iA LARGE CASE
SOLUTIONS

All the expertise.
All the products.
All our attention.

IMMEDIATE FINANCING ARRANGEMENT (IFA)

Implementation Guide

iA Financial Group

There are many ways for contract holders of permanent life insurance policies to access their contract's cash surrender value. The immediate financing arrangement (IFA) is a financial strategy that allows policyholders of Universal and participating life insurance policies to benefit from permanent insurance coverage while having access to the cash required to reinvest in income-producing assets or their companies to support the growth of their activities. A Participating life insurance that tends to maximize short-term cash surrender values, can be a particularly advantageous solution for implementating an immediate financing arrangement.

GENERAL OVERVIEW OF THE IFA

To implement an IFA, the interested person purchases a permanent insurance product that meets their needs, as determined by their advisor. All available payment duration options (10-year quick pay, payable in 20 years or payable for life) can be suitable to implement an IFA. Policyholders make this decision with advisors, based on their objectives and needs. Even though this strategy can be used by an individual, it is favoured in the majority of cases when the contract holder is a company, and the insured is a shareholder (or any other key person). The company pays the premiums for this life insurance policy so that the total cash surrender value grows as quickly as possible, according to the tax limits determined by the *Income Tax Act* (ITA). The life insurance policy's cash surrender value accumulates in a tax shelter. It is recommended that the paid-up additions dividend option be selected. Depending on the version of the product selected, the contract holder's needs and budget, we try to take maximum advantage of the additional deposit option (ADO).

The cash surrender value is used as collateral to set up a loan or line of credit with an external financial institution. The financial institution grants loans to the company or directly to the shareholder. Other credit facilities can be used for the strategy, such as lines of credit. The maximum amount of loans granted is determined according to a percentage of the total cash surrender value or premiums paid by the company. The borrower then chooses to reinvest the cash generated by the loans in the company's current business activities or in any other eligible commercial project. The borrower pays the interest on the loans on a monthly or annual basis. When the conditions are met, the interest on the loans is deductible for tax purposes. New loans are issued each year to the borrower to optimize the strategy. To determine the maximum loan, we recommend considering the borrower's capacity to generate taxable income, to ensure that they can continue to benefit from the advantages of the IFA. To limit growth of the loan, the borrower can stop requesting loan advances at any time, while continuing to pay the annual interest.

When the insured dies, the death benefit is paid out to the company tax-free. The difference between the death benefit and the adjusted cost basis (ACB) is deposited in the capital dividend account (CDA). The death benefit is then paid to the insured shareholder's estate as a non-taxable capital dividend. Depending on the agreement between the financial institution and the shareholder, the death benefit is used to repay the loan.

When the company is the borrower, the loan can be repaid in such a way as to create an unused portion of CDA, which can be used to distribute other assets to the shareholder's estate as a non-taxable capital dividend.

THE IFA IS NOT SUITABLE FOR EVERYONE

The IFA is a strategy meant for a sophisticated, high-end clientele of any age who has a significant need for permanent life insurance. Interested persons must have a good tolerance for risk and must be able to understand and comply with financial leverage strategies. Borrowers who want to implement an IFA must also be able to produce sustainable long-term taxable income, to benefit fully from the interest deduction and other benefits of the strategy.

The policyholder and borrower's professionals (accountants, lawyers, tax specialists and financial advisors) must be involved in the IFA implementation process. Their participation is required on an annual basis, for the duration of the strategy.

The IFA is not meant for those whose need for liquidity is such that they cannot cover their insurance need without resorting to external financing. Nobody should purchase life insurance with the single goal of assigning the policy as collateral to get a loan.

BENEFITS OF THE IFA

Tax savings

Interest deduction

Subject to the conditions of the ITA, the interest paid on the loans is deductible when the loans were incurred for the purpose of earning income.

Access to cash

The loans are a source of non-taxable cash for the shareholder.

Subject to the conditions of the ITA, the cash received as loans guaranteed by a life insurance policy with an external financial institution are not taxable. Therefore, the IFA provides access to cash with no tax impact.

Tax-sheltered growth

The annual growth generated by a life insurance policy is not taxable. With these tax savings, the annual growth of a life insurance policy is accelerated compared to other types of investment.

Passive income rules not applicable

Life insurance policies are not subject to passive income rules. The amounts paid into life insurance policies do not negatively affect the small business deduction (SBD), unlike other types of investment.

Creating a capital dividend account

All or part of the death benefit is deposited into the CDA. The rapid growth of the cash surrender value created by maximizing payments into the life insurance policy helps grow the CDA. The capital dividends paid from the CDA are tax free.

Increased net estate value

The death benefit is paid to the insured shareholder's estate tax free.

Flexibility

The loans granted to borrowers provide them with the cash they need to carry out their activities while benefiting from life insurance protection.

STEPS FOR ESTABLISHING AN IFA

STEP 1

Purchasing a participating or universal life insurance policy

The company purchases a participating or universal life insurance policy on the life of a shareholder (or any other key person). The company is named as beneficiary. Any other beneficiary designation risks provoking a taxable benefit for the company's shareholders.

STEP 2

Loan agreement and collateral assignment

A loan and collateral agreement is established between the shareholder, the company and an external financial institution. Depending on the strategy chosen, the borrower is either the company holding the life insurance policy, or a shareholder. The company assigns the life insurance policy as collateral. The insurer is advised of the collateral assignment but is not party to the agreement.

STEP 3

Total cash surrender value

The company makes the maximum premium payments in the life insurance policy to increase the total cash surrender value as quickly as possible. Participating products may allow for rapid growth of the cash surrender value through quick payments or by maximizing the ADO.

STEP 4

Loan

The financial institution issues loans to the borrower, up to a predetermined percentage of premiums paid or the surrender value of the life insurance policy.

For strategies whose loans are calculated according to the surrender value, the authorized maximum is generally set at 90% of the total cash surrender value.

As for PFIs whose loans correspond to a percentage of the premium paid, the borrower should expect to assign other assets as additional collateral. The type of collateral and the value that is allocated may vary from one financial institution to another.

STEP 5

Reinvestments

The borrower invests the borrowed funds to generate income. The borrower has several options. When the shareholder is the borrower, the amounts can be reinvested as an advance to their company or invested directly in another project to earn income.

STEP 6

Interest payment

The borrower pays the accumulated interest at the end of the year. Depending on the agreement with the external financial institution, the interest payments can be refinanced by issuing a new loan to the borrower.

STEP 7

Interest deduction

The shareholder deducts the interest paid annually from their taxable income, as set out in the *Income Tax Act* (ITA).

STEP 8

Annual strategy

Steps 3 to 7 are repeated on an annual basis, according to the conditions and duration of the strategy.

The scope of the strategy can be planned according to the borrower's needs and profile. In most cases, the policyholder's maximum underwriting period spans a period of 10 to 20 years, or until the shareholder's expected age of withdrawal from the business. During this period, significant premiums are paid into the policy. This causes the collateral loan to grow rapidly to maximize the interest deduction. After this period, the policyholder and the borrower can stabilize growth of the loan by ceasing the year-end loan advances. The borrower pays the interest annually so that the loan stops growing, and the interest deduction remains stable until death.

Some people choose not to impede growth of the loan. They must ensure that they can generate enough taxable income until the end of their life for the strategy to work.

STEP 9

Death and loan repayment

When the insured shareholder dies, the company receives the death benefit tax free. The payment of the death benefit is subject to the conditions of the loan agreement. The lending institution must give the insurer its consent before it can pay the benefit.

When the company is the borrower, the loan is repaid from the death benefit. The company credits the difference between the death benefit and the adjusted cost basis to the CDA. Therefore, the CDA balance is higher than the balance of the death benefit, net of the loan. The company can eventually have the estate benefit from this unused portion of the CDA by paying a tax-free dividend. The unused value of the CDA is considered equal to the income tax that would have been payable on a corresponding taxable dividend.

When the shareholder is the borrower, the death benefit cannot be paid until their estate and the financial institution have agreed on how to repay the loan. According to the agreement entered into at that time, the loan can be repaid using other assets, or even the death benefit. If the death benefit is used, specific instructions must be given to the insurer for the benefit payment to avoid any tax consequences. It is important to make sure that there is no ambiguity about the fact that the loan is repaid by the borrower's estate and not by the company.

STEP 10

Payment of the balance of the death benefit to the estate

The death benefit, net of the loan, is paid to the insured's estate as a non-taxable capital dividend. As stated above, when the company is the borrower, the estate can also benefit from the unused portion of the CDA, if any.

Non-taxable loans and other tax provisions

The ITA and its interpretation by the tax authorities evolve and must be validated on a regular basis by the policyholder and borrower's independent advisors.

When implementing the strategy, the legal relationship between the parties must be clearly established in the loan agreement. To protect against any undesired tax consequence, the collateral loan must not constitute a policy loan, as defined in subsection 148(9) of the ITA.

According to the ITA and the current position of the Canada Revenue Agency (CRA), loans paid in accordance with a loan agreement whereby a life insurance policy is assigned as collateral are not taxable. Moreover, the collateral loan does not affect the tax characteristics of the life insurance policy, such as the ACB.

Collateral fee

There is no provision in the ITA whereby a taxable benefit is necessarily attributed to a shareholder due to the sole fact that the company assigns the life insurance policy that it holds as collateral for a loan granted to the shareholder. The CRA's current position is to the effect that a taxable benefit should be attributed to a shareholder if the shareholder was unable to obtain such loan, in the same conditions, without the company assigning the policy as collateral. If applicable, the benefit to the shareholder could be the difference between the loan rate obtained and the rate that the shareholder would have obtained without this collateral. The fiscal risk must be determined for each situation.

It is current practice to provide for the payment of a collateral fee to reduce the fiscal risk. Depending on the situation, this collateral fee corresponds to a percentage of the loans obtained by the shareholder. It is customary for the collateral fee rate to be 1% or 2% of the total amounts borrowed. This collateral fee represents taxable income for the company. In addition, this fee must be paid as long as the loan remains in effect. It is therefore important that the borrower take this fee into consideration when establishing an IFA.

Interest deduction

The interest is deductible if all conditions outlined in subsection 20(1)c) of the ITA are met. In summary, an amount paid in the year or payable in respect of the year pursuant to a legal obligation to pay interest on the amount borrowed and used for the purpose of earning income from a business or property is deductible. It is understood that the realization of a capital gain is not income according to the meaning of the ITA. Therefore, the interest deductible or payable on a borrowed amount in view of realizing a capital gain, is not deductible.

Interest deductibility case law is rich, complex, and changing. That is why we recommend to anyone who wants to establish an IFA, to consult their independent professionals to ensure that they meet the recognized eligibility criteria, such as the purpose, reasonability, and direct use.

To fully benefit from the interest deduction, the shareholder must be able to generate sufficient eligible taxable income that can be sustained over the long term.

Loan terms and conditions

Obtaining a loan from an external institution is beyond the control of iA Financial Group. The terms and conditions of the loan are set out between the borrower and the financial institution and could change over time. Certain financial institutions could require additional collateral.

The future growth of the life insurance policy's surrender value could result in the financial institution requiring additional collateral, requesting a partial repayment, or limiting the amount of loans.

If the borrower defaults, the financial institution could exercise its guarantees and require the redemption of the life insurance policy. Redeeming the life insurance policy leads to a disposition and, eventually, the realization of taxable income corresponding to the difference between the surrender value and the ACB. The insurance protection also terminates at the same time.

The cash value can be a disadvantage while the strategy is in effect

The IFA must meet the company and the borrower's needs and long-term financial capability. Terminating the strategy could lead to major tax consequences. A partial or total redemption constitutes a disposition. This disposition leads to the realization of taxable income, which corresponds to the difference between the policy's surrender value and the ACB.

Moreover, when the shareholder is the borrower, repayment of the loan must not provoke a taxable benefit. The policyholder and borrower should consult their professionals to determine the consequences.

Longevity risk (growth of the loan)

The strategy must be reviewed if the loan/insurance ratio exceeds the long-term forecasts. Several solutions can be considered:

1. Paying the interest to limit growth of the loan.
2. Assigning additional collateral.
3. Repaying a portion of the loan.
4. Making additional deposits in the life insurance policy (if possible).

Limitations

Assigning the life insurance policy as collateral limits how the company can use it without obtaining prior consent from the financial institution with which the policy is placed as collateral.

Cash surrender value of the life insurance policy

Subject to exceptions, the surrender value of the life insurance policy may not be protected from the company's creditors during the accumulation period.

Additionally, the surrender value is not considered an eligible asset for purposes of the definition of qualified small business corporation shares (SBC) of the ITA. Disposition of the SBC gives rise to a capital gains deduction, according to the conditions of the ITA.

iA LARGE CASE **SOLUTIONS**

The iA Large Case Solutions program provides a support service for high-net-worth clients who require more complex financial strategies regarding taxation matters, sales concepts and optimization of individual insurance and savings products.

Our team of experts offers personalized, simple, and performing solutions, which allow advisors to meet the specific needs of wealthy clients, professionals and business owners.

F13-1164A(22-01) ACC

INVESTED IN YOU.