Personal Insurance Needs

Many life changes cause different needs for life insurance. This Tax Topic will focus on life insurance funding for family and estate needs upon an individual's death. The need for insurance in the business context is discussed in the Tax Topic "Business Insurance Needs".

Funding Needs at Death
In general, one of the greatest benefits of life insurance is that it provides a tax-free lump sum payment upon the death of the individual who is insured. A beneficiary designation enables the proceeds to be paid directly to the party indicated by the policyholder on the death of the individual insured. In the personal context, life insurance is generally used to provide protection for surviving dependants, to preserve, create, increase the value of or replace an estate and to provide funds required to bring about an equitable distribution of an estate.

Protecting Dependents
Life insurance proceeds received on the death of an individual can provide funding for the maintenance of the deceased's dependants. The proceeds can replace the deceased's earnings, pay debts and other liabilities, or cover education costs and daily living expenses of dependants.

In the case of separated or divorced parties a court order may require that insurance be in place to continue to support the dependent(s) after the death of the individual. A full discussion of these obligations can be found in the Tax Topic "Life Insurance and Support Obligations on Marriage Breakdown".

To ensure that death benefit proceeds are received at an appropriate time or circumstance for the beneficiary, the policy owner may direct a Trustee as to how distribution of the proceeds should occur. This is particularly useful in situations where intended beneficiaries are minors, mentally incompetent or incapable of prudently managing their own financial affairs. For a discussion of planning with insurance trusts see the Tax Topic "Insurance Trusts".

Normally, death benefits are received in one tax-free lump sum payment. However, insurance contracts may also provide a number of settlement options. For example, the contract may allow a policyholder or the beneficiary to choose to have the insurance proceeds purchase an annuity for the beneficiary or beneficiaries. This would allow for the payment of the death benefit in installments over a period of time.

Estate Preservation
Life insurance proceeds may be used to pay down debts, tax liabilities and other estate costs so that estate assets do not have to be eroded, liquidated or borrowed against in order to pay for these expenses. The following funding needs are discussed in more detail below: capital gains tax liabilities, tax liabilities associated with registered plans, estate tax liabilities and estate costs including probate, estate creation or capital replacement.

a) Capital Gains Taxes
Subsection 70(5)(a) of the Income Tax Act, (the "Act") provides that a deceased taxpayer is deemed to have disposed of each capital property owned by him or her, immediately before death, for proceeds equal to the fair market value at that time. Capital property includes depreciable and non-depreciable property. Shares of a corporation, partnership interests, mutual or segregated fund units, and cottage properties and land are common examples of non-

depreciable capital property. Common examples of depreciable capital property include machinery, buildings and business vehicles.

At death, a capital gain will be realized for tax purposes to the extent that the fair market value exceeds the deceased's adjusted cost base (ACB) of the property. Subsection 38(a) of the Act includes an amount equal to 50% of this gain in the deceased's terminal income tax return. The deceased may utilize any remaining capital gains exemption if the property consists of "qualified small business corporation shares", "qualified farm property", or "qualified fishing property" each respectively defined under s. 110.6(1) of the Act. Any taxable capital gains that are not sheltered by the capital gains exemption will be subject to tax in the deceased's terminal return.

For tax purposes subsection 70(5)(b) of the Act provides that the deceased's estate is deemed to have acquired the property at fair market value and accordingly this becomes the estate's ACB of the property.

In addition, for depreciable capital property, the deceased taxpayer may have to include recapture of capital cost allowance (CCA) on the terminal income tax return. Recapture is equal to the amount by which the lesser of capital cost and fair market value of the property immediately before death exceeds the undepreciated capital cost (UCC) of the property. Such amounts are fully taxable as regular income.

Life insurance may be purchased to provide the funds necessary to pay the tax liability resulting from capital gains and recaptured depreciation triggered upon the death of the individual. Life insurance will be particularly important as a funding vehicle if the beneficiaries wish to retain the property or if market conditions will not provide the estate with an amount equal to the fair market value of the property.

Taxation at death may be deferred if a spouse (or common-law partner) or a qualifying spouse trust receives capital property of the deceased. Under subsection 70(6) of the Act, the property will be deemed to have been transferred at proceeds of disposition equal to the ACB (the capital cost and UCC in the case of depreciable capital property) of the property. As a result, the taxpayer would realize no capital gain or loss in the year of death. Any capital gains (or recapture of CCA) are postponed until the spouse or qualifying spouse trust disposes of the property. A qualifying spouse trust is defined under subsection 70(6)(b) of the Act as a trust where only the surviving spouse or common-law partner is entitled to its income and has access to its capital until the surviving spouse's death.

Where a rollover is available the tax liability will result on the death of the surviving spouse. Therefore, the funding need is postponed until that time. Joint last-to-die life insurance may be used to fund the tax liability resulting from the capital gains and recaptured depreciation triggered upon the death of the survivor spouse.

For a further in-depth discussion see the Tax Topic "Taxation of Capital Property Held at Death".

b) Registered Plans Tax Liabilities

At death, a taxpayer is deemed to have disposed of registered retirement savings plans (RRSP) and registered retirement income funds (RRIF) for proceeds equal to their fair market value pursuant to subsections 146(8.8) and 146.3(6) of the Act, respectively. This is included as regular income and is fully taxable in the year of death. A rollover to a spouse's or common-law partner's RRSP or RRIF is permitted by subsection 60(l) of the Act. Similar to the capital gains tax liability, life insurance may be purchased to fund the tax liability associated with bringing registered funds into income on the first or second (of two spouses') death.

For a full discussion of registered plans and taxation see the document "Registered Plans and Treatment on Death" attached as Appendix "A" to this Tax Topic.

c) Estate Taxes

A deceased person may be liable for estate taxes in other jurisdictions. For example, the United States imposes estate taxes, (income and gift taxes) on its citizens' worldwide assets, no matter where they reside. For a further discussion on this topic see the Tax Topic "U.S. Estate Taxes".

Careful planning should take place when estate taxes in another jurisdiction are at issue. Insurance can be used to address estate taxes in other jurisdictions, such as the United States but there may be some limitations to the planning that can occur. The laws of that jurisdiction should be reviewed and a professional advisor(s) in the foreign jurisdiction consulted to ensure appropriate planning occurs.

d) Probate Fees and Other Estate Costs

Life insurance can provide the necessary funding for estimated probate costs in addition to other estate costs. Other estate costs could include burial and funeral arrangement expenses, estate administration costs (e.g. executor's fees, valuator or appraiser fees) and legal and accounting fees.

Probate (now referred to as a tax in some jurisdictions) validates a deceased's Will and confirms the appointment of the executor(s) by confirmation of the court. The fees also apply to intestate estates where no valid Will exists. The fees or tax are based on the value of the estate and vary from province to province depending upon how the value is determined in applicable provincial legislation. Ontario and British Columbia currently have the highest probate fees in the country while Alberta has capped its probate fees and Quebec has virtually no fee. The estate may be liable for probate fees in more than one province. There is no mechanism to credit fees paid in one jurisdiction against fees owing in another jurisdiction.

A named beneficiary in a life insurance policy and/or annuity contract is one method of planning that can be used to avoid probate fees. Life insurance proceeds are paid directly to the named beneficiary and do not form part of the assets of the estate for valuation purposes. The proceeds are therefore not calculated in the assets of the estate to determine the value. This planning obviously does not work if the estate of the insured is named as the beneficiary under the policy.

For a further discussion of probate fees and planning with life insurance see the two Tax Topics, "Probate Overview" and "Probate Fees: Valuing the Assets of the Estate".

e) Create, Increase or Replenish an Estate

It may be difficult to accumulate sufficient assets to pass on to beneficiaries. The death benefit proceeds from an exempt life insurance policy are received tax-free to the beneficiary on death. Thus life insurance can be an efficient means to create an estate or to pass on wealth to the next generations. By investing funds that would normally be subject to annual accrual taxation into an exempt policy, more funds may be provided to heirs than would have otherwise been the case.

Life insurance is often used to replenish an estate. Debt of the estate may erode what would otherwise be available to beneficiaries. By having life insurance proceeds available to pay the debt, the estate is left fully intact for beneficiaries to receive their share.

During life an individual may donate property to a charity. The donor would benefit from the tax credits available in respect of such a donation. To ensure that the estate is not depleted by such gifts, life insurance is often purchased to replace the capital, which was conveyed to the charity.

Another instance in which capital replacement may be the goal is where the individual utilizes life insurance and an annuity together. Using this planning arrangement, a prescribed annuity (defined under Regulation 304 of the Act) is purchased in combination with a life insurance policy. The strategy is commonly employed when the individual desires to maximize income during life and preserve capital at death. A prescribed annuity contract is not subject to annual accrual taxation. Instead subsection 56(1)(d) and 60(a) of the Act provide that a blended payment of capital and income in the same ratio for the term of the contract is received. This averages out the amount subject to tax and results in more favourable current tax treatment due to an element of tax deferral. The purchase of the annuity uses up capital and therefore a life insurance policy is purchased to replace capital. As of 2017, this concept may not be as attractive as in the past as a result of new tax rules. These rules therefore should be reviewed to determine if the concept still works in a favourable manner for the particular situation. See the Tax Topic on "Insured Annuities" for a lengthier discussion of this concept and the tax considerations.

Another common use for life insurance is to facilitate the equal or equitable distribution of an estate amongst beneficiaries. A common example is where an estate includes shares of a family business which will be distributed to the family members who are active in the business. Often the business represents the major asset of the estate and the value of the remainder that will be divided among the other family members who are not part of the business is significantly less. Life insurance may provide a lump sum to non-active family members to ensure an equitable or fair inheritance.

Creditor Protection

During the life of the insured under a life insurance policy, there is the potential for protection of the policy from the owner's creditors. In the common law provinces, provincial legislation provides that if a beneficiary designation is made in favour of a spouse (depending on the province "spouse" may include a common-law or same-sex partner), child, grandchild or parent of the life insured under the policy, the policy will be exempt from seizure by the owner's creditors. In Quebec, it is the relationship between the owner and the beneficiary that is relevant. The class includes ascendants and descendants of the owner. In Quebec, only married and civil union spouses can benefit from creditor protection. Common law partners have to be designated irrevocably to get the same benefit.

If a beneficiary is named irrevocably, the policy will be exempt from seizure by the insured's creditors. Where there is a named beneficiary, other than the estate, the death benefit passes directly to the named beneficiary and is not subject to creditors of the insured.

A full discussion of creditor protection can be found in the two Tax Topics, "Creditor Protection and Life Insurance" and "Limitations on Creditor Protection and Life Insurance".

Withdrawals, Policy Loans and Leveraging
Once a significant cash value has been built up within an exempt policy, it may be utilized to supplement the owner's retirement income or provide funding for a shortfall experienced during a period of disability.

The cash values within the policy may be accessed directly by way of a withdrawal or policy loan. These transactions would be considered dispositions of the policy and potentially subject to taxation. In respect of withdrawals, the policy's adjusted cost basis (ACB) will be allocated proportionate to the ratio that the withdrawal is of the accumulating fund. In respect of policy loans, it is the entire ACB of the policy that is available. Even where a withdrawal or policy loan is subject to taxation either in whole or in part, there still may be a tax advantage to investing in life insurance. It may be possible to accumulate more in an exempt life insurance policy than would have been possible had the same funds been invested in a traditional investment that is subject to annual taxation. Moving the savings from a tax-exposed environment to a tax-sheltered environment may maximize the growth on the savings. It is for this reason that this strategy can make a great deal of economic sense.

Leveraging an exempt life insurance policy, which has accumulated sufficient cash values is another method of accessing the tax-free growth within the policy. A collateral assignment of a policy is not a disposition of the policy for tax purposes. See the Tax Topic "Leveraged Life Insurance – Personal Ownership".

Collateral Insurance
Life insurance may also be used as collateral insurance. Where an individual makes loan arrangements the lender may require that the borrower provide life insurance as collateral security for the loan. The borrower would be the life insured under the policy. Should the borrower die, the lender would be assured of the quick repayment of the debt that is secured by the policy. Where a separate policy is purchased for this purpose a collateral assignment of the policy is required. The borrower would own such a policy and the borrower would have the right to name a beneficiary. A collateral assignment of a separate policy assures that the death benefit proceeds are used first to repay the creditor and any remaining amount would be paid to the designated beneficiary. Depending upon the use of the funds, the life insurance premium may be deductible for tax purposes (the potential deduction is the lesser of the net cost of pure insurance (NCPI) or the premium paid). For a further review of this topic see the Tax Topic "Collateral Life Insurance".

Intergenerational Transfer of Life Insurance
Certain transfers of a life insurance policy will not be subject to taxation. A life insurance policy, therefore, may be a vehicle for transferring accumulated wealth to the next or succeeding generations on an inter vivos basis.

Subsection 148(8) of the Act allows for a tax-free transfer of an interest in a life insurance policy to a child under certain conditions. Where this subsection applies, the transfer takes place for proceeds equal to the policy's adjusted cost basis (ACB). The transferor will be deemed to have disposed of his/her interest in the policy at the ACB and the transferee will be deemed to have acquired the interest in the policy at a cost equal to the same ACB.

To qualify for the rollover, the interest in the policy must be transferred for no consideration to the policyholder's child and a child of the policyholder or a child of the transferee must be the life insured under the policy. For the purposes of the rollover, the definition of child includes grandchild, great grand-child, a spouse of a child, a child of the person's spouse or an individual under 19 years of age who is wholly dependent on the policyholder for support and is in the custody of the policyholder for the relevant time.

The transfer must not be made under the terms of the Will of the parent or grandparent. In such a case, the policy would be transferred from the parent or grandparent to the estate and then from the estate to the child or grandchild and would not qualify for the rollover. Subsection 148(8) of the Act does not contemplate a transfer of the policy at death. In technical interpretation 9433865 dated February 15, 1995, the Canada Revenue Agency (CRA) indicates that in order to qualify for the rollover the transfer must be made inter vivos or by way of a successor owner designation in order to prevent the policy from passing to the estate and thereby giving rise to a taxable disposition. For an in depth discussion on intergenerational transfers, see the Tax Topic "Intergenerational Transfers of a Life Insurance Policy".

It should be noted that a tax-free rollover of a policy to a spouse at death is also available pursuant to subsection 148(8.2) of the Act. In order for the rollover to apply, both the policyholder and the spouse or common-law partner (or former spouse or common-law partner) must be resident in Canada. The provisions deem that the interest is disposed of for proceeds of the disposition equal to the adjusted cost basis to the policyholder immediately before the transfer, and the spouse, common-law partner, former spouse or former common-law partner acquires the policy at the adjusted cost basis equal to those proceeds.

Other Personal Insurance Strategies

Life insurance may be purchased by an inter vivos family trust for the benefit of trust beneficiaries. The benefits of having the family trust invest in a life insurance policy are that the 21-year deemed disposition rule does not apply. Also, no annual income is allocated to the beneficiaries and the trust may be able to deduct the premiums from the trust's income as an expenditure made on behalf of the beneficiaries. The Tax Topics "Trusts Just the Basics" and "Trusts as a Planning Tool" discuss planning with trusts and life insurance.

Often, split dollar arrangements are used in the personal insurance context to benefit two or more family members. The individuals jointly purchase a policy and enter into a formal split agreement. One party may have a need for a permanent level amount of insurance to fund a death benefit need and the other party may have a need for a tax-efficient investment vehicle. Each party would pay a portion of the premium for the benefit that they receive. See the Tax Topic "Split Dollar Life Insurance – Applications" for a more detailed description of situations where split dollar life insurance can be used.

Conclusion

Life insurance can serve many purposes in the personal needs context. Traditional needs for life insurance proceeds include protecting dependants, preserving the estate, paying debts, tax liabilities and other estate costs. Life insurance can also be used to create, increase or replenish an estate or to equalize the estate amongst beneficiaries. Life insurance can meet various needs throughout an individual's lifetime, as their particular needs change.

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