Accessing cash value from a corporate-owned life insurance policy using policy loans

There are three ways your corporation can access the cash value from its life insurance policy:

1. **Policy loan**[i] – take a loan from the insurance company based on the policy's contractual terms
2. **Cash withdrawal** – withdraw cash directly from the policy via a partial surrender
3. **Collateral loan** – assign the policy to a bank as collateral for a loan[ii]

This article looks at the considerations and tax implications of using policy loans as a method of accessing the cash value of a corporate-owned life insurance policy. Also included is an example showing how policy loans may help supplement retirement income and enhance estate value.

Considerations

Canada Life policyowners have a contractual right to obtain a policy loan based on their policy's cash value. Participating life insurance policyowners may obtain policy loans totaling the sum of the guaranteed cash value and cash value of any existing paid-up additions, less any outstanding policy loans and accrued interest. Universal life policyowners may obtain policy loans up to their policy's cash surrender value less 25% of the sum of all variable interest option account balances, one year of accrued interest and remaining monthly deductions up to the next policy anniversary.

Other considerations applicable when considering a policy loan include:

- No financial underwriting is required
- Preservation of the policy's growth potential compared to a partial surrender[iii]
- Policy loan interest rates are typically higher compared to bank loans[iv]
- Policy loans may be taxable depending on the policy's adjusted cost basis (ACB)

Policy loans may be more attractive than collateral loans in cases where you plan to repay them in the near to mid-term time horizon. In these cases the convenience of policy loans may outweigh the higher interest costs. Any tax costs from policy gains associated with the loan may be offset by the tax deduction obtained when the loan is repaid (discussed below). Also, the death benefit proceeds is contractually reduced by any outstanding policy loans at the time of death, so by repaying the policy loan during your lifetime, the full death benefit is received by the beneficiary.

Taxation of policy loans

A policy loan is a disposition for tax purposes which may or may not result in a taxable policy gain to the policyowner. The tax consequences to the policyowner primarily depend on the amount of cash taken from the policy (the loan proceeds) and the policy's ACB at the time the policy loan is taken.

A policy's ACB

Like many other types of property, a life insurance policy has a cost base, referred to as its ACB. The policy's ACB generally increases with premiums paid and decreases at the end of each calendar year from its net cost of pure insurance (NCPI)[v].

Generally speaking, NCPI is a government-prescribed estimate of the cost of insurance protection. NCPI increases as the life insured ages. Over time, NCPI generally reduces the ACB and in some cases, the ACB reduces to zero by the time the insured person reaches their life expectancy.

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Calculating the policy gain

A life insurance policy's ACB is used for determining the tax consequences resulting from a policy loan. A taxable policy gain generally arises if the policy loan exceeds the policy's ACB. This means policy loans are tax-free up to the policy's ACB. Policy gains realized by a corporation are treated as passive income[vi].

Policy loan interest

Interest paid on a policy loan is added to the policy's ACB unless it's tax deductible. Policy loan interest may be tax deductible if the loan proceeds are used for the purpose of earning income from a business or property. In addition, for the policy loan interest to be deductible the insurer must verify on form T2210[vii] that it was paid in the year and the amount of the interest wasn't added to the policy's ACB[viii].

Policy loan interest may be capitalized by taking a new policy loan to pay the interest on an existing policy loan. In these cases, the policy's ACB remains unchanged[ix] unless the interest is tax deductible. If the capitalized interest is tax deductible, the policy's ACB is reduced by the amount of the capitalized interest[x]. Consequently, a policy gain may arise from the new policy loan depending on the policy's ACB at the time. Canada Life tracks this tax information and reports policy gains to policyowners on a T5 (RL-3) tax slip.

Policy loan repayments

A policy loan repayment,using cash external to the policy,[xi] may be tax deductible in cases where the policyowner realized prior policy gains[xii]. The amount of the repayment that may be tax deductible is the lesser of the repayment and a historical calculation of any prior policy gains realized less other deductible repayments. Policy loan repayments that are tax deductible don't increase the policy's ACB. Repayments in excess of the deductible portion increases the policy's ACB[xiii]. If the policyowner[xiv] dies with an outstanding policy loan balance, the remaining balance reduces the policy's death benefit proceeds and does not entitle the deceased or their estate to a tax deduction.

Policy loans and a corporation's capital dividend account

Generally, the amount of the death benefit received by a corporation less the policy's ACB, credits its capital dividend account (CDA). A CDA balance allows a private corporation to pay tax-free capital dividends to Canadian resident shareholders. Where a corporate policyowner has an outstanding policy loan upon the death of the life insured, the death benefit is reduced by the policy loan. Consequently, the amount *received* by the corporation for the purposes of the CDA credit calculation is the full death benefit less the outstanding policy loan[xv].

Example – Michelle and her holding company

Let's look at an example using a corporate-owned participating whole life insurance policy.

Suppose the life insured is Michelle, age 50, a non-smoker and standard risk. Michelle has an insurance need based on her capital gains tax liability at death. She owns a holding company (Holdco) that purchases a Canada Life participating life insurance policy on her life[xvi]. Holdco pays an annual premium of $50,000 for 20 years and is also the policy beneficiary.

Holdco takes policy loans annually during policy years 21-30. The policy loan interest rate is 5.95% and the total policy loan equals 94% of the policy's total cash value at age 99. Assuming a 5.25% dividend scale interest rate, Holdco can obtain $112,228 of policy loan proceeds annually over this ten year period. See the graph below to compare the annual after-tax amounts from the policy loans. Holdco's tax rate on its passive income is 50%[xvii].

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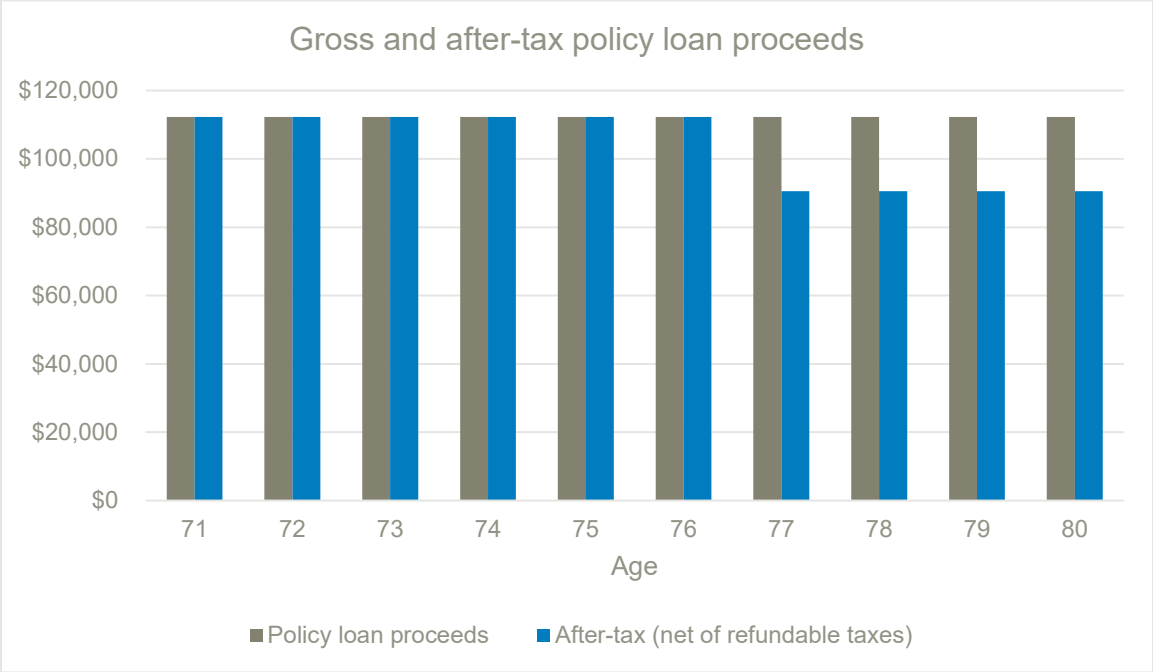

The above examples are for illustrative purposes only. Situations will vary according to specific circumstances.

Comparison of net estate values from corporate policy loans

Assume Holdco purchased a guaranteed investment certificate (GIC) with a 4% interest rate using the same premium dollars and also took the same after-tax withdrawal amounts to provide Michelle with an annual income. Compare the net estate values from the GIC and the Canada Life participating life insurance policy. Michelle's estate's dividend tax rate is 44%.

	Net estate value	
Age	GIC at 4%	Canada Life participating life insurance
75	$541,529	$1,699,377
85	$427,915	$1,330,311
95	$570,844	$856,019

Policy loan interest is capitalized in this example. Capitalizing policy loan interest may result in a declining death benefit in the policy's later years as the interest costs exceed the death benefit growth from the paid-up additions. In this example, the net estate value crossover point with the corporate investment is at age 98.

The main reasons why the net estate values produced from Holdco's life insurance policy is attractive relative to the corporate investment comparison is because of the 1) tax-advantaged growth of policy values[xviii] and 2) all, or a significant portion, of the insurance proceeds credit Holdco's CDA. In contrast, the interest income from the GIC is taxed at a high corporate rate and, generally, it's received as a taxable distribution when paid out to its shareholder(s).

Summary

Policy loans are appealing to corporate policyowners because they offer easy access to a policy's cash value and don't require financial underwriting. From a tax perspective, they're dispositions of the policy and therefore may result in a

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taxable policy gain. Overall, however, as the example with Michelle's Holdco illustrates, an income strategy using policy loans from a corporate-owned life insurance policy is competitive with other corporate investments of a similar risk profile while potentially generating greater net estate values.

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[i] All reference to policy loan in this article refer to a cash policy loan, not an automatic premium loan.
[ii] Collateral loans involve risk. They should only be considered by sophisticated investors with high risk tolerance and access to professional advice from a lawyer and accountant. The terms of future availability of collateral loans cannot be guaranteed. The loan or line of credit must be negotiated between the policyowner and the lender. It's subject to the lender's financial underwriting and other requirements. The policyowner should have enough income and capital to cover the interest and loan repayment, as well as the insurance premium.
[iii] A partial surrender reduces the policy's cash value and thus, decreases its potential future growth.
[iv] The policy loan interest rate is 5.95% as of January 2020.
[v] For policies last acquired before December 2, 1982, NCPI doesn't reduce the ACB of the policy.
[vi] Passive income of an associated corporate group in excess of $50,000 reduces the corporation's access to the small business deduction.
[vii] Canada Revenue Agency (CRA) form T2210 "Verification of Policy Loan Interest by the Insurer".
[viii] Subsection 20(2.1) of the Act and CRA Folio S3-F6-C1 Interest Deductibility, paragraphs 1.84-1.86.
[ix] Capitalized interest results in an increase to the ACB as a premium and a decrease of the same amount for the proceeds of disposition.
[x] Capitalized interest that is deductible for tax purposes doesn't increase the ACB as a premium.
[xi] Policy loan repayments in this article are made with cash external from the policy. Using internal policy cash value or policy dividends can result in different tax consequences depending on whether the policy was issued before or after January 1, 2017.
[xii] Paragraph 60(s) of the Act.
[xiii] For policies issued after 2016, only repayments made with funds external to the policy would increase the ACB of the policy.
[xiv] Assuming the life insured is the policyowner.
[xv] This is unlike the case where a corporation collaterally assigns a life insurance policy to a bank for a loan. While the repayment of the bank loan at death would leave less cash (or possibly none) for the corporation, it would generally still obtain the CDA credit based on the full insurance payout less the policy's ACB: CRA Technical Interpretation 2014-0555581E5, June 5, 2015. The corporation should remain the owner and beneficiary of the policy.
[xvi] Canada Life Par Estate Achiever Plus Max 20 of $1,454,079 with paid-up additions dividend option.
[xvii] Net of non-eligible refundable dividend tax on hand is 19.33%.
[xviii] If the values remain in the policy, subject to government limits.

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