Accessing the cash value of a life insurance policy

Advisor guide

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Life insurance protects your client's family or business.

When the insured person dies, their family, friends, favourite charity or business receives the payout at death. With permanent life insurance, your client's policy can build up assets within the policy that may be used during their lifetime (called cash value[1]). The life insurance policy's cash value can grow tax-free, subject to legislative limits.

About

This guide summarizes the most common ways clients can access built-up cash value in individual or corporately owned permanent life insurance policies, as well as the policies' benefits and considerations. The information provided is based on current tax legislation and interpretations for Canadian residents. It's accurate to the best of our knowledge as of May 2022. Future changes to tax legislation and interpretations may affect this information. This information is general in nature and is not intended to be legal or tax advice. For specific situations, you should consult an appropriate legal, accounting, or tax advisor.

Examples in this guide relating to private corporately owned policies assume both the payout at death and cash accessed by the corporation are paid to the shareholders. Corporations also have the option to keep the payout and accessed cash.

A policyowner has three options for accessing their policy's cash value[2]:

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

Note: Clients can also cancel their policy and receive its cash value, less any outstanding policy loans and loan interest and surrender charges, where applicable.

Creditor protection

When clients access their policy's cash value during their lifetime, the amount they receive may not be protected from creditors.

This contrasts with the payout at death, which, when it is about to be paid out to a named beneficiary (other than the policyowner or the policyowner's estate), will not be subject to the claims of the policyowner's creditors, except in relatively rare cases (for example, a payout could be 'intercepted' to cover a policyowner's unsatisfied spousal support obligations; or a creditor may successfully challenge a 'last minute' beneficiary designation, made by the policyowner in an attempt to thwart the policyowner's creditors). Protection against a policyowner's creditors depends on court decisions and applicable legislation. It's subject to change and may vary by province or territory. Clients should talk to their lawyer to find out more about the potential for creditor protection for their specific situation.

[1] Cash value also refers to account values for universal life policies.

[2] Depending on the option used, accessing cash value may reduce both the policy's cash value and the payout at death, and may also result in taxable income.

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Accessing cash

Methods and considerations at a glance

Clients with permanent life insurance may want to access their policy's cash value for business expansion, retirement, education or travel. Cash value can grow tax-free within a life insurance policy up to legislative limits

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

1 Partial surrender/withdrawal

- Contractually guaranteed with quick access
- May impact insurance payout (death benefit) and future policy growth
- Any cash received in place of coverage may result in taxable income being reported to the policyowner

2 Policy loan

- Contractually guaranteed with quick access
- Loan amount greater than adjusted cost basis (ACB) is taxable
- Doesn't impact insurance coverage or policy growth
- Any outstanding loan balance and interest will:
  - reduce the cash value available on surrender, and;
  - be deducted from the insurance payout on death

3 Collateral loan[3]

- Isn't a contractual option under the policy
- Subject to underwriting and requirements by the third-party lender
- Only a sophisticated policyowner with high-risk tolerance should consider this option
- Policyowner can maximize the loan amount they receive by using a collateral loan. Loan proceeds are received tax-free by the policyowner
- Policyowner pays interest to the lender, and may be required to make an immediate repayment if the lender calls in repayment of the loan
- Doesn't impact insurance coverage or policy growth
- Personal borrowing using corporately owned policy may create a taxable shareholder benefit

[3] Under Quebec law, a policy is used as security by way of a 'movable hypothec'. It's important to understand that Canada Life's issuing of a life insurance policy is completely separate from the lending side of this strategy. A client shouldn't purchase life insurance with the sole intention of using it as security to obtain a collateral loan from a third-party lender in the future. Collateral loan isn't a contractual option under the policy and there's no guarantee a bank or other third-party lender will offer a loan. The client must negotiate that with the lender, subject to their underwriting and requirements. This strategy involves greater risk and a client shouldn't consider a collateral loan unless they're a sophisticated investor and an individual with a high-risk tolerance. They also need enough income and capital to cover the interest and repay the loan, in addition to paying the required life insurance premium payments. The policyowner may need to make immediate repayment if the lender calls in repayment of the loan.

Accessing considerations	1 Partial surrender (participating life insurance) Withdrawal (universal life insurance)	2 Policy loan	3 Collateral loan
Contractually guaranteed (No credit checks)	✓ Yes	✓ Yes	✗ Subject to approval of lending institution
Access cash	✓ Must have cash value available	✓ Amount available depends on: • Cash value • How much the policyowner borrowed and not repaid[4] • Interest owing on any unpaid loan amounts (previously borrowed)	✓ Must have cash value available to use as collateral for loan ✓ Policyowner(s) need to meet lender's underwriting criteria
Taxation of amount accessed	✓ Tax-free where the policy adjusted cost basis (ACB) is higher than policy's total cash value ✓ A taxable policy gain arises if the cash withdrawn from a policy exceeds the prorated ACB attributed to the withdrawal (prorated ACB is based on the policy's total cash value in relation to the amount of cash withdrawn from the policy)	✓ Tax-free up to the policy's ACB ✓ Policy loans in excess of the policy's ACB are taxable	✓ Not taxable
Maintain full control of policy	✓ Yes	✓ Yes	✗ Any changes may require third-party lender's consent since the policy is assigned to the lender

[4] Clients aren't eligible to make additional deposit option (ADO) premium payments when a policy loan is active.

Accessing considerations	1 Partial surrender (participating life insurance) Withdrawal (universal life insurance)	2 Policy loan	3 Collateral loan
Repayment	✗ For participating life insurance: • Withdrawals are permanent and repayment isn't an option ✓ For universal life insurance: • Policyowner can replace the account value taken, subject to legislative limits	✓ Repayment can be made to the insurer at any time. While the insured is alive, loan repayment: • Restores the insurance payout (death benefit) to beneficiaries and cash value on surrender Annual payment of the loan interest is recommended to keep the policy in force. If the loan isn't repaid, we deduct the loan balance, including interest, from the payout or any cash value we pay. This is what this guide means when it references a "reduced payout", or a "reduction in payout".	✓ Repayment can be made to the lender. ✓ Lender typically reserves the right to demand loan repayment in full at any time. While the insured is alive loan repayment: • Release the policy as collateral for the loan The insurance payout at death repays the outstanding collateral loan including interest first, and the remaining insurance payout is received by the policy's beneficiary.
Tax deductions	✗ Not applicable.	✓ Policy loan interest may be deductible if • The loan proceeds are used for the purpose of earning income from a business or property; and if otherwise deductible, the insurer verifies on Form T2210 (Form TP-163.1- V for Quebec) that it was paid in the year and the amount of the interest wasn't added to the policy's ACB ✓ On loan repayment, a tax deduction may be available in amount equal to the lesser of: • The amount repaid • The amount included in income when the loan was taken, less the deductible repayments in previous years	✓ Bank loan interest may be deductible if the loan proceeds are used to earn income from a business or property. • The collateral life insurance deduction may be available where certain conditions are met. The deductible amount is the lesser of premiums paid and net cost of pure insurance. The deductible amount must reasonably relate to the loan.
Credit to the capital dividend account[5]	✗ Reduced payout at death may result in lower amount credited to the capital dividend account.	✗ Reduced payout at death may result in lower amount credited to the capital dividend account.	✓ Doesn't affect credit to the capital dividend account.

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

1 Partial surrender / withdrawals

Withdrawing cash value

The owner can withdraw some or all of the policy's cash value, adjusted for any outstanding policy loans, loan interest and/or fees. Withdrawals may permanently cancel some or all of the client's coverage and may result in taxable income being reported.

Partial surrenders / withdrawals:

Cash withdrawn from a policy may be tax-free, partially taxable or fully taxable depending on the policy's ACB. A taxable policy gain generally arises if the cash withdrawn from a policy exceeds the prorated ACB attributed to the partial withdrawal. A prorated ACB is based on the policy's total cash value in relation to the amount of cash withdrawn from the policy. This means a withdrawal is tax-free if the policy's ACB is higher than the policy's total cash value, or conversely fully taxable if the ACB is nil.

Example:

A client withdraws $30,000 from their policy. Policy has $100,000 cash surrender value and an ACB of $20,000

Description	Policy before transaction	Partial surrender cash withdrawn
Cash value surrendered	$100,000	$30,000
Adjusted cost basis (prorated for partial surrender)	$20,000	$6,000 (Adjusted cost basis is reduced to $14,000)
Taxable amount	$80,000	$24,000
Percentage taxable	80%	80%

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

Individually owned policy

You make a premium payment

↓

Life insurance policy — No tax on growth[1]

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You access the cash — Withdrawal may result in taxable income being reported

↓

At death

↓

Your policy beneficiary gets the remaining payout on death — Tax-free payout on death and potential creditor protection[2]

88-2403

[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

[2] Payable to your named beneficiaries. Protected against your creditors, in some cases.

Corporately owned policy

Corporation makes a premium payment

↓

Life insurance policy — No tax on growth[1]

↓

Corporation pays a salary or dividend

- **Withdrawal may result in:**
  - Reduction of death benefit payout
  - Taxable income being reported
- **Shareholder pays tax on dividends**

↓

At death — **Corporation receives:**[2]
- Death benefit payout
- Credit to capital dividend account

↓

Shareholder gets death benefit payout as dividends — **No personal tax on capital dividends**

88-2136

[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

[2] At death, the insurance proceeds are paid to the corporation on a tax-free basis. The capital dividend account of the private corporation typically receives a credit equal to the payout on death less the adjusted cost basis of the policy. The capital dividend account credit typically allows the corporation to pay a tax-free dividend to the Canadian resident shareholders.

2 Policy loan

Borrowing from the policy

A permanent life insurance policy contract guarantees that the owner can borrow money from Canada Life against the policy's cash value, subject to accrued interest. A client can take advantage of the policy loan feature if the cash value in the policy is large enough and available. The policy loan is tax-free, up to the policy's ACB. The loan doesn't reduce the client's coverage. However, any outstanding loan balance, including interest, will be deducted from the insurance payout on death or any cash value that is paid out on a full surrender.

Policy loans:

- If the ACB is zero at the time the policy loan is taken, every dollar borrowed is taxable.
- If the total outstanding loan balance including interest on your policy exceeds your policy's cash value, your policy will lapse, meaning it will no longer provide insurance coverage

Repaying the loan with external funds:

- If repaid in full, including full interest:
  - There will no longer be a policy loan deducted from the policy's payout at death or on surrender.
    - A tax deduction may be available equal to the lesser of the repayment amount and a historical calculation of any prior policy gains realized less other deductible repayments.
  - Amounts repaid, excluding any amount that's claimed as a tax deduction, are added to the ACB.

Example:

Person A takes two policy loans ($20,000 and $10,000) over a two-month period totaling $30,000. From external funds, they'll repay $15,000 of the loan within the same taxation year.

- The policy has $100,000 cash surrender value and an ACB of $20,000.

Description	First loan	Second loan
Loan amount	$20,000	$10,000
Adjusted cost basis	$20,000	$0
Taxable amount	$0 – Adjusted cost basis reduced to zero	$10,000
Amount repaid from external funds	$15,000	$15,000
Tax deduction	$10,000	$10,000
Adjusted cost basis increase on repayment	$5,000	$5,000

The taxable amount may be higher or lower depending on what the ACB is at the time of the policy loan. Statements regarding tax are based on current Canadian tax legislation and interpretations for Canadian residents, which are subject to change.

Individually owned policy

You make a premium payment

↓

Life insurance policy — No tax on growth[1]

↓

Life insurance company advances a loan to **you** — Loan is tax-free up to the adjusted cost basis of the policy

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At death — Payout on death is reduced by any outstanding policy loan balance and interest

↓

Your policy beneficiary gets the remaining payout on death — Tax-free payout on death and potential creditor protection[2]

88-2137

[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

[2] Payable to your named beneficiaries. Protected against your creditors, in some cases.

Corporately owned policy

Corporation makes a premium payment

↓

Life insurance policy — No tax on growth[1]

↓

Corporation requests a policy loan ⇄ **Canada Life** advances the loan — Loan is tax-free up to the adjusted cost basis of the policy

↓

Corporation pays a salary or dividend — Shareholder receives cash and pays tax

↓

At death — Payout on death is reduced by any outstanding policy loan balance and interest — **Corporation receives:**[2]
- Any excess death benefit payout
- Credit to capital dividend account

↓

Shareholder gets excess death benefit payout as dividends — No personal tax on capital dividends

88-2138

[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

[2] At death, the insurance proceeds are paid to the corporation on a tax-free basis. The capital dividend account of the private corporation typically receives a credit equal to the payout on death less the adjusted cost basis of the policy. The capital dividend account credit typically allows the corporation to pay a tax-free dividend to the Canadian resident shareholders.

3 Collateral loan

Using the policy as collateral for a third-party loan

The owner may be able to borrow from banks or other third-party lenders against the policy's cash value. Known as a collateral loan, it is not a disposition for tax purposes, but the policyowner pays interest to the lender. A collateral loan doesn't reduce the insurance coverage, the cash value growth, any dividends the policy may receive, or the capital dividend account credit. If the loan isn't repaid to the lender, the outstanding balance, including interest, is deducted first from the death benefit payout.

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

- Between 50 and 75%, if invested in equity-linked accounts for universal life insurance
- Up to 100% for guaranteed investment accounts in universal life insurance
- 90% for participating life insurance policies

A collateral loan may be available at a lower interest rate than a policy loan. There's no guarantee a bank or other third-party lender will offer a loan. The client will have to negotiate that with the lender, subject to their underwriting and requirements. Because it involves greater risks, a client shouldn't consider a collateral loan unless they have a high tolerance for risk. Clients should also be aware that collateral loans are typically demand loans. This means the lender may call repayment of the loan at any time.

Example:

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

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

Interest is paid annually

Individually owned policy

You make a premium payment

↓

Life insurance policy — No tax on growth[1]

↓

Lending institution advances a loan to **you**[2] — Loan is tax-free

↓

At death — Loan plus interest is repaid to the lending institution

↓

Your policy beneficiary gets the remaining payout on death — Tax-free payout on death and potential creditor protection[3]

88-2139

[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

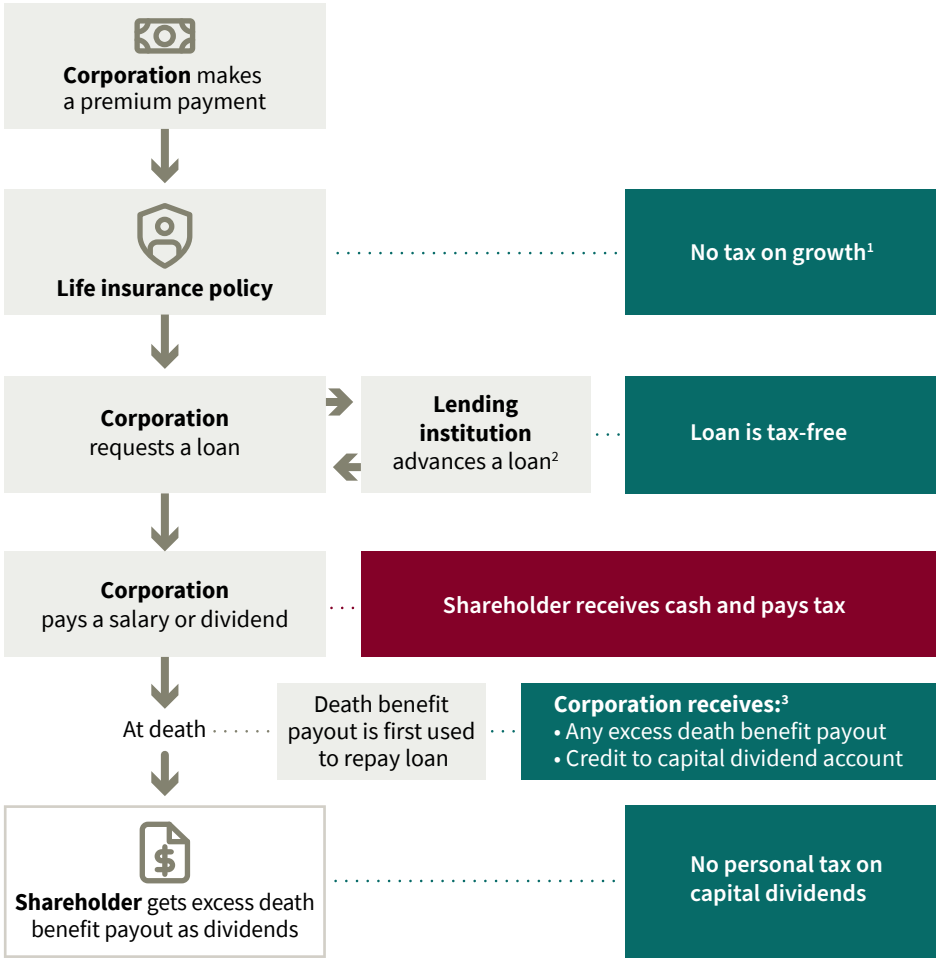
[2] Need to be underwritten by the lender to qualify. Policyowner may need to make immediate repayment if the lender calls for repayment of the loan.

[3] Payable to your named beneficiaries. Protected against your creditors, in some cases.

Corporately owned policy

- A collateral loan doesn't affect the capital dividend account credit.
- The corporate policyowner is the policy beneficiary (not the lending institution).
- When the insured person dies:
  - Corporation receives a capital dividend account credit (equal to the full payout at death minus the ACB)
  - Payout at death is first used to repay the outstanding loan, the corporation will receive any excess.

Where the corporation has a CDA balance (resulting from the life insurance payout) they can elect to payout a tax-free capital dividend. A shareholder obtaining a collateral loan from a bank personally using a corporate-owned life insurance policy as security may result in a taxable benefit to the shareholder. The shareholder benefit may be addressed by paying a reasonable guarantee fee to the corporate policyowner. Clients are strongly advised to consult with their tax advisor before using a corporately owned policy as security for a shareholder's personal borrowing.



[1] The policy's cash value grows tax-free while inside the policy, subject to legislative limits.

[2] Need to be underwritten by the lender to qualify. Policyowner may need to make immediate repayment if lender calls in repayment of the loan.

[3] At death, the insurance proceeds are paid to the corporation on a tax-free basis. The capital dividend account of the private corporation typically receives a credit equal to the full death benefit less the adjusted cost basis of the policy. The capital dividend account credit typically allows the corporation to pay a tax-free dividend to the Canadian resident shareholders.

Accessing cash from corporately owned policies

More points to consider

Retirement compensation arrangements

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

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

Deductibility of payment from company to shareholders

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

Taxable benefit to shareholder

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

As a rule of thumb, the corporate policyowner should be the beneficiary of the payout at death.

A corporation that assigns a life insurance policy to a bank or other third-party lender as security for a loan made to the shareholder may also give rise to a taxable shareholder benefit.

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