

LIFE INSURANCE MORE THAN JUST A DEATH BENEFIT

Understanding your life insurance policy cash value

When people think of life insurance, they often think of a beneficiary receiving a lump sum of money (or death benefit) after the insured person passes away. Your need for insurance must be the reason for buying life insurance, but there are other advantages. What you may not know is that your permanent life insurance may also have a savings component (or cash value) that can grow tax preferred throughout the life of the policy¹. You can access the cash value through loans or withdrawals. There can be very good personal or business reasons to do this. But note, using policy cash values may reduce your policy's death benefit.

ACCESSING YOUR LIFE INSURANCE POLICY'S CASH VALUE

There are three options available for you to access the cash value in your life insurance policy, each having their own advantages and disadvantages:

1. Policy loan
2. Policy withdrawal
3. Collateral assignment

If you choose to access the cash value in your policy, your financial and tax advisors can help you determine which option is best for you.

Depending on which option you choose, the policy's adjusted cost basis (ACB) must be considered for tax purposes. The ACB is the non-taxable part of the policy's cash value, calculated according to a complex formula in the Income Tax Act. The Canada Revenue Agency (CRA) uses a policy's ACB to decide if you will need to report any income when you access your policy's cash value.

IN GENERAL, THE ACB EQUALS:

Total premiums paid (excluding premiums paid for attached benefits or substandard premiums) less policy dividends not used to pay premiums (if applicable) less accumulated net cost of pure insurance determined by CRA² less total policy loans on the policy.

¹ Within the tax exempt limits. There may be tax consequences to accessing your policy cash value.

² The Net Cost of Pure Insurance is calculated based on CRA rules by multiplying the net amount at risk (death benefit less cash value) for the year by mortality rates from tables set by CRA. It does not affect the cost of the insurance.



ACCESSING THE POLICY'S CASH VALUE THROUGH A POLICY LOAN³

With this type of borrowing, Sun Life issues a loan that is secured by the policy's cash value. A policy loan does not affect the cash value growth, and interest is often charged at a variable rate. There is no application process, and there are no fees for creating the loan arrangement.

Policy loan amounts equal to or less than the policy's ACB are tax-free. But policy loan amounts greater than the policy's ACB will be taxable. Sun Life will issue a T5 slip to report the taxable gain.

LET'S LOOK AT A POLICY LOAN EXAMPLE.

You want to take a policy loan in the amount of \$30,000. Here are two scenarios showing the tax implications of the loan depending on the amount taken in relation to the policy's ACB:

	Policy loan taken within the ACB amount	Policy loan taken with a portion greater than the ACB amount
Cash value of the policy	\$100,000	\$100,000
ACB	\$40,000	\$20,000
Policy loan taken	\$30,000	\$30,000
Amount in excess of the ACB amount (Taxable gain)	\$0	\$10,000

If a policy loan is greater than the ACB, the amount of the loan that exceeds ACB will be taxable. If the policy loan had a taxable portion, loan repayments will reduce the taxable part of the policy loan first. You can deduct loan payments that repay the taxable portion of a policy loan.

If the insured person dies, and there is a policy loan outstanding, the death benefit will first pay the policy loan plus accumulated interest. The remainder will be paid to the beneficiary.

ACCESSING THE POLICY'S CASH VALUE THROUGH A POLICY WITHDRAWAL⁴

A policy withdrawal involves withdrawing (or surrendering) cash from the policy, and results in a decrease to both the cash value and the death benefit. Funds withdrawn from a policy can't be returned. This means that the remaining cash value and death benefit may not have the same opportunity to grow over time, if the withdrawal wasn't made.

³ A policy loan is considered a disposition for tax purposes, per paragraph (b) of the definition of "disposition" in subsection 148(9) of the ITA.

⁴ A policy withdrawal is considered a disposition for tax purposes, per paragraph (a) of the definition of "disposition" in subsection 148(9) of the ITA.

To determine the taxable amount of the withdrawal, we compare the policy's ACB to the cash value. The percentage of ACB is then applied to the withdrawal amount. For example, if 40% of the policy's cash value is tax-free ACB, then 40% of the withdrawal will be tax-free. If some of the withdrawal is treated as taxable gain, Sun Life will issue a T5 tax slip to report the gain as income to the policy owner.

LET'S LOOK AT AN EXAMPLE OF A POLICY WITHDRAWAL.

You want to withdraw \$30,000 from your policy. Your policy's total cash value is \$100,000, and the ACB is \$40,000. Since 40% of your policy's cash value is tax-free ACB, 40% of your withdrawal will be treated as having come from tax-free ACB. The rest of your withdrawal will be treated as taxable income.

	Policy withdrawal taken
Cash value	\$100,000
ACB	\$40,000
Percentage of ACB in the policy's cash value	40%
Policy withdrawal amount	\$30,000
Amount of withdrawal treated as ACB	40% x \$30,000 = \$12,000
Amount of withdrawal treated as taxable gain	\$30,000 - \$12,000 = \$18,000

Policy withdrawals reduce the policy's cash value by the amount of the withdrawal. In the above example, the remaining cash value would be \$70,000. The withdrawal also causes the policy's ACB to decrease. Any taxable part of the withdrawal will cause the policy's ACB to then increase. For example:

The withdrawal caused a decrease in the policy's ACB of \$30,000 leaving \$10,000 in ACB. Since \$18,000 of the withdrawal was taxable, this amount was then added back to the ACB leaving a final ACB of \$28,000 ($\$10,000 + \$18,000 = \$28,000$).

Accessing the cash value through policy withdrawals does not carry any interest rate risk like a policy loan or collateral assignment. If interest rates rise in the future, the interest required on the policy loan or collateral assignment loans may become greater than anticipated.

ACCESSING THE POLICY'S CASH VALUE USING A COLLATERAL ASSIGNMENT⁵

As the owner of a life insurance policy you can apply for a loan with a third party lender using the cash value of your policy as security for the loan. Depending on the type of loan you take, the interest on the loan may be payable or may be added to the loan balance every year. Often the loan will be provided to you as a line of credit. You must qualify for the loan based on the lender's criteria. The lender may consider your ability to repay the loan, your net worth and the value of any other collateral you may have. If approved, a loan agreement will be created outlining the borrowing limits, repayment terms, collateral requirements and the rights and obligations for both parties. Lenders may also charge fees to set up this type of arrangement.

At the insured person's death, the death benefit will be used to repay the total amount of the loan plus any interest that has accumulated. If any balance from the death benefit remains, it will be paid to the beneficiary you have named.

This type of arrangement is attractive because collateral loans are not currently considered taxable income, so no additional tax will be due on your tax return.

If accessing the cash value of your permanent insurance policy is something you would like to learn more about, your advisor can give you more information and help you to determine which option best fits your financial plans.

⁵ A collateral assignment is currently not considered a taxable disposition, per paragraph (f) of the definition of "disposition" in subsection 148(9) of the Income Tax Act (Canada) (ITA) and will not result in a taxable policy gain. Collaterally assigning a life insurance policy can be a complicated transaction. You should consult with a tax advisor before using this strategy.

At Sun Life Financial, our goal is to provide relevant and candid advice, encourage you to be proactive about your finances and give you the tools to help create the life you want to lead. When you work with us, you're joining millions of Canadians who trust in our ability to give them the products, knowledge and confidence they need to build a solid financial plan and put it into action.



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