

# Impact of 2017 tax changes on life insurance

## THE DETAILS

Life insurance provides protection, but some policies also allow clients to accumulate savings on a tax-preferred basis. The Income Tax Act governs how much growth can accumulate within a life insurance policy, contains rules on how those savings are valued, and the tax implications associated with accessing them. The exempt test is used to distinguish 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.

The exempt test compares the savings component of the actual life insurance policy to the savings component of a theoretical benchmark policy (the exempt test policy – or ETP). This article takes a closer look at how tax changes will affect life insurance policies issued as of January 1, 2017.

There haven't been many changes since the current Income Tax Act provisions related to life insurance were put in place in 1982. But since then, product development and innovation has led to the potential for inconsistent

treatment of different product types. In particular, Universal Life (UL) insurance wasn't fully considered when the existing rules were written. The new rules take the unique attributes of UL into account.

In the 2012 federal budget, the Department of Finance indicated it would introduce legislation to modernize the life insurance exempt test and related rules. After consultation with the industry and interested players, Bill C-43 received Royal Assent on December 16, 2014. An implementation period was provided, with the rules going into effect January 1, 2017. Grandfathering rules will be in place for policies issued prior to that date.

### THE KEY CHANGES INCLUDE:<sup>1</sup>

- a revised definition of the benchmark policy,
- prescribed assumptions when calculating the savings element, known as the Accumulating Fund (AF) of the exempt test policy,
- prescribed assumptions and changes to the reserve method when calculating the AF of the actual policy,
- revisions to the 8% rule and the 250% test,

- updated mortality tables for calculating the Net Cost of Pure Insurance (NCPI), and
- changes to the formula for the Adjusted Cost Basis (ACB) of a life insurance policy.

While changes are needed to accommodate these new rules, all product types, including UL, will continue to provide clients with tax-preferred protection and savings solutions. The following provides a review of the changes.

| Acronyms |                                 |
|----------|---------------------------------|
| ACB      | Adjusted Cost Basis             |
| AF       | Accumulating Fund               |
| CDA      | Capital Dividend Account        |
| CIA      | Canadian Institute of Actuaries |
| COI      | Cost of Insurance               |
| GIO      | Guaranteed Insurability Option  |
| ETP      | Exempt Test Policy              |
| LCOI     | Level Cost of Insurance         |
| NCPI     | Net Cost of Pure Insurance      |
| NPR      | Net Premium Reserve             |

<sup>1</sup>Bill C-43 also included changes that impact the taxation of prescribed annuity contracts. This article is limited to changes specific to life insurance policies.

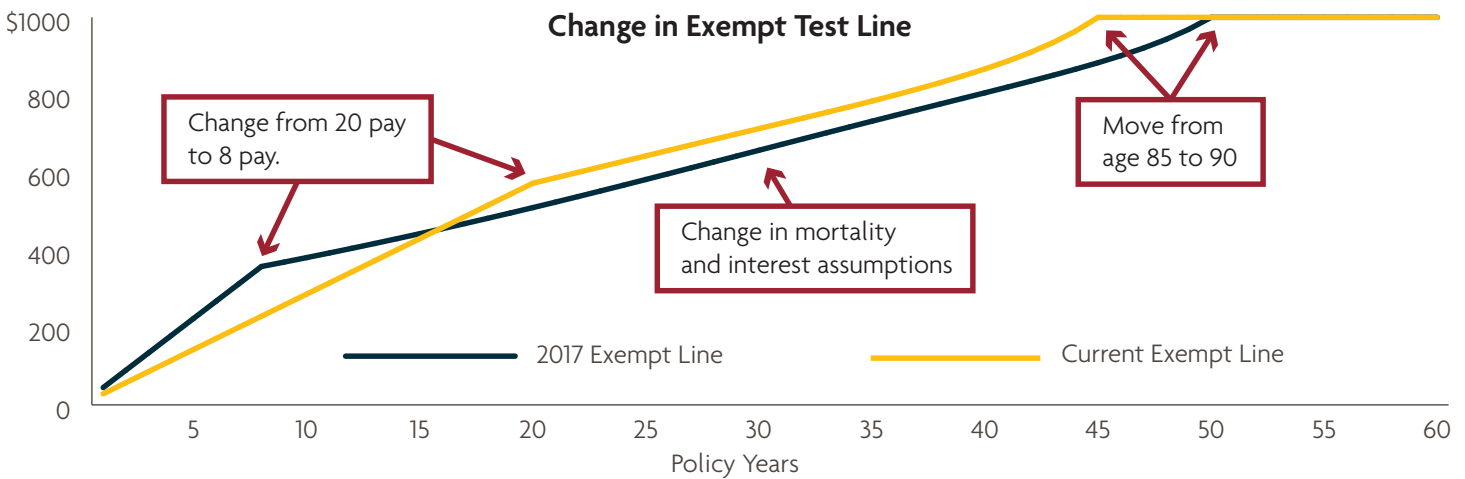
## THE EXEMPT TEST POLICY

Every life insurance policy is compared to a hypothetical, benchmark policy called the exempt test policy (ETP), with the comparison against the actual policy occurring at each policy anniversary. As long as the savings component of the actual

policy stays within the savings element of the ETP, it will remain exempt. The ETP is currently based on a 20-pay endowment policy at age 85. This means that a policy that would pay a lump sum at age 85 if the insured was still living, based on 20 premium

payments. With the new legislation, the ETP will be based on an 8-pay endowment policy at age 90. This change may provide additional funding room in a policy's early years, and a reduction in the later years.

## THE FOLLOWING GRAPH DEMONSTRATES THE CHANGES.



## THE ACCUMULATING FUND

The savings element of the ETP and the actual policy is measured by the Accumulating Fund (AF) in each policy. Historically, insurers used their own pricing or cash value assumptions in order to measure the AF of the ETP. The new legislation defines the assumptions used to calculate the AF for the ETP as follows:

- Interest rates will use a fixed assumption of 3.5%.
- Mortality will be based on the Canadian Institute of Actuaries (CIA) 1986-1992 table.

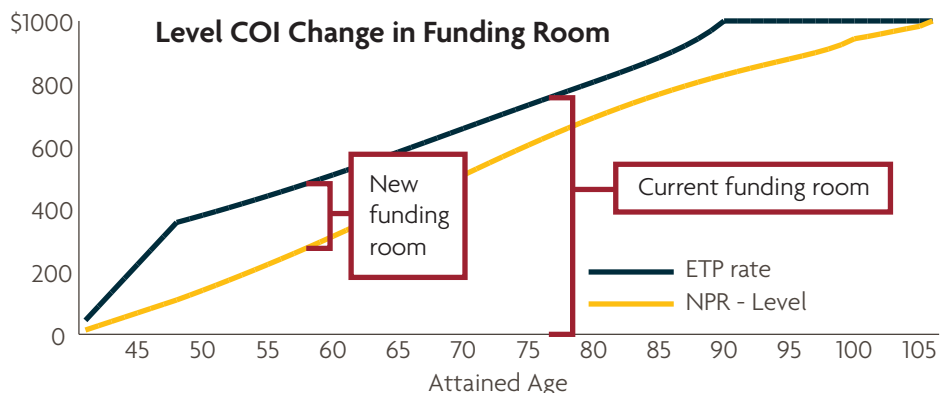
Currently, the AF of the actual policy is equal to the higher of the cash value of the policy, or an actuarially calculated reserve known as the 1.5 preliminary term reserve. For UL policies with variable premiums, the reserve component was not able to be determined, so insurers looked to the cash value of the policy to determine the AF instead. Surrender charges reduced the cash value allowing for

a lower AF, and more deposit room available in the policy in the early years.

The new rules continue to have the AF of the actual policy as the higher of the cash value of the policy, or an actuarially calculated reserve. The new reserve method is called the Net Premium Reserve (NPR) and is based on the premium or cost of insurance pattern. The assumptions used to calculate the NPR for the AF for the actual policy are prescribed in the new rules. Instead of using pricing or cash value assumptions, the interest and mortality assumptions will be the same as those used to value the AF of the ETP.

Surrender charges will no longer be taken into account when comparing against the cash value. This significantly impacts the AF of UL policies, particularly so for Level Cost of Insurance (LCOI) UL policies.

The changes to the AF of the actual policy when compared to the ETP change the pattern of the funding room, with the potential for a reduction over the lifetime of the policy. This will be particularly significant with LCOI UL, due to the change in the reserve calculations. The impact to traditional types of insurance, such as participating insurance, will be much less severe.



## THE 8% RULE

To help ensure the policy remains exempt, the death benefit can be increased by up to 8% annually. Sometimes, a policy election can be made for this to happen automatically if it's in the policy owner's best interest to do so. When the death benefit of a policy increases by more than this amount, a new ETP is established. This new ETP for the additional insurance amount is issued at the current date. This limits the amount of exempt room when compared against increasing the original ETP for the entire amount.

The 8% rule is currently applied at a policy level – looking at the entire death benefit amount under a particular policy. If any of the following apply, the 8% increase can be allocated to whichever coverage is necessary in order to maintain exempt status and avoid issuing a new ETP.

- Multiple lives are insured under the policy
- There's a term rider
- A UL policy is designed to pay the face value plus a fund value

The rule will remain in 2017, but instead of using 8% of the full death benefit, it will apply at a life coverage level. If there are multiple lives under 1 policy, the 8% increase can only be applied in respect to each particular life.

If a policy pays the face plus the fund value at death, the fund value will be treated separately from the face value for the purposes of the 8% test.

It's expected that this change will reduce the amount of exempt room available within certain policies.

## THE 250% TEST

The 250% test (also known as the anti-dump-in rule) was established to prevent policy owners from underfunding a policy in the early years to accumulate additional deposit room that could be used in the future.

The 250% test prevents large, future deposits into the policy. Starting in the 10th policy year, the growth of the AF is limited over any 3-year period. It compares the AF of the policy to that on its anniversary date 3 years prior. If this exceeds 250%, it results in a failure.

When this occurs, there are typically 2 courses of action taken by the insurer to make sure the policy remains exempt. Funds can be withdrawn from the policy, or the ETP can be re-dated. If the ETP is re-dated, funding room may be significantly reduced. In practice, most insurers correct 250% test failures on significantly funded policies by withdrawing funds from the policy to ensure it remains within the limit. For policies that have been minimally funded, the insurer may simply re-date the ETP rather than requiring small amounts to be withdrawn.

The updated legislation adds an additional component to the 250% test. This change will be beneficial to some policy owners, and is the only change that will apply to both in-force and new policies when the new rules take effect. In addition to the policy's AF exceeding 250% on its anniversary date 3 years prior, the policy must also have a material level of funding in order to fail the new test. The new, additional component of the test is as follows:

- For policies issued prior to 2017, the AF of the actual policy must be more than  $\frac{3}{20}$  of the AF of the ETPs associated with that policy.
- For policies issued on or after January 1, 2017, the AF of the actual policy must be more than  $\frac{3}{8}$  of the AF of the ETPs associated with that policy.

It's anticipated that the additional step will result in fewer 250% test failures for policy owners who aren't maximizing funding. Minimal funding can sometimes result in failures based on the current rules.

## CALCULATING THE NET COST OF PURE INSURANCE

The Net Cost of Pure Insurance (NCPI) provides a measure of the annual cost associated with the mortality risk for a life insured in a particular year for tax purposes. It generally increases each year in conjunction with the mortality factors and is calculated by multiplying a mortality factor by the net amount at risk under the coverage. A number of factors used in this calculation will be changing.

- Mortality tables - On January 1, 2017, the mortality tables used will be updated to the Canadian Institute of Actuaries (CIA) 1986-1992 from the CIA 1969-1975 mortality tables. The new table reflects the improvement of Canadians' longevity. It also has been extended, providing factors until age 90. The legislation provides a prescribed method of extrapolating beyond this point. The previous tables only went to age 70, leaving insurers to determine their own method of extending the factors.
- Calculating risk - The legislation also introduced a new method of calculating the net amount at risk for the purposes of calculating the NCPI. Currently, insurers look at the death benefit, minus the AF or the cash surrender value of the policy (depending on the method previously used by the insurance company). It will now be determined as the difference between the death benefit and an actuarial calculation referred to as the Net Premium Reserve (NPR). This change results in a lower net amount of risk for NCPI than before.
- Substandard ratings - After the changes take effect, the mortality factors used will also consider substandard ratings when calculating the NCPI.

Combined, the revised calculations will generally result in a lower NCPI

amount than under the current rules. The NCPI of a life insurance policy is an important factor in determining the deductibility of life insurance premiums for tax purposes in certain situations. Section 20(1)(e.2) of the Income Tax Act allows for the lesser of: the premium; or the NCPI amount for the year to be deducted when the life insurance policy has been collaterally assigned as security for a loan, provided certain conditions are met. Life insurance strategies involving leveraging may experience a decrease in the deductible amount available to the client for income tax purposes.

### THE ADJUSTED COST BASIS OF A LIFE INSURANCE POLICY

The Adjusted Cost Basis (ACB) of a policy is a critical component in calculating the taxable policy gain that arises from certain transactions. For example, policy owners are able to access policy loans up to the ACB of the policy on a tax-free basis. Surrenders of life insurance policies trigger taxable gains by the amount of which the cash surrender value exceeds the ACB. Corporate beneficiaries of life insurance policies may be able to credit an amount equal to the death benefit of the policy, less the ACB, to their notional Capital Dividend Account (CDA), which allows tax-free capital dividends to be paid to shareholders.

The formula for calculating the ACB of a life insurance policy is complex, but can be generalized by referring to the sum of the premiums paid less the NCPI. The formula also contains several other variables that are being revised in a number of ways. For example, the current formula only includes the standard premium, excluding additional amounts paid for substandard ratings. The updated formula will alter this, with the additional premium amount being included in the calculations.

The changes to the NCPI factors as described above will also have a significant impact on the ACB. A lower NCPI results in a higher ACB for a longer period time.

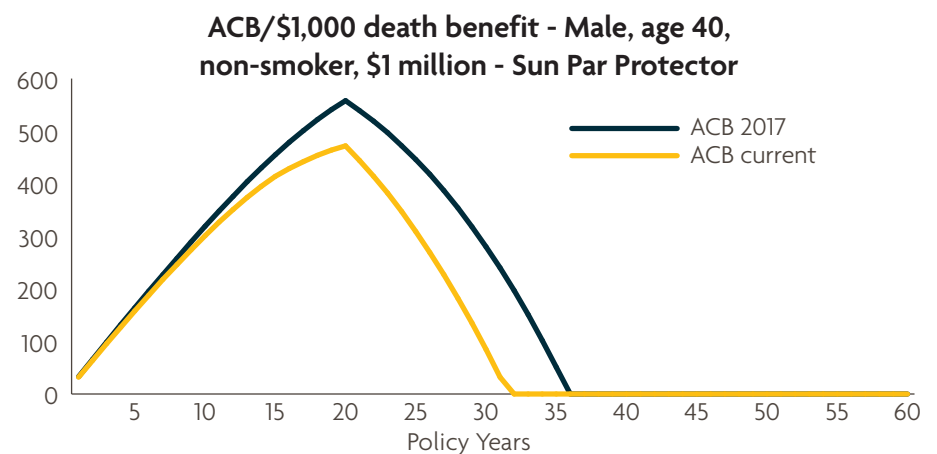
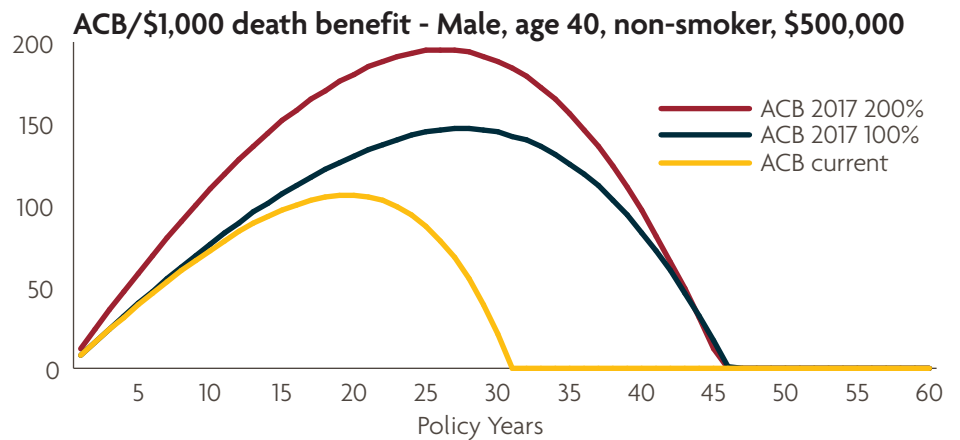
It's expected that the ACB of LCOI UL policies will see the most significant impact due to these changes. Based on very limited testing, it's reasonable to expect the ACB of an LCOI UL policy to extend out – that is, not grind down to zero – for an additional 7 to 17 years, and reaching a taxable policy gain position 4 to 13 years later. More traditional life insurance products will see less of an impact. Participating policies can expect to see the ACB extend out by another 2 to 3 years, with the policy reaching a taxable policy gain position 1 to 3 years later.

The ACB formula is also being revised to address multi-life policies. Currently, there's no adjustment to the ACB when a life insurance policy pays out the fund value at the first

death on a policy insuring more than 1 life. Under the new rules, the ACB will be reduced. When an insured life dies, only the fund value that would have been paid out tax-free had the policy been a single life policy will be received on a tax-free basis. Excess amounts will be treated as a partial withdrawal, with a taxable gain being calculated accordingly.

For personally owned policies, the higher ACB may lessen the taxable gain associated with certain transactions as described above. For corporately owned policies, who are also the beneficiary of the death benefit, the changes to the ACB may impact the amount of CDA credits available.

While the majority of the other tax changes described above will only impact permanent life insurance policies, the revisions to NCPI and ACB rules will also affect term policies. This would generally only affect corporately-owned policies, as it could have a minor impact on the amount



of a death benefit creating a credit to the CDA.

Substandard ratings will result in a higher NCPI factor, but this will typically be more than offset for ACB purposes by the inclusion of substandard premiums in the revised formula. While achieving a higher NCPI for collateral loan deduction purposes, clients with substandard ratings shouldn't expect to see a lower ACB.

### **GRANDFATHERING OF LIFE INSURANCE POLICIES ISSUED PRIOR TO JANUARY 1, 2017**

Given the long-term planning that life insurance addresses, grandfathering is a critical aspect when changes are made. The new rules will offer grandfathering protection to policies issued before January 1, 2017. Loss of grandfathering occurs when:

- A policy issued prior to January 1, 2017 is converted to another type of policy on or after this date, or
- Coverage that requires medical underwriting is added to the policy on after January 1, 2017.

Therefore, term policies issued prior to 2017 will be subject to the new rules if converted to a permanent policy on or after January 1, 2017. Any medically underwritten event that increases the insurance amount or the net amount at risk under the policy will cause the loss of grandfathering.

The following are a few examples:

- An increase or additional life insurance coverage on or after January 1, 2017.
- Addition of a term insurance benefit to a policy.
- Substitution of a life insured under a policy.

Certain exceptions have also been included in the legislation. The following are examples of events that aren't expected to cause a policy to lose grandfathering after 2017:

- Changing from smoker to non-smoker status
- Medical underwriting to reduce a rating
- Reinstatements of a policy
- Addition of a non-life insurance rider to a policy, like a disability waiver
- Switching dividend options
- Transfers of ownership

The triggers deeming a policy to be issued after 2016 and subject to the new rules differ from the grandfathering triggers for policies issued prior to December 2, 1982. It's important to keep these distinctions in mind when dealing with long-standing policies issued prior to that date.

### **THE BOTTOM LINE**

The new rules in 2017 will impact the amount of money that can accumulate within an exempt life insurance policy on a tax-preferred basis. The most significant impact will be to LCOI UL, bringing UL more in line with other product types.

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, if certain changes are avoided. Conduct a thorough review of clients' needs to determine if it's in their best interest to make any changes before 2017. It's important to recognize that all types of permanent life insurance, including UL, will continue to offer clients significant advantages over alternative, taxable investments, even with the changes taking place in 2017.

Life's brighter under the sun

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