2017 tax changes for life insurance

SIMPLY PUT

The current tax exempt rules for life insurance policies have been in effect since 1982. While only a few changes have been made to the rules over the past few decades, the products they apply to have evolved greatly. This has resulted in inconsistent tax treatment of life insurance products. To help modernize the legislation, the federal Department of Finance has revised the life insurance exempt test and some of the related rules.

These changes will come into effect January 1, 2017. Grandfathering rules will be in place for policies issued prior to that date.

WHAT MAKES A POLICY TAX EXEMPT?

Simply put, the exempt test distinguishes between a life insurance policy that's primarily:

- focused on protection (an exempt policy, which receives tax-preferred treatment), or
- an investment accumulation vehicle (a non-exempt policy, with investment growth taxed annually).

Policies are reviewed on their anniversary date to determine if their projected values still comply with the limits.

WHAT ARE THE KEY CHANGES?

The assumptions used to determine if a policy is tax exempt have been updated or are now prescribed in the Income Tax Act and Regulations. Some of the key changes include:

- The revised benchmark policy (also known as the exempt test policy or ETP) used to determine if a policy is tax exempt, limits the cash value a policy can accumulate. The updated ETP typically results in more savings room in a policy in the early years, with a reduction in the later years.
- Changes to the 250% test, which is intended to prevent the build-up of unused exempt room in early years that could be used at a later point in time, should result in fewer 250% test failures.
- The 8% rule, which creates a new ETP when death benefit coverage increases by more than 8% annually, is being revised. The rule is applied at a policy level today, but will be done at a coverage basis under the new rules. This could result in less funding room for some product types.
- Changes to the calculation of the Net Cost of Pure Insurance (NCPI) include updated mortality tables, and a new calculation for determining the net amount at risk. This will generally result in a lower NCPI and potentially lower tax deductions.
- Updated calculations for determining the Adjusted Cost Basis (ACB) of a life insurance policy. Substandard premiums will now be included in the calculations, and in most cases, the ACB will be impacted by the lower NCPI. This will result in a higher ACB for some product types, and an extended period before the ACB reaches zero.

Term policies will be the least impacted, with a relatively minor impact to the ACB. Universal life policies will see the most change to exempt room, NCPI and ACB, bringing them more in line with traditional product types like participating insurance.

GRANDFATHERING

Grandfathering will be available for policies already in force. A policy will lose its grandfathered status and be subject to the new rules if:

- a policy is converted from one type of life insurance to another. A term policy that's converted to a permanent policy after December 31, 2016 will lose grandfathering.

- coverage requiring medical underwriting is added to the policy. This includes things like increasing the coverage amount, adding a term life insurance benefit to a policy, or substituting a life insured under a policy.

There are certain events that won't cause loss of grandfathering, even if they involve medical underwriting. A few examples include:

- Changing from smoker to non-smoker status.
- Reducing a rating.
- Transfers of ownership.

Maintaining grandfathering will be very important for policies issued prior to January 1, 2017. Policy owners who need to make changes to their policy that could cause loss of grandfathering should do so before the new rules take effect.

THE BOTTOM LINE

Regardless of the changes to the exempt test, the need for life insurance protection remains the key driver for any life insurance policy. The new rules will provide new opportunities, and existing policies already in place will be protected from losing their status so long as certain changes are avoided. Conduct a thorough review of clients' needs to determine if it's in their best interest to make any of these changes before 2017. For more information, contact your Sun Life Financial Sales Director.

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