to its CDA balance due to its capital gain, but the amount was reduced back to $0 as it suffered $100,000 in capital loss. In year 3, the corporation received a death benefit amount from a life insurance policy, which increased its CDA balance by $200,000. Even though there was another $100,000 in capital loss in year 4, it did not reduce the CDA balance generated by the life insurance proceeds, as capital losses would only reduce the CDA balance related to capital gains, and they have no effect on the CDA balance created by life insurance proceeds.

	Non-taxable capital gain	Non-deductible capital loss	Net life insurance proceeds	Capital dividend paid	CDA balance at a given time
Year 1	$100,000				$100,000
Year 2		$100,000			$0
Year 3			$200,000		$200,000
Year 4		$100,000			$200,000

[8] https://files.ia.ca/-/media/files/solutions-cas-avances/pdf/13-1183a_sca_transfertpropriete-assvie-20250414.pdf

[9] https://files.ia.ca/-/media/files/solutions-cas-avances/pdf/13-1194a_acc_20240510.pdf

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