

LIFE INSURANCE

# Retirement Strategy Advisor Guide

For Individuals And Corporations

**A STRATEGY USING  
TAX-EXEMPT LIFE INSURANCE**

## **What's inside**

How it works  
Client profiles  
Benefits  
FAQs



We help. You grow.

## Important information about this guide

This guide includes information on the Retirement Strategy using tax-exempt life insurance as of January 1, 2017. The information in this guide has been prepared for advisor use only.

This guide doesn't provide tax, legal, accounting or other professional advice. We suggest that you advise Clients to seek the advice of a tax professional when making decisions. It's the Client's responsibility to determine the tax consequences under their relevant tax legislation. Any tax information provided in this advisor guide is based on the provisions of the Income Tax Act (Canada) and the regulations as of the date of this guide. In addition, these are subject to Sun Life's current understanding and interpretation of the rules and the administrative practices of the Canada Revenue Agency (CRA) in effect.

This guide discusses accessing cash values from a personally or corporate owned cash value life insurance policy to supplement retirement income. The guide compares the income producing potential from different types of investments – taxable, tax deferred, and tax-free – including life insurance policy cash values. It also considers the ideal Client profile. The guide discusses the two different ways of borrowing from a corporate owned policy, and discusses the tax consequences and risks of each strategy in a details FAQ section.

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# Overview

## **What is the retirement strategy?**

When planning for the future, Clients can face a number of tax-related challenges that affect how much income they can receive and the amount they'll leave behind. The Retirement Strategy benefits Clients because it enhances their estate value, addresses a variety of these tax challenges, and provides an option to supplement their income.<sup>1</sup>

With it, Clients can see how the collateral assignment of a cash-value life insurance policy allows them to generate additional after-tax income, and achieve enhanced estate values from the life insurance coverage.<sup>1</sup> It compares the net estate value of a life insurance solution to the net estate value of a taxable alternate investment, assuming an identical stream of payments and after-tax income from each.

Use it to show high net worth Clients how they can access the cash value of their life insurance policy in a tax efficient manner, to supplement their income, if needed. The Retirement Strategy demonstrates how individual or corporate Clients can:

- grow their assets in a tax-preferred environment,
- receive a stream of tax-free income, and
- provide a tax-free death benefit.

<sup>1</sup> In Quebec, using a life insurance policy as collateral involves the use of a movable hypothec. Like a collateral assignment, the movable hypothec doesn't involve the transfer of policy ownership. It provides security for the loan by giving the lender rights in the policy to the extent of the loan balance.

## How it works

A tax-exempt participating or universal life insurance policy offers advantages that can help to reduce or eliminate some of the challenges that may occur during the life and at the death of the insured person. And when the policy has accumulated cash values, it can be pledged as collateral in exchange for a series of tax-free loans from a third-party lender. Currently, the Income Tax Act (ITA) doesn't treat these loan proceeds as income, so they can potentially be received tax free. There are various methods of structuring the loan, depending on whether the strategy is implemented on an individual or corporate basis.

These factors often allow the Retirement Strategy to provide higher estate values when compared to an alternate taxable investment, even while accessing values to supplement income for a period of time. The following table compares how the Retirement Strategy addresses a variety of tax challenges, both while living and at death, and the advantages of insurance over taxable investments.

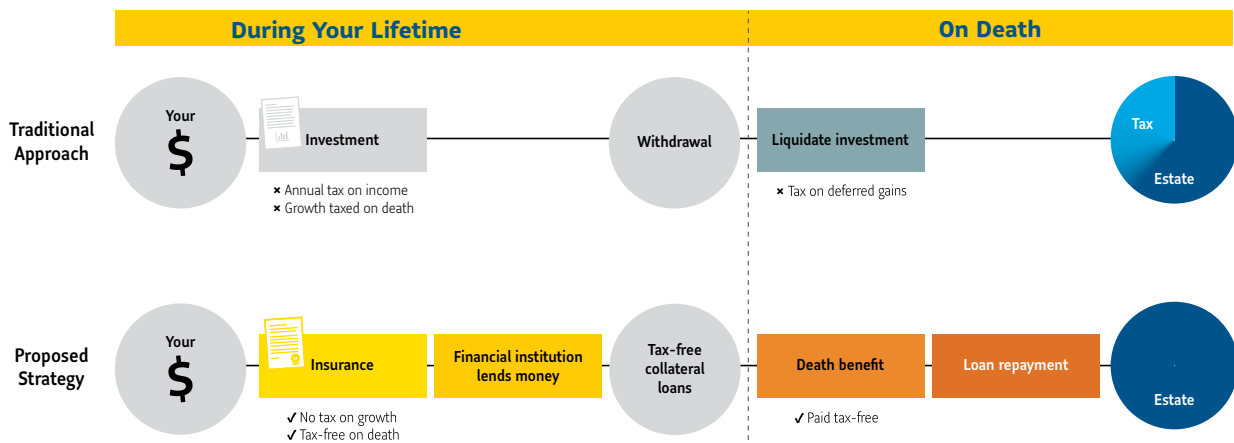
Challenges that can exist with taxable investments	How the Retirement Strategy addresses those issues
<ul style="list-style-type: none"> <li>Income earned on investments outside of a registered plan – such as interest, dividends or capital gains – may be subject to tax. These annual taxes reduce the overall net return and can substantially slow the accumulation of assets and estate value over time.</li> <li>Registered plans such as registered retirement savings plans (RRSPs) and tax-free savings accounts (TFSAs) have contribution limits. This can restrict the accumulation of assets needed to fund a Client's desired future lifestyle.</li> <li>Non-registered investments provide the opportunity for tax-preferred dividend and capital gain income. Despite advantages like the dividend tax credit, taxes must be paid on income earned throughout the tax year, slowing the accumulation of asset growth.</li> <li>Accessing savings can be costly. Withdrawals from an RRSP or RRIF are fully taxable and Clients may need to withdraw significantly larger amounts from these plans in order to receive their desired income. Selling non-registered assets can trigger capital gains, 50% of which are taxable.</li> </ul>	<ul style="list-style-type: none"> <li>A life insurance policy's cash value grows tax-preferred, within legislative limits.</li> <li>This cash value may be accessed by collaterally assigning the policy to a lender in exchange for a loan, helping to supplement a Client's income.</li> <li>Currently, the collateral assignment of a life insurance policy isn't a disposition for tax purposes. As a result, no taxes are payable when the policy is assigned to the financial institution.</li> <li>Loans or advances on a line of credit are not treated as income, and are therefore not taxable.</li> <li>Some lenders allow interest owing on the loan to be capitalized, meaning principal or interest repayments aren't required while the Client is living. Instead, interest owing on the loan is added to the loan balance.</li> <li>At death, the tax-free death benefit is used to pay the outstanding loan plus accumulated capitalized interest, or to replenish other amounts used to pay off the debt.</li> <li>The remainder of the death benefit is received by the named beneficiary, avoiding probate, executor and legal fees, addressing the common tax challenges often faced at death.</li> </ul>

Challenges that can exist with taxable investments	How the Retirement Strategy addresses these issues
<ul style="list-style-type: none"> <li>When an individual dies, their assets are deemed to be disposed of at fair market value. There may be rollover opportunities available for the first death of a married or common-law partner, but taxes are triggered upon the second death, reducing the estate value.</li> <li>Probate, executor and legal fees may also apply, further reducing the amount available to beneficiaries</li> </ul> <p><b>Corporate Clients</b></p> <ul style="list-style-type: none"> <li>Passive investment income within the corporation, including interest, dividends and half of all realized capital gains, are taxed at the high corporate investment income tax rates.</li> <li>Depending on the province, taxable income within the corporation is subject to a tax rate near 50% (qualified small business corporation income can be taxed at a lower rate, between 10 – 15%, depending on the province).</li> <li>When the assets are liquidated and distributed from the corporation following the shareholder's death, any deferred capital gains are triggered and half of them are included in the corporation's taxable income. The after-tax value of these assets in the company needs to be paid out as a taxable dividend to the estate or new shareholders, resulting in an additional layer of taxation.</li> </ul>	<p><b>Corporate Clients</b></p> <ul style="list-style-type: none"> <li>The method for repayment of the loan balance using the tax-free death benefit depends on the structure in place. This is described in more detail in the next section. Regardless of the structure, the full amount of the death benefit minus the policy's adjusted cost basis (ACB) just before death can be posted to the corporation's capital dividend account (CDA). Since the ACB of a policy decreases as the insured person nears life expectancy, in some circumstances the full death benefit could be credited to the CDA.</li> <li>The CDA can be used to pay tax-free capital dividends out of the corporation. Any remaining portion of the death benefit that didn't provide a CDA credit, representing the ACB of the policy, can be paid as a taxable dividend.</li> </ul>

# The individual retirement strategy (IRS)

Implementing the strategy for individual Clients involves the following steps:

1. An individual purchases a participating or universal life insurance policy.
2. Premiums are paid by using excess income or investable assets not needed for other purposes.
3. The cash value accumulates within the life insurance policy on a tax-preferred basis. Depending on the policy type, the death benefit may also grow over time. By directing excess income to a life insurance policy instead of taxable investments, an individual can reduce their annual taxable income, potentially resulting in greater asset growth.
4. If Clients wish to supplement their income, the policy is assigned as collateral to a lending institution for a series of tax-free loans.
5. When the insured person dies, the life insurance tax-free death benefit is paid directly to the named beneficiaries. This ensures the proceeds don't pass through the insured's estate and aren't subject to probate taxes. Because there's a collateral assignment, the insurance company issues one cheque, payable to the lender and the beneficiaries jointly.
6. The lender and the insured's estate trustees determine the correct amount owing under the loan agreement. With the consent of the beneficiaries, the loan is paid. The remaining amount of the death benefit goes to the beneficiaries.



## The corporate retirement strategy (CRS)

For corporate Clients, the CRS can be structured in one of two ways: with corporate borrowing, or with shareholder borrowing. Both methods use the corporate-owned life insurance policy as collateral, but the borrower differs.

With corporate borrowing, the corporation borrows funds directly from the lender. With shareholder borrowing, the shareholder borrows funds directly from the lender.

The tax consequences will vary depending on the structure selected. The decision whether to use corporate or shareholder borrowing will depend on the circumstances of the corporation at the time that loans are needed.

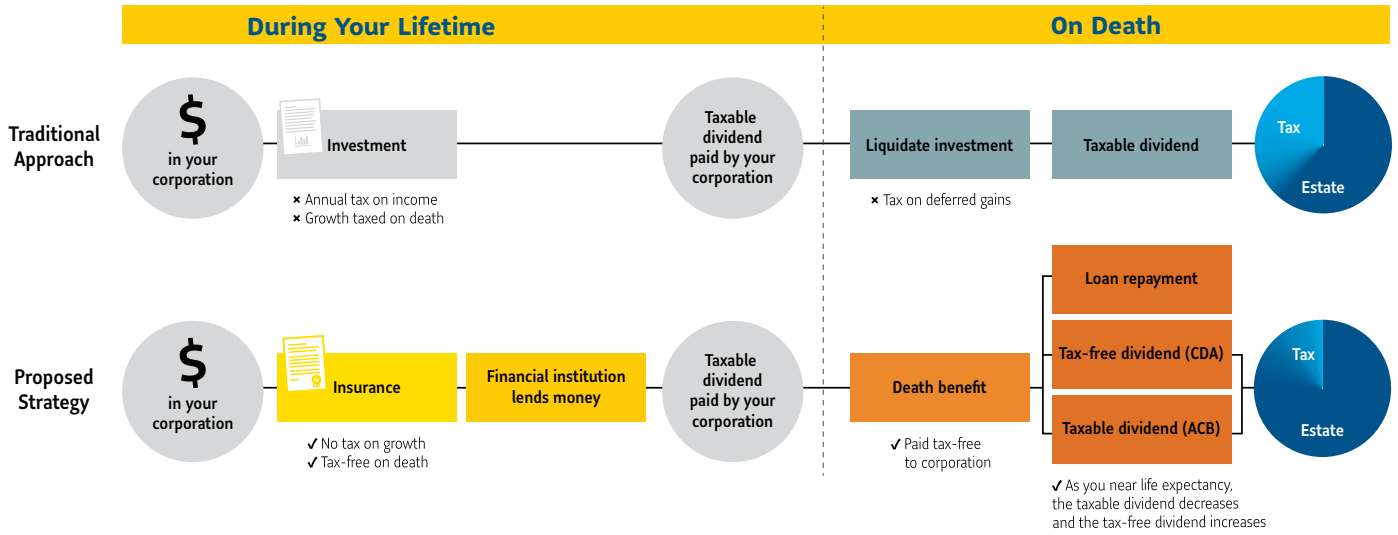
### CRS WITH CORPORATE BORROWING

Corporate borrowing involves the corporation applying for the loan proceeds directly, using the following steps:

1. A corporation purchases a participating or universal life insurance policy on the life of a shareholder. The corporation owns the policy, pays the premiums, and names itself as the beneficiary.
2. Premiums are paid by using excess cash flow or investable assets not needed for business operations.
3. The cash value accumulates within the life insurance policy on a tax-preferred basis. Depending on the policy type, the death benefit may also grow over time. By directing excess income to a tax-exempt life insurance policy instead of taxable investments, the corporation can reduce its annual taxable income, potentially resulting in greater asset growth.
4. If the corporation requires access to the cash value in the policy, it can apply for a loan from a third-party lender in return for a tax-free series of loans. The corporation can use these funds for business purposes or pay them to the shareholder as taxable dividends.
5. When the insured person dies, the tax-free life insurance death benefit proceeds are paid. Because there's a collateral assignment, the insurance company issues one cheque, payable to both the lender and the corporate beneficiary.
6. The lender and the corporation's accountants determine the amount owing under the loan agreement, and the loan is repaid. The remaining amount of the death benefit not needed for the loan repayment goes to the corporate beneficiary.



7. Even though a portion of the death benefit is used to repay the loan, the full amount of the death benefit, less the ACB of the policy at the time of death, can create a credit to the corporation's CDA. Working with its tax advisors, the corporation can use the CDA credit to pay tax-free capital dividends out of the corporation to the estate of the deceased or to any surviving shareholders. Any additional money can be paid out as a taxable dividend.



## CRS WITH SHAREHOLDER BORROWING

With shareholder borrowing, the shareholder applies for the loan proceeds personally, using the corporate policy as collateral. Shareholder borrowing involves the following steps:

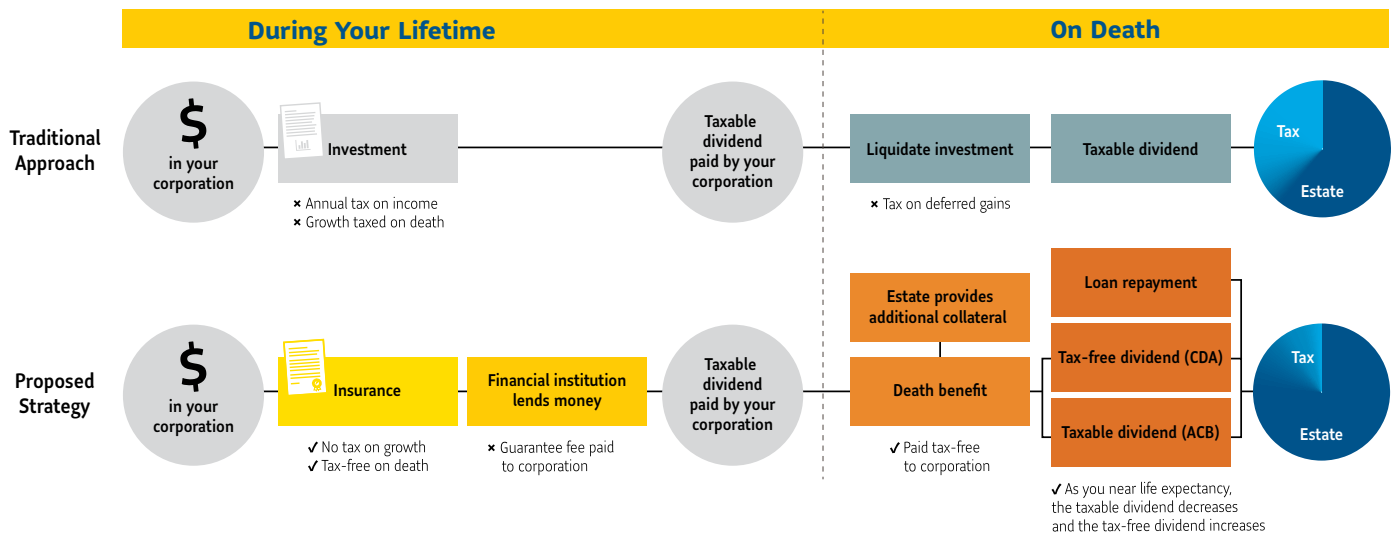
1. A corporation purchases a participating or universal life insurance policy on the life of a shareholder. The corporation owns the policy, pays the premiums, and names itself as the beneficiary.
2. Premiums are paid by using excess cash flow or investable assets not needed for business operations.
3. The cash value accumulates within the life insurance policy on a tax-preferred basis. Depending on the policy type, the death benefit may also grow over time. By directing excess income to a tax-exempt life insurance policy instead of taxable investments, the corporation can reduce its annual taxable income, potentially resulting in greater asset growth.
4. If the shareholder wishes to supplement their personal income, they get the corporation's consent to use the corporate-owned life insurance policy as collateral for a loan. The policy is assigned as collateral to a third-party lender in return for a series of tax-free loans payable directly to the shareholder.
5. The shareholder pays the corporation a guarantee fee for the right to use the corporate-owned insurance policy as collateral for their personal loan. Alternatively, the shareholder includes the value of the benefit in income and pays tax on it.
6. When the insured shareholder dies, their estate pledges additional collateral to the lending institution to secure the outstanding loan and any accumulated interest. In return, the lender releases their claim on the life insurance policy.
7. After the lender has released its claim on the life insurance policy, the tax-free death benefit proceeds are paid to the corporation as the beneficiary. The death benefit, less the ACB of the policy at the time of death, can create a credit to the corporation's CDA.
8. Working with its tax advisors, the corporation can use the CDA credit created by the life insurance policy death benefit to pay tax-free capital dividends out of the corporation to the estate of the deceased shareholder. Any additional money can be paid out as a taxable dividend.
9. The estate uses a portion of the proceeds received from the corporation to repay the loan, and the lender releases their claim on any additional collateral that was used as security.

An important difference with the shareholder borrowing method is how the loan repayment occurs. When the shareholder dies, the estate should be willing to provide additional collateral to the lender so it can release its interest in the policy. If the death benefit flows directly from the insurer to the financial institution to repay the shareholder's loan, the loan repayment may be characterized as a taxable shareholder benefit. This is because it's a corporate asset being used to discharge a shareholder's personal loan.

In addition, shareholder borrowing usually results in a taxable shareholder benefit while the strategy is in place, based on either:

- the interest rate savings that the borrower achieves by having the corporate guarantee, or
- a benefit that's equivalent to a guarantee fee that would otherwise be charged.

This risk may be reduced or eliminated by having the shareholder pay a guarantee fee to the corporation for the right to use its policy as security for the loan. The facts of each case should be examined to ensure the structure is tax effective.



## Client profiles

The need for permanent life insurance protection should be the primary reason for purchasing life insurance, not the desire to access cash in the future. There are many reasons a Client might need permanent life insurance protection including: estate protection, charitable giving, or to leave something to the next generation. Because the Retirement Strategy uses life insurance, Clients must be reasonably healthy and able to qualify for coverage to experience the benefits of life insurance and the advantages offered by this strategy.

While there are many benefits of using the Retirement Strategy, Clients must:

- realize they’re using borrowed funds, are assuming the risks associated with leveraging, and that tax rules may change in the future,
- be comfortable with carrying a potentially large and growing debt,
- have sufficient funds to pay their premiums and build significant cash values within the policy,
- understand that they’ll need to qualify for the loan based on the lending criteria set out by the third-party lender, and that the lender’s rules may change at any time,
- have a long-term view to maximize the benefits of this strategy, and
- understand that many of the benefits of this strategy are realized on the death of the insured.

Individual and corporate Clients who are building assets during their working years have some common objectives. They want to ensure their assets will grow, that they can access them while paying minimal taxes, and typically, they both want to maximize the value available for their heirs. Clients should seek their own tax and legal advice to ensure this strategy meets their needs.

Individual Clients	Corporate Clients
<ul style="list-style-type: none"> <li>• Individuals, aged 35-55, and in good health</li> <li>• Have a large permanent life insurance need</li> <li>• Have high net worth with strong and stable income, and a secure financial future</li> <li>• Have already maximized RRSP and TFSA contributions</li> <li>• Have excess cashflow or investable assets not needed for current lifestyle needs</li> <li>• Have a desire to access assets to supplement future income, if needed</li> <li>• Want to maximize their estate value for their beneficiaries</li> </ul>	<ul style="list-style-type: none"> <li>• Shareholder and key-person of a Canadian controlled private corporation (CCPC), aged 35-55, and in good health</li> <li>• Corporation has a large permanent life insurance need</li> <li>• Has a successful business with either excess income or a large corporate surplus, and a sound future outlook</li> <li>• Interested in reducing tax on corporate investment income</li> <li>• Shareholder is maximizing their individual RRSP and TFSA contributions</li> <li>• Wants access to cash for business opportunities in the future, if needed</li> <li>• Want to maximize the value of their business at death</li> </ul>

## Benefits of the retirement strategy

Life insurance is the driving force behind the success of the Retirement Strategy. Here's a summary of the benefits life insurance can provide for individual and corporate owners:

- **Tax-preferred cash accumulation** – The policy's cash value grows tax free, as long as it remains within the policy.
- **Tax-free death benefit** – The named beneficiary receives the tax-free death benefit, a portion of which is used to repay any outstanding loan balance. By avoiding probate and estate settlement costs, a larger amount can be passed directly to beneficiaries. For corporate Clients, the CDA credit provides a tax-efficient way of moving the proceeds out of the corporation. In many cases, insurance provides a greater after-tax amount to the estate than using taxable investments.
- **Tax deductibility through collateral assignment** – When collateral loan proceeds are being used to earn income from a business or property, interest on the loan may be tax deductible. Also, when the policy is used to secure the collateral loan, some or all of the life insurance premiums may also be deductible. The resulting savings allow the individual or the corporation to access cash in a tax-efficient manner. Deductibility is not available if the loans are used simply as a source of additional income. Clients should discuss this in more detail with their tax advisor.
- **Liquidity** – If the policy owner requires access to the accumulated funds within their policy and doesn't want to collaterally assign the policy to a third-party lender, other options are available. They may have the option of taking a policy loan directly from the insurer, or withdrawing cash value from the policy. Many Clients appreciate the comfort that comes from knowing they can access the cash value of their life insurance policy at any time, in a variety of ways.
- **Potential creditor protection** – For personally owned policies, the accumulated cash value of the policy may be protected from the claims of the policy owner's creditors during the policy owner's life and after their death. Policies owned by holding companies may offer some degree of protection against creditors of a related operating company.
- **Protection of privacy** – By naming a beneficiary, life insurance proceeds don't pass through the policy owner's estate but go directly to the person or organization named. The tax-free death benefit isn't part of the probate process and doesn't become a matter of public record. This helps Clients keep their final wishes and the distribution of their assets private.

## FAQs

### **How are the net estate values of the strategy using life insurance able to out-perform an alternate taxable investment?**

Traditional investment portfolios are subject to annual taxation of earned interest, dividends received, and half of all realized capital gains. When these assets are liquidated, it also triggers taxation of half of all deferred capital gains. For corporations, money is typically moved to the estate or new shareholders by payment of a taxable dividend.

A life insurance policy's cash value grows tax-preferred. Transferring funds from taxable investments to an exempt life insurance policy can help to reduce overall taxable income, although the transfer could trigger taxation of deferred capital gains. The tax-free death benefit is paid to the beneficiary, bypassing probate, executor and legal fees, addressing the common tax challenges often faced at death for individual Clients. For corporate beneficiaries, the capital dividend account provides a tax efficient method of moving money out of the corporation to the estate or new shareholders.

The tax-free loans received in exchange for a collaterally-assigned life insurance policy aren't currently treated as income by the Income Tax Act (Canada). They can be potentially received tax free, providing a significant advantage over other forms of income. These factors will often allow the strategy to outperform an alternate taxable investment, in particular when the policy is held until the death of the insured person.

### **What additional benefits can the strategy offer, besides higher estate values?**

Life insurance may also offer an element of creditor protection when properly structured. If the beneficiary of an insurance policy is irrevocable or a member of a specified family class, the cash value of the policy and the death benefit may be protected against creditors of the individual policy owner. Policies owned by holding companies may offer some degree of protection against creditors of a related operating company. In any situation though, creditor protection can never be guaranteed.

By designating a beneficiary, death benefits can flow directly to them, bypassing the estate, resulting in reduced probate fees and other costs. These benefits allow for an efficient transfer of assets to the named beneficiaries of the policy upon death of the insured person. This can lead to a significantly faster settlement process, and increased privacy when compared to probating an estate.

### **What tax deductions are available when using the Retirement Strategy?**

Tax deductions aren't available if borrowing is solely to supplement income. When the loan proceeds are used to earn income from a business or property, interest on the loan may be tax deductible. Where a life insurance policy has been assigned as collateral for a loan, the lesser of the premium paid, or the net cost of pure insurance (NCPI) may also be deductible.

Interest deductibility is subject to the deductibility criteria under paragraph 20(1)(c) of the Income Tax Act (Canada). If loan interest is paid or payable, the proceeds of the loan are invested to earn income from a business or property, and there's a reasonable expectation of profit, then the interest expense may be deductible from the borrower's taxable income.<sup>2</sup>

Life insurance policies used as collateral security for a loan may provide additional deductions. Clients may be able to deduct the lesser of the premium paid, or the NCPI if certain conditions are met. These include:

- The loan must come from a financial institution, such as a bank, trust company, credit union or insurance company.
- As a condition for granting the loan, the financial institution must require a life insurance policy owned by the borrower to be collaterally assigned to it.
- The policy owner must assign the life insurance policy to the lender as security for the loan. The assignment won't be treated as a disposition of the policy, so no tax consequences will arise from the assignment itself. At least some of the associated loan interest must also be deductible.

There are restrictions on the types of income against which the Client may deduct the premiums or NCPI. Generally, the deduction may be used only against income earned from a business or property, including investment income. The policy owner and the borrower must be the same individual or entity to qualify for the deduction, so the Corporate Retirement Strategy with shareholder borrowing won't qualify. Deductibility is limited to the amount of the premiums or NCPI that can reasonably be related to the loan amount outstanding.

Clients should consult their legal and tax advisors to confirm the applicable deductions for their situation.

### **Why would a Client choose corporate ownership of the policy over individual?**

Many factors need to be considered when a Client is choosing between individual versus corporate ownership of a policy. At the top of the list is choosing an ownership option that properly reflects the insurance need. The following are a few additional considerations, although there may be more. Clients should work with their advisor, estate planning specialist, and tax and legal advisors to determine the best ownership structure. They'll want to avoid the need for a transfer of ownership at some point in the future, since this could trigger taxable gains and taxable shareholder benefits, depending on the situation.

In general, life insurance premiums are paid for with after-tax dollars. A corporation that's a Canadian controlled private corporation (CCPC) is generally eligible for the small business tax deduction, and may pay tax at a lower rate than the insured shareholder. If so, the corporation won't need to earn as much money as the insured to pay the premiums.

Shareholders of qualifying small business corporations benefit from the lifetime capital gains exemption. However, qualifying the company for the exemption is very important. One of the requirements is that at the time the gain is realized, 90% of the fair market value (FMV) of the corporation's assets must be used in an active business carried on in Canada. Life insurance policy cash values are passive assets, and don't count towards this requirement. The Canada

<sup>2</sup> The Quebec Taxation Act limits the annual interest deduction to the amount of taxable investment income generated in the year.

Revenue Agency (CRA) uses the policy's cash surrender value to measure the value of a life insurance policy when determining eligibility for capital gains exemption purposes. It may be useful to have the policy owned by a holding company rather than own policies in an operating company to avoid jeopardizing the operating company's status as a qualifying small business corporation.

While corporate-owned life insurance can increase the after-tax value to the estate, it may also increase the tax liability on the shareholder's terminal tax return. Shares of a closely held corporation are deemed to be disposed of at death for their FMV immediately before death. The value of all the assets, including the cash value of any life insurance policies the corporation owns, helps determine the FMV of the corporation's shares. The significant cash value growth of the insurance policy may exceed what would otherwise have accumulated in the taxable investment. This may increase the tax liability on the terminal return and reduce the advantage of the corporate-owned insurance. Careful planning should be done with the Client's tax advisor to minimize this risk.

### **What's the best way to fund the life insurance premiums?**

The decision to fund premium payments from cash flow or from an existing investment portfolio depends on the unique needs of each Client. Transferring funds from individual- or corporate-owned investments such as stocks or mutual funds to a life insurance policy may trigger capital gains, which could result in taxes owing. Clients should consult their tax advisor to ensure a tax-efficient transfer can be made where possible.

### **What types of life insurance policies are typically used with the strategy?**

The Retirement Strategy can be illustrated using either participating whole life or universal life insurance. The Client's specific needs will determine which type of policy is best for their situation.

Participating life insurance may offer Clients the opportunity to have their policy credited with policy owner dividends. It allows Clients to benefit from the stability offered from a diversified mix of bonds, real estate, equities, private fixed income and mortgages through the Sun Life participating account.

Universal life insurance provides Clients with access to a number of customizable investment options, allowing them to build their own portfolio, and may be more suitable for Clients who prefer a high degree of control over their investment decisions.

### **How much of the cash value can be borrowed against?**

Lenders will typically lend from 50% to 90% of the policy cash surrender value. The Retirement Strategy refers to this amount as the collateral value. It can also be expressed as the ratio of loan balance to policy cash surrender value.

The exact amount depends on how the policy funds are invested. Policies with equity-based investments have a lower collateral value while policies with guaranteed sources and paid-up additional insurance have a higher collateral value. Lenders may be willing to lend more against a participating whole life (Par) policy's cash value than against an asset exposed to more market volatility because of the guaranteed cash values and potential steady dividend growth Par plans offer.



## **How do Clients qualify to collaterally assign their life insurance policy?**

Much like a car loan or a mortgage, individuals must qualify for borrowing when collaterally assigning their policy. Owning a life insurance policy with significant cash values doesn't guarantee approval for a loan. Each lender has their own criteria, which may include evaluation of credit history, net worth and income. Lenders may ask for additional collateral beyond the life insurance policy. It's important to note that lending practices may change over time.

Often set up by the lender as a line of credit, the loan agreement is a contract between the lender and the borrower. It sets out each party's rights and obligations, which include borrowing limits, repayment terms, collateral requirements and interest. Lenders also have the option to call the loan at any time.

Collaterally assigning a life insurance policy has the potential to provide Clients with significant benefits. Policy owners should keep in mind that once they collaterally assign a policy, they're giving up certain rights and control over that policy. The owner can't withdraw funds, take a policy loan or make changes to the policy without the lender's consent or paying off the loan balance.

## **What impact does a change in assumptions have on the strategy?**

There are a number of factors to be considered before implementing the Retirement Strategy. Clients must understand there are many variables that contribute to the projection of any values in the report. Even a small change in the assumptions used in the strategy can have a significant impact on their effectiveness. Advisors should illustrate the strategy using a number of different assumptions, so Clients can fully understand the impact changes can have on the results.

When comparing the growth of a life insurance policy to a taxable investment, policy performance is an important consideration.

- When using participating whole life insurance policies, illustrate at alternate dividend scales to help Clients understand the impact of a change in the dividend scale on the cash values and death benefit of their life insurance policy.
- When illustrating universal life insurance policies, be sure to consider the impact of alternate rates of return.

Maximum loan amounts are based on the policy cash value, so any variation affects the amount the Client can borrow. Lower than expected performance over the long term may mean borrowers will need to reduce their income expectations or risk exceeding the maximum collateral value sooner than expected.

Increasing the assumed life expectancy for the Retirement Strategy results in a lower annual loan amount and creates a greater safety net in case the Client lives longer than statistical life expectancy. The closer to age 100 for assumed life expectancy, the lower the risk the Client will exceed the maximum collateral value.

A lower collateral value provides a safeguard in the case of higher than expected interest rates and/or lower than expected policy value growth.

The interest rate the borrower pays on the loan isn't guaranteed and fluctuates with prevailing interest rates. Higher than expected loan interest rates could cause the accumulated loan balance to catch up to the policy cash surrender value faster than illustrated, and trigger the need for additional collateral.

### **What if the Client doesn't want to borrow when the time comes?**

The decision to borrow against the policy doesn't have to be made when getting the policy, and there's no requirement to obtain a loan in the future.

If a Client still wants access to the cash value in the policy but doesn't want to collaterally assign the policy, they may be able to access the money by taking a policy loan or withdrawal. Policy loans and withdrawals come with their own associated risks, and both may trigger a taxable disposition.

### **What if tax rules change?**

One of the primary advantages of the Retirement Strategy is that the Income Tax Act (ITA) doesn't currently treat collateral loan proceeds as income, so these amounts can be potentially received tax free. Tax laws change frequently, and it's possible that legislative changes could affect this strategy in the future. Because the Retirement Strategy is a long-term strategy, there's the risk that tax treatment applicable to loans and life insurance policies may change without any grandfathering provision between now and the time the Client decides to take a loan.

The tax rules surrounding these strategies can be complicated. Clients should work with their tax advisor to ensure that the strategy is right for them.

The General Anti Avoidance Rules (GAAR) may apply to any transaction that attempts to avoid taxes. Specifically, sub-section 245(3) of the ITA defines an avoidance transaction as any transaction "that but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit." The Canada Revenue Agency has indicated a key issue in determining whether or not the loan is taxable as a policy loan will be the link between the loan agreement and the purchase of the life insurance policy that may contain terms relating to the loan.

### **What happens if the loan amount exceeds the maximum collateral value set by the lender?**

There's a risk that the loan balance could exceed the maximum collateral value outlined in the loan agreement. If this happens, the policy owner must provide additional collateral or pay off a portion of the loan balance. If the policy owner can't provide the additional collateral, the lender may force a surrender of the policy.

This can have serious consequences for Clients. If the lender forces a surrender of the policy, the proceeds are used to pay the loan. The remaining funds might not be enough to pay the potential tax liability triggered by surrendering the policy.

Not only would Clients lose their valuable life insurance protection, they might not have enough to cover taxes owing. For corporate arrangements using shareholder borrowing, it could also result in a taxable shareholder benefit, as the corporate asset is being used to discharge a shareholder's personal loan.

### **Why would a Client want access to the cash value in the life insurance policy?**

An individual Client may want to access cash values from a life insurance policy to supplement their income, for emergency purposes, to fund a vacation or for a number of other personal reasons. A corporate Client may want to access cash values from a life insurance policy to build a pool of tax-preferred capital to take advantage of business opportunities, to expand the business, to provide a source of additional income for key employees, or for emergency purposes.

Corporate Clients must take care to avoid having the arrangement deemed to be a retirement compensation arrangement (RCA). An RCA is a plan or an arrangement made by an employer or a former employer to provide retirement income or benefits to an employee or former employee. Where a corporation acquires a life insurance policy, and is obligated to fund retirement benefits from it, through the Retirement Strategy or otherwise, and it's reasonable to assume that the policy was acquired to fund those benefits, an RCA may be deemed to exist. This may result in significant tax consequences. Clients should consult with their professional legal and tax advisors on this issue.

### **What's better for corporate Clients – corporate or shareholder borrowing?**

On the surface, shareholder borrowing may appear to be the more attractive option because loan proceeds are paid directly from the lender to the shareholder and not through the corporation as a taxable dividend. While this may seem advantageous, there are tax considerations that may apply when a shareholder uses a corporate asset for their benefit.

Because the shareholder is getting the benefit of a loan that is secured by the corporate-owned life insurance policy, there's a risk that a taxable shareholder benefit could be assessed. To help reduce this concern, a guarantee fee could be paid to the corporation.

Upon death, the shareholder's estate may be deemed to have received a taxable benefit if the loan balance is paid directly from the corporation instead of from the estate of the shareholder. The shareholder's estate needs to have additional collateral acceptable to the lender available immediately after the shareholder's death so the lender will release their claim on the policy prior to payment of the death benefit.

With corporate borrowing, the credit to the capital dividend account isn't used when repaying the loan and remains available to the corporation. This is an added benefit over the shareholder borrowing method.

Special care should be taken when considering the Corporate Retirement Strategy using shareholder borrowing. Clients should consult their legal and tax advisors.

### **Why is the guarantee fee an important part of the Corporate Retirement Strategy with shareholder borrowing?**

The Canada Revenue Agency (CRA) has indicated that when a private corporation pledges its assets, such as a life insurance policy, to secure a shareholder's personal loan, the corporation is conferring a benefit on the shareholder. The shareholder may pay an amount for the value of this benefit to the corporation for this right.

In considering what an acceptable value for this loan guarantee would be, the CRA has said:<sup>3</sup>

*The value of a benefit arising from the right to use someone else's property as security for a loan is a question of fact. One method of calculating the fair market value of such a right might be to compare the difference between the interest rates charged with and without the corporation's collateral security. Another method might be to determine what the shareholder would have to pay a third party to provide a similar collateral security.*

There are a variety of other factors to be considered by Clients' tax advisors. For example, if the lender were willing to charge the same interest rate, but lend more money, or allow a longer time for repayment, valuing the guarantee fee could become more complicated.

The fee could be adjusted for the risk that the corporation is assuming. For example, a shareholder with a decades-long stellar credit rating, wanting to borrow for a short period of time, could expect to pay a fee at the low end of the range, because of the low risk that the corporation would ever have to honour its guarantee. But a guarantee fee for a shareholder just emerging from their second bankruptcy, and wanting to borrow for a long period of time, could be at the high end, reflecting a higher risk of default.

The amount of the guarantee fee is determined and taken into account each year that the loan is outstanding. If the loan balance varies annually, the guarantee fee that the shareholder pays also varies. The Retirement Strategy anticipates an increasing loan balance as the shareholder borrows money each year, spends that money, borrows again, capitalizes the interest on the outstanding loan balance, and never pays back any of the borrowed money. Repayment of the loan principal and accumulated interest occurs at the shareholder's death. As a result, the guarantee fee should rise throughout the shareholder's life as the amount of the corporation's collateral supporting the loan increases.

Clients should consult with their tax advisors regarding the guarantee fee with shareholder borrowing.

<sup>3</sup> CRA Document 2000-0002575, dated March 29, 2000.

## Where to go for more information

The Retirement Strategy can provide Clients with valuable life insurance protection and the opportunity to supplement income by accessing policy values on a tax-free basis. For additional information, contact your Sun Life Sales Director.

## Why choose Sun Life?

Sun Life is a leading international financial services organization. In Canada, we started selling life insurance in 1871. Since then, our commitment to helping people achieve lifetime financial security through market leading products, expert advice and innovative solutions has made us a household name – a name that people trust.

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