

# Cross-Border Implications of Purchasing Life Insurance Policies

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The funding of a Canadian life insurance policy is a common strategy for Canadian residents with excess liquidity who are looking for a tax-effective investment vehicle. However, when there is a U.S. person in the family, there are specific U.S. income and estate tax issues that should be considered.

This article provides a very broad outline of the more common U.S. tax considerations. Generally, contributions to a life insurance policy and the accumulation of a cash value in the policy is tax deferred for Canadian income tax purposes because the policy meets the “exempt test” under Canadian income tax rules. If you or a family member is a U.S. person (U.S. citizen, U.S. Greencard holder or a U.S. resident), there are additional complexities that should be considered.

## U.S. income tax

All U.S. persons, regardless of where they reside, are required to file a U.S. individual income tax return every year and should therefore consider U.S. tax rules before making an investment decision. In particular, when there is a U.S. person included in an investment planning strategy that involves life insurance, they should be aware that the “exempt test” for life insurance policies under U.S. tax rules is not the same as the “exempt test” under Canadian income tax rules. As a result, a U.S. person who owns a Canadian life insurance policy that does not meet the U.S. “exempt test” would be required to include any growth in the policy’s value as taxable income for U.S. income tax purposes. Similarly, a U.S. person who is a beneficiary of a policy that does not meet the U.S. “exempt test” would be required to include a portion of the death benefit as taxable income for U.S. income tax purposes. While an actuary may be able to analyze and test the policy under each of the tax jurisdiction’s rules, it is often costly and therefore not practical in many situations.

Given the potential complexities of having a U.S. person own a Canadian life insurance policy, if a non-U.S. spouse is married to a U.S. citizen, it is generally more practical from a U.S. income tax standpoint to have the non-U.S. spouse own the life insurance policy. Alternatively, a “term” life insurance policy or minimum funded universal life insurance policy may be considered because those types of policies have little or no investment growth.

## U.S. estate tax

A U.S. citizen may be subject to U.S. estate tax upon their passing if the fair market value of their estate exceeds the

U.S. estate tax exclusion amount that is applicable at the time of their death. The 2021 U.S. estate tax exclusion amount is US\$11.7 million but is scheduled to revert to the inflation adjusted amount of US\$5 million at the end of 2025. The U.S. estate tax rates are graduated from 18% to 40%.

The proceeds payable upon death from an insurance policy owned by a U.S. citizen would be included in their estate, potentially increasing the U.S. estate tax payable upon death of that owner. In order to exclude the life insurance proceeds from the estate, a common strategy is to structure the ownership of the policy such that a properly structured Irrevocable Life Insurance Trust (“ILIT”) purchases the life insurance policy. Typically, a Canadian resident insured with Canadian resident beneficiaries would structure the ILIT as a Canadian resident trust. The ILIT is usually created and funded by the insured and the trust acquires the policy.

Among other specific terms, in order for the death benefit from the life insurance policy to be excluded from their estate, it is important that the ILIT is properly structured so that the creator of the ILIT (generally the insured) does not have any rights to the trust or the policy benefits.

## U.S. gift tax

As part of the U.S. transfer tax regime (which includes U.S. estate tax), U.S. citizens are also subject to a gift tax on the lifetime transfer of assets. The gift tax is imposed on the giver and not the recipient. Accordingly, gift tax should also be a consideration when implementing any estate or tax planning strategies. Since U.S. gift tax is generally tied to U.S. estate tax, the gift tax lifetime exclusion amount for a U.S. citizen is the same as the exclusion amounts applicable for U.S. estate tax purposes (US\$11.7 million for 2021). Any use of the lifetime exemption amount towards gift tax will have a corresponding decrease in the exemption amount available for U.S. estate tax. In addition to the lifetime gift tax exclusion, U.S. citizens can give US\$15,000 annually per recipient, and up to US\$159,000 to a non-U.S. citizen/non-U.S. resident spouse without being subject to gift tax. Both these amounts are indexed annually to inflation.

If you are a U.S. citizen who is considering owning a Canadian life insurance policy through a properly structured ILIT, it may be possible to apply your annual U.S. gift tax exclusion amounts of US\$15,000 or US\$159,000 (as applicable) per beneficiary to fund the life insurance premiums.

### Other common considerations for U.S. beneficiaries

#### Life insurance owned by a corporation

Wealth planning strategies often include the ownership of a life insurance policy by a corporation. The common planning for Canadian income tax purposes is to distribute the proceeds from the life insurance policy to its shareholders through the Capital Dividend Account (“CDA”). While dividends paid out through the CDA are not included as taxable income for Canadian income tax purposes, these dividends are considered taxable income for U.S. income tax purposes. If a U.S. person is the intended recipient of the dividend from the CDA, consideration should be given to structuring the insured’s Will such that the estate receives the life insurance generated capital dividend instead of the U.S. beneficiary. The insured may then make a specific bequest of a specific amount that is at least equal to the capital dividend to that beneficiary.

If the beneficiary of the estate is not a resident of Canada and a resident of the U.S., planning should be considered to avoid Canadian withholding tax on any distribution associated with the dividends paid out of the CDA to the non-resident beneficiary. In this specific circumstance, it is particularly important to seek external tax advice before purchasing the life insurance policy as the rules for both Canadian and U.S. income tax purposes may be subject to varying interpretation by different tax practitioners.

#### U.S. person who is a direct beneficiary of a Canadian life insurance policy

A U.S. person who receives a death benefit directly from a Canadian life insurance policy should be made aware that while proceeds from a “U.S. exempt” policy would be excluded from taxable income for U.S. income tax purposes, a portion of the proceeds from a policy that does not meet the U.S. “exempt test” would be included as taxable income for U.S. income

tax purposes. Therefore, if the Canadian policy qualifies as an insurance contract under U.S. tax law (which is difficult to determine), the proceeds will be received by the beneficiary free of U.S. income tax. If, however, the Canadian policy is not an insurance contract under U.S. tax law, and the policy has a cash surrender value, a portion of the death benefit which relates to the cash surrender value of the policy may be taxable as income to the beneficiary. To address this issue, some practitioners may suggest that the proceeds be made payable to the estate rather than a U.S. beneficiary.

#### What if the insurance policy was in an ILIT?

There are U.S. “throwback rules” that apply when a U.S. taxpayer is a beneficiary of a “foreign” (non-U.S.) trust. Very briefly, distributions from a foreign trust derived from income that has been accumulated in the trust from prior years may result in an interest component added to the U.S. tax associated with the distributions. Generally, the ILIT would be structured as a Canadian resident trust if the insured is a Canadian resident. In this case, certain distributions from the trust, such as investment income from the death benefit that may have been accumulating in the ILIT, may be taxable to the U.S. beneficiary at ordinary U.S. income tax rates with an additional interest component.

Finally, it should be noted that the Internal Revenue Service imposes a 1% excise tax on insurance premiums paid to any non-U.S. companies for any life insurance policy issued on the life of a U.S. citizen. This also applies to U.S. citizens living in Canada who purchase Canadian insurance policies. As the person who is insured is liable for the tax, the excise tax would still apply if the policy is in an ILIT.

The purpose of this article is to provide overview of what you should consider if you have U.S. family members involved in the insurance planning process. You should always consult with an external cross-border tax advisor before implementing any investment strategy that includes the purchase of a life insurance policy.

**For more information, speak with your BMO financial professional.**



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