COMMENT

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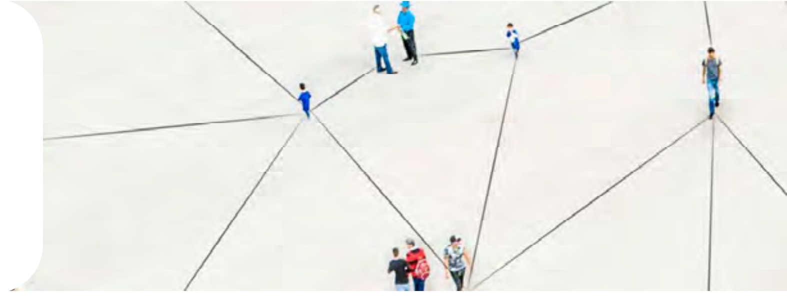
A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

Underwriting insurance during a pandemic



At the time of publication, the COVID-19 pandemic has reached 215 countries and territories, infected 7.9 million people and climbing, and has caused nearly 437,000 deaths, according to numbers from the Centers for Disease Control and Prevention.

In Canada, the infection and mortality rates vary significantly by province and territory. Having witnessed the devastation of COVID-19 in China and Europe, and closer to home in the U.S., our provincial and territorial governments were quick to declare states of emergency and mandate the closure of non-essential businesses. With the collective action taken to physically isolate, alongside other key public health guidelines, Canada has so far been able to avoid the same consequences, and we are contemplating how to safely lift restrictions, even as the number of infections in South America, South Asia, and similar areas continue to rise.

To date, COVID-19 has lower mortality rates than earlier pandemics like SARS and MERS, however it is still too early to tell what the final impact will be. In underwriting, COVID-19 first hit the radar when advisors began expressing concern about meeting in person with clients who had just returned from China. There was an urgency to facilitate physical distancing and keep advisors and their clients safe.

International travel quickly became a concern, with the expectation that travellers be back in Canada for at least 14 days before they could be considered for insurance coverage.

As we were seeing how this was severely impacting some other countries, it wasn't long before provinces and territories implemented physical isolation, and suspension of paramedical services quickly followed. It was no longer safe to have medical health professionals visit clients' homes to secure medical information and collect the vitals and blood and urine specimens needed for underwriting purposes.

> *This sort of pandemic is a first for the insurance industry, at least in our lifetimes.*

Medical exams have traditionally been used to help accurately assess risk, yet, within weeks, most insurance carriers had increased coverage amounts for life, critical illness, and disability insurance products no longer requiring medical exams.

Physical distancing also ramped up the introduction and acceptance of digital signatures, e-contracts, and the use of video chat to verify client identification. These digital offerings are likely to remain embedded in the insurance landscape.

For life and living benefits insurance products, there is the additional mortality and morbidity risk posed by COVID-19 infection. These risks are especially present for those over age 60 who have pre-existing conditions like diabetes, cardiovascular disease, chronic respiratory disorders, hypertension, and cancer. Insurance companies have had to limit their risk exposure in these situations. Some applicants in this group will need to wait until the pandemic

recedes before insurance coverage may be considered.

Those who have recovered from severe COVID-19 infection also need to be underwritten with care. The onset of increasing dyspnea, or shortness of breath, is usually the main symptom of severe disease, and some of the complications arising are acute respiratory failure, and heart, liver, and kidney injury. The patient may also have heart arrhythmias, and clot formation and stroke are increasingly being observed. Prognosis depends on the severity of the infection and the immune response of the individual. Also emerging is a possible link between COVID-19 and the onset of an illness in children that is similar to Kawasaki disease, a hyper-inflammatory syndrome that can be fatal.

For insurance purposes, hospital reports with results of all testing, extent of recovery, and any complications will be needed to consider an application for insurance coverage. Many applications can be submitted one to three months post recovery; however, if the individual needed to be ventilated during the acute stage, longer wait times will be necessary.

Aside from the health risks associated with COVID-19, physical isolation, job loss, insecurity, and fear contribute to an increased risk of depression and anxiety. We must find ways to stay connected and take care of our mental health while the pandemic lasts. Those of us who already live with depression and anxiety may find it particularly difficult to cope at this time, so this needs to be taken into consideration during the underwriting process.

Financial health has also been affected by the pandemic, as shutting down the economy has certainly had global impacts as well. Financial advisors who predominantly sell insurance coverage have struggled with the inability to secure insurance medicals due to physically distancing, and the resulting limited amounts of coverage on offer. Those in the high-net-worth market have had to wait patiently for these services to resume so that they can attend to their clients' insurance needs.

As the provinces are just beginning to reopen for business, attention is now turning to resuming paramedical services, with an eye to doing so responsibly and safely. There has been a real collegial attitude among the many carriers in in Canada, who share a unified interest in ensuring consumers, health professionals, and the community at large are not at undue exposure to risk of contracting COVID-19 when they have insurance medical exams completed.

Over the past few years, insurance companies have been innovating and finding new ways to assess risk aside from the traditional forms of medical evidence that we secure today. Insurers are deploying predictive analytics and artificial intelligence to simplify underwriting and reduce the burden of securing blood and urine specimens and vitals.

This will continue to be an important part of the landscape in future. In anticipation of a possible second wave or future pandemics, insurers are scoping out ways clients can collect their specimens in their own homes and use video chat to obtain or provide medical information.

As with many aspects of our lives, like more people working from home and the need to continue to physically distance until a hoped-for vaccine is distributed to the population, this pandemic will change how we do business going forward. The insurance industry is no exception. ©

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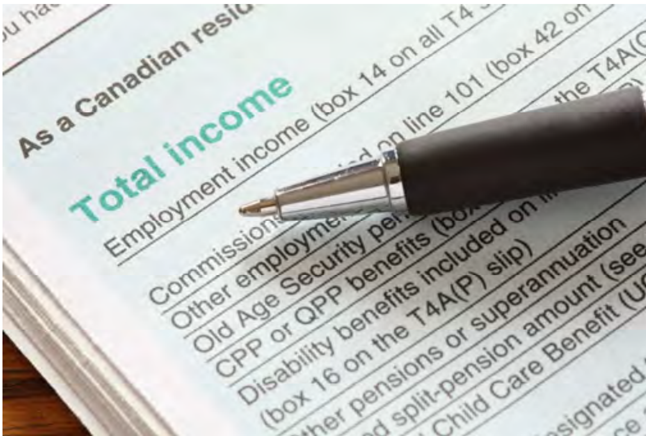
Tax implications of accessing a life policy's cash value



The impacts of COVID-19 on our economy are far reaching — businesses have been forced to temporarily and, in some cases, permanently close their doors, and many individuals have been put out of work. As such, these events have likely thrown a curveball in your client's cash flow and overall financial plans, and they may be looking at ways to generate cash to fund necessary expenses.

One potential source of cash could be the cash surrender value (CSV) of a permanent exempt life insurance policy. There are three main methods to consider for accessing cash values within an exempt policy that do not involve a full surrender of the policy: cash value withdrawals, policy loans, and collateral loans. Both a cash value withdrawal and a policy loan will result in a disposition of an interest in an exempt policy. On the other hand, a collateral assignment of a policy's cash value to a lender as security for a loan is not a disposition. Where there is a disposition of an interest in an exempt policy, there can be tax consequences.

At the time of a disposition, the general tax consequences are the proceeds of the disposition (POD) that are in excess of the policy's adjusted cost basis (ACB) results in a taxable policy gain. This policy gain, if any, is reported on a T5 slip by the insurer. Although it is called a policy gain, it is NOT a capital gain and is treated as ordinary income (like interest income) to the recipient. If realized by a corporation, this income is considered passive investment income, and for private corporations is subject to the refundable tax regime.

When one is considering accessing a policy's cash value, it's important to consider several things in addition to the tax implications. Let's examine the positives and negatives of the three main methods of accessing the CSV of a life insurance policy, including the different tax rules that apply.

Policy Withdrawals

A policy withdrawal appeals to policy owners who have a need for cash and have no intent to repay the amount withdrawn. The process is fairly simple, with few administrative requirements. Any amount up to the cash value of the contract can be withdrawn, but the policy will lapse if the withdrawal results in insufficient funds available in the policy to cover policy costs. Withdrawals will reduce the remaining cash value, if any, in the policy and may reduce the death benefit under the policy.

For tax purposes, a withdrawal is a surrender (or partial surrender) of a policy and is a disposition of an interest in the policy. To calculate any taxable policy gain for a partial surrender, the POD will be the amount withdrawn and the ACB of the policy will be prorated based on the proportion that the POD is of the entire cash surrender value. For example, if the withdrawal is 25% of the cash surrender value, the ACB, used in determining if there is a taxable policy gain will be 25% of the ACB of the whole policy. Therefore, any time the CSV exceeds the ACB a withdrawal will result in a taxable policy gain. For Canadian resident policy owners, tax is not withheld at source by the insurer on a partial withdrawal.

Policy Loans

A policy owner who has a temporary need for cash and who intends to repay the amount borrowed may consider a policy loan. Policy loans are contractual

rights, so the policy contract should be consulted to ensure this is an available alternative. If a contract permits policy loans, the process is fairly simple with few administrative requirements. In general, up to 90% of the policy's CSV may be accessible via a policy loan. The cash value of the policy remains intact but access to it is impacted by the policy loan. A policy loan can be repaid at any time, but any outstanding loan amount will reduce the proceeds payable at death. This means that if the policy owner is a corporation, a policy loan will reduce the death benefit, and thus the credit to the capital dividend account will be net of the policy loan outstanding.

Interest is charged on policy loans by the insurer, and loan rates are typically higher than commercial loan rates. Debt servicing is not required on a policy loan, but the policy will lapse if the loan, including any unpaid interest, exceeds the cash surrender value of the policy.

A policy loan is a disposition for tax purposes, but unlike partial withdrawals, a policy loan amount (the POD) is compared to the ACB of the entire policy. If the policy loan is less than the ACB of the policy at the time of the loan, no policy gain will arise, but the ACB of the policy is reduced by the amount of the policy loan. Policy loans will only be taxable when the loan exceeds the ACB of the policy. The amount in excess of the ACB is a taxable policy gain, and the insurer will issue a T5. Depending on what the borrowed money is used for, the loan interest may be deductible for tax purposes. Borrowed amounts can be repaid and create a tax deduction where the borrowed amount had a taxable portion (was previously T5'd) and interest was not deductible.

Collateral Loans

Although not always the case, a collateral loan would generally appeal to policy owners with more significant cash values who require access to cash over a longer period of time and who have no immediate intent to repay the amount borrowed. Many financial institutions will lend money to a policy owner using the CSV of the policy as collateral security. In general, financial institutions may lend 75% to 90% of the CSV. The CSV remains intact, but the policy is subject to a collateral assignment.

There are more complex administrative requirements for collateral loans, and fees may apply. Should the loan's terms and conditions (debt or interest servicing, or loan to CSV margin requirements) not be met, the lender would have full recourse to force a surrender of the policy to satisfy the outstanding loan amount. Should a surrender occur, there is a potential tax liability, as discussed earlier.

Collateral loans are generally repayable at any time. Loan interest is payable and may be tax deductible depending on the use of the borrowed funds. At death, any remaining loan balance would be repaid from the death benefit proceeds. If a corporation owns the policy and is the borrower, unlike a policy loan, the outstanding loan balance under a collateral loan has no impact on the corporation's capital dividend account credit since the amount used to repay the corporation's loan is seen as being received by the corporation as beneficiary under the policy.

...clients who own permanent life insurance policies with cash value may have access to a much-needed lifeline.

So, during these difficult times, clients who own permanent life insurance policies with cash value may have access to a much-needed lifeline. Clients considering accessing their cash value should review their particular contract to confirm available options and review the tax and non-tax implications. ©

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Transferring a life insurance policy to a shareholder from a corporation

The rules governing the transfer of life insurance policies to shareholders from corporations are complex and frequently misunderstood. The tax implications for both the corporation and the shareholder must be carefully reviewed. This article will consider policy transfers to both individual and corporate shareholders.

The first example assumes that Jasmine, a Canadian resident and citizen, is the sole shareholder of Jasmine Co., a private Canadian corporation. Jasmine Co. is the owner and beneficiary of a policy on Jasmine's life. The policy has a $500,000 face amount, cash surrender value (CSV) of $50,000, and an adjusted cost basis (ACB) of $40,000. Based upon the policy features and other circumstances addressed below, an actuary has determined that the fair market value (FMV) of the policy is $200,000.

Jasmine is selling the shares of Jasmine Co. to a third party and wants to transfer the insurance policy to herself so that it can be used for personal planning purposes.

The second example assumes that Jasmine has a holding company (Holdco) that is the shareholder of Jasmine Co. In this example, the policy is to be transferred to Holdco.

TRANSFER TO JASMINE FROM JASMINE CO.

Tax Implications to Jasmine Co.

The transfer of the policy to Jasmine from Jasmine Co., as a gift or sale for example, would be considered a non-arm's-length transaction governed by subsection 148(7) of the *Income Tax Act* (the Act). The distribution of the policy to Jasmine as a dividend in kind would be governed by the same provision. Other types of transfers are also governed by subsection 148(7), including the transfer of a policy as part of a share redemption, but these are not discussed in this article.

Where subsection 148(7) applies, Jasmine Co. will be deemed to have received proceeds of disposition equal to the greatest of the following three amounts:

1. the value of the interest in the policy at the time of disposition (in this case "value" means the policy's CSV);
2. the FMV of consideration given by Jasmine; and
3. the ACB of Jasmine Co.'s interest in the policy at the time of transfer.

In this example, if the policy was transferred to Jasmine for no consideration, or distributed to her as a dividend in kind, the FMV of consideration paid by Jasmine would be zero. Therefore, Jasmine Co. would be considered to have received proceeds of disposition of $50,000 (the greater of the policy's CSV and ACB). This amount, less the policy's ACB of $40,000, would result in taxable income of $10,000 to Jasmine Co. This is not a capital gain, but is fully taxable as investment income.

No amount would be deductible to Jasmine Co. including, if applicable, any taxable shareholder benefit received by Jasmine (see discussion below). A benefit conferred on a shareholder is not considered to be a cost of doing business.

Tax Implications to Jasmine

Under subsection 15(1) of the Act, a shareholder is taxed on the value of a benefit conferred by the corporation ("value" for these purposes means FMV). Therefore, if the policy was transferred by way of sale or gift to Jasmine, her taxable benefit would equal $200,000 less the amount (if any) that she paid to Jasmine Co. to acquire the policy. Similarly, if the policy was distributed as a dividend, and the amount of the dividend was less than the policy's FMV, the difference would either be taxed at dividend rates, or taxed to Jasmine as a shareholder benefit.

Jasmine's ACB would equal the deemed proceeds of disposition to Jasmine Co. ($50,000), although it is possible that there would be a further ACB increase equal to any taxable benefit she incurs on the transfer.

Policy Valuation Considerations

In cases where the Act provides no specific rules, it is likely that Canada Revenue Agency would rely upon the factors listed in Information Circular IC 89-3 in determining the fair market value of a given policy. These would also be important in any valuation performed by an independent actuary, and would have been considered in determining the FMV of Jasmine's policy. These factors are as follows:

- the CSV of the policy;
- the loan value of the policy;
- the face value of the policy;
- the state of health of the life insured and his or her life expectancy;
- the policy's conversion privileges;
- replacement value; and
- the perceived imminence of death.

TRANSFER TO HOLDCO FROM JASMINE CO.

Other options are available on a transfer of the policy to Holdco (Jasmine's holding company) from Jasmine Co. In many such cases, intercorporate dividends are tax free to the recipient.

This introduces the possibility of the insurance policy being distributed to Holdco as a dividend in kind on a tax-effective basis.

As in the earlier example of a dividend in kind being paid personally to Jasmine, the amount of the dividend to Holdco should equal the FMV of the policy ($200,000). Also, as in the previous example, Jasmine Co.'s proceeds of disposition, and the ACB of the policy to Holdco, would under subsection 148(7) be the greatest of the policy's CSV ($50,000), ACB ($40,000), and the amount of consideration paid by Holdco (zero). The CSV of $50,000 would be the highest of the three amounts, and, like the previous example, a taxable gain of $10,000 to Jasmine Co. would be realized.

Unlike the previous example, under the general rules the dividend would not be taxable to the shareholder, Holdco. There is however a provision that could cause the dividend to be treated as a capital gain, and therefore be subject to tax if there is not "safe income" available in Jasmine Co. at least equal to the amount of the dividend. Safe income requires complex calculations by an income tax advisor, but can be roughly described as Jasmine Co.'s retained earnings as adjusted for income tax purposes.

Therefore, the tax results arising from the intercorporate transfer of an insurance policy is dependent on the FMV of the policy (which can vary widely based upon policy features and the insured's state of health) and the tax position of the corporations involved in the transfer. Some transfers can be achieved without significant income tax impact, while others can create onerous tax consequences. Careful planning is a must.

Unfortunately, the Act does not provide a cohesive, consistent set of rules concerning the transfer of life insurance policies. This is particularly problematic in cases where corporations transfer policies to shareholders. Unexpected tax liability can arise unless advice from a knowledgeable professional is obtained. ©

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