London Life

Tax and planning

Life insurance

Commentary on the 2014 legislative changes to the life insurance policy exempt test

Bill C-43, containing legislation that changes the exemption test and some aspects of the taxation of disposition of life insurance policies and some non-registered payout annuities, received Royal Assent on December 16, 2014. Draft legislation was released on August 23, 2013 and since then some improvements and technical changes have been made and were included in Bill C-43.

Improvements and changes included in Bill C-43

The effective date of the legislation is now Jan. 1, 2017.

Generally, changes only apply to policies issued after 2016. They also apply to policies issued before 2017 that lose grandfathering due to certain types of policy changes made after 2016.

Conversions after 2016 will not be grandfathered and the new permanent policy will be subject to the new legislation.

Policies that are issued before Jan. 1, 2017 and are changed after 2016 will continue to be grandfathered if one or all of the following apply:

- Coverage is increased as a result of a change in dividend option.
- The insured is medically underwritten to reduce the premium or cost of insurance due to reduction in rating or a change to non-smoker status.
- The policy is reinstated.

The August 2013 draft legislation contained a specific anti-avoidance policy provision that would have only applied to life insurance policies. The rule could have been applied when certain transactions were made to increase the available funding room under the policy. This anti-avoidance policy provision has been removed from the legislation. The general anti-avoidance rule (GAAR) provisions will still apply.

Highlights of Bill C-43

Bill C-43 is very technical so we have prepared the following highlights.

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The *Income Tax Act* contains rules regarding the taxation of the income earned on the savings in a life insurance policy (a 'policy'). In the case of a policy other than an annuity contract, the tax treatment differs depending on whether or not a policy is classified as an exempt policy. A test (the exemption test) is applied each year to determine whether a policy is an exempt policy. The exemption test measures the extent to which a life insurance policy is protection-oriented (e.g., an exempt policy) or savings-oriented (e.g., a non-exempt policy). Generally, if the savings element of the policy (the greater of the cash surrender value and a reserve) is always less than or equal to the savings element of the exemption test policies associated with the actual policy, it is exempt from accrual taxation.

Income earned in a non-exempt policy is taxed at the same rates as interest income and on an accrual basis at the policyowner level. In contrast, income earned in an exempt policy is not taxed on an accrual basis at the policyowner level. Instead, it is subject to a minimum tax (the Investment Income Tax) that is paid by the insurer and the policyowner will only be taxed on the income if there is a disposition of part or all of the policy.

These income tax rules, including the exemption test, were introduced in the early 1980s. Among other things, Bill C-43 amends the following aspects of the rules relating to the tax treatment of life insurance policies.

Note

When reading the following, it is important to remember that the changes only apply to policies issued after 2016, or that lose grandfathering after 2016.

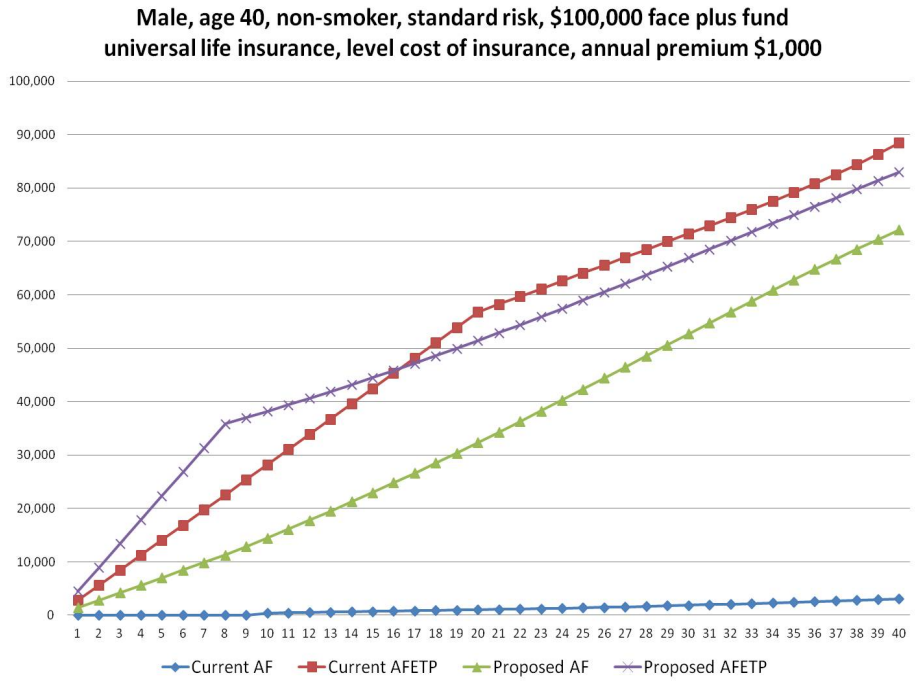
The determination of whether a policy is an exempt policy

For policies issued, or that lose grandfathering, after 2016, a single prescribed mortality and interest basis for the reserve components is to be applied to all life insurance products for the purposes of the exemption test. The same assumptions will be prescribed for both the actual policies and the benchmark exemption test policies. Net premium reserves is mandated for all insurance products and is based on the duration of the coverage as well as the pattern and duration of premiums or cost of insurance rates. Surrender charges on policies issued, or that lose grandfathering after 2016, is explicitly ignored for purposes of determining the savings element of the policy in performing the exemption test for universal life policies. The prescribed payment period for exemption test policies for such policies is shortened from 20 years to eight years and the assumed endowment age is increased from age 85 to age 90.

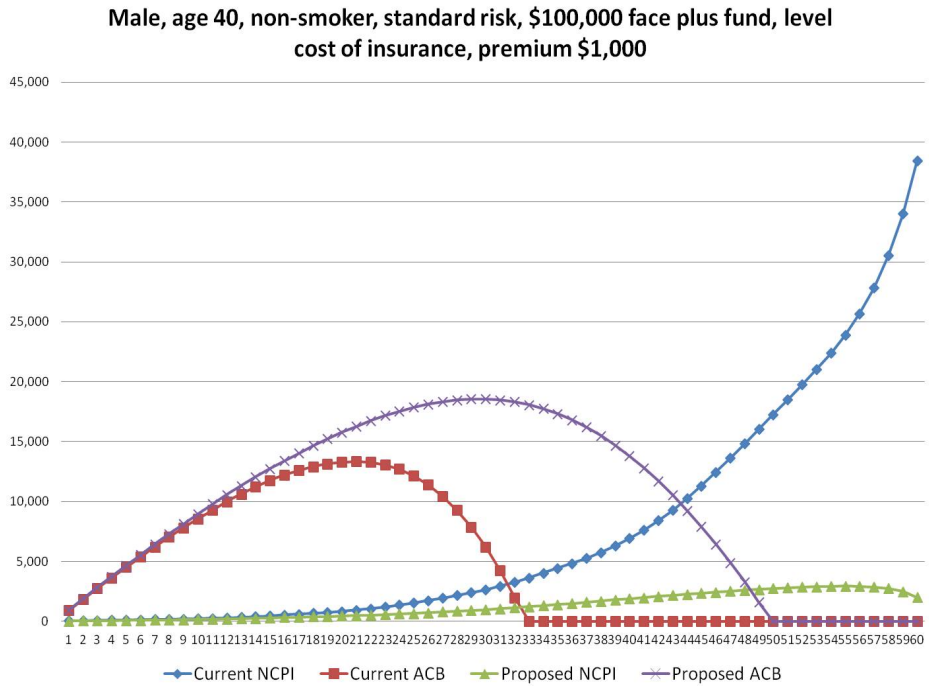
> The combined result of the changes to the savings element of a policy is that they will generally be larger than under the current law.
>
> The combined results for the changes to the savings element of the exemption test policies is that they will provide more exempt room in the early policy durations but less exempt room at later durations.
>
> The overall result is that the shortest possible premium paying periods will be longer and the maximum possible premiums will be lower than under the current rules.

The following charts illustrate the effects of the proposed changes on a $100,000 universal life insurance policy on a male, age 40, non-smoker,

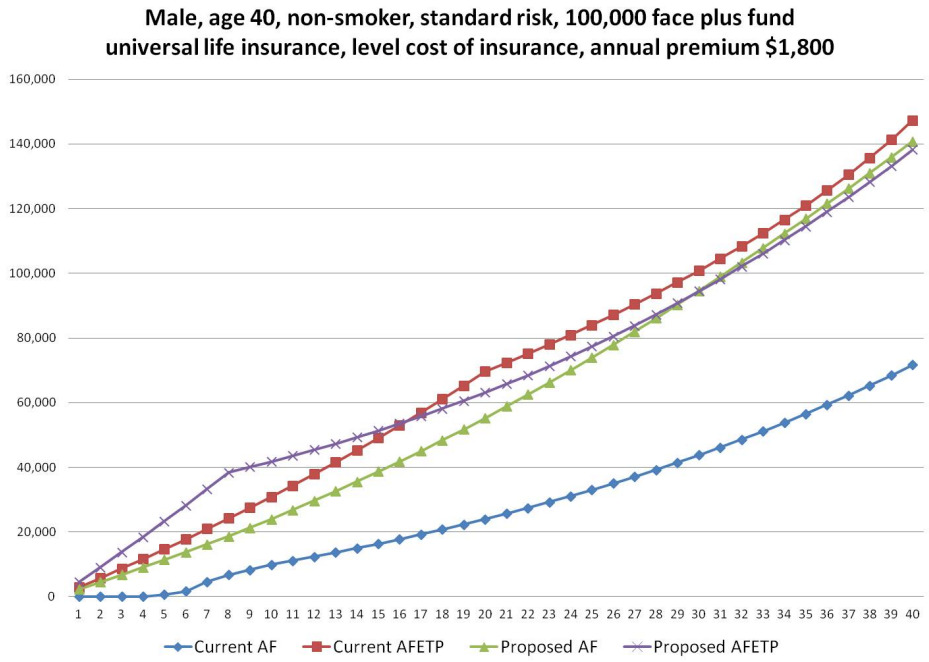
standard health risk, with level cost of insurance charges to age 100. Level premiums are assumed to be paid to age 100 and the assumed yield is 3.5 per cent without bonus. For a minimum funded and a moderately funded policy, charts one and three compare the current versus proposed accumulating fund, and accumulating fund exempt test policy. Also, for the minimum funded and moderately funded universal life insurance policy examples, charts two and four compare the current and proposed net cost of pure insurance (NCPI) and adjusted cost basis (ACB).



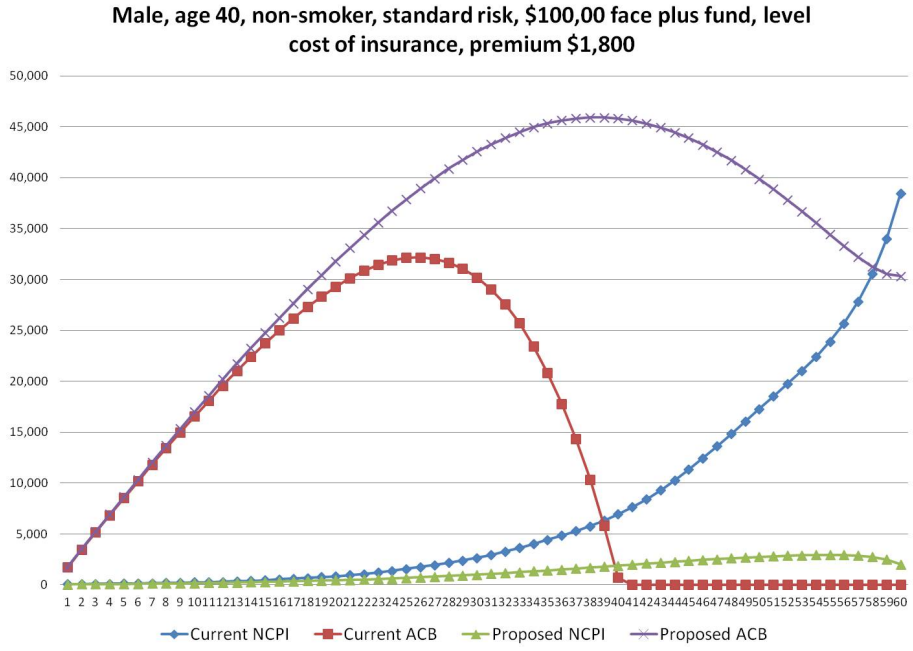
In chart one, for a minimum funded universal life insurance policy, the current rules produce an accumulating fund of the policy that will be minimal over time; however, under the proposed rules, the accumulating fund will grow dramatically over time. The policy would be exempt under both the current and proposed rules. The proposed rules for the accumulating fund exempt test policy will allow more exempt room in the early policy durations but less exempt room at later durations.



In chart two, the proposed NCPI will be significantly less than under the current rules over time, which will cause the ACB to be larger. For accessing cash value of the policy through policy loans or partial withdrawals, less of the amount will be taxable. For corporately owned policies, the larger ACB will mean a smaller credit to the corporation's capital dividend account on receipt of a death benefit as the credit is the death benefit less the ACB.



In chart three, for a moderately funded universal life insurance policy, the proposed accumulating fund will be much larger than under the current rules and the accumulating fund of the exemption test policy will be lower in later years. The result would be that in order to keep the policy exempt in later years, the premium amount permitted would have to be limited.



In chart four, the proposed NCPI will be significantly less than under the current rules. This will cause the ACB to be much larger than under the current rules.

Taxable income on disposition of an interest in a policy

For policies issued after 2016 or policies that lose grandfathering after 2016, changes apply to the calculation of a policy's ACB.

ACB is used to calculate a policyowner's gain on policy dispositions such as, partial or full surrenders, policy dividends, transfers' of ownership, and policy loans. These changes include a smaller decrease to the ACB for the NCPI and new ACB decreases for the payment of certain benefits (e.g., part or all of the cash value on first death of a joint last to die policy or on a disability of a life insured). Generally, the result of a smaller decrease to ACB from a lower NCPI reduction (a higher ACB) will be a lower taxable income on dispositions. The result of the new ACB reductions (a lower ACB) will be larger taxable income for policyowners on subsequent dispositions.

For most policies, the ACB will be higher than it is today, so the taxable income on dispositions will be lower. However a higher ACB negatively affects the amount that can be credited to the capital dividend account of private corporations on payment of the life insurance proceeds on death. The lower NCPI will also reduce the amount that could be deducted by policyowners if the policy has been assigned as collateral for a loan on which the interest paid is deductible.

Comments above regarding NCPI and ACB are for lives insured who are considered standard risks. As a result of Bill C-43, the inclusion of substandard premiums will increase the ACB and reflecting the substandard rating in the NCPI which will decrease the ACB compared to a standard risk. Compared to the current rules, one action will increase the ACB and the other will reduce it. Current rules exclude substandard premiums and ignore ratings in the calculation of the NCPI. Bill C-43's overall impact on the ACB for policies that insure substandard lives will vary from policy to policy.

Policies with multiple lives insured

The changes mentioned in the article also apply to policies with multiple lives insured. These policies are impacted by the following:

> If the claim paid on the death of one of the lives insured includes payment of some or all of the fund value and that amount exceeds the maximum amount that could have been paid on an exempt policy where the deceased was the only life insured, then the amount of the excess will be proceeds of disposition for a partial surrender of the policy—some of the death benefit may be taxable. When a death benefit is paid on a policy with multiple lives insured, the ACB of the policy will be reduced by an approximation to the portion of the ACB that relates to the terminated coverage. The result will be a lower ACB that would produce higher taxable income on subsequent dispositions and increase the amount that can be credited to the capital dividend account of private corporations on subsequent payments of the life insurance proceeds on death

Amendment to investment income tax

Bill C-43 ensures investment income tax applies equitably to universal life insurance policies (and other policies that do not have specified premiums). The Department of Finance is introducing this change to address the concern that the current investment income tax rules do not work appropriately for universal life insurance policies. Investment income tax is a tax imposed on the insurer on the theoretical annual increase in the savings element of policies.

The policyowner does not directly pay the tax. However investment income tax is an expense that is reflected in the cost of insurance charges.

Amendment to the rules that determine the capital element of annuity payments for certain annuity contracts

Generally, the taxable portion of annuity payments from prescribed annuity contracts issued after 2016 will be larger than they would be under the current rules. Bill C-43 requires the use of a more recent mortality table to calculate the taxable portions. Since the more recent mortality table expects people to live longer, a smaller portion of the payments will be considered a return of capital.

However, there is a welcome change if the measuring life is substandard and the life insurance company reflects that fact in determining the amount of the annuity payment by using an older age (age rating) to determine the amount of the annuity payments. For prescribed annuity contracts issued after 2016 that are in that situation, the rated age of the measuring life will be used together with the more modern mortality table to determine the taxable portion of the annuity payments. The use of the rated age will reduce the taxable portion from what would be produced using the actual age. The current rules require the use of the actual age in for age rated annuities. The combination of the new table and use of rated age could result in a smaller capital portion of the annuity payments.

Grandfathering

The adjusted cost basis and exemption test rules that currently apply to policies issued before 2017 will continue to apply after 2016 unless certain changes are made. Bill C-43 makes it clear that the conversion after 2016 of a term policy issued before 2017 will result in the new exempt test rules for policies applying to the converted policy. Also, any addition of coverage with medical underwriting after 2016 to a policy issued before 2017 will result in the new rules for exempt testing and ACB adjustments applying to the entire policy (not just the added coverage). The exceptions are that if the underwriting was done to obtain a reduction in premiums or cost of insurance charges (e.g. to reduce a rating or change to non-smoker) or to reinstate a policy that had lapsed then the rules that applied to the policy before the underwriting will continue to apply (i.e., the policy retains its grandfathered status).