

CRA 10/8 POSITION PAPER COLLATERAL LOANS VS. POLICY LOANS



ISSUE

We recently received a copy of an undated and unsigned document titled **“The CRA positions on collateral loans promoted by the 10/8 scheme.”**

The nine page white paper argues that loans under the 10/8 insurance concept are policy loans rather than collateral loans and, if that view should not succeed, as a secondary position, the collateral loans should be recharacterized as policy loans under the general anti-avoidance rule (“GAAR”).

Although the CRA has not validated the authenticity of the document, we believe that it is a new internal CRA position paper regarding the 10/8 insurance concept.

This Viewpoint gives Westward’s thoughts on this new development.

The opinions expressed in this memorandum are strictly those of Westward Advisors Ltd. This memorandum is for information purposes only and is not legal or tax advice.



OUR VIEWPOINT

Historical Background

In November 2008, the CRA made its first public declaration that it views certain tax benefits claimed under the 10/8 insurance concept as inappropriate and that the GAAR might apply to deny those tax benefits.

The GAAR threats subsided and, up until now, the CRA’s public criticisms of the 10/8 concept have been largely limited to questioning the reasonableness of the interest rates charged on 10/8 loans. Insurers apply great effort and exacting methodology in order to offer the loans at reasonable interest rates, giving consideration to all the terms and conditions of the loans. We are confident that insurers have established reasonable rates and can back up their calculations with plenty of supporting documentation and market comparisons.

The position paper indicates that the CRA may now be broadening its basis for possible re-assessments against 10/8 plans beyond the reasonableness of the interest rate. Arguing that 10/8 collateral loans are, or should be, treated as policy loans effectively limits the loan advances to the adjusted cost basis of the policy, because policy loans in excess of the adjusted cost basis are taxable to the policyholder.

Collateral Loans vs. Policy Loans

Collateral loans made under the 10/8 concept are not policy loans for the following reasons:

1. The Income Tax Act defines a policy loan as *“an amount advanced by an insurer to a policyholder...”*¹ In contrast, the insurer is often advancing a 10/8 collateral loan to a borrower who is not the policyholder, and so this requirement of the policy loan definition is not satisfied.
2. The Act defines a policy loan as *“an amount advanced by an insurer ... in accordance with the terms and conditions of the life insurance policy.”* The Insurance Act provides that the provisions in the application, the policy contract, any document attached to the policy contract when issued, and any amendment agreed upon in writing after the policy is issued constitute the entire contract.² The collateral loan agreement does not satisfy any of the criteria that would cause it to form part of the policy contract. In contrast, the insurer is advancing the loans to the borrower under the terms of a standalone commercial credit agreement, and not under the terms of the policy contract. Each of the loan agreement and the policy contract include “entire agreement” clauses that specifically exclude the incorporation of other agreements to affect their terms.
3. The fact that the same company is both the lender and the insurer is irrelevant to whether the loan advances are policy loans. The CRA has recognized that an insurer can make a loan to a policyholder with terms and conditions separate from the policy without resulting in a policy loan.³
4. A policy loan never has a maturity date. In contrast, the collateral loans mature no later than ten years from the commencement date, at which time the borrower is legally obligated to repay the loan or renew the loan under a new commercial loan agreement.

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5. There is no legal obligation to repay a policy loan to the insurer, whose only recourse is the policy itself. In contrast, the borrower under a 10/8 collateral loan has a legal obligation to repay the loan, and the lender has recourse against the borrower to recover the loan. A 10/8 collateral loan provides that the borrower does not have a right to offset the loan obligation to the insurer against the insurer's policy obligation to the policyholder.
6. A policy loan reduces the policy's cash surrender value. In contrast, loan advances to the borrower under a 10/8 collateral loan do not reduce the cash surrender value of the policy to the policyholder.
7. A policyholder does not have to qualify for a policy loan. The policyholder has an automatic right to draw a policy loan under the terms of the policy if there is sufficient cash in the policy. In contrast, the borrower under a 10/8 collateral loan must qualify for the loan independent of the collateral offered by the policy. The loan facilities are underwritten as commercial loans, and there are many examples of policyholders approved for policies but refused for 10/8 collateral loans.

GAAR

The CRA position paper argues why the GAAR should apply to recharacterize 10/8 collateral loans as policy loans for tax purposes. It argues that 10/8 collateral loans do not have the legal characteristics of collateral loans, and therefore concludes that the 10/8 collateral loans result in a misuse and abuse of the object, spirit or purpose of the policy loan provisions. But in fact, the 10/8 collateral loans do possess the legal characteristics of collateral loans, and the legal relationships of the policyholder, the borrower, the insurer, and the lender under the policy contract and the collateral loan agreement must be respected, preventing 10/8 collateral loans from being recharacterized as policy loans under the GAAR.⁴

What do Others Think?

RBC Life Insurance Company and Industrial Alliance Insurance and Financial Services Inc. each obtained tax opinions in 2009 from different leading tax law firms that the GAAR should not apply to recharacterize 10/8 collateral loan advances as policy loans for tax purposes.

Westward obtained a tax opinion from Thorsteinssons tax lawyers dated August 2011 that delivered the same conclusion.

The CRA position paper is a reversal of prior conclusions of the CRA Rulings Directorate. A September 22, 2008 internal CRA memo from the Income Tax Rulings Directorate to the GAAR Committee analyzed the 10/8 concept and concluded, "*As we are of the view that the facts and law in this case do not support the finding that the series of transactions being proposed result in a misuse of any provision of the Act or an abuse of the provisions of the Act when read as a whole, we do not believe that GAAR can be applied in this case.*"⁵

In her November 1, 2011 Federal Court decision, The Honourable Madam Justice Tremblay-Lamer wrote, "*At the hearing, the Insurer's [sic] conceded that the Minister had a valid audit purpose in issuing the requirements [to disclose the names of 10/8 clients], but argued that this valid purpose was extraneous to her primary goal, which was to chill the 10-8 plan business. I agree.*"⁶

Conclusion

We remain confident in the opinions of the insurers and the tax lawyers who have studied the 10/8 collateral loans and determined that they are not policy loans for tax purposes.

A well structured 10/8 life insurance plan is a valuable wealth management and estate planning tool for owners of private corporations that need hard-to-find financing to grow their businesses and the Canadian economy while at the same time providing long-term protection for their estates.

We are confident that the loans are not policy loans... and this opinion is shared by the insurers and tax lawyers who have studied 10/8s extensively.

References

- ¹ See the definition of "policy loan" in 148(9).
- ² See subsection 174(2) of the Insurance Act (Ontario).
- ³ See CRA Document 2002-0138895.
- ⁴ See for example *Shell Canada Limited v. The Queen*, 99 DTC 5669 (SCC) where the Court stated "...this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases."
- ⁵ See 2011 FC 1249, court file document pages 2800-2811.
- ⁶ See 2011 FC 1249, paragraph 58.

