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Leveraged Insured Annuities

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Leveraged insured annuities (aka Triple Back to Backs) typically involve one or more related corporations that purchase a non-prescribed annuity, a life insurance policy and borrow money for an interest deductible purpose. The tax benefits of this structure can be summarized as follows:

1. The corporation may claim an interest expense on the borrowed funds;
2. The corporation may claim a collateral loan deduction for the lesser of the premium and net cost of pure insurance related to the insurance policy;^[2]
3. A capital dividend account credit equal to the policy death benefit less the policy adjusted cost basis is created on the death of the life insured; and
4. On death, the value of the shares owned by the deceased shareholder may be reduced from what would have been the case had the structure not been implemented, thus reducing capital gains taxes to the deceased's estate.

The CRA has provided commentary^[2] that GAAR could apply to such an arrangement where the structure involves a subsidiary company ("Subco") borrowing to pay a dividend to a parent company ("Parentco") where Parentco uses the dividend to purchase the annuity. It stated that normally, borrowing to "fill a hole" is an acceptable indirect use of borrowed money, but GAAR could apply to limit the interest deduction to the taxable portion of annuity payments. We are aware of one reassessment on this basis.

At the 2011 CALU Associate meeting the CRA stated that it would apply GAAR to Parentco/Subco structures to limit the interest expense to the taxable portion of the annuity contract. The CRA also expressed concern with the tax benefits arising in situations involving these strategies where one corporation purchases the annuity, the life insurance policy and borrows money. At that time, the CRA stated that they had raised this with the Department of Finance. It is unclear whether the CRA currently views there to be a basis for applying GAAR to situations that do not involve Parentco/Subco structures.

It appears that the CRA's concerns have now been elevated to the Department of Finance. During his comments at the 2012 CALU AGM, Finance Minister Flaherty announced that the Department plans to review leveraged insured annuities to ensure that the integrity of the tax system is maintained. CALU subsequently followed up with Finance for more information and we were advised that their review is in the early stages and that CALU will be consulted as part of their process. We will keep members advised as the Finance proceeds with its legislative review.

Endnotes

[1] Paragraph 20(1)(e.2) of the Income Tax Act (the "Act").

[2] 2009-344721E5.