

COMMENT

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Tax-Free Transfers of Personally Owned Life Insurance Policies — Part 1

by Joel Campagna



There may be situations where your client owns a life insurance policy and the life insured is another individual (e.g., their business partner, spouse, or child). Your client has died owning this policy and now the ownership of the policy needs to be changed. What are the tax implications of the ownership change and is it possible to transfer the policy to the new owner on a tax-free basis?

A transfer of ownership of an interest in a life insurance policy represents a disposition.¹ A disposition of an interest in a life insurance policy generally refers to any transaction in which the interest is transferred to another party. This includes an absolute assignment of the interest, whether by way of gift or sale. It also includes a transfer of an interest in a policy that occurs on the death of the policyholder where the life insured is someone other than the policyholder. The taxation of an ownership transfer depends on the relationship between the transferor and the transferee.

Subsection 148(7) contains specific rules that will override the general disposition rules discussed above if a policyholder disposes of his or her interest in a policy in the following situations:

1. a gift (either during life or by way of will),
2. a distribution from a corporation,
3. a transfer of an interest by operation of law only to any person (whether or not arm's length), or
4. a transfer of an interest to any person with whom the transferor is not dealing at arm's length.

In general, if subsection 148(7) applies, the proceeds of the disposition (PD) to the transferor and the new adjusted cost basis² (ACB) to the recipient are deemed to be equal to the greatest of the ACB, the cash surrender value of the interest in the policy, and the fair market value of consideration given in respect of the transfer. Where the PD exceed the ACB the transferor will realize a policy gain.³ The policy gain is treated as regular income⁴ and not a capital gain.⁵

Tax-Free Rollovers

The *Income Tax Act* (Act) does provide for automatic tax-free rollovers of an interest in a life insurance policy in limited situations. These situations are:

1. transfer to a “child” during life or at death⁶ (subsection 148(8)); and
2. transfer to a spouse or common-law partner during life (subsection 148(8.1)) or at death (subsection 148(8.2)).

Where a rollover applies the transferor will be deemed to have disposed of the life insurance policy for PD equal to the ACB of the policy. The recipient will be deemed to have acquired the interest in the policy at a cost equal to those deemed proceeds (i.e., the transferor's ACB).

Let's focus on the first scenario.

Rollover to a Child

As noted above, subsection 148(8) of the Act allows for a tax-free rollover to a “child” when:

1. the policy is transferred for no consideration to the policyholder's child; and
2. the life insured is a child of the policyholder or a child of the transferee.⁷

However, note that the transfer of the policy must be to a child directly. Transfers cannot occur to a trust even where a child may be a beneficiary under the trust and would otherwise qualify under the provisions for the rollover as a child.⁸

But who is considered a child?

The definition is very broad⁹ and includes grandchildren, great grandchildren, persons under the age of 19 who are wholly dependent and in the custody of the taxpayer, adopted children, and the spouse or common-law partner of a taxpayer's child (i.e., son-in-law or daughter-in-law).

By way of example, the Act allows a rollover where a grandparent owns the policy, the son of the owner is the life insured, and the son's child is the transferee of the policy.

What about a step-child?

The definition of child may include a step-child or step-grandchild. For example, consider a grandparent with a child who has a step-child. A step-child is considered a child of the step-parent.¹⁰ Since the step-child is a child of the step-parent, the stepchild is considered a child of the grandparent.¹¹

What about nieces and nephews?

The definition would not normally include nieces and nephews. However, where the nephew/niece was wholly dependent and under the custody and control of the taxpayer either before the nephew/niece attained the age of 19 years, or in some cases where the nephew/niece was wholly dependent on the taxpayer after the age of 19 years, the definition of child could be met. Meeting the definition of "child" in these cases may be dependent on meeting the definition of "wholly dependent" and will be fact specific.

Death and Marriage Breakdown

For a tax-free rollover to occur, the definition of child must be met at the time of the transfer.

A son-in-law or daughter-in-law continues to be considered a child of the taxpayer even after death of the natural child as long as they were considered a "child" immediately before the death.¹² However, where the marriage breaks down prior to the transfer occurring, the tax-free rollover may not be available.

A step-child will no longer be considered a child of the step-parent after the death of the parent of the step-child if the step-child was at no time wholly dependent on the step-parent and was not adopted in law or fact by the step-parent.¹³ This is consistent with the position that the step-child and step-parent would no longer be considered to be related to each other by marriage as the marriage is considered to be dissolved by the death of the parent. As the definition of child is no longer met, a tax-free rollover would not be available.

Why Should My Client Name a Successor Owner?

Naming a successor owner on the life application or while the life insurance policy is in force should be done in situations where the owner and the life insured are different (e.g., parent owning policy on life of child). This important step allows the insurer to quickly transfer the policy when the original policy owner dies. It also means avoiding time consuming and costly administrative steps later.

If a successor owner is not named and the policy is owned by an individual other than the life insured and that individual dies, the policy will go to his or her estate. If a successor owner is named, the policy can be directly transferred to the successor owner without any hassles and, as noted above, it can also result in a tax-free rollover of the policy to a child who is named as the successor owner.

The rollover treatment under subsection 148(8) does not apply to an insurance policy transferred from parent to child by way of the policyholder's will.¹⁴ When the policyholder dies, the policy would first be transferred to the estate and then to the child, resulting in a disposition of the policy. In this case, the deceased policyholder has a disposition of the policy and any policy gain would be taxable in the terminal return. (Note that administrative practices among insurance carriers may differ and T5s

may sometimes be issued to the estate instead of the deceased in these circumstances.)

For example, consider the following situation: Dad dies owning a life insurance policy on their adult son. At the time of dad's death, the policy had a CSV of \$25,000 and an ACB of \$1,000. Dad did not name his son as the successor owner and thus the policy formed part of the residue of dad's estate. Dad's estate will have a policy gain and taxable income of \$24,000 to be reported as a result of the transfer.

Naming the child as a successor or contingent owner is a solution to this problem. The Canada Revenue Agency has confirmed that this would qualify for the rollover.¹⁵ Where a successor owner is named, the policy will not fall into the estate, instead it will be transferred to the named successor owner. Where the successor owner is a child as contemplated under subsection 148(8), the rollover provisions will apply provided other requirements of the provision are met. It should be noted that a transfer to a child should be made after the age of 16, when a child is deemed able to deal with a contract of insurance (age 18 in Quebec).

Returning to our example above, if dad had named son as the successor owner of the policy there would have been no policy gain to be reported and the policy would have transferred to son on a tax-free basis.



Generally, naming a successor owner is also beneficial from the perspective of limiting administrative requirements. Where a successor owner is named, a probated or notarial copy of the will is not required, nor are the same number of forms required to be completed, thus saving time and money. As well, since the policy passes directly to the successor owner and does not pass through the estate, it is not subject to creditors of the estate. ©

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¹ The term “disposition” as it relates to an interest in a life insurance policy is further defined under subsection 148(9) of the Income Tax Act (the “Act”), Revised Statutes of Canada 1985, c.1 (5th Supplement) (as amended). Unless otherwise stated, all statutory references are to the Act.

² Defined in subsection 148(9).

³ Per subsection 148(1).

⁴ Income inclusion per paragraph 56(1)(j).

⁵ A policy gain is specifically excluded from being a capital gain per subparagraph 39(1)(a)(iii).

⁶ As will be discussed later, the transfer at death cannot be via a will.

⁷ CRA technical interpretation letter #2001-0098185, dated October 17, 2001, confirms that a rollover is not allowed if the policy is transferred to the owner’s child and the owner is the insured under the policy.

⁸ Technical Interpretation Letter #9826715, dated January 19, 1999.

⁹ Subsection 148(9) defines the term “child” to include the definition found in subsection 70(10). Furthermore, the extended definition of “child” is found in subsection 252(1).

¹⁰ Paragraph 252(1)(c) provides that a child includes a child of the taxpayer’s (step-parent’s) spouse or common-law partner.


¹¹ By virtue of subsection 70(10), which states that a child includes a child of the taxpayer’s (grandparent’s) child.

¹² Paragraph (b.1) of definition of “child” in subsection 70(10).

¹³ Technical Interpretation #2005-0114721E5.

¹⁴ Technical Interpretation letter #9433865, dated February 15, 1995.

¹⁵ Technical Interpretation letter #9618075, dated September 3, 1996.



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