

Immediate Leveraged Life Insurance Arrangement

Introduction

The concept of using a life insurance policy with cash value as collateral security for a loan is not new. However, in recent years, this concept has evolved from future leverage (often at retirement) to one in which large sums of money are deposited into a life insurance contract, and then immediately accessed by way of a loan. For a discussion of leveraged life insurance used in the future, see the Tax Topics entitled "[Leveraged Life Insurance – Personal Ownership](#)" and "[Leveraged Life Insurance – Corporate Ownership](#)". This Tax Topic will examine the issues and tax implications to consider where an individual acquires an exempt life insurance policy with the intent of accessing the policy's cash value by collaterally assigning the policy immediately or in the near future.

What is it?

An Immediate Leveraged Life Insurance Arrangement (ILA) is an arrangement in which an individual or corporation purchases an exempt life insurance policy and deposits money into the policy in excess of what is needed to fund the insurance and policy charges. (The deposits usually equal the maximum permitted under the Income Tax Act). This has the effect of creating significant cash value.

The policy is then immediately (or in the near future) used as collateral security for a loan. Often the loan is structured as a demand line of credit with a floating interest rate. As such, the timing of the loan advances may be very flexible. The main limitation is that the outstanding loan cannot exceed a specified percentage of the cash surrender value of the life insurance contract. This percentage is often referred to as the "lending margin". If desired, other assets may be assigned to provide additional collateral security to allow higher loan advances.

The borrowed funds are used to invest in a business or property that produces income. It is assumed that the policy owner can claim a tax deduction for the loan interest and a deduction for a portion of the insurance premiums paid, if applicable.

A collateral assignment of a policy is specifically excluded from the definition of "disposition" of a life insurance policy in subsection 148(9) of the Income Tax Act. This allows the policy's cash value to continue to accumulate on a tax-deferred basis and therefore be used as a continuing source of collateral for bank loans to the policy holder.

The immediate leverage structure discussed in this Tax Topic has the following attributes: the loan is negotiated separately with the lender (not the insurance company) and the loan rate is determined independently from the insurance contract. There is no direct link between the contract of life insurance and the collateral loan agreement. The rate of return inside the policy is determined based on the contract and the policy performance. Because of these attributes, a ILA is not a "10/8 policy" as defined by subsection 248(1)

of the Act and is therefore not impacted by the negative tax consequences of being a "10/8 policy". Please refer to As a Matter of Tax article entitled "[10/8 Plan Measures tabled](#)" for more information on the rules relating to 10/8 policies.

Also, the borrower is the policyholder. If the insured dies while the loan is outstanding, the insurance proceeds repay the outstanding loan balance, and any excess amount is paid tax-free to the beneficiary named under the policy. Alternative structures involving a corporate-owned policy with shareholder borrowing are not contemplated in this Tax Topic. For a discussion of this structure and the related tax issues in the context of leveraged life insurance more generally see the Tax Topic entitled "[Leveraged Life Insurance – Corporate Ownership](#)".

This arrangement requires three separate legal documents: a life insurance policy, a collateral assignment and a loan agreement.

Manulife markets an arrangement of this nature where the insurance policy is issued by Manulife Financial and the lender is Manulife Bank. Manulife refers to this arrangement as an "Immediate Finance Arrangement" or "IFA".

Why Immediate Leverage?

The purpose of the structure is usually two-fold. First, it fulfils the need or desire for an estate benefit (i.e. life insurance). Secondly, it reduces the cash outflow needed to purchase this benefit. This is accomplished through a combination of tax-free growth in the policy, loan advances and tax savings from deductions. Immediate Leverage is an investment strategy; it allows the policy owner to get the insurance coverage they need while at the same time realizing the benefits of leveraged investing.

Who is it for?

Life insurance with immediate leverage is for healthy Canadian resident individuals who:

- need permanent life insurance protection
- are affluent and have steady cash flow exceeding their lifestyle requirements
- have significant amounts of taxable income subject to tax at a high rate,
- want to accumulate wealth in their corporation or through investments,
- are not adverse to debt (leverage) and have additional liquid assets available to help secure debt (if required),
- are receptive to long-term planning and investment strategies, and
- understand that there are tax and legal considerations which require consultation with a professional advisor.

Life insurance characteristics

Any life insurance policy that has cash value can be used for immediate leverage. However, lenders often advance a higher margin on whole life policies (eg. 90%) than on universal life (UL) policies where the account value is invested in equity accounts. For example, on a whole life policy with \$100,000 of cash value, the bank may allow a loan advance of \$90,000, whereas on a UL policy with the same cash value invested in equity accounts, the bank may not lend at all or may only allow a loan advance of \$50,000 or less. In addition, whole life policies tend to provide more stable long-term returns. This means that it is less likely for the cash value to fluctuate and therefore less likely for the loan to exceed the bank's lending margin unexpectedly. As a result, typically whole life products with high cash values are used, but depending on the facts and circumstances, other policies may work as well.

What are the issues to consider?

Having gone through an overview of the basic ILA structure, we now turn to a discussion of the issues associated with these arrangements.

This section is divided into two parts:

- The first part looks at the details of the structure and the economic risks of the arrangement.
- The second section looks at the tax risks of the arrangement.

Structure and Economic Risks

Effect of Changes in Assumptions under ILA Illustrations

Numerical representations of ILA's typically show the loan advances that may be available based on a projection of the future cash values of the exempt life insurance product contained in a separate product illustration. The projected cash value within the product illustration is based on assumptions including investment performance, funding levels, and timing of deposits. In addition, the ILA presentation itself is based on a number of assumptions including loan interest rates, deductibility of loan interest, tax rates, and a particular pattern of borrowing. If these assumptions are not realized, actual performance of the arrangement will differ from illustrated values. For example, loan amounts that may be taken or the timing of these amounts may differ from what was illustrated. If the illustration assumes the use of additional collateral, the amount of additional collateral required may also be affected.

Performance of the Life Insurance Product

The accumulation of cash value in the life insurance product provides the collateral for the loan advances. The life insurance product illustration projects the future cash values and death benefit amounts based on an assumed investment return. The return earned in the policy is dependent on policy performance. For a participating or non-participating whole life contract, this return would relate to the specific assets held in the related fund managed by the insurer. In the case of universal life contracts, the return relates to the investment choices the policy owner makes for the funds inside the contract. It also assumes a particular funding pattern (amounts and timing of deposits). If the actual return or funding pattern does not conform to the assumptions made in the preparation of the product illustration, cash values and death benefits will differ from illustrated values.

When the policy is pledged as collateral security for the bank loan or series of bank loans the actual loan advances may be less than the illustrated values if the insurance product's investment return or funding pattern has not been achieved. Conversely, if the investment return has been greater than illustrated values, the opportunity for additional loan advances may be available.

Bank Loan Terms and Repayment

As noted earlier, ILA's require a loan agreement and separate loan underwriting to obtain the loan. The terms and conditions of the bank loan will vary depending on the bank used and the borrower's creditworthiness. The terms are negotiated with the bank at the time of borrowing. In addition the client will most likely incur bank fees in order to set up and maintain the loan. Most ILA bank loans are structured as a demand line of credit with a floating rate based on prime. The floating rate means the policy owner will be subject to both short-term and long-term interest rate fluctuations. In addition, because it is a demand loan, it is possible for the loan to be called at any time, forcing the policy owner to repay the loan. (In practice such action is unlikely unless the borrower is in default of the loan terms.) Other common loan terms include minimum loan amounts, initial loan set-up fees and annual renewal fees.

Universal life policies may offer investment accounts that have investment returns linked to an equity index or fund. It is possible for these indices or funds to provide a negative rate of return. Therefore, the bank making the loan or series of loans may not lend at all or may reduce the loan margin for particular universal life policies with funds in investment accounts tied to an equity index or fund. In cases where the bank reduces its margin, the loan advances available at the time of borrowing will be less than originally illustrated if the illustration assumed a higher margin.

ILA presentations use a projected bank loan rate that is normally assumed to remain constant. If at the time of borrowing or during the period the loan balance is outstanding the actual loan rate is higher than projected, the outstanding loan balance will grow faster than illustrated and this will be compounded if the loan interest is reimbursed via additional loan advances (see further discussion below). A higher loan rate than expected may result in the loan balance exceeding the loan margin. If this occurs the bank will require steps be taken to bring the loan balance back within acceptable limits. To accomplish this, the bank may require any of the following:

- repayment of principal or a portion thereof;
- provision of additional security as collateral for the loan; or
- the withdrawal of cash value from the life insurance policy sufficient to repay the loan as provided for under the terms of the collateral assignment.

In the worst case scenario, if the bank requires the withdrawal of all of the cash value in the life insurance policy to repay the outstanding bank loan, the policyholder would receive a T5 for the amount of any taxable policy gain resulting from the disposition of the policy. The policyholder may not have sufficient funds

available to pay the resulting tax liability because the proceeds were used to repay the outstanding loan. As well, the insurance protection provided by the policy might be lost if the policyholder does not have the funds to make deposits to the policy sufficient to keep the policy in force.

ILA illustrations commonly assume that the loan will remain outstanding for life, and that the loan will be repaid at death utilizing the death benefit from the policy. Any death benefit in excess of the loan balance will be available to be distributed to the named beneficiary under the life insurance contract.

Interest payments

With an ILA, the policy owner must have the cash flow to actually pay the interest costs during each year. An additional loan advance at the end of the year may reimburse this cost, however, it is generally held that this advance must be used for the purpose of producing income for the interest to meet the tests for interest deductibility under the Act. (See further discussion under the Tax Issues section). The loan interest deduction is assumed to generate tax savings which are usually shown as a decrease in the cost of funding the interest charges. Since new loan advances are taken each year for the interest cost net of the tax savings, ultimately the tax savings reduce the growth in the loan balance.

Unwinding the arrangement

With immediate leverage strategies it is important to consider the ability to “unwind” the structure, and the consequences of doing so. Although it is intended that the arrangement remain in place until the death benefit repays the loan, circumstances may change, and the policy owner may, at some future time, wish to retire the loan prior to the death of the life insured.

A collateral loan cannot be repaid using policy values without triggering a disposition of the life insurance policy. To repay a collateral loan with policy values, a partial or full surrender of the policy is required. The proceeds from the surrender would be paid first to the collateral assignee. The excess, if any, would be paid to the policy owner. However, surrenders will usually result in taxable policy gains. The proceeds received by the policy owner may not be sufficient to cover the tax liability arising as a result of the surrender.

In an ILA the only tax-effective way of repaying the loan prior to death may be to use other assets. This could be an issue if the borrower does not have liquid assets available to repay the loan.

A related issue to consider is: Would the underlying insurance contract be satisfactory if the leveraging aspect of the structure is unwound, or the policy owner decides not to leverage the policy at all? It is necessary to review the insurance contract itself to ensure that it is one that will meet the long term needs of the policy owner. This may include considerations such as cost of insurance charges, policy fees, investment accounts, flexibility, product design, and the financial strength of the insurer.

Life Expectancy

ILA presentations usually make an assumption regarding the life expectancy of the individual insured under the policy. If the illustration is shown without additional collateral being provided, it will typically show the maximum loan advances available so that at life expectancy the loan margin relative to the cash value will not be exceeded. At this point, the outstanding bank loan may reach that margin and if the life insured lives beyond the assumed age of life expectancy, the loan may exceed this margin. If this occurs the bank may demand any one of the measures discussed above be undertaken to bring the loan balance back within acceptable limits.

Tax Issues – Risks and Benefits

Immediate Leverage Life Insurance Arrangements usually rely on tax deductions to provide the presented benefits. The cash flows from the tax savings are usually shown as a reduction of the loan balance or as an increase to the net cash flow. To achieve these results, policy owners must structure their affairs to meet all the tests in the Income Tax Act (“the Act”) for those deductions. The following sections outline the requirements to claim the interest and collateral insurance deductions and discuss the issues associated with these deductions, as well as other tax benefits, in the context of an ILA.

Interest deductibility

The most significant tax issue is the availability of the deduction for loan interest. Paragraph 20(1)(c) of the Income Tax Act states that interest charged on borrowed money is deductible when it is paid or payable in respect of the year (depending on the method regularly followed by the taxpayer) pursuant to a legal obligation, provided the borrowed money is used for the purpose of earning income from business or property.

The key requirement is that the borrower must use the borrowed funds for the purpose of producing income from a business or property. The borrower must be able to demonstrate a clear link from the borrowed funds to the income-producing use to meet this "direct use" test.

Administratively, the Canada Revenue Agency (CRA) will accept that certain indirect uses of funds will nonetheless meet the direct use test. One of these exceptions is borrowing to pay a dividend, provided certain criteria are met. For a detailed discussion of CRA's position on exceptions to the direct use test and the requirements of interest deductibility generally, refer to the *Tax Topic* entitled "[Interest Deductibility](#)." These requirements must be met in the ILA structure in order for the interest to be deductible.

Paragraph 20(1)(c) of the Act also specifically states that interest on borrowed money used to acquire a life insurance policy is not deductible. Therefore, if borrowed funds are deposited into a life insurance contract, the interest will not be deductible.

Reasonableness of interest

Another key requirement is that the interest will only be deductible to the extent it is a reasonable amount. Consequently, if interest exceeds a reasonable amount, the deduction for the excess amount will be denied.

To assess reasonability, comparison should be made to the rates on similar loans with similar terms and conditions. If interest rates are based on market rates, reasonability should not be a concern.

Compound interest

It is important to distinguish compound interest from simple interest. Compound interest is not "interest charged on borrowed money", and does not arise on borrowed money used for the purpose of producing income. Instead, it arises on unpaid interest.

As a result, there is a separate provision of the Act – paragraph 20(1)(d) – that permits a deduction for compound interest. Under this provision, a deduction for compound interest will be allowed if it is paid in the year, and the related simple interest is deductible. Note that unlike simple interest, which is deductible when it is paid or payable (i.e. accrued), compound interest is only deductible when it is physically paid. It will not be deductible in the year it arises if it is simply added to the outstanding loan balance (i.e. capitalized).

In the context of immediate leverage, this means that if interest is capitalized (i.e. added to the loan balance), then interest arising on that interest (i.e. compound interest) will only be deductible when it is paid. Since generally an ILA loan is intended to be outstanding until the death of the insured, this would mean that compound interest will only be paid, and therefore deductible, at death. To avoid this problem, careful structuring is required to ensure that simple interest is paid each year so that no compound interest arises.

Typically this is done by paying the simple interest out of pocket, and then taking an additional loan advance equal to the interest to replace the funds previously used to pay the interest. Note that these advances must still meet the requirements outlined previously, including the requirement to use the funds for the purpose of producing income.

If interest were allowed to compound, the compound interest component could get very large by life expectancy. If it is not deductible until it is paid (which, in theory, will be when the death benefit repays the loan), the benefits of the strategy would be reduced.

Although the preceding discussion reflects the traditional view of the issues arising with respect to compound interest in the context of life insurance and immediate leverage, several CRA technical interpretations (#2004-007034 and #2005-0116661C6) seem to imply that borrowing money to pay simple interest would be deductible so long as the simple interest is deductible and have created some uncertainty as to what will be considered to be compound interest. (Refer to the *Tax Topic* entitled "[Interest Deductibility](#)" for further details). Regardless, it is still prudent to structure any collateral leverage of a life insurance policy so that interest is paid out of pocket each year.

Collateral insurance deduction

ILA presentations often assume that the borrower/policyholder will claim the collateral insurance deduction described in paragraph 20(1)(e.2) of the Act. In summary, the collateral insurance deduction in this provision is only available if the assignment of the life insurance policy is required by the lender under the terms of the loan, the lender is a "restricted financial institution" as defined under the Act and the interest payable on the money borrowed is deductible.

As a result, if the arrangement is not structured properly to achieve interest deductibility, the collateral insurance deduction will not be available either. (Note that a "restricted financial institution" is defined in section 248 of the Act and includes a bank and an insurance corporation, as well as several other financial institutions.)

The deduction available is equal to the lesser of the premiums payable under the policy and the Net Cost of Pure Insurance (NCPI) as can reasonably be considered to relate to the amount owing. Generally, this is interpreted to mean that the deduction must be pro-rated based on the ratio of the loan to the total death benefit of the policy. (Confirmed at the 2006 CALU Round Table - technical interpretation 2006-0174781C6.)

CRA has indicated in technical interpretation 9220255 dated September 23, 1992, that the Act refers to premiums payable under a life insurance policy rather than to premiums paid and 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. , a participating whole life policy) arguably 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., non-participating whole life and universal life policies), a contractual obligation to pay a premium does not exist, and therefore CRA would not consider the premium "payable".

Based on this view, for life insurance policies without a stipulated premium, premiums at least equal to the NCPI must be paid to claim the maximum deduction and no collateral insurance deduction would be available in years where no premium is paid. For this reason ILA's may be structured with the policy owner paying the insurance premiums annually.

Refer to the Tax Topic entitled "[Collateral Life Insurance](#)" for full details of the collateral insurance deduction.

Sufficient income

To realize the benefits of the tax deductions, the borrower must have sufficient income each year to use the deductions. This can be a particularly onerous requirement in ILAs because they may be in place for an extended period of time – possibly for life. If the loan balance is also growing over time either because of continual advances or because interest costs are increasing the loan balance, the annual interest costs continue to increase, which in turn means larger and larger amounts of income are required to use the deductions and realize the tax savings.

Capital Dividend Account (CDA) credit

If the arrangement is corporately owned, the corporation will receive a credit to its CDA equal to the life insurance proceeds received upon the death of a life insured minus the corporation's ACB of the policy. In an ILA the corporation will receive a CDA for the excess of the total death benefit (including the account value) over the ACB, even though a portion of the death benefit may flow directly to the creditor to repay the collateral loan. This is confirmed in paragraph 6 of (archived) IT430R3.

General Anti-Avoidance Rule

By its nature, the General Anti-avoidance Rule (GAAR) in subsection 245(2) of the Act has extremely broad potential application. If it applies, GAAR allows the CRA to ignore the legal effect of any transaction or step in a series of transactions and determine the income tax consequence(s) "as is reasonable in the circumstances to deny a tax benefit that... would result... from that transaction or series of transactions...". The intent of the GAAR provisions is to distinguish between legitimate tax planning and abusive tax avoidance.

It is a well-established principle in tax law that taxpayers are entitled to structure their affairs in a tax effective manner. Still, the CRA could attempt to apply GAAR to a series of transactions if it finds, in a particular situation, there is a misuse or abuse of the provisions of the Act.

In determining whether GAAR applies, the main question is whether there is an avoidance transaction, whether provisions of the Act have been abused, and if so, what are the "reasonable" tax consequences. For ILA's, the following points would be relevant in this regard:

- whether an insurance need has been demonstrated;
- the economic sense of the transactions undertaken independent of any tax benefits, and
- all other facts in the particular situation.

There is a risk the CRA may argue there is little economic benefit from the transactions apart from the tax benefits. For example they may argue that the client already has access to cash to invest, however instead of investing this cash directly, the cash is flowed through the arrangement by over-funding the life insurance policy and then using a collateral loan to immediately access the funds. The objective of flowing the funds through the arrangement is to take advantage of the investment component of the life insurance policy (that is sheltered from current income tax) and get a tax deduction for the interest expense and possibly the collateral insurance deduction. Structuring it as a collateral loan avoids the disposition which would arise if the arrangement were structured utilizing a policy loan. If these tax benefits are the main purpose of the transactions, then it could be considered abusive tax avoidance, and CRA might treat the collateral loan as a policy loan (which would be taxable to the extent it exceeds the ACB of the policy).

However, it can be argued that the client is simply structuring their affairs in a tax efficient manner, and that the primary purpose of the transactions is to obtain a collateral loan for investment or business purposes while at the same time acquiring life insurance protection. Accordingly, the transactions have a bona fide purpose other than to obtain a tax benefit and therefore do not constitute an avoidance transaction.

In addition the definition of "disposition" in subsection 148(9) specifically excludes "an assignment of all or any part of an interest in the policy for the purpose of securing a debt or a loan other than a policy loan". This is the provision which is relied upon to assert that collateral loan arrangements do not result in a disposition of the policy. A "policy loan" is further defined in this subsection as "an amount advanced by an insurer to a policy owner in accordance with the terms and conditions of the life insurance policy". So, if it is a true collateral loan from a bank, with no link to the policy, arguably there has not been "abusive tax avoidance". The provisions of the Act are merely operating as they were intended.

Another possibility is that GAAR might be used to deny the interest deductions. CRA attempted to use the GAAR to deny interest deductibility in a Supreme Court of Canada decision (Lipson v. Canada, 2009 SCC 1)). This case and its impact are discussed extensively in the Tax Topic "[Interest Deductibility](#)". In summary, it would appear that based on the Lipson decision, as long as taxpayers structure their leveraged life insurance arrangements so that the direct use of the borrowed funds is for the purpose of producing income, it is unlikely that CRA would be successful in applying GAAR to deny the interest and collateral insurance deductions. However, the case may suggest that where interest deductions are combined with other tax benefits CRA may have success using GAAR to attack other aspects of the arrangements. The remedy in this case could be something other than denial of interest deductions or characterization of the loan as a policy loan.

An example where interest deductions are combined with other tax benefits where there may be greater GAAR risk is where the owner of the policy is a corporation and the borrower under an ILA is the shareholder of the corporation. For an in depth discussion of issues surrounding shareholder borrowing structures, including GAAR risks, see the Tax Topic entitled "[Leveraged Life Insurance – Corporate Ownership](#)."

Regrettably, the nature of the GAAR provisions do not allow for general conclusions. The court cases on GAAR have been somewhat inconsistent in their approach to GAAR analysis and their conclusions. As a result, whether CRA will be successful in applying GAAR in any particular instance will depend on the specific facts of the case and will be subject to the interpretation of the courts. GAAR will always be a concern for those who undertake complex tax planning.

Future changes to tax rules

The preceding discussion reflects the tax rules as they exist presently. The reality is, however, that tax rules are constantly changing, and it is impossible to predict what the rules will be in the future. As a result, future deductions for interest and insurance premiums will be subject to any changes to the Act that might affect the requirements for deductibility.

It should be recognized that a life insurance policy has been acquired which stands on its own merit. Even if future changes to the Act impact the tax rules regarding leveraging a life insurance policy, cash values may still be accessed by way of policy loans or withdrawals.

It is also possible that "grandfathering" may be available to policies in existence on the date the rules in the Act are changed and for subsequent transactions that occur with these policies. Generally speaking, "grandfathering" refers to the continued application of existing rules (i.e. the old rules) to policies or transactions in certain circumstances, notwithstanding the subsequent changes to the rules that would otherwise apply. The taxation of life insurance policies has generally had the benefit of grandfathering when

rules relating to their taxation were amended. For example, the changes in 1982 to the rules for computing the adjusted cost basis (ACB) of a life insurance policy do not apply to policies in existence on the date the rules were changed. However, even though grandfathering may have been available in the past, there is no assurance that this same relief will continue to be granted should the rules in the Act be changed at some time in the future.

Conclusion

An ILA is an investment strategy. It allows the client to get the insurance coverage they need while preserving their cash flow as much as possible. The client can use the loan advances to invest in a business or property, and the tax benefits to reduce the cash outflow. Significant financial benefits can be provided by leveraged life insurance strategies. In assessing these benefits, as with all leveraged strategies, it is important to consider the economic and tax risks in consultation with a professional advisor.

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