



Collateral Life Insurance

Introduction

As a general rule, premiums paid under a life insurance policy are not an allowable deduction for income tax purposes. An exception may arise where a taxpayer borrows money for the purpose of earning income and the lender requires the collateral assignment of a life insurance policy as security for the loan.

Applicable to premiums payable on or after January 1, 1990, some or all of the premiums payable in respect of a life insurance policy used as collateral security may be an allowable deduction under paragraph 20(1)(e.2) of the Income Tax Act (the "Act").

Requirements for Deductibility

In order for all or a part of premiums payable on an insurance policy to be deductible, the following requirements must be met in accordance with paragraph 20(1)(e.2) of the Act:

1. the policy must be assigned to the lender
2. the lender must be a "restricted financial institution"
3. the interest payable in respect of the debt would, but for certain provisions in the Act, be tax deductible in computing income for the year, and
4. the assignment must be required by the lender as collateral for the debt.

These requirements are discussed below in more detail.

1. Policy Assigned to the Lender

The collateral assignment of a life insurance policy is similar in concept to mortgaging real property. The owner/assignor retains certain ownership rights in the policy, but the "value" of the policy (i.e. the cash value or the death benefit) must first be used to satisfy the debt owing to the lender/assignee. Any remaining amount may then be paid to the owner/assignor, or upon death of the life insured under the policy, to the designated beneficiary. This is to be distinguished from the absolute assignment of a life insurance policy, whereby the assignor transfers all ownership rights in the policy to the assignee, retaining no residual interest

2. Lender is a Restricted Financial Institution ("RFI")

An RFI is defined in section 248 of the Act as a bank, trust company, credit union, insurance corporation, a corporation whose principal business is the lending of money or purchasing of debt obligations at arm's length, a controlled subsidiary company of one of the above, or a corporation related to any one of the above. As a result of this requirement, insurance used as collateral security in respect of shareholder loans would generally not be eligible for the deduction.

A 2003 interpretation letter from the CRA has added a wrinkle to the collateral insurance deduction by requiring that the lender continue to be the original institution that made the loan. The letter (#2002 – 0167085 dated January 14, 2003) concluded that where the RFI has assigned / sold its rights under the loan agreement to a trust or other third party, the borrower would not be permitted a deduction. This assignment of debt, referred to as securitization, means that even though the borrower continues their relationship with the original RFI in respect of payments, statements, etc. the actual debt is held by another party. As a result, this extremely technical reading of paragraph 20(1)(e.2) will require the borrower to ensure that the borrowed amount continues to be owed to the original financial institution, not some other party, in order to qualify for a deduction.

3. Interest Payable on Debt is Tax Deductible

Generally, in order for interest on debt to be deductible under the Act, several conditions must be met: there must be a legal obligation to pay interest; interest must be paid or payable in respect of the year that the deduction is taken; the amount of interest must be reasonable in the circumstances; and the borrowed money must be used for the purpose of earning income from property or from a business. The latter requirement generally means that the funds borrowed must be used in the operation of a business, or to earn investment income, not for the purpose of purchasing non-income producing property or for personal expenses. In addition proposed legislation regarding the deductibility of interest and other expenses may limit interest expense deductions for taxation years beginning after 2004. (For more information, refer to the Tax Topic entitled "Interest Deductibility").

Where interest deductibility is denied, the collateral insurance deduction will also be denied. However, if the interest deduction is limited (for example if it is limited to a "reasonable amount"), it is unclear whether the collateral insurance deduction would be available, unavailable, or somehow prorated. The requirement that the interest payable on the debt be tax deductible in order to claim the collateral insurance deduction is in clause 20(1)(e.2)(i)(B) of the Act. This clause uses the words "the interest payable in respect of the borrowing is ... deductible." At the 2004 APFF Conference CRA was asked to comment on the availability of the collateral insurance deduction in a situation where a corporation's interest expense deduction might be limited to the annuity income on a non-prescribed annuity purchased with the borrowed funds (due to subparagraph 20(1)(c)(iv) of the Act) (technical interpretation #2004-0085551C6). CRA expressed the opinion that in this case the requirement "the interest payable in respect of the borrowing is ... deductible" in order to claim the collateral insurance deduction would be satisfied even if only a portion of the interest were deductible. CRA confirmed this position at the 2005 CALU Tax Policy Roundtable Question #4 (technical interpretation #2005-0116651C6) and again in an advanced ruling (#2005-143281R3). It is not certain that this same logic would apply if the interest deduction was limited for some other reason, but it certainly provides some comfort that it might.

4. Collateral Assignment Required by Lender

The lender must require, not merely "appreciate", security in the form of life insurance. A written request from the lender that a life insurance policy be collaterally assigned to secure the loan is generally sufficient evidence that this requirement has been met.

In the case of "Jens v. the MNR, 86 DTC 1061", a deduction was disallowed for premiums paid for "collateral insurance" because the lender merely indicated that life insurance coverage on the life of the debtor would be "appreciated", and did not require that the policy be collaterally assigned to the lender. The court held that these conditions were not stringent enough to meet the condition that the assignment of insurance be "required".

Based on CRA assessing practice, it appears that this requirement must be satisfied in each taxation year in which a deduction is taken. That is, the policy in question must continue to be required as collateral security in the taxation year.

Amount Deductible

Assuming all of the above requirements have been met, paragraph 20(1)(e.2) of the Act provides that the amount deductible in respect of a policy for a taxation year is determined as follows:

The portion of the lesser of:

- (i) the premiums payable by the taxpayer under the policy (other than an annuity contract) in respect of the year, and
 - (ii) the net cost of pure insurance ("NCPI") of the policy for the year
- as can reasonably be considered to relate to the amount owing from time to time during the year by the taxpayer.

Each of these elements is discussed in more detail below.

(i) Premiums Payable under the Policy in Respect of the Year

CRA's Interpretation Bulletin, IT-309R2, "Premiums on Life Insurance Used as Collateral", indicates that where the taxation year is different from the policy year, the premiums payable under the policy should be prorated on a reasonable basis to the taxation year.

CRA has also indicated in an Interpretation Letter dated September 23, 1992 (#9220255), that the Act refers to premiums payable under a life insurance policy rather than to premiums paid and that the method by which the premiums are paid is not relevant to their deductibility. Therefore where premiums are being paid with internal policy values (i.e. with dividends or out of investment accounts), the contract wording is very important. For policies where there is a stipulated premium (e.g. participating policy), the premium payable in respect of the year is the stipulated premium under the contract. For contracts that do not have a stipulated premium (e.g. universal life policies), a contractual obligation does not exist and therefore the premium would not be considered payable.

Where a universal life contract is maximum funded and a premium holiday is taken, there would be no premium payable in respect of the year and therefore it is CRA's view that a deduction would not be available even if the policy is used as collateral security (see technical interpretation #9901875). Question 3 at the 2007 APFF conference confirmed CRA's position maintaining that CRA is generally of the opinion that the premiums payable correspond to the premiums that the policyholder elects to pay to the insurer under the terms of the policy and the amounts that the insurer withdraws from the accumulation account to cover the cost of insurance and related fees do not constitute premiums. In such circumstances the borrower may wish to actually pay at least that portion of the premium equal to the NCPI on an annual basis to take advantage of the deduction for collateral insurance purposes.

A CRA interpretation (2004-009365 in French) dated March 31, 2005 dealt with the collateral assignment of life insurance and disability insurance policies to a lender where the loans were also backed by a provincial government fund. CRA concluded that when there is other security, this should not prevent the taxpayer from deducting life insurance premiums, provided all the other conditions are satisfied. However, regarding the premiums for the disability insurance, the CRA confirmed

that these premiums are not deductible because the premiums are not specifically referred to in subsection 20(1)(e.2) of the Act. A similar CRA interpretation (2006-0191541E5 in French) dated November 30, 2006 came to the same conclusion. Presumably this could apply to critical illness insurance premiums since it may be viewed as accident and sickness insurance.

(ii) NCPI of the Policy for the Year

Similar to the pro-ration of premiums, IT-309R2 provides that the NCPI, which is determined by the insurer on a calendar year basis, should be pro-rated on a reasonable basis to the taxation year.

NCPI is defined in Regulation 308 of the Act. The NCPI of a policy is the net amount at risk multiplied by a mortality factor. The net amount at risk is equal to the excess of the death benefit over the cash value of the policy. Regulation 308 refers to the 1969-75 mortality tables of the Canadian Institute of Actuaries for purposes of determining the mortality factor in respect of any given policy.

For example, assume that a \$100,000 policy has a \$10,000 cash value and the mortality rate for the attained age is \$10 per \$1,000 (or a mortality factor of 0.0100). The NCPI of the policy would be \$900 $[(\$100,000 - \$10,000) \times 0.0100]$.

Where the insured under a policy is rated (i.e. the life insured is a substandard risk based on medical underwriting due, for example, to a health problem), standard mortality tables should be used for the NCPI calculation if standard tables are used in the calculation of NCPI for purposes of determining the adjusted cost basis of the policy. This may cause an "unfair" result in rated cases because the actual insurance costs may be significantly higher than the NCPI calculated on this basis.

For life insurance policies issued prior to December 2, 1982, there is no requirement to calculate the NCPI for the policy; however, it is possible that policies issued prior to December 2, 1982 may be assigned as collateral for a loan. Question 7 (2008-0270441C6) at the 2008 CALU Annual General Meeting dealt with this issue and CRA confirmed that where a pre December 2, 1982 policy is used as collateral security for a loan, the taxpayer would be permitted a deduction for the lesser of the premium and NCPI and that in calculating the NCPI of the policy, the taxpayer would have to determine this in accordance with Regulation 308. Although the responsibility would be on the taxpayer to calculate the NCPI for this purpose, insurers may be willing to help even though they are not required to do so.

Portion of Deductible Amount Reasonably Relating to Amount Owing in the Year

Once the "lesser of" amount is determined in respect of the year, only the portion that may reasonably be considered to relate to the amount owing in the year may be deducted. IT-309R2 provides the following example: Where the life insurance coverage under the assigned policy is \$500,000, and the amount owing under the loan throughout the taxation year is \$200,000, the amount deductible under paragraph 20(1)(e.2) of the Act is limited to 40% of the lesser of the premiums payable and the NCPI of the policy for the year.

Question 1 (#2006-0174781C6) at the 2006 CALU Annual General Meeting dealt with determining the portion of the premiums or NCPI that "can reasonably be considered to relate to the amount owing from time to time during the year by the taxpayer" where a life insurance policy has a cash surrender value. The question assumed a policy with a death benefit of \$1 million, a cash surrender value of \$300,000 and an amount owing of \$500,000. The net amount of risk is \$700,000, which is the amount of insurance for which the NCPI is determined. The CRA stated that, regardless of whether the NCPI or the premium qualifies as the "lesser of" amount, the simple interpretation of this phrase means that the deductible amount of either premium or NCPI is prorated, in this case by 50%, "calculated with

reference to the death benefit payable under the insurance policy and the outstanding amount of the loan without reference to other collateral or the cash surrender value of the policy.”

Where the amount of the loan decreases during the year; the deduction for collateral insurance should be prorated for each premium payment based on the new loan balance. Although technically these pro-rations are required, practically speaking it should be acceptable to base the deduction on the average outstanding balance for the year. IT-309R2 does not discuss this issue; however, CRA has referred to the “average balance owing under the loan” when commenting on the collateral insurance deduction in the explanatory notes to the legislation when introduced in 1991. Presumably, there would be some variation in determining the “average balance owing during the year”. For example, mid-year balance owing or the average of monthly (or quarterly) balances could be used.

IT-309R2 indicates that an unused line of credit is not an amount owing in determining the portion that “can reasonably be considered to relate to the amount owing from time to time during the year”, even if the unused line of credit is subject to a standby charge or commitment fee.

In accordance with industry practice, a restricted financial institution may require that other assets be pledged as collateral for a loan, such that the total value of the collateral exceeds the loan balance. CRA has indicated in IT-309R2 that in these cases, a deduction under 20(1)(e.2) will usually not be denied unless it is clear that the lender has made the life insurance requirement simply to accommodate the taxpayer.

Other Considerations

Either a term or cash value life insurance policy may be used for collateral insurance purposes. Prior to 1990, only term life insurance was permitted for the collateral insurance deduction.

It is not necessary that a policy be purchased at the time of borrowing. The assignment of an existing policy is also acceptable. However, such an assignment must satisfy a bona fide requirement of the restricted financial institution and not be an accommodation to provide the borrower access to a deduction of otherwise non-deductible premiums.

For premiums payable after 1989, the taxpayer seeking the collateral insurance deduction must also be the policyholder. This means that the corporation must own the life insurance policy in order for the corporation to obtain a deduction for any premium it pays. A corporation cannot use a policy owned by a shareholder as collateral for a corporate loan and obtain a deduction for the premiums paid. CRA interpretation, 2007-0219601E5, dated March 14, 2007 looked at the situation where premiums are paid by a parent corporation on a life insurance policy, which it holds, and which it has assigned as security for a loan taken out by its subsidiary. CRA concluded that the premiums paid by the parent corporation are not deductible since the conditions in paragraph 20(1)(e.2) have not been met. A split dollar arrangement where the death benefit is owned by the operating corporation may permit an existing policy owned by a shareholder (parent company) to be changed to a structure which would allow a portion of the premium to be deductible.

Question 2 (#2006-0175101C6) at the 2006 CALU Annual General Meeting CRA commented where a partnership borrowed money from a restricted financial institution with a partner-owned policy used as collateral security. The CRA stated that the partner would not be permitted to deduct the lesser of the premium and NCPI under the policy since the paragraph requires that “the interest on the borrowed money be deductible in computing the income of the taxpayer who paid the premiums. In the example above, the interest is deductible by the partnership in computing partnership income by virtue of subsection 96(1), rather than in computing the income of the partner who is paying the premiums.”

A lender may require that the lives of more than one person be insured in respect of a particular borrowing. In this case, IT-309R2 indicates that the deductibility of the premiums payable by the borrower under each policy is determined independently of the other policies, as if each policy were the only life insurance policy assigned as collateral for the loan.

Even though tax-deductible dollars are used to pay the premiums, the proceeds received on the death of the life insured remain tax-free. CRA has confirmed in a 2004 technical interpretation (#2004-00681401E5) that a corporation will receive a capital dividend account credit where policy premiums have been deducted. Furthermore, even though part or all of the life insurance proceeds may be paid directly to the lender under the collateral assignment, they are considered to be received by the borrower. Therefore, if the borrower (named beneficiary of the contract) is a private corporation, the death benefit proceeds in excess of the policy's adjusted cost basis may be added to the company's capital dividend account, and may be distributed as non-taxable capital dividends at a future date.

Conclusion

Where all of the above conditions are met, the lesser of life insurance premiums and the NCPI of the policy for the year may be a deductible expense under paragraph 20(1)(e.2) of the Act. An example of the collateral insurance deduction is attached in Appendix I.

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APPENDIX I

Collateral Insurance Example

Assumptions:

- All of the requirements for the collateral insurance deduction have been met
- Loan of \$600,000 is payable over 15 years with 9% interest
- Insured is male, 48, non-smoker
- Ten-year Term renewable and convertible with \$500,000 death benefit

Year	Age	Insurance Premium	Insurance NCPI	Death Benefit	Bank Loan	Tax Deduction
1	48	1,540	690	500,000	590,002	690 (1)
2	49	1,540	805	500,000	568,667	805
3	50	1,540	935	500,000	545,412	935
4	51	1,540	1,085	500,000	520,064	1,085
5	52	1,540	1,275	500,000	492,434	1,256
6	53	1,540	1,505	500,000	462,318	1,392 (2)
7	54	1,540	1,775	500,000	429,491	1,323
8	55	1,540	2,075	500,000	393,710	1,213
9	56	1,540	2,405	500,000	354,709	1,093 (3)
10	57	1,540	2,775	500,000	312,197	962
11	58	4,785	3,155	500,000	265,860	1,678
12	59	4,785	3,585	500,000	215,352	1,544
13	60	4,785	4,085	500,000	160,298	1,310
14	61	4,785	4,680	500,000	100,289	939
15	62	4,785	5,405	500,000	34,880	334
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		39,325				16,559
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E. & O.E.						

(1) - deduction = lesser of 1,540 and 690 = 690

(2) - deduction = (lesser of 1,540 and 1,505) x 462,318 / 500 000 = 1,392

(3) - deduction = (lesser of 1,540 and 2,405) x 354,709 / 500 000 = 1,093