2013 federal budget overview

The 2013 federal budget contains several proposals that affect the life insurance industry but it’s mostly about:

• providing help for Canada’s economy,
• closing tax loopholes, and
• eliminating the deficit by 2015-2016.

Here are some highlights.

Changes for leveraged insured annuities (LIAs) and 10/8 arrangements

For several years, the Canada Revenue Agency (CRA) has questioned the tax benefits from LIAs and 10/8 arrangements. Now the Department of Finance has offered to help. The budget proposes some important changes to the tax treatment for these arrangements.

LIAs

An LIA results from a policyholder borrowing money to buy an immediate annuity and using the annuity income to pay life insurance premiums. The objective is to convert what would otherwise be a taxable investment into a tax-free investment with tax deductible borrowing and premiums and a tax-free death benefit. These arrangements are also known as “triple back-to-backs”.

Under proposed changes, an insurance policy will be an LIA policy if:

• a person becomes obligated after March 21, 2013, to repay an amount to another person at death; and
• a life annuity contract and the policy are assigned to the lender.

Each element of the LIA arrangement is treated separately for tax purposes. Current arrangements typically allow for deductions for interest under paragraph 20(1)(c) of the Income Tax Act (Canada) (the “Act”) and the lesser of premium or net cost of pure insurance (NCPI) under paragraph 20(1)(e.2) of the Act. Additionally, at the insured’s death, a Canadian controlled private corporation (CCPC) gets a capital dividend account credit equal to the life insurance proceeds less the policy adjusted cost basis (ACB).

The budget proposes to treat the insurance policies used in these arrangements as non-exempt policies subject to accrual taxation under section 12.2. In addition, the proposal eliminates the deduction for the lesser of premium or NCPI under paragraph 20(1)(e.2) of the Act and the capital dividend account (CDA) credit at death.

For the purposes of the deemed disposition rules under subsection 70(5) of the Act, as well as the deemed disposition on death for spousal/alter ego and joint partner trusts under subsection 104(4) of the Act, the fair market value of the annuity assigned to the lender in connection with an LIA policy will be deemed to be equal to the total premiums paid where the deceased is the annuitant.

Arrangements where the borrowing was completed prior to budget day (March 21, 2013) will not be affected by these changes. It’s also important to note that these changes are not intended to have any impact on insured annuities that don’t have a borrowing arrangement.

Clients contemplating an LIA will find that the tax advantages they thought they would get with these arrangements no longer exist. Existing arrangements, however, are grandfathered.
10/8 policies

A 10/8 arrangement results from the policyholder funding a life insurance policy, then borrowing from that policy. The part of the policy cash value supporting the loan is typically credited at eight per cent, while the loan from or against the policy’s cash value is usually charged 10 per cent interest. Under this type of policy, the amount borrowed is typically used for income producing purposes, such as investing the funds back into the policyholder’s business allowing for an annual interest expense deduction.

Under proposed changes, a 10/8 policy will be defined as a life insurance policy where an amount is or may become:

- payable, under the terms of a borrowing agreement, to a person that has been assigned an interest in the policy or in an investment account in respect of the policy, or
- payable under a policy loan made in accordance with the terms and conditions of the policy,

and either:

- the rate of interest payable on an obligation held in an investment account in respect of the policy is determined by reference to the rate of interest payable on the borrowing or policy loan, or,
- the maximum amount of an investment account in respect of the policy is determined by reference to the amount of the borrowing or policy loan.

For the purposes of the paragraph 20(1)(e.2) deduction, the NCPI will be reduced to zero for a 10/8 policy. This will eliminate the paragraph 20(1)(e.2) deduction for these policies. New subsection 20(2.01) of the Act will exclude as interest for the purposes of the paragraph 20(1)(c) deduction, an amount that is paid or payable as described in the definition of a 10/8 policy. In addition, the credit to the CDA in subsection 89(1) of the Act for CCPCs will be amended to exclude the amount of the borrowing or policy loan outstanding at the time of death. These measures apply after 2013 to all 10/8 policies.

The government is offering some relief for those who may want to get out of a 10/8 arrangement in anticipation of the new rules. If a policyholder disposes of any interest in a 10/8 policy prior to January 1, 2014, they will be permitted a deduction from income equal to the least of the:

- taxable gain as a result of the partial or complete surrender,
- repayment of a borrowing or policy loan on a 10/8 policy, and
- amount a policyholder is entitled to receive out of an investment account.

There was nothing in the budget about the CRA’s continuing efforts to audit taxpayers who have created 10/8 arrangements. At this point, it’s not certain whether the CRA will drop or continue its auditing efforts.
Previously announced exempt test proposals

The government reconfirmed its intention to proceed with legislative proposals to change the life insurance policyholder exempt test as announced in the 2012 budget. We are expecting draft regulations describing those rules before the end of June 2013.

Changes for investors and small businesses

The budget proposes many changes for individuals and businesses. Some changes that may interest clients include the following.

Lifetime capital gains exemption increased

The lifetime capital gains exemption is being increased from $750,000 to $800,000 effective January 1, 2014, and will be indexed to inflation for tax years after 2014. This is good news for clients who own qualified small business corporations or shares in qualified farming and fishing properties.

Dividend tax credit for non-eligible dividends reduced

The dividend tax credit for non-eligible dividends is being reduced. Non-eligible dividends are those paid from corporate income taxed at a preferential rate like the small business tax rate that currently applies on up to $400,000 of a small business’ active business income. Currently, non-eligible dividends are grossed up by 25 per cent and a dividend tax credit of 13.33 per cent applies to the grossed up dividend. After 2013, non-eligible dividends will be grossed up by only 18 per cent and the dividend tax credit will be reduced to 11 per cent. The net effect will be to increase the top federal marginal tax rate on non-eligible dividends from 19.58 per cent to 21.22 per cent. The client’s ultimate tax liability will depend on provincial tax rates.

Tax incentives for first time charitable donors

The government is introducing a temporary measure to encourage people to donate to charitable organizations. At present, the first $200 donated to charity earns a 15 per cent federal tax credit. After that, the credit is 29 per cent, effectively turning the credit into a deduction.

Under the First Time Donor’s Super Credit, a first time donor will get an additional 25 per cent tax credit on donations up to $1,000. That’s 40 per cent on donations up to $200 and 54 per cent on the rest up to $1,000. Provinces also allow charitable donation tax credits.

A taxpayer doesn’t even have to be a first time donor. If they or their spouse haven’t claimed a charitable donation tax credit since the 2007 tax year, they’re treated as a first time donor. The super credit will be available for one-time use only until the 2018 tax year.

Changes to mutual fund taxation

Among other tax-related measures, the government is proposing changes that may have an impact on investors in mutual funds with certain tax-advantaged structures. The budget refers to “character conversion transactions” where forward sale agreements are used to convert investment returns that would normally be characterized as income, to capital gains. A host of variables and conditions make the impact of the proposal uncertain at this early stage.
Addressing Canada’s skilled labour shortage

Canada spends a lot of money educating and training people for work but many Canadians remain unemployed and underemployed. Meanwhile, businesses say that they can’t find enough skilled workers and have to hire foreign workers. The problem has worsened since 2009 and may be impeding Canada’s economic growth. The government is proposing a number of initiatives to address this problem.

The Canada Jobs Grant

A business with a plan to train someone for an existing or better job will be able to apply for up to $5,000 in federal funding as long as the business puts up $5,000. Including provincial and territorial matching funds (still to be negotiated) up to $15,000 in total could be available to pay for short duration education and training programs. If employers can’t find skilled workers, they can now hire people and receive some money to help their new hires receive training needed for the job.

Help for apprentices

The federal government also wants to work with the provinces and territories to smooth the path from apprentice to journeyperson status and eliminate barriers that skilled tradespeople face when trying to work in different provinces. The federal government also intends to change its procurement policies to encourage the hiring of apprentices in projects that receive federal funding.

Easing access to employment for people with disabilities

The federal government wants to work more closely with Canadian businesses and provide more money to help employers accommodate people with disabilities at their workplaces.

Helping youth and aboriginal peoples enter the job market

The budget introduces a host of initiatives aimed at helping people in these groups get the education and training needed to get good paying jobs.

For more information

For more information on the 2013 budget, please visit http://www.budget.gc.ca/

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