iA LARGE CASE
SOLUTIONS

UNDERSTANDING CANADIAN LIFE INSURANCE FOR US PERSONS

Introduction

Life insurance is a crucial financial tool that provides tax efficiency, flexibility, security and peace of mind by ensuring that loved ones are financially protected in the event of the policyholder's death. While residing in Canada, many US persons may consider Canadian life insurance to attain these benefits. This text aims to explore the feasibility of Canadian life insurance for US persons and to offer insights into cross-border considerations from the US side.

US tax regimes

The US has four federal tax regimes: income tax, gift tax, estate tax, generation-skipping transfer tax. This text will only cover estate tax and income tax. US persons should review with their US tax experts the other tax regimes as well as individual states' tax considerations, where applicable.

Estate tax

Upon death of a US person, there is an estate tax imposed on the taxable value of the US deceased's worldwide estate: the fair market value of the estate less the allowable deductions and credits. The deceased's worldwide assets at death include all property owned or controlled by the deceased: real and personal, tangible and intangible, notably life insurance proceeds.[1] The taxable value of the estate is sheltered from estate tax on the first US$13.99M in 2025.[2] Over this threshold, the estate is taxed at 40%.[3]

Income taxation of US persons

The United States of America is one of a few countries that taxes US persons regardless of their residence.[4] US persons are taxed on worldwide incomes regardless of where they earn said incomes. However, US persons may be entitled to foreign tax credits in their country of residence to help reduce or offset their US tax liability.

Internal Revenue Code (IRC) 7701 provides the definition of US person: a citizen[5] or resident of the United States. A US resident is an individual who:

1. is lawfully admitted for permanent residence[6];
2. meets the substantial presence test[7]; or
3. makes a first-year election be treated as a US resident, under certain conditions[8].

Under the substantial presence test, a non-US individual may still be treated as a US resident if they have a closer connection to the US than to a foreign country.[9] This may apply to people with extended stays in the US for work, such as foreign athletes.

US income taxation of life insurance

To be qualified as a life insurance contract under the IRC, the contract must meet the state law requirements and satisfy the definition of life insurance under IRC 7702 for all life insurance contracts issued after 1985. Upon meeting the IRC 7702 requirements, life insurance contracts receive several tax benefits, namely:

1. Gains earned on premiums paid are not subject to taxation;

2. Death benefits are received tax free;
3. Withdrawals or distributions from the cash value are not taxable to the extent that said amounts are less than the policyholder's basis in the contract;
4. No gain or loss is recognized on the exchange of life insurance contracts for other insurance products (life, endowment, annuity, and long-term care policies[10]);
5. Amounts borrowed against the cash value are received tax free.

If a contract meets IRC 7702 requirements and it is overfunded during the first seven contract years, IRC 7702A may convert said policy into a Modified Endowment Contract (MEC). Once a contract is qualified as a MEC, it loses several tax benefits[11]:

1. Loans, withdrawals and distributions are subject to taxation on a last-in-first-out (LIFO) basis, instead of first-in-first-out (FIFO), meaning that gains earned on premiums are taxed before the return of the tax-free policyholder's basis;
2. Assignments or pledges of a MEC as collateral security for a loan are treated as taxable distributions;
3. If the US person is under the age of 59½, withdrawals may be subject to a 10% penalty, in addition to the income tax.

Life insurance policies must always comply to IRC 7702. Hence, policyholders must exercise caution when contemplating additional contributions to the policy and should consult the insurance provider to confirm whether such investments could jeopardize the policy's compliance status. IRC 7702 rules are extensive: for more details, refer to the explanations and examples presented in the appendices below.

Canadian life insurance for US insureds

The Canadian life insurance market offers two major policy types: term and permanent.[12] Term life insurance policies do not accumulate cash value and are not subject to IRC 7702. Permanent life insurance policies accumulate cash value and must pass either exemption test under IRC 7702.

To determine if a Canadian permanent life insurance policy on the life of a US insured meets the US exemption test, iA Financial Group strongly recommends that the policy be evaluated by US actuaries because:

- The US allows less premium at early years than Canada;
- The US exempt tests should be performed more regularly[13] than the Canadian test since the policy can no longer be exempted once the US exemption test is failed;
- Whole life policies with base premium and no overfunding may be fine;
- Overfunding generally increases the cash value and decreases the death benefit[14]: overfunding must be conservative to meet IRC 7702 requirements;
- Universal life policies present risks: investment choices should be conservative since market volatility may offside policies at any time during the year.

Ownership of Canadian life insurance for US insureds

When purchasing Canadian life insurance for US persons, the ownership of the contract must also be considered because the death benefit is included in the US deceased's estate if the deceased had "incidents of ownership"[15] at the time of their death. The following table shows different situations that trigger incidents of ownership:

Personal incidents of ownership	Corporate incidents of ownership

– Having ownership interest in the policy
– Being a beneficiary of the policy
– Having the following:
  – rights to change the beneficiary of the policy,
  – rights to borrow against the policy,
  – rights to surrender/ cancel the policy,
  – option to acquire the policy,
  – rights to elect settlement options.
	– The US insured controls the corporation (more than 50% of votes) and contract proceeds are payable to an individual or entity other than the corporation.
	– There are no incidents of ownership if the proceeds are paid or payable to the corporation: the contract proceeds are included in the value of the shares, which are part of the deceased's estate.

To avoid the inclusion of the life insurance proceeds in the deceased's taxable estate, irrevocable life insurance trusts (ILIT)[16] are commonly used to own the policy. When taking out life insurance contracts owned by ILIT, US persons should consult their US legal and tax experts since the following should be considered:

- Beneficiary: the ILIT, ordinarily, to limit the incidents of ownership;
- Premiums: paid by the trust thanks to contributions made by donors[17].

In addition to corporate incidents of ownership, the corporate ownership of life insurance may present other challenges:

- No capital dividend account (CDA) is available in the US tax system;
- US tax residents cannot benefit from the CDA because to receive the death benefit tax-free via non-taxable capital dividend, the beneficiary must be a Canadian resident;
- If the life insurance policy fails the US exemption test, it is considered a foreign investment vehicle, and the corporation may be subject to Controlled Foreign Corporation (CFC) rules and Passive Foreign Investment Company (PFIC) rules.

CFCs are identified based on their ownership and control by US shareholders.[18] PFICs are determined based on the nature of their income and assets, focusing on passive income.[19] Although CFC and PFIC rules possess different criteria and apply differently, they both aim to prevent tax deferral on foreign investments and to impose taxes on US shareholders annually on said investment income. These rules go beyond the scope of this text because of their criteria, complexities, tax implications and compliance. Therefore, iA Financial Group strongly advises that US persons consult their US tax specialists when thinking about purchasing Canadian life insurance via a corporation.

Other US considerations for Canadian insurance

Excise tax

Canadian life insurance policies covering US persons are subject to an excise tax equal to 1% of the premiums paid during the tax year to any foreign insurer.[20] This excise tax is also imposed on sickness, accident or annuity contracts issued by any foreign insurer. The payer of the premium is generally responsible to report and pay said tax quarterly.[21]

Reporting requirements

A Canadian life insurance policy on the life of US persons may require several types of reporting:

Reporting rules	Description
Foreign Account Tax Compliance Act (FATCA)[22]	– Applicable to US persons owning certain foreign financial accounts or other offshore assets, including foreign-issued life insurance or annuity contracts with cash value. – IRS Form 8938 attached to the annual income tax return (IRS Form 1040).
Report of Foreign Bank and Financial Accounts (FBAR)[23]	– Electronic reporting applicable to US persons with financial interests in or signatory authorities over foreign financial accounts (bank, brokerage account, mutual fund, trust, or other type of foreign financial account), such as foreign-issued insurance with cash value. – Financial Crimes Enforcement Network (FinCEN) Form 114.

FATCA also imposes reporting to foreign financial institutions (Canadian life insurers) via the Common Reporting Standard (CRS). Under these rules, Canadian life insurers must report annually, to the Canada Revenue Agency (CRA), life insurance policies owned by tax residents of countries other than Canada.

The information reported to CRA is provided to the Internal Revenue Service (IRS) for US persons. This information is extensive and contains personal information and life insurance specifics, including the cash surrender value for life policies and amounts paid or credited to the account holder (i.e., policy withdrawals, redemptions and more).

Conclusion

Canadian life insurance presents a viable option for US persons seeking diverse and potentially cost-effective coverage when residing in Canada. While there are several challenges to navigate, the benefits can be substantial with proper planning and professional guidance: for instance, whole life and universal life policies (especially at base premiums) might be US compliant while responding to clients' needs. When purchasing Canadian life insurance policies, prospective US persons should work with US advisors and experts, alongside their Canadian advisors, to be able to compare Canadian and US illustrations with the same information: age, health, and so on.

APPENDIX – IRC 7702 IN DEPTH

IRC 7702 applies to all cash value life insurance contracts, including whole life, universal life, indexed universal life and variable universal life. To qualify as a life insurance contract, IRC 7702 considers the type of policy, date of issuance, death benefit, cash value and premiums paid by providing two tests:

1. Cash Value Accumulation Test (CVAT); or
2. Guideline Premium and Corridor Test (GPT).

The insurer must choose either test at issuance. This choice is irrevocable.

Cash Value Accumulation Test

The CVAT limits the cash surrender value (CSV) and determines the maximum CSV a life insurance policy can accumulate proportionally to the death benefit (DB). Under the CVAT, a CSV can never exceed the net single premium (NSP), a single up-front premium needed to fund future benefits[24] under the contract at any time. The NSP is based on:

- prescribed reasonable mortality charges[25],
- interest rates: the greater of 4%[26] or the guaranteed rate at issuance,
- any reasonable policy charges (other than mortality charges).[27]

Once the NSP is determined, it is compared to the policy CSV.[28] If the CSV is lower than the NSP, the policy passes the CVAT, otherwise the policy fails and is treated as an investment contract. To better explain the CVAT analysis, here is an illustration:

Policy Year	Death Benefit	NSP	CSV	CVAT
0	$100,000	$2,500	0	Pass
5	$100,000	$2,200	$1,400	Pass
10	$100,000	$1,800	$1,500	Pass
15	$100,000	$1,400	$1,450	Fail

At year 15, the CSV of $1,450 exceeds the NSP of $1,400, and the entire contract would fail the CVAT. To avoid failing the CVAT and to keep the policy compliant:

- The death benefit and premiums should be monitored;
- Rapid growth of the CSV should be avoided by limiting large upfront premiums;
- Actuarial tests comparing CSVs to NSPs should be run regularly as values change;
- Here, the death benefit may be increased or the premium reduced before year 15.

Guideline Premium and Corridor Test

The GPT is the second test used to qualify a contract as a life insurance contract. The GPT is a two-prong test that: (1) limits the sum of premiums paid into a life insurance policy to maintain a sufficient death benefit and (2) keeps the death benefit greater than applicable percentage of the cash value corridor.

To pass the first part of the GPT, the total premiums paid must always be less than the guideline premium limit (GPL): the greater of the guideline single premium (GSP)[29] or the sum of guideline level premiums (GLP)[30]. Similar to the NSP, the GPL is based on:

- reasonable mortality charges (not exceeding standard mortality tables),
- reasonable expense charges other than the mortality charges (based on the insurer's experience),
- interest rate[31]: the greater of 4% or the guaranteed rate at issuance.

To pass the second part of the GPT, the death benefit must fall within the cash value corridor: the death benefit must be greater than the applicable percentage of the CSV corridor[32], which is based on the age of the insured at the beginning of the contract year.

The applicable percentage starts at 250% for an insured person up to 40 years of age and decreases to 100% when the insured person reaches age 95. Starting at age 40, there are age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage decreases by the same amount for each year in the age bracket. For instance, the applicable percentage of the 45 to 50 age bracket is from 215% to 185%, or 6% for each annual increase in age: at age 47 at the beginning of a contract year, the applicable percentage is 203%. Thus, if an insurance contract has a cash value of $10,000, the death benefit must be at least $203,000 (203% of $10,000).

To illustrate the GPT, imagine a policy issued on a 47-year-old insured with a death benefit of $500,000, a GSP of $100,000 and a GLP of $5,000 annually up to age 95. If $90,000 of premiums are paid over 10 years, and the cash value grows to $120,000:

- The premiums paid are within the GPL limit[33]: $90,000 is less than $100,000 (GSP).
- The death benefit must be at least 203% of cash value: $120,000 × 2.03 = $243,600. The death benefit of $500,000 is greater than $243,600.
- The policy passes the GPT because the premiums paid are lower than the GPL and the death benefit is greater than the applicable percentage of the cash value.

APPENDIX – APPLICABLE PERCENTAGE OF THE CASH VALUE CORRIDOR

Insured's age		Proportionate annual decreasing percentage	
More than	**Less than or equal to**	**From**	**To**
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

1 IRC 2042.
2 $15M in 2026 and indexed annually thereafter.
3 Estate tax rates are assessed on a progressive basis: 40% applies to taxable estates over US$1M.
4 Citizen-based taxation, which is different from residence-based taxation based on individual residence in a country regardless of citizenship.
5 There are several ways to be a US citizen, notably birth in the US, birth outside the US to two US citizens, birth outside the US to one US citizen with other applicable conditions depending on if the birth is before November 14, 1986, or not.
6 US green card holder.
7 Factual determination based on the number of days in the US equal to or exceeding 183 days over three years, with current year being at least 31 days and having a multiplier of 1, the first preceding year having a multiplier of 1/3, and the second preceding year having a multiplier of 1/6.
8 Presence in the US for at least 31 days in a row in a year and for at least 75% of days after the 31-day period.
9 Under tax treaties with a foreign country: for example, Article IV:2 of the Canada and USA tax treaty.
10 IRC 1035.
11 IRC 72.
12 US residents interested in purchasing Canadian life insurance must be residents of Canada at issuance.
13 Monthly US exemption test compared to Canadian annual exemption test.
14 A policy at $50,000 base annual premium (with $37,000 CV and $2.7M DB) vs. a policy at $25,000 base annual premium and additional deposit option of $25,000 (with $42,000 CV and $1.4M DB).
15 IRC 2042(2): personal incidents of ownership may be exercised alone or in conjunction with any other person.
16 For more information on ILITs, clients should consult US tax and legal experts.
17 In 2025, a donor can donate $19,000 for each beneficiary of the trust without triggering the gift tax.
18 IRC 951 to 965: more than 50% (vote or value) owned by US shareholders, each owning at least 10% of votes.
19 IRC 1291 to 1298: at least 75% of its gross income is passive or at least 50% of its assets produce passive income.
20 IRC 4371(2).
21 IRS Form 720; IRC 4374: the advisor who sold the policy may also be liable, if the client does not pay the tax.
22 Penalties are $10,000 or up to $50,000 for continued failure.
23 Penalties are civil and/or criminal with a minimum of 50% of the unreported account balance at the time of violation per violation.
24 Death benefits and endowment benefits.
25 Most recent table: 2017 commissioners standard ordinary (CSO) mortality table.
26 2% for contracts issued after December 31, 2020, or less if insurance interest rate is lower.
27 For qualified additional benefits.
28 Alternatively, the CVAT can be expressed in terms of a ratio of CSV / death benefit, which must fall within allowable limits set by the IRS. The CVAT ratio and the traditional method both provide benefits and limitations.
29 The GSP is the single premium needed at issue to fund future benefits.
30 The GLP is a series of level annual premiums payable until the insured reaches age 95.
31 For GLP, the interest rate is increased by 2%.
32 See appendix below on the applicable percentage of the cash value corridor.
33 GPL = the greater of GSP ($100,000) or the sum of GLP (10 x $5,000).

Get ahead

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