Transfers of Personally-Owned Life Insurance

Introduction
A policyholder may choose to transfer ownership of an interest in a life insurance policy to another person. This Tax Topic will discuss the income tax implications of transferring a personally-owned policy to a spouse, to a child and to a non-arm's length person.

A transfer of ownership of an interest in a life insurance policy is considered a disposition for tax purposes. The taxation of a transfer of ownership of a life insurance policy depends on the relationship between the transferor and the recipient of the policy. The relationship will determine if the general rules, a specific rule or a rollover for the disposition is applicable.

The general rule
The transfer of ownership of an interest in a life insurance policy is included in the definition of disposition in subsection 148(9) of the Income Tax Act (the "Act"). The general rule for the taxation of a disposition is contained in subsection 148(1). A disposition of life insurance policy may result in a taxable policy gain to the transferor. A policy gain is equal to the excess of the proceeds of disposition over the adjusted cost basis (ACB) of the interest in the life insurance policy.

Note that at death, where the policyholder is not the life insured and the policy passes through the estate (i.e. the policy is transferred to another person via the will as opposed to a successor owner designation), there will technically be two transfers: a transfer to the estate at death resulting in a disposition to the deceased, and a second transfer from the estate to the beneficiary (unless there is a rollover under subsection 148(8.2) of the Act to the spouse).

The recipient of the transfer will receive the policy at an ACB equal to the proceeds of disposition. (For a general discussion of dispositions of life insurance, see the Tax Topic entitled "Dispositions of Life Insurance Policies")

Gifts and non-arm's length transfers
Specific rules that override the general rules are provided in subsection 148(7) of the Act for certain circumstances. Subsection 148(7) applies to a disposition of an interest in a life insurance policy in the following situations:

- a distribution of an interest from a corporation;
- a gift of an interest (either during life or by way of will):
- a transfer of an interest by operation of law only to any person; and
- a transfer of an interest to any person with whom the transferor is not dealing at arm's length.

(For a discussion on transfers of life insurance policies from corporations, see the Tax Topic entitled, "Transfer Of An Insurance Policy Involving Corporations and a Shareholder Or Employee")

This subsection covers the gift situation in which a policyholder transfers a life insurance policy to any person (whether or not the person is at arm's length) for no consideration. It also contemplates a situation where the transfer is between non-arm's length persons for consideration. An example of this situation is the case of two brothers who had previously purchased insurance on each other to fund a criss-cross method buy-sell agreement and are selling the company. The insurance is no longer needed for buy-sell purposes; however, the brothers may wish to retain the insurance coverage on their own lives for estate planning purposes.
For transfers after March 21, 2016, subsection 148(7) deems the proceeds of disposition to the transferor and the new ACB to the transferee to be the greatest of:

- the "value" of the interest in the policy at the time of disposition,
- the fair market value (FMV) of the consideration, if any, given for the interest in the policy, and
- the ACB to the policyholder of the interest in the policy immediately before the disposition time.

To the extent that the transferor's deemed proceeds of disposition are greater than the ACB of their interest in the policy, the transferor will realize a policy gain. This policy gain, if any, will be taxed as regular income. Losses, if any, are deemed to be nil. The recipient is deemed to acquire the interest in the policy at an ACB equal to proceeds of disposition.

The term "value" is defined in subsection 148(9) of the Act as the amount the holder of the policy would be entitled to receive if the policy were surrendered (essentially the cash surrender value (CSV) of the policy net of policy loans). It should be noted that the CSV of a term policy would normally be nominal or nil and as such, the value for the above calculation would be nil.

Prior to March 22, 2016 subsection 148(7) deemed the proceeds of disposition to the transferor and the new ACB to the recipient to be equal to the "value" of the policy at the time of disposition. This provision ensured that any policy gain was based only on the CSV at the time of transfer regardless if consideration was paid for the policy.

Revisiting the above example with two brothers who had previously purchased insurance on each other to fund a criss-cross method buy-sell agreement, the company is now being sold, the insurance is no longer needed for buy-sell purposes and they want to swap the policies. For transfers prior to March 22, 2016 each brother would be deemed to dispose of the policy on their brother's life for the CSV at the time of transfer.

For transfers after March 21, 2016 the calculation is more complex, the new subsection 148(7) deems the proceeds of disposition to Brother A on transferring ownership of the life insurance policy on Brother B's life to be the greatest of:

- the CSV of the policy on Brother B's life,
- the FMV of the policy on Brother A's life (consideration given for policy on Brother B), and
- the ACB of the policy on Brother B's life.

A similar result would happen to Brother B transferring the policy on Brother A's life (with appropriate reference changes to the right policy).

Tax Free Rollovers
The Act provides automatic rollovers in limited circumstances. Where a rollover applies, the transferor will be deemed to have disposed of the life insurance policy for proceeds of disposition 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 proceeds. The Act permits a tax free rollover in the specific situations outlined further on:

a) Transfer to Spouse or Common-law Partner during Life
Subsection 148(8.1) states that a transfer during a policyholder's life, to the policyholder's spouse or common-law partner, or a former spouse or common-law partner in settlement of rights arising out of their marriage or common-law partnership, is treated as a tax free rollover. Both the policyholder and the recipient person must be resident in Canada at the time of the transfer.

This subsection provides an automatic rollover. However, the policyholder can elect out of the rollover by filing an election as part of his or her income tax return for the year of the transfer. If the policyholder elects out of the rollover, then the specific rule in subsection 148(7) would apply to deem the proceeds to be essentially equal to the greatest of: the CSV of the policy, the FMV of consideration given for the policy, and the ACB of the policy.

Where there is a disposition resulting in a taxable policy gain after the transfer of the policy to the spouse or common-law partner, the attribution rules may apply and the policy gain may be taxable to the original policyholder. However, where the transfer was made to a former spouse or common-law partner in settlement of rights arising out of their marriage or common-law partnership and there is a subsequent disposition resulting in a taxable policy gain, the attribution rules will not apply. For additional details see CRA document, Archived IT-511R, *"Interspousal and Certain Other Transfers and Loans of Property"*.

b) Transfer to Spouse or Common-Law Partner at Death

Another automatic rollover provision is contained in subsection 148(8.2) and applies to transfers of a life insurance policy to a policyholder's spouse or common-law partner in the event of the policyholder's death. Both the policyholder and the recipient person must be resident in Canada immediately before the policyholder's death.

This subsection provides an automatic rollover. However, the deceased's representative can elect out of the rollover by filing an election as part of the deceased's terminal income tax return. If the policyholder elects out of the rollover, then the specific rule in subsection 148(7) would apply to deem the proceeds to be essentially equal to the greatest of: the CSV of the policy, the FMV of consideration given for the policy, and the ACB of the policy.

It should be noted that the provisions of subsection 148(8.1) and 148(8.2) do not apply to the transfer of a policy to a spousal trust. Such a transfer would give rise to proceeds of disposition as calculated under subsection 148(7) of the Act.

c) Intergenerational Transfers

Subsection 148(8) defines another situation where an automatic tax free rollover is available. The situation is when a policy is transferred for no consideration to the policyholder's child; and the life insured is either a child of the policyholder or a child of the recipient. There is no time limit as to when the transfer must take place. This allows parents to maintain control over the policy until they believe that the child is capable of assuming ownership.

It should be noted that the term child includes a grandchild, a great-grandchild, a spouse or common-law partner of a child, a child of the person's spouse or common-law partner or an adopted child. It also includes an individual under 19 years of age who is wholly dependent on the person for support and who is in the custody and control of the person.

The child who receives the policy does not have to be the same person as the child whose life is insured. For example, a life insurance policy on the life of the policyholder's child may be rolled to the policyholder's grandchild.

This rollover provision provides an opportunity for income splitting. For example, a parent (or grandparent) could purchase a life insurance policy on the life of a child (or grandchild). The life insurance would be purchased to provide final expense coverage in the event of the death of the child and to provide tax shelter opportunities. When the child attains age 18, the policy may be transferred to the life insured child on a tax free rollover basis under subsection 148(8). The child could then withdraw funds from the life insurance policy to pay for a major expenditure such as post-secondary tuition costs or the down payment for a home. Any policy gain arising from a disposition subsequent to the transfer will be taxed in the child's hands provided that the policy withdrawal takes place after the child has attained the age of 18, in order to avoid the attribution rules.

For more detailed discussion of intergenerational transfers, see the Tax Topic entitled, "Intergenerational Transfer of a Life Insurance Policy."

Conclusion
The Act provides general rules, specific rules and rollover provisions that deal with the tax treatment on the transfer of a personally-owned life insurance policy. The applicability of the rules depends on the relationship between the transferor and the recipient. A transfer of this sort may result in unwanted tax consequences or rewarding opportunities.

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