Budget 2024:

Implications for Canadian life insurance

While still awaiting important details for several federal Budget proposals, many financial professionals had already signalled a significantly larger role for life insurance in Canadians' future-oriented planning. As those measures continue to move through the legislative process, it's an excellent time to review the attributes and strategies that make life insurance so prominent in Canadian decisions about entity structure, asset transfer, and estate planning. Because recent Budget measures – like proposed changes to the Capital Gains Inclusion Rate (CGIR) and Capital Loss Inclusion Rate (CLIR), and enacted changes to the Alternative Minimum Tax (AMT) – provide plenty for clients and their advisors to think about, let's take a more detailed look at potential implications for some key life insurance strategies and concepts.

Life insurance and trusts

Since trust arrangements can provide significant flexibility and protection to beneficiaries, combining them with life insurance is a popular strategy for life-cycle planning. This combination is especially useful in addressing the tax considerations that can arise because, in addition to being subject to one or more deemed dispositions of capital assets, many (though not all) trusts may:

- face top tax marginal rates on income taxed within them; and
- lack exemption regarding the Alternative Minimum Tax (AMT).

Certain related attributes can make life insurance particularly attractive for trusts: policies are not subject to the 21-year capital-asset deemed disposition rule, and an exempt policy's cash-value growth is not included in a trust's income calculation under Part I tax or the AMT. At the same time, recent federal Budget measures now make it especially important for clients and their advisors to discuss and revisit insurance-oriented trust considerations, including:

- **Adequacy of insurance:** Consider supplementing existing life insurance: what was purchased to cover a trust's originally envisioned obligations may no longer be adequate. This can occur due to changes in asset mix or to tax rates; for example, consider the tabled increases enacted for the AMT rate (from 15% to 20.5% per Budget 2023) and proposed for the CGIR (from 50% to 67% per Budget 2024). Another specific tax sensitivity for trusts: as tabled, the Budget provided no threshold under which a trust could retain a 50% CGIR (though a threshold provision was later signalled for Graduated Rate Estates and Qualified Disability Trusts).
- **Type of insurance:** Planning shouldn't stop at simply matching a trust's insurance to the dollar-amount of its envisioned needs: clients and advisors should also consider if the proposed type of insurance best matches the unique realities of trust-owned assets. Given that a policy may soon be even more well-suited than capital assets for a trust's long-term hold (e.g., no 21-year capital asset disposition rule, and unaffected by the proposed CGIR increase), selecting a policy with larger overall value accumulation may provide trusts with a better insurance solution than choosing a policy designed to provide a high initial cash-surrender value (CSV).
- **Owning and funding insurance:** Positioning and financing trust-oriented insurance requires awareness of a trust's own attributes, as well as the trust's place within an overall planning structure. For example, consider the proposed Budget 2024 increase to the lifetime capital gains exemption (LCGE). To preserve a private corporation's LCGE eligibility, one or more policies may be held within the trust, or (if possible) the trust itself may be a shareholder of a corporation that owns the relevant insurance. Even if a trust's structure allows it to pay ongoing premiums, consider that high AMT exposure and top marginal tax rates can make most after-tax

trust dollars a very expensive means of funding an insurance policy. A fully paid-up policy may therefore be a preferrable option for trust-owned insurance.

- **Adjusting the asset mix:** While liquidating a trust's capital assets to fund additional trust-owned insurance may seem attractive, remember that a wide variety of legal and financial factors must be considered before adjusting a trust-owned asset mix. One example: consider that disposition of a trust's capital assets prior to June 25, 2024 (to get ahead of the proposed CGIR increase) could have simultaneously subjected the trust to increased tax obligation under the AMT.

Because the terms and structures of trusts arrangements can vary considerably, it's important that all advisors – legal, tax, and insurance – be involved with any trust-oriented planning. With the above items in mind, a client's advisor can provide valuable insight into trust-related insurance.

Life insurance for individuals

From cottages to corporate shares, life insurance has long been a premier tool in the Canadian individual's asset-transfer planning. Given recent federal Budget measures, it's a relevant time for advisors and their clients to revisit how life insurance can: (a) help finance proposed increases to tax obligations on asset transfers; and (b) integrate proposed tax relief into part of a larger future-oriented planning strategy. When discussing where to position insurance and non-insurance assets (and how to plan for their eventual disposition), consider the Budget-proposed thresholds under which income would be subject to a lower rate of tax when realized in an individual's hands:

- **AMT:** Now-enacted measures from Budget 2023 mean that, unlike for many trusts, an individual's adjusted taxable income under an indexed $173,205 threshold (previously $40,000) would not be subject to the AMT. This is particularly noteworthy, given that now-enacted measures from Budget 2023 also increased several of the income inclusion rates for the AMT, as well as the AMT rate itself (from 15% to 20.5%); and
- **Capital gains:** Budget 2024 proposed that, unlike for corporations and trusts, the existing 50% inclusion rate would continue to apply to an individual's net capital gains below an annual $250,000 threshold. Though several crucial details were not available at its tabling, Budget 2024 proposed that 67% of most net capital gains – realized on or after June 25, 2024 – in excess of the $250,000 threshold would be included in an individual's taxable income.

In its 2024 budget, the federal government also proposed changes to the taxation of qualified and qualifying small business corporation shares. Together with the proposed CGIR and CLIR increases, the proposals provide a starting point to consider the following potential life insurance implications:

- **Deemed disposition at death:** Across social and income classes, the largest taxable disposition faced by most Canadian individuals is typically the disposition of all capital assets, deemed to occur in the moment immediately prior to death. Because Budget 2024 as tabled contained no special accommodations for the death of a taxpayer, it's easy to envision how the simultaneous deemed disposition of a person's every capital asset could easily exceed the Budget's proposed $250,000 annual threshold – thereby triggering the proposed 67% inclusion-rate on the excess. And because tax is calculated on each deemed disposition (i.e., regardless of whether the assets are actually liquidated), the CGIR increase as tabled further highlights the importance of life insurance to address tax obligations at death.
- **Principle and Secondary Properties:** In the current real estate environment, capital gains on a property not exempted by the Principal Residence Exemption (PRE) could easily exceed the Budget's proposed $250,000 annual threshold. And once that annual threshold is exceeded, both the gains on that property as well as on all other non-exempt capital gains incurred in that year would be subject to the heightened 67% proposed CGIR. With the potential for a variety of after-tax proceeds to be reduced in this fashion, it's an excellent time to consider/revisit whether a client has enough life insurance – especially in the context of estate equalization.
- **Exempt and reduced-rate capital gains:** Recent federal Budgets proposed several tax-relief measures pertaining to the transfer of qualifying corporate shares. To maximize the effect of these proposals, consider strategies to combine them with insurance, including:
  - **For the LCGE:** Budget 2024 proposes increasing the LCGE to $1.25 million for dispositions on or after June 25, 2024. With this in mind, consider:
    - if an insured buy-sell arrangement exists to best access the LCGE; and
    - if additional insurance is required for those proceeds that exceed the LCGE, especially because as-tabled the increase for the CGIR is also set to take effect for those gains incurred on or after June 25, 2024.

- **For the CEI:** With a proposed phase-in beginning January 1, 2025, the Canadian Entrepreneurs' Incentive (CEI) would reduce to 33% the CGIR on a portion of qualifying share dispositions. Advisors may find this an excellent time to revisit why life insurance is particularly useful for transitioning ownership of a professional corporation: a PC is one of the many entities to which the Budget as tabled proscribed CEI treatment.
- **For the EOT:** In both the 2023 and 2024 Budgets, the federal government sought to incentivize the transfer of corporate shares to an Employee Ownership Trust (EOT). While the specifics of the proposed measures are complex, an important realization is that as-tabled the $10 million EOT exemption would have to be shared among owners of the transferred business. To this end and as more information becomes available, there may be potential to integrate EOT planning alongside insured buy-sell arrangements.

Life insurance for corporations

When it comes to planning for corporate-owned assets, advisors and clients have always had to carefully balance several important competing considerations, and recent proposed Budget measures have made this contemplation even more important. While corporations are not subject to the AMT and its now-enacted increased tax and inclusion rates, for example, corporations would be subject to the increased CGIR (without the benefit of the $250,000 threshold proposed for individuals). The recent Budget proposals present an excellent opportunity for advisors and clients to discuss the role life insurance can serve in a corporate asset mix, including the following considerations:

- **Adjusting the corporate-owned asset mix:** Especially relevant to corporations that hold investment portfolios to plan and provide cash-flow for future events, the proposed CGIR increase would mean less after-tax money when capital assets are sold to finance significant challenges (e.g., the interim period following the death of key personnel, ownership changes upon a shareholder's death, etc.). By reallocating their asset mix to include life insurance (along the lines of the Corporate Asset Transfer Plan), corporations can gain access to faster and more tax-efficient cash flows that can see them through these challenging business events. As tabled, the Budget carried a measure of time sensitivity for capital asset dispositions to subsequently fund life insurance premiums: (i) capital gains prior to the proposed June 25, 2024 rate changeover date could yield greater after-tax proceeds; while (ii) capital losses after June 24, 2024 could generate larger loss recovery carrybacks.
- **Planning for exempt capital gains:** Given Budget 2024 proposed to increase the LCGE to $1.25 million, it's important to ensure that corporate-owned life insurance (COLI) helps rather than hinders shareholders' access to the exemption. For example, there's a requirement that before its shares can be considered eligible for the LCGE, 90% of the fair market value (FMV) of a small business corporation's assets must be used in active business carried on in Canada. While professional valuation of COLI's FMV is very important, advisors and clients should also consider:
  - If the COLI belongs in a holding company (HoldCo) rather than in the operating company (OpCo); CSV is typically considered a passive asset that can run afoul of the 90% rule.
  - Where the COLI is secured on the life of a "key person", the excess of the policy's face value over its CSV may be considered an asset used in the corporation's active business.
  - A combination where: (a) non-CSV term insurance on a key person is owned within an OpCo, to supplement (b) permanent insurance with CSV that is owned within a HoldCo.
- **The capital dividend account, part 1:** The balance in corporation's Capital Dividend Account (CDA) – and the resultant ability to distribute tax-free capital dividends – is increased upon the death of an insured under a COLI policy. In addition to advisors and clients considering which combination of policy and rider(s) is likely to best provide the desired CDA increment, Budget 2024's proposed CGIR and CLIR increases should prompt corporations to pay closer attention to the timing of their capital dividend payments. Because the ability to pay capital dividends is limited to CDA's "positive balance", it is expected that after transitional rules only 33% of a capital gain (as opposed to 50%) will be added to the CDA balance.
- **The capital dividend account, part 2:** Subject to transitional clarity not available at Budget 2024's tabling, consider the CDA-specific timing consequences for corporations considering capital dispositions, especially as part of a change in corporate asset mix (see above). On the one hand and in addition to benefitting from the current (lower) CGIR, corporations that realized capital gains prior to June 25, 2024 would add a CDA increment of 50%, equal to the current non-taxable portion of the capital gains. On the other hand, and while a CDA dividend would typically be declared prior to realizing any capital loss, the proposed CLIR change would limit CDA balance decrements after June 24, 2024 to 33% of the non-deductible portion of capital losses.

A closing thought

While it typically does not comment on legislative proposals, some reassurance regarding the CGIR measures had already come from the Canada Revenue Agency (CRA)'s Income Tax Rulings Directorate. Regarding the "locking-in" of capital gains at the 50% inclusion rate (called "crystallization"), in its Document Number 2024-1016011E5 the CRA stated:

- on the one hand, its view was that "where a taxpayer crystallizes an accrued capital gain prior to the increase in the capital gains inclusion rate, the GAAR would generally not apply to redetermine the inclusion rate in respect of the crystallized capital gain"; but
- on the other hand, the CRA noted that "the crystallization of an accrued capital gain as part of a series of transactions, one of the main purposes of which is to obtain a tax benefit (other than, or in addition to, the taxation of an accrued gain at the current inclusion rate) would not be immune from scrutiny under the GAAR".

While the CRA also stated its view was subject to some supplementary comments, its response should provide some measure of comfort to those who planned around the Budget-proposed capital gains measures. At the same time, because the CRA could potentially assess subsequent activities – for example, declaration of a capital dividend or realization of a capital gains exemption – as forming a series of GAAR-able transactions, it's a good reminder that advisors and clients should first discuss planning facets (including the ones mentioned in this article) with their trusted legal and tax professionals.

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