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# Early Death Benefit - Truth and Consequences

If your clients need joint last-to-die life insurance coverage, but could also use a tax-free death benefit when the first insured dies, they should consider the Early Death Benefit (EDB).

Nearly all life insurance companies offer an EDB on their joint last-to-die universal life insurance policies. The EDB pays a percentage of the policy's cash surrender value when the first insured dies, all the way up to 100%. The policy does not end at that time. It remains in force until the second insured dies, when it pays the remaining death benefit.

There are several financial planning situations where an EDB can offer real advantages for a client. This bulletin discusses how the EDB works, some issues your clients need to be aware of if they select the EDB and the tax treatment of the EDB.

## How does the early death benefit work?

When your clients apply for a joint last-to-die Sun universal life insurance policy, and if the death benefit option they choose is insurance amount plus fund, or fund builder, we automatically include the EDB in their policy at no extra charge. If your clients don't want the EDB, they don't need to do anything – the EDB fund value paid at the first insured's death is initially set to zero, so nothing will be paid until the second insured dies.

If your clients do want the EDB, they need to complete and sign a separate beneficiary form naming the beneficiary to receive the EDB and the percentage of the fund value the beneficiary will receive. It's not a problem if your clients don't select a beneficiary or fund percentage when they apply for the policy or if they want to change or eliminate it at a later date. As long as both insureds are still alive, the policy owner may name, change or delete an EDB beneficiary and may change the percentage of the fund value to be paid at the first insured's death up or down in increments of 5%.

We don't offer an EDB if your client chooses a level or indexed death benefit. Since the net amount at risk declines as the cash surrender value grows, when the first insured dies payment of the EDB reduces the amount of insurance payable at the second insured's death. If the original face amount of insurance is still needed at the second insured's death, increasing the face amount requires evidence of insurability, using rates based on the insured's attained age. It is possible that the insured may no longer be insurable. For these reasons, EDB is not available when the client chooses a level or indexed

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death benefit.[1] However, by selecting the EDB with insurance plus fund, the policy owner ensures that the death benefit available at the second insured's death will at least equal the death benefit initially chosen (assuming the policy remains in force after the first death).

While the EDB is also available with our Fund Builder option, there is some risk. Fund Builder is designed to produce a large cash value. It is useful for clients who want to use their life insurance policy to shelter as much money from tax as possible and who are unconcerned about having a large death benefit. Over time, the Fund Builder option will produce a large policy cash value, but will also reduce the pure amount of insurance. At the first insured's death, up to all of the policy cash value may be paid as a death benefit. At that time the pure insurance portion of the policy could be very small and could be far less than the original face amount chosen.

Some additional notes:

- Each insured must be under age 80 when the policy is issued.
- Sun Life Financial does not offer the EDB when one of the proposed insureds is uninsurable. However, other insurance companies may allow this type of benefit on a selective basis.
- We won't pay the EDB if both insureds die simultaneously. We will only pay the policy death benefit.
- If both insureds die in circumstances where it is uncertain who survived the other, we will deem that the younger insured survived the older insured.
- The death benefit at the last insured's death will be reduced by the amount of the EDB paid at the first insured's death.

## How does the policy stay in force after the EDB is paid?

Since the EDB pays out the policy's cash surrender value as a tax-free death benefit, the cash surrender value is no longer available to help pay for the cost of insurance and other policy expenses after the first insured dies. This can be a problem, especially if the policy was aggressively funded in its early years in anticipation of not having to pay premiums at a later date. There are several ways to address this issue:

- Set the EDB percentage to lower than 100%. This way, some cash value will remain in the policy after the first insured dies and the EDB is paid. Whether or for how long the remaining cash value will support the policy will depend on many factors, including when the first insured died, how aggressively the policy was funded, rates of return and so forth. It's possible that premiums will still need to be paid or, if premiums had been stopped, will have to be restarted.
- Add an optional death benefit rider to the policy at issue, like the Coverage Death Benefit (Protection) or (Savings) rider, for an additional charge. Only one rider may be selected, not both:
  - The Coverage Death Benefit (Protection) rider pays for the continuing cost of insurance after the first insured dies, until the end of the benefit period or the second insured dies. The policy owner selects which insureds to apply the coverage to and chooses the benefit period when selecting the rider. It's possible to select a benefit period up to each insured's age 100.
  - The Coverage Death Benefit (Savings) rider pays up to two times the insurance factor into the policy each month, until the end of the benefit period or until the second insured dies. The cost of insurance will still be deducted from the cash surrender value each month.

## How can the EDB help your clients?

There are many uses for a life insurance policy with the EDB. Here are some of them.

### 1. To help equalize pension benefits

The EDB may help spouses with unequal pension benefits provide for the spouse with the smaller pension. Consider Sam and Mary. Sam has a large pension income with a small survivor benefit. But his wife Mary has no pension. If Sam dies before Mary, Mary won't have enough money to maintain the lifestyle she and Sam enjoyed. She would have to sell assets they had both wanted to pass to their children or live on less income.

Rather than risk that possibility, Sam and Mary use Sam's excess pension income to buy a joint second-to-die life insurance policy with an EDB. The policy death benefit is available after they have both died to help pay their estate settlement costs and taxes.

If Mary dies before Sam, Sam won't need the EDB because he will still have his pension income. In that case he won't claim the EDB and will just leave the cash surrender value in the policy. But if Sam dies first, Mary will claim the EDB to get some extra money – paid as a tax-free death benefit – to help her maintain the lifestyle she and Sam had enjoyed. To the extent the EDB helps her maintain her lifestyle, she will not have to sell the assets she and Sam were saving for their children. If Sam and Mary had also chosen the optional Coverage Death Benefit (Protection) or the optional Coverage Death Benefit

[1] The problem is reduced but not eliminated when using the indexed death benefit because the policy cash surrender value may be larger than increases in the size of the death benefit as a result of indexing.

(Savings) rider when they applied for their policy, there would be money available to help Mary keep the policy in force until she dies.

### 2. To offset the financial impact on retirement assets from a long term illness or from non-covered medical expenses

Kate and Leonard have saved well for their retirement, and expect to receive a good retirement income from their RRSPs and pensions. They also have other assets that they want to pass to their children and expect that those assets will attract taxes at their deaths. To provide a death benefit to help cover those taxes and other expenses, they buy a joint second-to-die life insurance policy with EDB, using their excess retirement income to pay the premiums.

At the time they buy their policy, they see no need for the EDB. However, years later, Kate becomes seriously ill, and uninsurable. Kate's non-covered medical expenses and long-term care costs force them to take more from their retirement assets than they had expected. Before Kate dies, she and Leonard complete a beneficiary change form naming the surviving insured as an EDB beneficiary and selecting a percentage of the policy's cash surrender value at the first insured's death. The fact that Kate is uninsurable at this point has no impact on their right to add an EDB beneficiary or to increase the EDB from zero to 100%.

When Kate dies, the value of their RRSPs and pensions has been considerably reduced. Without additional funds, Leonard doubts he could maintain the income level that he and Kate had saved and sacrificed for without selling the assets that they wanted to pass to their children.

Fortunately, the EDB helps reduce the impact of their earlier large withdrawals from their RRSPs and pensions, allowing Leonard to maintain his income without selling assets.

### 3. To help manage inter-generational transfers of wealth

Bob and Laura are using some of their excess income to maximum-fund a joint last-to-die life insurance policy with EDB. They want tax-sheltered growth of the policy's cash surrender value during their lifetimes and a tax-free death benefit for their children when they die. While the children would normally have to wait until both parents had died before receiving the policy's full death benefit, adding the EDB feature gives them a tax-free partial death benefit on the death of either parent.

### 4. To help manage a business succession

Jeff and Susan own shares in their own private company. They want their children to take over the company when they die or retire. They have done an estate freeze, converting their own common shares to preferred stock, and having the corporation issue new common shares for the children. The corporation takes out a joint last-to-die life insurance policy on Jeff and Susan's lives, with EDB, and funds the policy with excess corporate cash. The death benefit will help fund a preferred share redemption when Jeff and Susan have both died.

Assuming that Jeff dies first, Susan will get his shares on a rollover basis, tax deferred. The EDB pays a tax-free death benefit equal to the life insurance policy cash surrender value which the corporation may use to redeem or buy back some or all of Susan's preferred shares. This accelerates the ownership transfer and also reduces Susan's exposure to business risk. A redemption also reduces the company's cash flow burden, because the company no longer has to pay dividends on the entire block of preferred shares.

A different option would be for Susan to retain all the preferred shares until her death. In that case, the corporation could use the EDB funds to redeem the common shares of family members who were not actively involved in the business or use the money for estate equalization purposes. This way, those children who worked in the business, and who accepted the risk that the business could fail, would control the business. But those children who were not involved in the business would not be disinherited for pursuing their own careers.

This is a simplified view of business succession planning. Clients should consult with their tax and legal advisors regarding any business succession planning.

### 4. To help reduce risk when leveraging a life insurance policy

Clients sometimes use a joint last-to-die universal life insurance policy as collateral for a loan to improve retirement income with nontaxable funds. However, this concept carries financial risks if the life or lives insured live longer than expected or if the spread between the loan interest rate and the cash surrender value's rate of return becomes wider than anticipated (in other words, the debt grows faster than anticipated in relation to the policy's cash surrender value). In either case, the lender could require additional collateral, could call the loan or could require loan repayments to restore the balance between the debt and the collateral securing the debt. As a last resort, the lender could even require that the life insurance policy be surrendered to pay down the loan.

EDB funds payable at the first insured's death could help pay some or the entire loan before the second insured's death. Clients using this strategy may also be able to borrow more money each year than they could without the EDB, since some of the debt would be repaid at the first insured's death. Please note that the lender will have a first claim against the EDB benefit and will use it to reduce the loan if the remaining cash value would be less than needed to secure the loan.

## Issues and considerations

While there are many advantages to using EDB funds, there are also some important issues that clients should consider. Some of them are as follows.

### 1. If the beneficiary does not need the death benefit at the first insured's death

If there is no need for a death benefit to be paid at the first insured's death, it may make more sense to forgo the EDB and leave the policy to pay a death benefit at the second insured's death. If the survivor or beneficiary is simply going to invest the EDB, then the money may simply be left in the policy to grow tax-free until the second insured's death.

### 2. Issues with irrevocable beneficiaries

A policyholder may designate an irrevocable beneficiary to receive the policy death benefit or the EDB. When you designate an irrevocable beneficiary you cannot change the policy without that beneficiary's consent. Some of the transactions requiring the irrevocable beneficiary's consent are:

- Withdrawals and loans
- Removal and addition of beneficiaries
- Changes to the amount or percentage of a death benefit (including the EDB) that a beneficiary receives

These restrictions apply even if a contemplated change to the policy would have no impact on the EDB beneficiary, such as changing the beneficiary intended to receive the death benefit at the second insured's death.

Since an irrevocable beneficiary designation is often made to carry out an obligation that the policy owner owes to the irrevocable beneficiary, policy owners should consider meeting the needs of irrevocable beneficiaries with separate policies.

### 3. Issues with multiple life coverage

A multiple life policy offers coverage on several different lives, all under the same contract. It also offers the freedom to select different death benefit face amounts for each life insured. Further, the death benefit may be paid in one of several ways – completely on the first death, completely on the last death, or on each insured's death in proportion to the amount of coverage on each individual. When a death benefit is paid on any life insured, the coverage on the surviving lives remains in force.

Most companies offering an EDB permit it in a multi-life policy containing joint last-to-die coverage and one or more single life coverages. In such cases, conflicts may arise as to the EDB amount payable when the deceased also has single life coverage in the same policy or when another insured dies and circumstances make it impossible to determine who died first.

Consider the following example. Dick and Jane are covered under a joint last-to-die policy. The policy also provides single life coverage on Dick's life (with Dick's mother as beneficiary) and single life coverage on each of their adult children, Joe and Sue. The Fund Value Allocation on the policy is "Fund Payable on First Death". Dick's EDB fund value percentage election is 100% and the beneficiary is Jane.

If Dick dies, there will be an EDB claim for 100% of the fund value payable to Jane and a single life coverage claim including 100% of the fund value payable to Dick's mother. Clearly, the fund value cannot be fully paid on both claims.

If Jane were to die at the same time as her daughter, the EDB claim on Jane's death would conflict with the claim for the fund value as part of Sue's coverage.

Most policies contain clauses that define how such conflicts are to be resolved, and these rules could affect how much is payable to which beneficiaries. This may create results that the policy owner did not intend.[2]

Advisors should pay particular attention to these details, and may prefer to meet the needs of some beneficiaries through separate policies to avoid some of the uncertainty with multi-life policies.

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[2] For example, Sun Universal Life does not allow an EDB claim if the life insured is also insured under a single life coverage on the same policy. Therefore, the Fund Value Allocation at the policy level governs. If an EDB claim is made on the death of a life insured who dies at the same time as another life insured under a single life coverage, Sun Universal Life will first pay the claim that is submitted first, and if the two claims are submitted together, will first pay the claim on the life who was older at the time of death. Other insurers may use different methods to resolve such conflicts.

## Tax issues

### Tax treatment of the EDB

The Canada Revenue Agency (CRA) initially ruled that the EDB was a withdrawal from the policy and was therefore potentially taxable.[3] However, they have since reversed that position and now agree that the EDB is a disposition payable because of the death of an insured and is therefore tax-free.[4]

It is important to note that this position relies on the CRA's interpretation of the Income Tax Act.[5] Because the law may change or the CRA may change its interpretation at a future date, clients should exercise caution in relying on this position. Having said that, changes to the Income Tax Act and regulations often contain "grandfathering" provisions. A grandfathering provision exempts those who purchased policies before the law changed. However, since CRA technical interpretations do not have the force of law, grandfathering provisions may not apply to them if the CRA develops a different interpretation or if the law changes.

As a final note, CRA guidance and the sections of the Act defining the EDB as a tax-free death benefit do not generally permit tax-free payouts on any event other than death. Disability benefits and accidental death benefits are payable on a tax-free basis. However, other payments may be taxable dispositions.[6]

### Corporate-owned life insurance

Multiple life and joint last-to-die policies are often owned by a holding company. This can be an advantage where the holding company's marginal tax rate is lower than its shareholders' marginal tax rates (since life insurance premiums are paid with after-tax dollars, a lower tax rate means that you need to earn less money to pay the same premium as someone in a higher tax bracket needs to earn). When the insured dies, the death benefit is paid to the company tax-free. The corporation then credits its capital dividend account (CDA) with an amount equal to the death benefit minus the policy's Adjusted Cost Basis (ACB).[7] A capital dividend may be paid to the company's shareholders tax-free.

While there can be many advantages to having corporate-owned life insurance, there are some concerns about a corporation owning a life insurance policy with an EDB:

- Not all of the death benefit will be paid to the shareholders tax-free. Only the "pure insurance" part of the death benefit (death benefit minus ACB) will be treated as a capital dividend. That part of the death benefit equal to the ACB will be treated as a taxable dividend.
- Dividends are paid to shareholders in proportion to their ownership interests in the corporation. As a result, the capital dividend representing the death benefit will be paid to all the corporation's shareholders even if it was originally intended to be paid only to a few shareholders, or to one.
- An EDB claim (like a claim on a multi-life policy) does not reduce the policy's ACB.[8] As a result, the CDA credit will be reduced by the ACB on the second death, just as it was on the first death. The bottom line is that a smaller amount of the death benefit will be paid tax-free to the shareholders than would be if they had owned the policy personally.

### The 250% rule problem

If the policy cash surrender value is all paid out and the policy cash surrender value is zero at the anniversary date, then three years later, the policy may fail the exempt policy test under the 250% rule. The policy owner would need to deposit sufficient funds before the next anniversary date to avoid this problem, but there may be cases where there would not be enough time between the date of the claim and the anniversary date. Furthermore, premium tax would be paid again on the funds when they were re-deposited to the policy. Policy owners should consider electing an EDB percentage less than 100% to avoid this problem.

## Conclusion

EDB is a valuable feature that may help to ease cash flow shortages at death for the reasons explained above. As with any life insurance feature, it requires careful attention to the client's goals, objectives and financial context to help ensure that the product satisfies their needs.

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[3] Sect. 148(1) ITA Mortality gain (Sect 308 ITR) (CALU Report. July 2000 "The CCRA Responds: Tax Policy Roundtable" CALU 2000, Question 2.
[4] CALU Special Reports, Issue Papers & Submission Sept 2000. - CCRA Technical Interpretation 2000-003388, Sept. 11, 2000.
[5] Para 148(9)(j) ITA.
[6] Situations which may permit tax-free payment of the policy fund value are described in ITA sections 148(9)(h) and (k). Subsection 148(9)(h) allows a tax-free payment under a policy made as a disability benefit or as an accidental death benefit. Subsection 148(9)(k) lets you receive the policy cash surrender value in the form of an annuity contract or annuity payments if the life insured is totally and permanently disabled, without the transaction being considered a disposition.
[7] Para. 89(1)(d) ITA.
[8] Sec.148(9) ITA defines the ACB of the policy and holds that the ACB is adjusted on a disposition, not on death.

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