



Business Loan Insurance – Taxation Issues

Purpose of Insurance

Life insurance can provide a secure and cost effective way of making sure that a business loan will not become a financial burden for the owner's family or the firm. Purchasing life insurance for this purpose can:

- provide the necessary funds to reduce or eliminate debt in the event of the business owner's death
- increase the credit resources of the business and protect its ongoing capacity to secure loans.

Premiums May Be Deductible

The premium cost may qualify for a tax deduction provided the policy is collaterally assigned to the lending institution. Unlike an absolute assignment, a collateral assignment does not result in a deemed disposition for tax purposes.

To qualify for the premium deduction, the criteria provided under paragraph 20(1)(e.2) of the Income Tax Act ("the Act") must be satisfied as follows:

1. The policy assignment is required by the lender
2. The lender is a restricted financial institution as defined in the Act. (This reference includes banks, trust companies and certain non-corporate lenders such as credit unions)
3. The interest on the loan is deductible as a business expense by the owner of the insurance policy
4. The amount of eligible premiums deducted cannot exceed the lesser of the net cost of pure insurance (NCPI) or the premiums payable. NCPI represents the yearly cost of insurance and is calculated by the insurer using prescribed rates set out in the tax regulations. (This applies to both term and permanent insurance)
5. The amount deductible is that portion of the maximum amount calculated above that may reasonably be considered to relate to the balance of the loan. For example, if the life insurance coverage under an assigned policy is \$500,000, and the amount owing under the loan throughout the taxation year is \$200,000, the amount deductible is limited to 40% of the lesser of the premiums payable and the NCPI under the policy for the year.

CRA Administrative Guidelines

Regarding collateral life insurance, the administrative practice of the Canada Revenue Agency (CRA) is set out in Interpretation Bulletin IT-309R2 entitled "Premiums on Life Insurance Used as Collateral". The following rules apply: The policy requested by the lender need not be a new policy, the collateral assignment of an existing policy is acceptable.

- The borrower must also be the policyholder. Prior to the issuance of IT-309R2, the CRA's position was that the policyholder need not be the borrower. The CRA now takes the position that the taxpayer seeking the deduction must also be the policyholder.

Every effort has been made to ensure accuracy, but errors and omissions are possible.



- An unused portion of a line of credit is not considered an amount owing for the purpose of the deduction.
- The existence of other collateral, which may be pledged to the lender for the loan, will generally not affect the deduction unless it is clear that the lender has made the life insurance requirement simply to accommodate the taxpayer.

Capital Dividend Account Treatment

The CRA's current interpretation is that where a creditor receives death proceeds payable on a corporately owned policy that is pledged to a lender, the corporation is entitled to credit the capital dividend account (CDA) for all proceeds in excess of the adjusted cost basis of the policy. The CDA is a notional account used for purposes of a private corporation to track certain amounts that are received on a tax-free basis so they may be distributed tax-free to shareholders. This feature provides an interesting selling point for an individual insurance policy that is payable to a corporation. Even though a portion of the life insurance proceeds will be taken by the lender to pay off the debt due by the corporation, the CDA will be credited with the full amount of insurance proceeds less the adjusted cost basis of the policy. Future profits can then be withdrawn tax-free by the shareholders of any class of participating shares to the extent of the credit made to the CDA.

Interpretation Bulletin IT-430R3 issued by the CCRA on February 10, 1997, titled "Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death", states the CRA's position in regard to the treatment of life insurance proceeds in the context of a life insurance policy used as security for indebtedness. Recent revisions to paragraph 6 of the bulletin dated January 7, 2003 confirm the availability of the CDA credit in the case of collateral assignments of a life insurance policy owned by a corporation. The CCRA has stated that a corporation would not be able to receive the CDA credit in circumstances where the creditor was the named beneficiary (and very often the policyholder as well), as occurs in creditor insurance arrangements, or in circumstances where there was an absolute assignment of the policy to the creditor. In those scenarios the use of the CDA credit is available to the creditor, and not the debtor corporation. However the CRA has confirmed that when there is a collateral assignment of the policy to a creditor in order to secure an indebtedness, the proceeds would be available to the debtor corporation for addition to its CDA.

Collateral Assignments in Québec

The CRA had previously taken the position in Quebec that where amounts are paid to a creditor because of the "hypothecation" of the policy, it is the creditor and not the private corporation debtor who receives the proceeds as beneficiary. (Under article 2462 of the Quebec Civil Code, the hypothecation of an insurance policy entails revocation of the revocable designation of the beneficiary in respect of the amounts owing. The creditor, not the debtor, receives as beneficiary the proceeds not exceeding the balance of the debt.) Based on this CRA interpretation, the private corporation would not be considered the beneficiary for the purposes of receiving an increase to its CDA.

In a letter dated July 8, 2002, the CCRA addressed this issue in response to a request by the Association de planification fiscale et financière in Quebec to reconsider their position. The CRA indicated in the letter that it has completed a review of this issue and stated it will now allow the CDA of a private corporation to retain the amount of the life insurance policy assigned to a creditor as a result of the mortgage or guarantee of collateral on the life insurance policy.

The previous CCRA position would have prohibited a credit to the corporation's CDA for an amount equal to the difference between the death benefit and the adjusted cost basis of the contract. The CCRA position is now reversed so corporations in Quebec are now allowed the same credit to the CDA as in the rest of the country. This point is confirmed in the recent up-dates to paragraph 6 of Interpretation Bulletin IT-430R3 that were referred to above.



Meaning of “Payable”

Under the terms of many cash value life policies, the policyholder may elect not to pay premiums out-of-pocket in a particular year and let the internal policy values fund the premium. Because the premium has to be “paid” in order to qualify for a deduction under paragraph 20(1)(e.2) of the Act, it would not appear possible to deduct premiums paid from the build-up of values in the policy. This issue was addressed by the CRA at the 1999 Annual Meeting of the Conference for Advanced Life Underwriting. The Department confirmed its position that the only premiums that qualify for the deduction are premiums payable in respect of the year in which they are made out-of-pocket by the policyholder. For example, if the owner of a universal life policy does not pay any premium in the current year then no deduction can be claimed for this year.

Therefore, in the case of a policy that is collaterally assigned for a loan, if the premiums qualify under the provisions of the Act for a deduction, the policy holder must also have paid the premiums in order for the deduction to be available.

Conclusion

Business loan insurance provides the means to pay off an outstanding loan on the death of the life insured and protect the family and business. Provided certain conditions are met, the insurance can provide two other benefits:

1. The premiums or a portion thereof may qualify for a tax deduction as a business expense which will reduce the overall cost of the premiums paid, and
2. A private corporation may be able to pay tax-free dividends to future shareholders out of the CDA increased by the life insurance death proceeds.

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