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Tax on the Surrender of a Life Insurance Policy

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Clients may surrender their life insurance policies for reasons such as no longer requiring the policies or due to financial hardship. However, on the policy surrender, Clients may be surprised with the amount they have to pay in tax. Also, when purchasing life insurance policies, Clients usually understand that there is an investment part to their policies, but they may have misconceptions and questions such as:

- Why do I have to pay tax (or that much tax) on the policy surrender?
- Isn't the adjusted cost basis (ACB) of the policy the amount paid in premiums?
- What is the net cost of pure insurance (NCPI) and why does it reduce the ACB?
- Isn't the T5 income received from the policy surrender taxed as a dividend (and not fully taxed as income)?[1]

In *Pudney v. The King*,[2] Barbara Pudney (Barbara) questioned the tax on the surrender of her life insurance policy. This article discusses *Pudney* and explains the tax consequences of surrendering a life insurance policy. It concludes with what to keep in mind before a Client surrenders a life insurance policy for its CSV.

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[1] See, for example, *Jarvis v. The Queen*, 2009 TCC 224 where the taxpayer opted to receive the maturity value of his life insurance policy of $30,004.50. The ACB was $12,411.38, resulting in a gain of $17,593.12. The Tax Court of Canada (TCC) concluded that this gain was properly included in the taxpayer's income as investment income and not as dividend income.

[2] 2023 FCA 42 (*Pudney*).

The Tax on a Surrender of a Life Insurance Policy

Under the *Income Tax Act (Canada)*,[3] a full surrender of a life insurance policy is a potentially taxable disposition.[4] The taxable gain is the amount, if any, by which the CSV of the policy exceeds its ACB.[5] This amount is taxable as income. The insurance company will give the Client a T5 slip to report this amount.[6]

The insurance policy's ACB is determined by a complex formula under the ITA.[7] There are eight factors that increase the ACB – one of which is the premiums paid on the policy.[8] There are also eight factors that lower the ACB – one of which is the NCPI.[9] The NCPI is the net amount at risk (generally the policy proceeds less its CSV) multiplied by a mortality factor prescribed in the ITA.[10] This mortality factor increases each year as the life insured grows older. The result is that the NCPI grinds down the policy's ACB each year. In most cases, a policy's ACB will grow in the early years because the NCPI will be less than the premiums paid. Over time, the NCPI will start to exceed premiums. This means that the ACB will decline over time to nil (but it can't become negative).[11]

Facts in *Pudney*

In 1991, Barbara Pudney (Barbara) purchased a $100,000 life insurance policy with these terms:

- monthly premiums of $64.89 for 22 years (for total policy premiums of $17,130.96),

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[3] R.S.C., 1985, c. 1 (5th Supp.) (ITA). Unless otherwise noted, all statutory references will be to the ITA.
[4] In the case of a partial surrender or withdrawal, a taxable gain will result where the policy's accumulating fund exceeds its ACB. The ACB will be prorated to determine the taxable amount.
[5] Paragraph 56(1)(j) and subsection 148(1).
[6] If the insurer issues a T5 slip for the full CSV, then the ACB in the insurer's records was nil (or deemed to be nil). Under section 257, the ACB cannot be negative even if subtracting the NCPI in the ACB calculation would produce a negative ACB.
[7] Subsection 148(9).
[8] Factor B in the definition of "adjusted cost basis."
[9] Factor L(a) in the definition of "adjusted cost basis."
[10] Regulation 308.
[11] Although this is generally the way the NCPI works, other factors can influence the NCPI calculation such as the type of policy and funding levels.

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- cash value accumulation,
- the right to:
  - borrow any amount up to the policy's CSV, and
  - surrender the policy in exchange for a payment equal to the policy's CSV (minus any outstanding policy loans and unpaid premiums).

In 2015, Barbara experienced financial difficulties and chose to surrender the policy in exchange for the CSV of $32,859.18. In 2016, the insurance company issued Barbara a T5 slip for the 2015 taxation year for $27,225.14, reported as "Other Income." In completing her 2015 income tax return, Barbara deducted the CSV she received as an "other deduction" in computing income. The Canada Revenue Agency (CRA) disallowed the deduction and reassessed Barbara. The CRA also assessed Barbara for added taxes of $11,415, plus interest.

Barbara believed her taxes should have been lower because of the premiums she paid on the policy. She asked the insurance company for an explanation. The insurance company explained that the taxable gain was the difference between the proceeds of disposition (the CSV paid to her) and the ACB of the policy. The letter explained that the ACB was $5,634.04, which was the difference between the total premiums she paid of $17,130.96 and the NCPI of $11,496.92. Barbara did not understand the insurance company's explanation and appealed to the TCC.

TCC Decision

The only question addressed by the TCC was whether the CRA was incorrect in disallowing Barbara's deduction of $32,859.18. In the TCC, Barbara explained the circumstances regarding her purchase of the policy and its surrender in 2015. She asserted that she did not understand why the insurance company adjusted her ACB or why the T5 slip did not reflect the full amount she received of $32,859.18. Barbara also explained that when she purchased the insurance, the salesperson told her it was not taxable. However, Barbara was unable to point to a rule in the ITA that allowed her to deduct the $32,859.18 in computing income. As a result, the TCC dismissed her appeal. Barbara then appealed to the Federal Court of Appeal (FCA).

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FCA Decision

The FCA empathized with Barbara, and stated that, "The rules in the *Income Tax Act* … governing insurance are complicated."[12] The FCA noted that Barbara understood some aspects of her policy, such as that there was an investment element to the policy, and that the policy had a CSV. However, Barbara did not understand why the ACB of the policy was not what she paid for it (that is, why it did not equal the premiums she had paid). She also did not understand what NCPI meant.

The FCA observed that the insurance policy document did not help Barbara with her questions. The policy document stated that it was an exempt policy, which means that Barbara was not required to include in income any amount relating to the periodic accrual of income within the policy while the policy was in force. Barbara understood this to mean that there was an investment element to the policy. The policy document also warned that, even though it was an exempt policy, if the owner surrendered the policy for the CSV or took a loan against the CSV, it may be necessary to include an amount in income. The FCA noted, however, that the policy document did not explain how the income inclusion was calculated.

The FCA concluded that the difference between what Barbara received on surrendering the policy and the ACB had to be included in her income (which she did). The FCA stated that the ITA, however, does not allow Barbara to deduct the $32,859.18 she received. The only available deduction is her ACB of $5,634.04. The insurance company deducted the ACB from the CSV and reported the taxable gain on the T5 slip as $27,255.14. Thus, the FCA saw no error in the TCC's decision and dismissed Barbara's appeal.

[12] See also *Greenstreet v. The Queen*, 2019 TCC 237 for similar facts as *Pudney* where the court stated that the taxation of insurance is very complicated. And see *Andersen v. The Queen*, 2020 TCC 51 where the TCC allowed the taxpayers' appeals because the TCC held that the Minister of National Revenue should have set out the policies' ACB's rather than relying on the T5 slips issued by the insurance company in assessing the taxpayers.

Key takeaways

Key takeaways from *Pudney* include:

- A full surrender of a life insurance policy is a taxable disposition. It is the CSV minus the ACB of the policy. This amount is taxable as income.
- The NCPI of the policy decreases the policy's ACB. This means that there may be a higher taxable gain to the Client than he or she may have anticipated.
- It's important to remind Clients that:
  - if the financial difficulty the Client is experiencing is expected to be temporary, the Client could consider a policy loan or partial withdrawal instead of a full surrender,
  - if a policy is surrendered, it would be unfortunate to lose the insurance protection for loved ones as named beneficiaries,[13]
  - if the policy is no longer required, instead of surrendering the policy, it may be better to:
    - transfer ownership of the policy on a tax-free rollover basis to a spouse or to a child,[14]
    - donate the policy to a charity of choice.[15]

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[13] For example, in Barbara's case, she lost the $100,000 death benefit as insurance protection for her beneficiar(ies) on a policy that was fully paid up.

[14] Subsection 148(8.2) and 148(8). For more information on transferring a policy on tax-free basis, see Sun Life's Guide by Jean Turcotte, "Tax Implications of a Life Insurance Policy Transfer."

[15] For more information, see Sun Life's Guide Planned Giving Guide.