CLU™ INSTITUTE

COMMENT

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POLICY LOANS

A policy loan made under the contractual provisions of a life insurance policy is not an ordinary loan, such as a bank loan or line of credit. A policy loan is specifically defined in the Income Tax Act as an amount advanced by an insurer to a policyholder under the terms and conditions of the policy.

Taking a policy loan, paying subsequent interest charges and repaying the policy loan all have income tax consequences and could result in an income tax liability or even savings.

Policy loan advance

Taking a policy loan is considered a disposition of an interest in the policy. The proceeds of the disposition are the lesser of

1. the amount of the loan (other than any part of the loan that is used to pay a premium under the policy); and
2. the cash surrender value of the policy minus the balance of any prior policy loans.

Where the proceeds of the disposition exceed the adjusted cost basis (ACB) of the policy, the excess is considered a policy gain and is included in the policyholder's income. Accordingly, it is possible to take a policy loan up to a maximum of the ACB of the policy without immediate tax consequences.

The ACB of the policy is reduced by the amount of the policy loan for the purpose of subsequent transactions. If the policyholder realizes a gain upon taking the loan, the amount of the gain is added to the ACB of the policy. Thus, the ACB is essentially rebalanced to zero when a gain occurs. For example, if a $4,000 loan is taken on a policy with an ACB of $3,000, the policyholder reports a $1,000 gain and the ACB of the policy becomes nil ($3,000 - $4,000 loan + $1,000 gain).

Policy loan interest

The policyholder can choose to pay the interest on the loan or to allow the interest to compound. If interest is paid, the payment will increase the ACB of the policy. If interest is allowed to compound on the loan, each compounded amount is considered a separate policy loan. The proceeds of the disposition for the new loan is deemed to be nil and there is no net ACB adjustment as a result of this capitalization.

The policy loan interest that is paid or capitalized may be deducted for income tax purposes if the policyholder uses the loan to generate income from a business or property and complies with the other interest deductibility rules. If the policyholder deducts the interest expense, then there is no increase to the ACB of the life insurance policy for the payment of the interest.

To claim a deduction for the policy loan interest, the policyholder must file a prescribed form with the insurance carrier. This ensures that the carrier knows the interest expense is being deducted by the policyholder for income tax purposes and, therefore, the amount should not be added to the ACB of the policy.

A publication distributed by CLU Institute™. A Chartered Life Underwriter (CLU™) is a financial advisor who specializes in advanced life insurance applications and estate planning solutions. Many are also experts in health insurance and employee benefits.

Policy loan repayment

There is no requirement to repay the policy loan during the life of the insured. If the policy loan has not been repaid at the time of the life insured's death, then the amounts owed under the policy are deducted from the insurance proceeds and only the remaining proceeds are paid to the beneficiary.

Upon the repayment of the policy loan during the life insured's lifetime, the policyholder may be entitled to a deduction against income from other sources if he or she previously reported a policy gain. The amount of the deduction is equal to the lesser of

1. the amount of the repayment; and
2. the amount previously reported as a policy gain minus any such deductions previously taken.

The ACB of the policy will be increased by the amount of the policy loan repayments in excess of any such deduction allowed.

In this fashion, policy loan repayments first "reverse" any gain recognized when the loan was taken (by allowing a deduction in the year of repayment). Repayments in excess of that gain will reverse the ACB reductions that occurred as a result of the loan. If a $2,500 repayment was made in the example above (and ignoring the effects of any interest), the first $1,000 would be deductible from other income to offset the reported gain. The remaining $1,500 would be added to the ACB of the policy. If the final $1,500 loan balance was then repaid, it would also be added to the ACB, restoring the ACB to its original $3,000 balance.

Note that the CRA does not generally consider that there is a repayment of the policy loan for these purposes where the policy proceeds net of an outstanding loan amount are distributed upon the life insured's death.

The ability to take a policy loan as a contractual right can give the policyholder a great deal of flexibility and many financial strategies have been developed based on this right. However, it is important for the policyholder to fully understand all of the income tax implications before proceeding with any plan.

I/R 7401.043

VOLUNTARY DISCLOSURE

The Canadian tax system is based on self-assessment and relies heavily on voluntary compliance. There are times, however, when taxpayers fail to comply with the system and could become subject to significant consequences. In an effort to promote voluntary compliance, the federal government created the Voluntary Disclosure Program ("VDP").

The VDP is designed as a fairness program to encourage taxpayers to disclose material they previously omitted, or to correct inaccurate or incomplete information, without penalty or prosecution. The program applies to the federal income tax, customs and GST/HST systems. In simple terms, it provides taxpayers with an easy way to self-correct tax reporting deficiencies and thus comply with their legal obligations. (Generally, the provinces have also instituted similar programs for taxes they administer.)

To qualify under the VDP, taxpayers must make a "valid disclosure." The taxpayer must pay any taxes and interest that result from the disclosure, but the CRA can waive any penalties and prosecution that would otherwise apply.

There are four conditions associated with what the Canada Revenue Agency (CRA) terms a "valid disclosure."

1. The disclosure must be voluntary and initiated by the taxpayer. However, it will not be considered voluntary if the disclosure occurs because the taxpayer becomes aware of an audit, investigation or enforcement action.
2. The disclosure must be full and complete. Any material errors or omissions will typically disqualify the disclosure from the VDP. "Completeness" includes all tax lines administered by the CRA. For example, if a taxpayer is non-compliant both for income tax and GST, the taxpayer would have to disclose both liabilities for the disclosure to be valid.
3. There must be a penalty involved. If the disclosed deficiency would not otherwise result in at least one penalty, the disclosure will not normally fall within the VDP. Nonetheless, the deficiency should still be reported.

4. The disclosure must generally relate to information that is more than one year past due. If the disclosure relates to information that is less than one year old, it cannot be made simply to avoid the late filing or instalment penalties.

The process for making a voluntary disclosure has been enhanced over recent years, as it now allows for initial discussions with a voluntary disclosure officer on a no-name (hypothetical) basis. This is significant and is quite often handled through the taxpayer's professional tax advisor or a representative acting on behalf of the taxpayer. On the other hand, the VDP provides a simple process for individuals who want to come forward on their own.

While the VDP is not a well-known program, an increasing number of taxpayers are accessing it as a means by which to "set the record straight."

I/R 7401.00

CAPITAL DIVIDEND ACCOUNT

The capital dividend account ("CDA") is an important element in estate planning since the use of corporate-owned life insurance in conjunction with the CDA can provide significant estate and tax planning opportunities. However, this is not the only role of the CDA. It is important to fully understand how the account works and how its balance is determined.

The CDA is available only to private companies. Public companies (essentially those with shares listed on Canadian stock exchanges) and publicly controlled companies (i.e., those controlled by public companies) cannot have a CDA. The mechanism is not restricted to Canadian-controlled companies, however. This means that foreign-controlled Canadian companies could have a CDA balance.

When a corporation pays out dividends, it can elect that they be treated as capital dividends to the extent that there is a balance in its capital dividend account. Such dividends are not subject to tax in the hands of Canadian-resident shareholders. However, where the company has foreign shareholders, it is important to note that the foreign country may not recognize the tax-free nature of capital dividends. In addition, capital dividends paid to non-residents will be subject to Canadian withholding tax, typically at a rate of 25 per cent.

The CDA is a notional tax account. It does not exist in an accounting system nor is it necessarily reported on financial statements. In addition, there is no tax reporting requirement with respect to the account balance or any annual transactions. While the Canada Revenue Agency tracks the balance within its system, it is not required to confirm whether the taxpayer's calculations match those recorded by the government.

To better understand how the CDA balance is calculated, imagine five distinct silos each of which represents a separate element of the CDA calculation. The CDA balance is the sum of the positive balances from each of the first four silos minus the balance from the fifth. This concept is important, because even though one silo may have a negative balance, it is only the positive balances that are considered in the calculation.

The first silo is the sum of all of the company's capital gains in excess of its taxable capital gains, less the sum of all the company's capital losses in excess of its allowable capital losses. Conceptually then, this silo contains the non-taxable portion of capital gains in excess of the non-deductible portion of capital losses. At the current 50 per cent capital gains rate, one-half of any gain will be subject to tax, while the remaining non-taxable portion will be added to the CDA. If the company makes a charitable donation of publicly listed shares, only 25 per cent of its capital gain is taxable and it will get a credit to its capital dividend account of 75 per cent of the capital gain (i.e., the non-taxable portion).

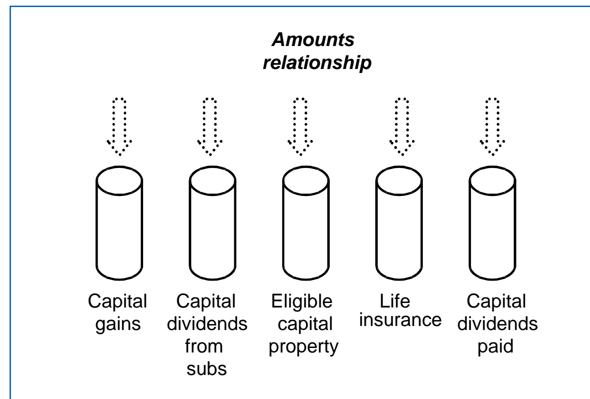
Mathematically, this first silo could have a negative balance, but since only positive balances from the first four silos are added together, a negative balance does not reduce the balance in the CDA. A negative balance in the first silo will remain until sufficient additional capital gains are realized to clear the negative balance.

The second silo is the sum of all capital dividends received by the company from other private corporations. This silo allows capital dividends to flow up from companies in the bottom of a corporate hierarchy to the holding companies higher up.

The third silo is similar to the first silo, except that it tracks the untaxed portion of the gain realized on the disposition of eligible capital property. Eligible capital property is generally defined to include intangible property such as goodwill, patents or trademarks.

The fourth silo is the life insurance silo. This silo records the amount of the life insurance proceeds received by the company in excess of the company's adjusted cost basis in the policy. If the company is only the policy beneficiary, but not the owner of the life insurance policy, it will not have an adjusted cost basis in the contract. Therefore, an estate planning technique might be to have a holding company own the life insurance policy and name a downstream company as the beneficiary of the policy. Under this structure, the credit to the CDA is not reduced by the adjusted cost basis in the contract because the downstream beneficiary company does not have any ownership interest in the policy. Note, though, that the Canada Revenue Agency has indicated that it might apply the general anti-avoidance rule to eliminate the tax benefits unless there was a bona fide non-tax reason for this structure.

The last silo is the sum of all capital dividends paid by the company. This silo is deducted from the sum of the positive balances of the first four silos to determine the capital dividend account balance at any point in time.



While there are several other silos in the calculation of the capital dividend account balance, the above four are the primary components of the CDA. Furthermore, the theory remains the same in terms of adding together only the positive balances of any of the silos in calculating the CDA.

Using corporate-owned life insurance to generate a CDA is an important element in estate planning, since life insurance can provide the necessary liquidity to deal with estate planning issues and the existence of the CDA balance can enhance the opportunity for tax plans. It is important to remember, however, that other amounts can impact the balance in the capital dividend account.

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