

## Accessing the cash value of a life insurance policy

Advisor guide

**The primary reason for life insurance is to protect your client's family or business.**

When the insured person dies, their family or business receives the insurance death benefit.

With permanent life insurance, your client's policy can build up assets within the policy that may be used during their lifetime (called cash value).

The life insurance policy can grow tax-free, subject to government limits.

## About

This guide summarizes the most common ways clients access built-up cash value in individual or corporately owned permanent life insurance policies, as well as the benefits and considerations associated with each method. The information provided is based on current tax legislation and interpretations for Canadian residents and is accurate to the best of our knowledge as of the date of publication. Future changes to tax legislation and interpretations may affect this information. This information is general in nature, and is not intended to be legal or tax advice. For specific situations, you should consult the appropriate legal, accounting, or tax advisor.

**Examples in this guide relating to corporately owned policies** assume both the insurance death benefit received and cash accessed by the corporation are paid to the shareholders. Corporations also have the option to keep the death benefit and accessed cash.

### A policyowner has three options for accessing their policy's cash value:<sup>1</sup>

- 1 | Partial surrender/withdrawal
- 2 | Policy loan
- 3 | Collateral loan ('movable hypothec' in Quebec)

**Note:** Clients can also cancel their policy and receive its cash value, less any policy loans and cancellation charges.

### Creditor protection

When clients access their policy's cash value, the amount they receive may not be protected from creditors. This contrasts with the insurance death benefit, which in some cases does not form part of the policyowner's estate and therefore not subject to the claims of the policyowner's creditors. Creditor protection depends on court decisions and applicable legislation and is subject to change and may vary by province or territory. Clients should talk to their lawyer to find out more about the potential for creditor protection for their specific situation.

<sup>1</sup> Depending on the option used, accessing cash value may reduce both the policy's cash value and death benefit and may also result in taxable income.

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## Accessing cash: Methods and considerations at a glance

Clients with permanent life insurance may want to access their policy's cash value for business expansion, retirement, education or travel.

Cash value can grow tax-free within a life insurance policy up to the maximum limit set by the applicable tax rules.

### Three ways policyowners can access cash value within a life insurance policy:

- 1 Partial surrender/withdrawal
  - Contractually guaranteed with quick access
  - Impacts death benefit and future policy growth
  - A portion of amount received could be taxable
- 2 Policy loan
  - Contractually guaranteed with quick access
  - Doesn't impact policy growth (impacts cash value available on surrender)
  - Loan amount greater than adjusted cost basis is taxable
  - Outstanding loan balance at death reduces death benefit and therefore not added to corporation's capital dividend account
- 3 Collateral loan<sup>2</sup>
  - Requires financial underwriting by the lender
  - Only sophisticated policyowners with high risk tolerance should consider this option
  - Clients can maximize the amount of accessed cash value
  - Doesn't impact policy growth or reduce the death benefit when calculating the capital dividend account credit
  - Loan proceeds are received tax-free by the policyowner
  - Personal borrowing using corporately owned policy may create a taxable shareholder benefit

<sup>2</sup> Under Quebec law, a policy is used as security by way of a 'movable hypothec'. Clients should not purchase life insurance just because of the future possibility of obtaining a collateral loan. 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 for future availability of collateral loans cannot be guaranteed. The loan or line of credit must be negotiated between the policyowner and the lender. It is 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.

Accessing considerations	1   Partial surrender (participating life insurance)  Withdrawal (universal life insurance)	2   Policy loan	3   Collateral loan
Contractually guaranteed (No credit checks)	✓	✓	✗ Subject to approval of lending institution.
Access cash	✓ Must have cash value available.	✓ Amount available depends on: <ul style="list-style-type: none"> <li>• Cash value</li> <li>• How much the policyowner has already borrowed</li> <li>• Built up interest on previous borrowing</li> </ul>	✓ <ul style="list-style-type: none"> <li>• Must have cash value available to use as collateral for loan.</li> <li>• Policyowner(s) need to meet lender's underwriting criteria.</li> </ul>
Taxation of amount accessed	✓ Tax-free if adjusted cost basis is higher than policy's total cash value.  A taxable policy gain generally arises if the cash withdrawn from a policy exceeds the prorated adjusted cost basis (ACB) attributed to the withdrawal (prorated ACB is based on the policy's total cash value in relation to the amount of cash withdrawn from the policy).	✓ Tax-free up to the policy's ACB. Policy loans in excess of the policy's ACB are taxable.	✗ Not taxable.
Maintain full control of policy	✓	✓	✗ Any changes may require lender's consent since the policy is assigned to lender.
Repayment	✗ For participating life insurance: <ul style="list-style-type: none"> <li>• Repayment isn't an option</li> <li>• Future premiums, if any, may contribute to policy's cash value</li> </ul> For universal life insurance: <ul style="list-style-type: none"> <li>• Repayment isn't an option</li> <li>• Policyowner may be able to contribute to the account value (within limits)</li> </ul>	✓ Repayment can be made to the insurer at any time.  While the insured is alive, loan repayment: <ul style="list-style-type: none"> <li>• Restores the death benefit payable to beneficiaries</li> <li>• May increase adjusted cost basis</li> </ul> Repayment is required to keep the policy in force if policy loan plus built up interest exceeds cash value.  At death, the outstanding loan and built up interest are repaid from the death benefit (death benefit is reduced).	✓ Repayment can be made to the lender.  Lender typically reserves the right to demand loan repayment in full at any time.  While the insured is alive loan repayment: <ul style="list-style-type: none"> <li>• Release the policy as collateral for the loan</li> </ul> At death, the death benefit repays the outstanding loan and the remaining death benefit is received by the policy's beneficiary.

Accessing considerations	1   Partial surrender (participating life insurance) Withdrawal (universal life insurance)	2   Policy loan	3   Collateral loan
<b>Tax deductions</b>	✗ Not applicable.	<p>✓ Policy loan interest may be deductible if the loan proceeds are used for the purpose of earning income from a business or property and insurer verifies on form T2210 that it was paid in the year and the amount of the interest wasn't added to the policy's ACB.</p> <p>On loan repayment, a tax deduction may be available in amount equal to the lesser of:</p> <ul style="list-style-type: none"> <li>• The amount repaid</li> <li>• The amount included in income when the loan was taken, less the deductible repayments in previous years</li> </ul>	<p>✓ Bank loan interest may be deductible if the loan proceeds are used for the purpose of earning income from a business or property.</p> <p>The collateral life insurance deduction may be available where certain conditions are met. The amount deductible is the lesser of premium paid and net cost of pure insurance. The deductible amount must reasonably relate to the loan.</p>
<b>Credit to the capital dividend account<sup>3</sup></b>	✓ Reduced death benefit may result in lower amount credited to the capital dividend account.	✓ Reduced death benefit may result in lower amount credited to the capital dividend account.	✗ Doesn't affect credit to the capital dividend account.

<sup>3</sup> The credit to the capital dividend account (generally equal to the death benefit minus the adjusted cost basis) can be used by a corporation to pay tax-free capital dividends to Canadian resident shareholders. In the case of a policy loan, the credit to the capital dividend account is calculated based on a death benefit that's reduced by the amount of the policy loan.

## 1 | Partial surrender/withdrawals

### Withdrawing cash value

Policyowners can withdraw some or all of their policy's cash surrender value pursuant to the terms of the insurance contract. Withdrawing cash value reduces insurance coverage and may be taxable.

#### Partial surrenders/withdrawals:

- Clients can withdraw all the cash value from a policy at once (lump sum full surrender) or through periodic amounts over time (partial surrender)
- Cash withdrawn from a policy may be tax-free, partially taxable or fully taxable depending on the policy's ACB. A taxable policy gain generally arises if the cash withdrawn from a policy exceeds the prorated ACB attributed to the withdrawal (prorated ACB is based on the policy's total cash value in relation to the amount of cash withdrawn from the policy). This means a withdrawal is tax-free if the policy's ACB is higher than policy's total cash value, or conversely fully taxable if the ACB is nil.

#### Example:

A client withdraws \$30,000 from their policy.

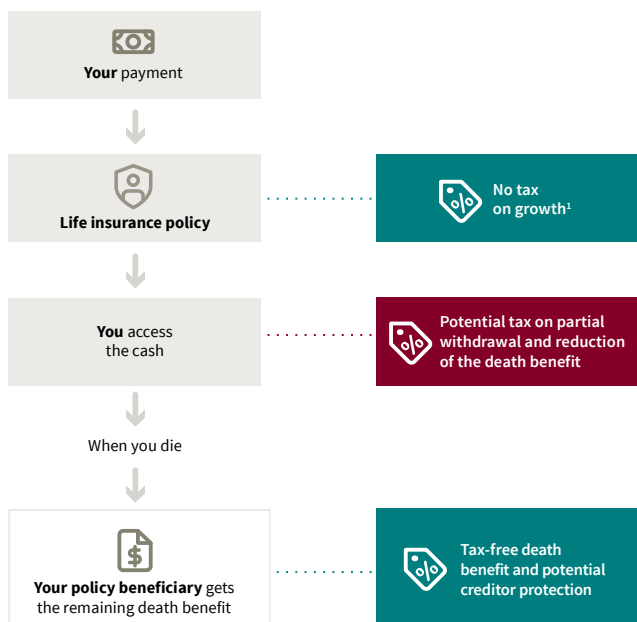
- Policy has \$100,000 cash surrender value and an adjusted cost basis of \$20,000

	Total policy surrendered	Partial surrender cash withdrawn
Cash value surrendered	\$100,000	\$30,000
Adjusted cost basis	\$20,000	- \$6,000 (Adjusted cost basis is reduced to \$14,000)
Taxable amount	\$80,000	\$24,000
Percentage taxable	80%	80%

The percentage taxable may be higher or lower depending on the adjusted cost basis at the time of withdrawal.



## Individually owned policy

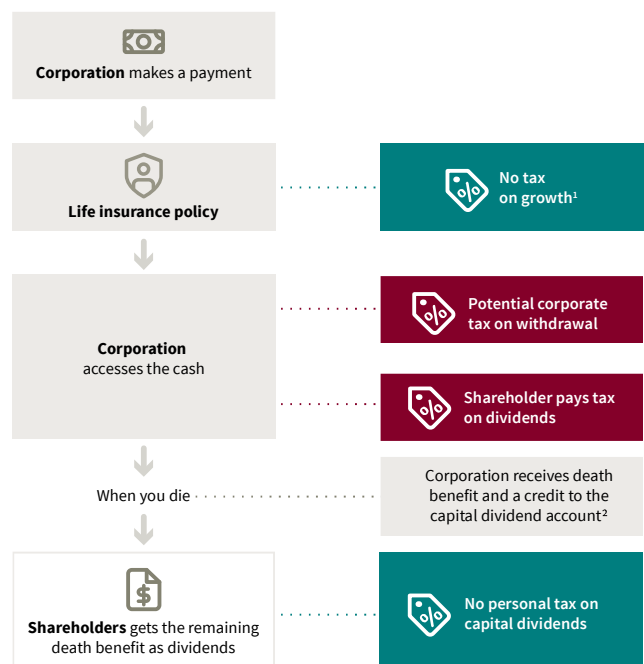


<sup>1</sup> No tax on growth within legislative limits while it remains in the policy.

Statements regarding tax are based on current Canadian tax law, for Canadian residents, and both the law and its interpretation are subject to change.



## Corporately owned policy



<sup>1</sup> No tax on growth within legislative limits while it remains in the policy.

<sup>2</sup> At death, the insurance proceeds are paid to the corporation on a tax-free basis.

The capital dividend account of the private corporation receives a credit equal to the death benefit less the adjusted cost basis of the policy. The capital dividend account credit allows the corporation to pay a tax-free dividend to the Canadian resident shareholders. Statements regarding tax are based on current Canadian tax law, for Canadian residents, and both the law and its interpretation are subject to change.



## 2 | Policy loan

### Borrowing from the policy

A permanent life insurance policy contract guarantees that policyowners can receive a policy loan. A policy loan is an amount received from the insurer that's based on the policy's cash value. The loan's tax-free, up to the policy's adjusted cost basis. The loan doesn't reduce the client's coverage. However, if the loan isn't repaid, then its balance, including interest, is deducted from the death benefit.

#### Policy loans:

- If the adjusted cost basis is reduced to zero, every dollar borrowed against the policy is taxable unless repaid within that taxation year
- If the total owed on your policy exceeds your policy's cash value, your policy will lapse, meaning it will no longer be in effect and so will no longer provide coverage

#### Repaying the loan:

- If repaid, the policy loan no longer impacts the policy's death benefit
- If repaid, the policyowner may get a tax deduction equal to the taxable income declared when they originally received the loan advances, less deductible repayments made in previous year(s)
- Amounts repaid, excluding any amount that's claimed as a tax deduction are added to the adjusted cost basis

#### Example:

A takes two policy loans (\$20,000 and \$10,000) over a two-month period totaling \$30,000. They'll repay \$15,000 of the loan within the same year.

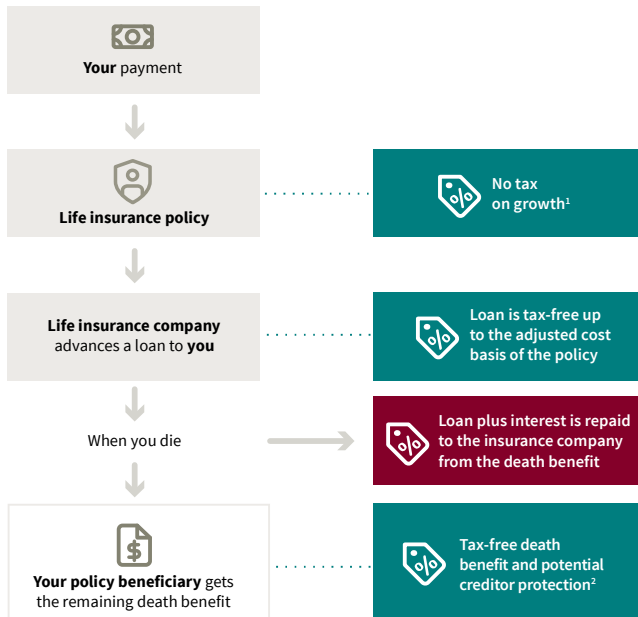
- Policy has \$100,000 cash surrender value and an adjusted cost basis of \$20,000

	First loan	Second loan
<b>Loan amount</b>	\$20,000	\$10,000
<b>Adjusted cost basis</b>	\$20,000	\$0
<b>Taxable amount</b>	\$0 – Adjusted cost basis reduced to zero	\$10,000
<b>Amount repaid</b>		\$15,000
<b>Tax deduction</b>		\$10,000
<b>Adjusted cost basis increase on repayment</b>		\$5,000

The taxable amount may be higher or lower depending on what the adjusted cost basis is at the time of policy loan.



## Individually owned policy



<sup>1</sup> No tax on growth within legislative limits while it remains in the policy.

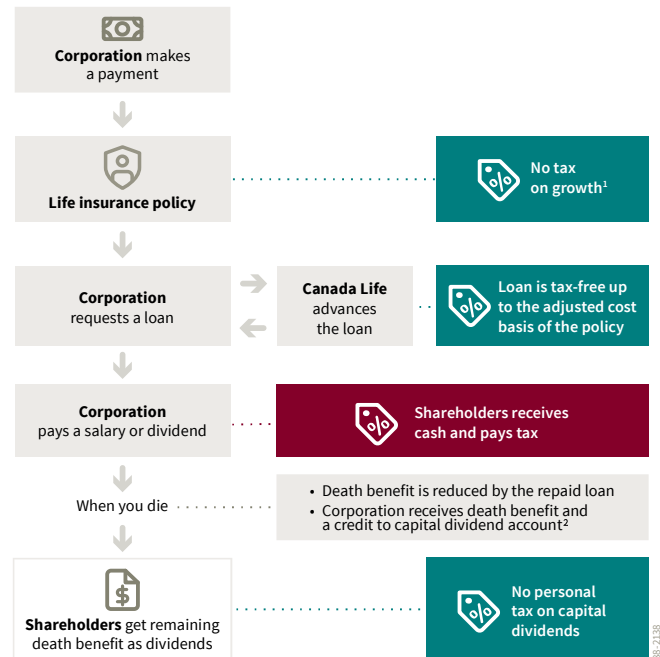
<sup>2</sup> Creditor protected in some cases.

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## Corporately owned policy



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<sup>2</sup> At death, the insurance proceeds are paid to the corporation on a tax-free basis.

The capital dividend account of the private corporation receives a credit equal to the death benefit less the adjusted cost basis of the policy. The capital dividend account credit allows the corporation to pay a tax-free dividend to the Canadian resident shareholders. Statements regarding tax are based on current Canadian tax law, for Canadian residents, and both the law and its interpretation are subject to change.

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### 3 | Collateral loan

#### Using the policy as collateral for a third-party loan

Policyowners may borrow from banks or other third-party lenders using the policy's cash value as security. Known as a collateral loan, it's like a policy loan as it doesn't reduce affect the growth in policy values. Collateral loans aren't not taxable, but the policyowner pays interest to the lender. If the loan isn't repaid, the agreement with the bank will require the balance, including interest, to be deducted from the amount received by the policy's beneficiary at death.

The client may be allowed to capitalize the interest and add it to the loan balance. It's important to ensure the loan balance remains below the specified percentage of cash surrender value that the lending institution requires on permanent life insurance:

- Usually between 50 and 75 per cent, if invested in equity-linked accounts for universal life insurance
- May be up to 100 per cent for guaranteed investment accounts in universal life insurance and for participating life insurance policies

A collateral loan may be available at a lower interest rate than a policy loan. However, there's no guarantee a third-party lender will offer a loan. Clients must negotiate with the lender, subject to the lender's financial underwriting requirements. Because it involves greater risks, clients shouldn't consider a collateral loan unless they're a sophisticated policyowner with a high tolerance for risk. Clients should also be aware that collateral loans are typically demand loans which means the lender may call repayment of the loan at any time.

#### Example:

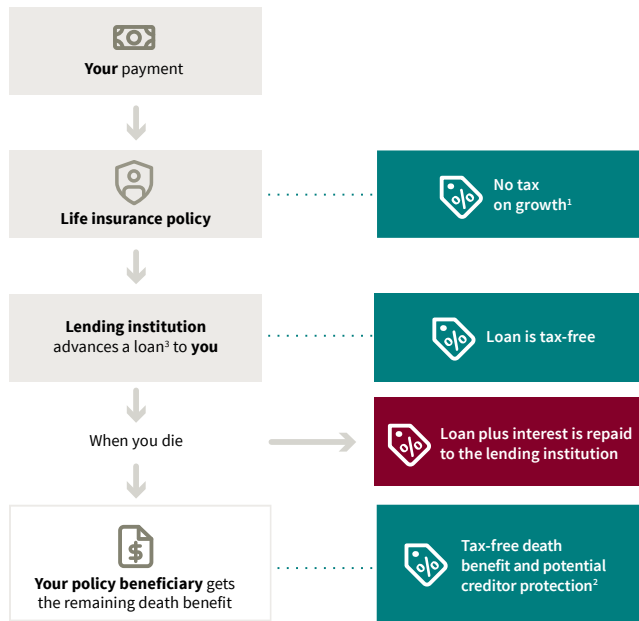
A client takes a loan of \$30,000 annually over the next 15 years.

- Interest is paid annual

	Individually owned policy	Corporately owned policy
Max loan age	90	90
Loan to cash surrender value ratio	90	90
Loan rate	6%	6%
Loan amount (for 15 years)	\$30,000	\$30,000
Total loan balance at death	\$450,000	\$450,000
Death benefit	\$2,000,000	\$2,000,000
Adjusted cost basis	\$200,000	\$200,000
Net death benefit (after loan is repaid)	\$1,550,000	\$1,550,000
Capital dividend account	N/A	\$1,800,000
Death benefit paid to shareholder as capital dividend	N/A	\$1,550,000
Residual capital dividend account	N/A	\$250,000



## Individually owned policy



<sup>1</sup> No tax on growth within legislative limits while it remains in the policy.

<sup>2</sup> Creditor protected in some cases.

<sup>3</sup> Policyowner may need to make immediate repayment if lender calls in repayment of the loan.

Statements regarding tax are based on current Canadian tax law, for Canadian residents, and both the law and its interpretation are subject to change.

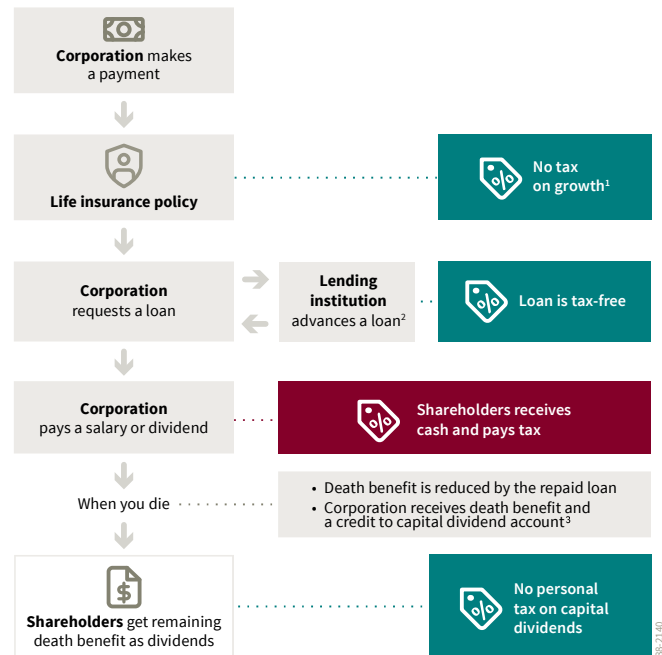




## Corporately owned policy

- A collateral loan doesn't affect the capital dividend account credit
- Ideally, the corporate policyowner is the policy beneficiary (not the lending institution)
- When the insured person dies:
  - Corporation receives a capital dividend account credit (generally for the death benefit minus the adjusted cost basis)
  - Death benefit used to pay outstanding loan
  - Corporation still has the full capital dividend account credit
  - Amount of capital dividend account credit above the net death benefit amount received may be used to distribute other assets tax-free as a capital dividend

A shareholder obtaining a collateral loan from a bank personally using a corporate-owned life insurance policy as security may result in a taxable benefit to the shareholder. The shareholder benefit may be addressed by paying a guarantee fee to the corporate policyowner. Clients are strongly advised to consult with their tax advisor before using a corporately owned policy as security for a shareholder's personal borrowing.



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<sup>3</sup> At death, the insurance proceeds are paid to the corporation on a tax-free basis.

The capital dividend account of the private corporation receives a credit equal to the death benefit less the adjusted cost basis of the policy. The capital dividend account credit allows the corporation to pay a tax-free dividend to the Canadian resident shareholders. Statements regarding tax are based on current Canadian tax law, for Canadian residents, and both the law and its interpretation are subject to change.



## Accessing cash from corporately owned policies

## More points to consider

### Retirement compensation arrangements

If a corporation buys life insurance policies to fund formal retirement arrangements for the business owner or employee(s), they may be considered retirement compensation arrangements and tax implications would apply, including:

- Imposition of a refundable tax equal to the premium paid (and possibly on policy dividends of participating policies)
- Life insurance death benefit effectively becomes taxable

### Deductibility of payment from company to shareholders

The amount of the payment to the shareholder may be tax deductible if it is characterized as employment income. This is a fact specific determination (clients should consult with their tax advisor). The deductibility may also depend upon the reasonableness of the payment. The usefulness of the deduction depends on the availability of taxable income against which to deduct the payment. These payments are not deductible if paid as a dividend.

### Taxable benefit to shareholder

If a client names an estate, spouse, employee or shareholder as beneficiary of a corporately owned policy, premiums paid by the corporation would be considered a taxable shareholder or employee benefit. The corporation can't claim a tax deduction on amounts that are considered shareholder benefits, but may for those considered employee benefits.

As a rule of thumb, the corporate policyowner should be the beneficiary of the death benefit as well.

As noted, a corporation that assigns a life insurance policy to a bank as security for a loan made to the shareholder may also give rise to a taxable shareholder benefit.