CESTNICK

TAX MATTERS

CRA takes offence with leveraged insurance products

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They say that all good things come to an end. Well, in the world of tax planning, at least, it seems that many good tax things come to an end eventually. On Aug. 26, the Canada Revenue Agency (CRA) issued a news release about a strategy known as a Leveraged Insured Annuity (LIA). Now, the government has known about LIAs for a long time and took steps back in 2013 to change the tax rules to make it difficult to use this type of planning. As it turns out, some creative folks have found a way around the rules, and now offshore LIAs are being promoted, and the taxman is not impressed.

LIA STRATEGY

The concept of an LIA involves purchasing an annuity and an insurance policy at the same time. These two products are then used as collateral for a loan. In most cases, it's a corporation owned by an individual that is purchasing the insurance and annuity, and taking out the loan. What are the benefits of the idea? There are a few.

First, the strategy reduces tax owing by the shareholder when he or she dies. How? By reducing the value of the corporation for tax purposes. Under the strategy, cash in the corporation is used to purchase an annuity, which has no value at the time of the insured shareholder's death (because annuity payments generally stop on death).

The annuity payments received by the corporation are used to pay the premiums on the life insurance policy. The policy will pay out when the shareholder dies and reimburse the company for the amount that was invested in the annuity. These insurance benefits are also excluded from the value of the corporation at the time of the individual's death – so the value of the company remains depressed, reducing taxes owing.

The benefits don't stop there. The company will borrow an amount equal to the cash invested in the annuity, with the loan secured by the life insurance and annuity. So, the company is not out of pocket today for the cash that was

used for the annuity. When the shareholder dies, the insurance is paid out tax-free and used to pay off the loan. Further, the company can deduct the interest on the loan, and a portion of the premiums paid for the insurance – another tax benefit.

In short, the cash position of the company isn't affected by this strategy, but tax deductions are created for interest and insurance premiums, taxes are reduced on death of the shareholder, and investments accumulate in the policy tax-sheltered.

There are a couple of other benefits here, too. A portion of annuity payments are tax free as a return of capital (as with all annuities), and tax-free withdrawals can be made from the corporation following the shareholder's death, thanks to a boost in the capital dividend account created by the insurance.

More recently, the same strategy has been implemented using annuities and insurance policies issued by offshore insurance providers, who also arrange limited-recourse loans as part of the planning.

CRA CONCERNS

The taxman is so concerned about the use of LIAs in general – but offshore LIAs in particular – that the department made a point of issuing the August news release. The CRA is concerned that the life insurance policy and annuity are "heavily interdependent, would not have been issued on a stand-alone basis and do not make commercial sense from the perspective of the purchaser, the provider or the individual being insured if the intent of the policy is, in fact, insurance."

That is, the strategy is solely tax driven, which the CRA doesn't like. The CRA has found that LIAs being promoted today abuse certain rules in our tax law and has said it will seek to apply the general anti-avoidance rule to deny the tax benefits being sought.

USING LIFE INSURANCE

If you've been reading my column for a while you may know that I'm a believer in the use of life insurance in financial planning for several reasons. For example, funds that accumulate inside a permanent insurance policy grow with very little volatility, and without personal income tax.

Further, the death benefit plus any accumulated funds in the policy pay out tax-free upon death, the death benefit received by a corporation can give rise to tax-free withdrawals from a corporation through the capital dividend account, and insurance can provide needed cash for supporting dependants, paying off debts, paying taxes, or making meaningful gifts to charity – among other things.

Since insurance has some very compelling tax attributes, you'll find some ideas from time to time that may push the envelope, like the LIA. Other insurance ideas, however, still make good sense and don't offend CRA – including ideas that involve life insurance as collateral on a loan. Let's not throw the baby out with the bath water here.

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