The Institute for Advanced Financial Education

# COMMENT

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## TRANSFERRING A LIFE INSURANCE POLICY

There are times when ownership of a life insurance policy is transferred from one person to another. Such a transfer is a disposition of the contract for income tax purposes and, as a general rule, the transferor will include any gain on the disposition as income to the extent the proceeds of disposition exceed the transferor's adjusted cost basis (ACB). There are, however, exceptions to the general rule.

### Spousal Exception

A life insurance policy that is transferred from one spouse or common-law partner to another is deemed to transfer at the policy's ACB unless an election is made to opt out of the rollover. Both spouses or partners must be resident in Canada at the time of transfer. Unless the opt-out election is made, the transferor is deemed to have received proceeds of disposition equal to the policy's ACB and the transferee is deemed to have paid an amount equal to the policy's ACB.

There is no restriction with respect to who the life insured is under the policy being transferred. For example, Ben and Jacquie are a common-law couple. Ben owns a life insurance policy on an arm's length individual, Sam, because of a business deal several years ago. Ben can transfer the policy on Sam's life to Jacquie on a rollover basis.

The *Income Tax Act* contains a special provision that specifically allows a deceased individual's estate to transfer the title of a life insurance policy to the surviving spouse or common-law partner on a tax-free rollover basis. Without this specific provision, the estate would realize a policy gain equal to the greater of the policy's cash surrender value and fair market value in excess of the policy's ACB.

### Child Exception

Parents often buy life insurance on the lives of their children – minors and adults. Often the intention of the parent is to eventually transfer title of the policy to the child. The *Income Tax Act* allows such a transfer to take place on a rollover basis, and utilizes an expanded definition of child to include grandchildren and children-in-law.

There are both opportunities and traps in the application of this exception. For example, the child acquiring ownership of the policy does not have to be the same child who is the life insured. As such, a policy on one child could be transferred by a parent to another child on a rollover basis. There is, however, a requirement that 'a child is the life insured' under the policy being transferred. As such, the interpretation is that a joint or multi-life insurance policy will not qualify for the tax-free rollover.

Below are three examples of planning opportunities associated with the transfer of a life insurance policy.

### Example 1

Edith purchases a life insurance policy on her daughter's (Christine's) life when Christine is first married. Years later when Christine's daughter, Emma, turns 18-years-old and heads off to university, Edith transfers the policy to Emma, but names herself as the irrevocable beneficiary. The transfer would take place on a rollover basis because the policy is being transferred to a child and a child is the life insured. Emma can use the cash value built-up within the policy to fund some of her university expenses and would report any policy gains realized. Given that Emma is attending university and not working full-time, she would typically be in a low-tax bracket.

When Emma has completed university, she could transfer the policy to her mother Christine. While this transfer would not qualify for rollover treatment, the tax consequences could be minor if the cash value has been removed and the granddaughter remains in a low tax bracket at the time of transfer.

### Example 2

Parents buy three life insurance policies on the lives of each of their three children. As each of the older two children graduate from university, the parents transfer their respective policy to each of them. Given that 'a child is the life insured and the transfer is to the child,' each transfer will take place on a rollover basis.

The youngest child has experienced health issues that have limited his ability to care for himself or to manage his own financial affairs. The parents decide to transfer the youngest child's policy to the oldest child who will assist the younger child should the parents be unable to. The transfer would take place on a rollover basis.

### Example 3

Father decides to buy a joint-last-to-die life insurance policy on his and his daughter's lives. The policy allows father to deposit a significant amount into the policy, creating more cash value than alternative structures.

In this scenario, the father cannot transfer title to the daughter on a rollover basis because the child is not the only life insured under the policy.

A possible consideration is for the father to transfer the policy into joint title with the child's mother. This could occur on rollover basis. Then, after the father has passed, the mother could transfer the policy to the daughter on a tax-free rollover basis.

In this scenario, the father cannot transfer title to the daughter on a rollover basis because the child is not the only life insured under the policy.

## WORKING WITH THE CAPITAL DIVIDEND ACCOUNT

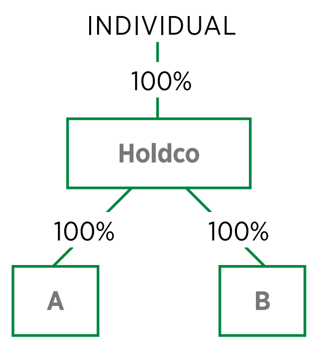
Corporations regularly use life insurance to address a wide range of needs and have become accustomed to the standard formula used to determine the credit applied to the company's capital dividend account (CDA) when proceeds of a death benefit are received. In simple terms, the credit was equal to the proceeds received less the beneficiary's adjusted cost basis (ACB). As such, if the corporation was a beneficiary but not an owner of the policy, there was no reduction applied and the full amount of life insurance proceeds were credited to the corporation's CDA.

A significant change was introduced in the 2016 Federal Budget whereby the CDA credit is now calculated as the life insurance proceeds received in excess of the policyholder's ACB. This means that the policy's ACB is used in the calculation regardless of the relationship of the beneficiary to the policy owner. Since this change has come into effect, the Canada Revenue Agency (CRA) has received many inquiries requesting their view of how the provision should be applied in a variety of situations.

The following two examples are scenarios recently addressed by the CRA.

### Scenario #1

An individual, Carry, is the sole shareholder of Holdco, a holding company that is the 100 percent shareholder of Corporation A and Corporation B. There are no other shareholders and there is no cross-ownership between Corporations A and B. The ownership structure appears as follows:



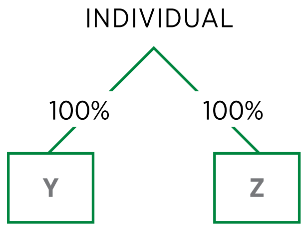

Holdco purchases a life insurance policy on the life of its shareholder, Carry, and names Corporation A as beneficiary for 40 percent of the proceeds while Corporation B is beneficiary for 60 percent of the proceeds. At the time of the Carry's death, the life insurance proceeds are $1,000,000 and the policy's ACB is $80,000.

| | Corporation A | Corporation B | TOTAL |
|---|---|---|---|
| Life insurance proceeds received | $400,000 | $600,000 | $1,000,000 |
| Policy's ACB | $80,000 | $80,000 | |
| Credit to the corporation's CDA | $320,000 | $520,000 | $840,000 |

In this situation, the policy's $80,000 ACB is applied in full for each corporation's CDA calculation, resulting in a double-counting of the policy's ACB.

### Scenario #2

An individual, Sally, is the sole shareholder of each of Corporation Y and Corporation Z. The ownership structure appears as follows:




Sally has decided she would like to have Corporations Y and Z enter into a split dollar (shared ownership) arrangement because Corporation Z is in need of life insurance on her life as owner-manager, while Corporation Y needs an investment. To meet these needs, one life insurance policy is acquired and Corporation Y owns the cash surrender value while Corporation Z is named as the beneficiary of the face amount ($500,000). Each corporation contributes to the annual premium and each corporation is named as the recipient of the benefit of their respective interest.

The following summarizes the status at the time of Sally's death:

- The total death benefit is $750,000 and the policy's ACB is $150,000
- Corporation Y receives $250,000 and has an ACB of $180,000
- Corporation Z receives $500,000 and has an ACB of $25,000
- While the life insurance carrier will only track one adjusted cost basis, each party to a joint ownership arrangement should track the ACB of their respective interest

| | Corporation Y | Corporation Z | TOTAL |
|---|---|---|---|
| **Life insurance proceeds received** | $250,000 | $500,000 | $750,000 |
| **Policy's ACB** | $150,000 | $150,000 | |
| **Credit to the corporation's CDA** | $100,000 | $350,000 | $450,000 |

In this scenario, the policy's $150,000 ACB is applied in full for each corporation's CDA calculation. The new rules do not take into account either corporation's actual ACB of their respective interest.

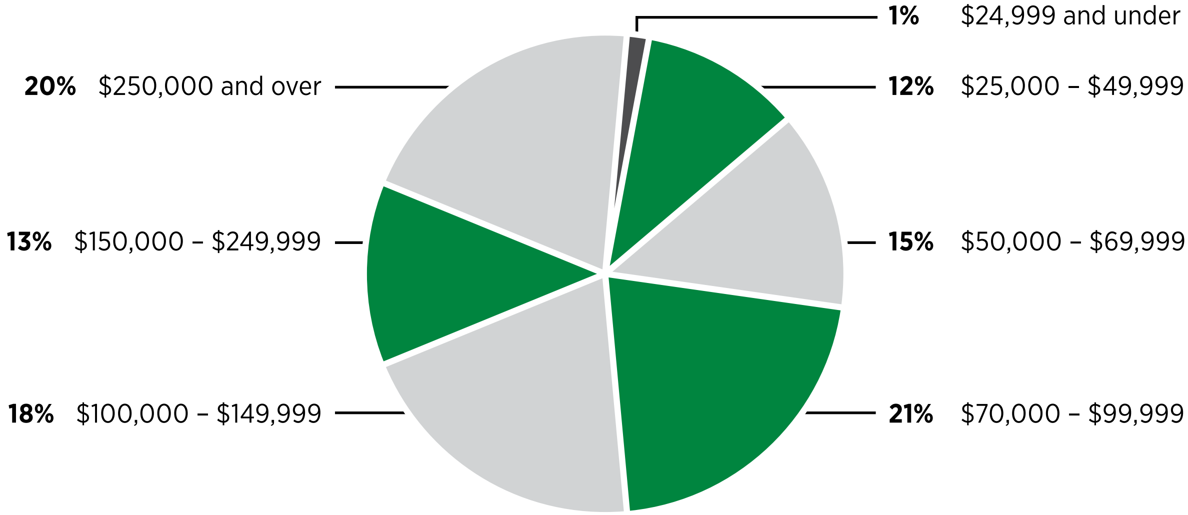
## FOLLOW THE MONEY

Earlier this year, the Canada Revenue Agency released statistics based on all of the income tax returns filed by individuals for 2016. The following are some interesting observations from the data as it relates to net federal income taxes.

Looking over the past few years, the federal government raises about half of its total revenue from personal income tax. In 2016, $128,913,000,000 (nearly $129 billion) of net federal income tax was collected from individuals. Chart A depicts the total income taxes collected from the various income bands. Taxpayers in the $70,000 to $99,999 band contributed 21 percent of the total net taxes, followed by the group in the $250,000 and over band at 20 percent and the $100,000 to $149,999 band at 18 percent. Taxpayers earning less than $100,000 accounted for 49 percent of the total net taxes, while those earning $100,000 or more accounted for 51 percent.

## CHART A

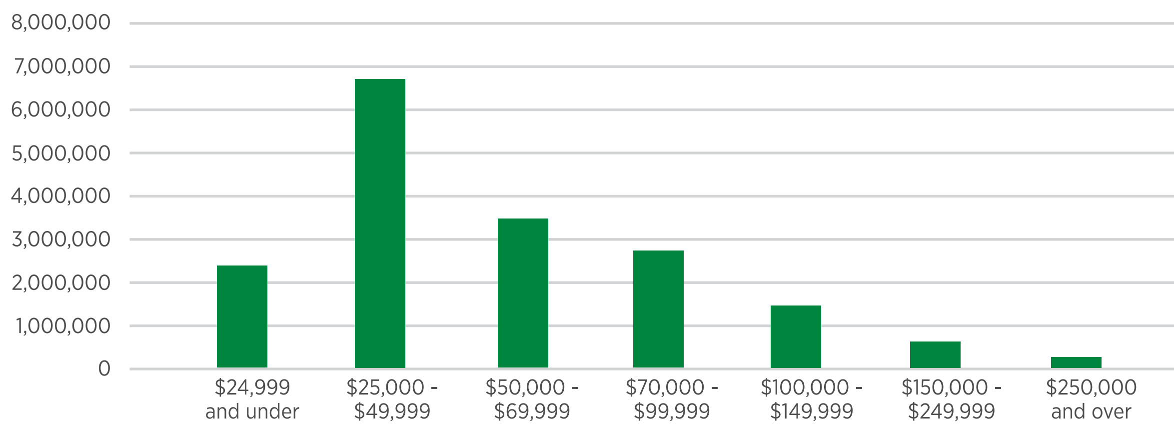
NET FEDERAL INCOME TAXES COLLECTED FROM VARIOUS INCOME BANDS




In 2016, there were 17,947,000 taxpayers with taxable returns. Chart B illustrates the total number of taxpayers in each of the income bands. A total of 15,645,000 taxpayers reported under $100,000 of taxable income, while the total number reporting over $100,000 was 2,302,000. This indicates that 12.8 percent of the total group contributed 51 percent of the total federal income taxes. The $25,000 to $49,999 income band is the largest single group with 6,784,000 taxpayers, representing 37.8 percent of the total. There were 251,000 taxpayers in the $250,000 and over band, which is the smallest group at 1.4 percent of the total; yet, this same group contributed 20 percent of the total federal income tax.

## CHART B

TOTAL NUMBER OF TAXPAYERS IN EACH INCOME BAND

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