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Life Insurance Changes

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Changes are soon coming to the tax treatment of life insurance policies at the end of 2016. If you are considering purchasing permanent life insurance, depending on your personal circumstances it may be beneficial to do so before January 1, 2017, so that the policy is "grandfathered" and the current, generally more favourable tax rules continue to apply. In some cases, however, it may be better to defer the purchase of the policy until 2017. We will discuss the changes and suggested recommendations below.

Why purchase life insurance?

Why do individuals purchase life insurance? There are a number of common reasons but protecting your dependents is often high on the list. For example, you may want to make sure that your current income can be replaced and possibly pay off your mortgage and other debts should you pass away. Similarly, you may wish to have life insurance pay off any taxes that are owing on your death so your beneficiaries get use of the entire value of the rest of your estate without selling any property to cover taxes. Another use of insurance could be in a case where you have a number of beneficiaries and you want to pass some of the property to particular beneficiaries. In this case, you could use life insurance to make similar gifts to the other beneficiaries.

If a business is involved, life insurance may be purchased on the life of a key employee or shareholder so that the insurance proceeds provide liquidity to assist the business in continuing should this person pass away. If there is more than one shareholder, life insurance proceeds could be used to fund the purchase or redemption of the shares of a shareholder who dies.

Once you have passed the threshold of deciding that life insurance should be purchased, you should then look to the changes on the horizon and figure out whether the purchase should be made now, or after the end of the year.

Exempt life insurance

A life insurance policy can either be a "term" policy, where the policy is temporary and only provides insurance during its term, or a "permanent" policy which provides insurance coverage until the death of the insured. Permanent insurance policies typically provide not only insurance protection, but also an investment component which can grow over time. An exempt life insurance policy is a permanent insurance policy where the policyholder is not required under the tax rules to include an amount in income annually. These policies must satisfy tests in the Income Tax Act so that only policies with insurance protection as their primary purpose, as opposed to a policy with a primary purpose of generating investment income, are excluded from annual taxation. What is commonly called the "exempt test" determines the amount that can be accumulated within the policy and not be subject to tax on an annual basis. Most insurance policies issued in Canada satisfy the exempt test.

Under changes to come into effect for policies issued after 2016, the exempt test will be more standardized across various types of policies. The cash amount that can accumulate under the policy will initially be similar to or higher than it would be under the current exempt test, but then will decrease from what it would otherwise currently be, until the insured reaches their early 90s. "Universal life" insurance policies are a type of permanent life insurance which can offer more flexibility than traditional "whole life" policies. Universal life policies with a level cost of insurance, where the premiums paid are constant over the insured's life, will be most impacted by these tax rule changes.

Many permanent life policies permit premiums to be paid that are in excess of what is required to fund the mortality and administrative charges for that year. This permits funds to accumulate earlier within the savings component of the insurance policy. There are tax rules governing how quickly policies can be pre-paid and the maximum amount that can be funded. Under the new rules, it will take longer for you to prepay a policy. Currently it is possible to do this in as few as four years, whereas under the new rules it will take a minimum of eight years based on current investment returns. Single premium policies, which require only one premium payment to fully prepay the policy, will no longer be possible. For the majority of Canadians, however, this will not be of material impact as only a very small portion of policyholders prepay a policy at the maximum amount.

Adjusted cost basis of insurance policies

The adjusted cost basis (ACB) of an insurance policy is important for determining the tax treatment when a policy is disposed of or transferred. Calculating the ACB of a life insurance policy can be a very complex process and you will not be able to easily determine this on your own. In general terms, the ACB is the total premiums paid, less the Net Cost of Pure Insurance (NCPI). The NCPI is the pure mortality cost of the policy (as defined in the Income Tax Act), being the part of the premium paid for the insurance coverage and not for any investment component. In other words, after deducting the NCPI from the premiums paid, the ACB is the portion of the premiums paid relating to the investment component of the policy. As a result, the NCPI is very important in this calculation and increases as the life insured gets older. Ignoring any other possible adjustments that may affect the ACB of a policy, this means that the ACB generally declines as you age.

The current calculation of the NCPI is based on a mortality table that was created many years ago. For policies issued after 2016, the table has been updated to reflect more recent life expectancy rates. Thus, under the new table the NCPI will generally be lower and as such, it will generally take longer for the ACB to drop to zero. For instance, it has been estimated that in circumstances where it currently takes less than 25 years for the ACB of a policy to fall to zero, it will take approximately 40 years under the new rules.[1] An exception to this, however, is for substandard policies (where the annuitant is rated as having a shorter life expectancy, perhaps due to medical issues), where the NCPI will generally be higher and ACB will be lower.

There are several situations in which the ACB is important:

I. Corporate-Owned Insurance

Where a corporation is the beneficiary of a life insurance policy, the death benefit will generally be received by the corporation tax-free. Whether the entire death benefit can be paid to the shareholder free of tax depends on how much of that death benefit can be allocated to the corporation's capital dividend account (CDA). Where there is a positive balance in the CDA, it can be paid by the corporation to the shareholder as a capital dividend, which is generally tax-free.

The insurance policy death benefit, less the ACB of the policy, can be added to the CDA. So, the ACB is a very important concept, as it reduces the amount of the death benefit that can generally be paid tax-free to the shareholder.

As it will take longer under the new rules for the ACB to fall to zero (other than for substandard policies), it will take longer for the entire amount of the death benefit to be able to be paid out as a capital dividend. For approximately the first ten years of the policy, the CDA credit will not change materially; after that time, however, there will be a material difference.[2]

Where an insurance policy is issued after 2016, the amount of the death benefit that may be paid tax-free to a shareholder must be considered in determining whether a business owner should own the policy or whether it should be corporately-owned. This potential change to the treatment of the death benefit must be weighed against potentially lower after tax cost of premiums if the corporation holding the policy is subject to a lower rate of tax than an individual.[3] That is, when the insurance policy is owned by a corporation, premiums are paid from corporate funds that have only been subject to tax at the corporate level. The corporate tax rate is generally lower than the personal tax rate. When life insurance premiums are paid with personal funds that were earned through a corporation, they are generally subject to tax at a higher rate as salary, or taxed at both the corporate and personal levels if received as dividends. As a result, corporate-paid premiums have a lower after-tax cost than premiums that are paid personally.

II. Policy Loans

If you have an insurance policy, and you need cash, you might be able to get funds by taking a loan from the insurance company that issued the policy, known as a “policy loan”. If the total of all policy loans does not exceed the ACB of the policy, there will not be any tax consequences. Once the total of the policy loans exceeds the ACB, however, a “policy gain” will arise which must be included in income at ordinary rates (it’s not a capital gain). A deduction is then permitted for any repayment of the policy loan. This is a situation where you would like the ACB to be high, since the greater the ACB, the more that can be taken as a policy loan without triggering an income inclusion. The new rules may work to your benefit in this situation, unless you own a substandard policy.

III. Transfer of an Insurance Policy

When a life insurance policy is transferred to another party, it is treated as a disposition for tax purposes. If the proceeds of disposition exceed the ACB of the policy, then it will result in a policy gain. In some circumstances, such as most transfers to a child or grandchild, or transfers between spouses or common-law partners, the proceeds of disposition are deemed to be the ACB, so no gain results. This is called a “rollover” for tax purposes. Once again, unless the transfer is a rollover, you would want the ACB of the policy to be higher, so the policy gain will be lower and, as a result, you may be better off under the new rules (with the exception of substandard policies).

Collateral loans

If you borrow for investment purposes, you may wish to use the insurance policy as collateral for such loan. Where the loan is made by a third party lender, and not the insurance company who issued the insurance policy, it would not be considered a "policy loan". When the insurance policy is required to be used as collateral for the investment loan and the interest on such loan is deductible for tax purposes, the insurance premiums paid during the time the loan is outstanding will be tax deductible, up to certain limits. In particular, the amount that can be deducted is equal to the lesser of the policy's NCPI and premiums paid in the year. As NCPI rates will be dropping, this will reduce the amount of premiums that will be eligible for the tax deduction. The exception, once again, will be for substandard policies where NCPI rates will generally be higher for policies issued after 2016.

The date to keep in mind for this rule change is the date that the insurance policy is issued. If the policy is issued prior to 2017, then the current rules continue to apply even if the loan is taken out at a later date.

Universal life policies

Certain universal life policies with a level cost of insurance will likely see some changes to pricing under the new rules. Insurance companies will have higher taxes imposed when such policies are issued after December 31, 2016 and it is expected that these higher costs will be passed onto policyholders as either higher charges or lower rates of return.[4]

Prescribed annuity contracts

Annuity contracts fall into two categories for tax purposes: prescribed annuity contracts (PAC) for which payments are taxed more favourably and accrual annuity contracts. For every payment under a PAC, part of the payment will be taxable and part will be a tax-free return of capital. Only individuals (not corporations) can purchase a PAC.

Under the new rules, the portion of PAC payments that represent a non-taxable return of capital will be reduced since the formula will be based on updated mortality tables. For substandard annuities, however, the opposite will occur — the portion of the PAC that will be non-taxable will increase for this subset.

This will also impact what is commonly known as insured annuities. An insured annuity is a structure where a PAC would be purchased, along with an insurance policy. The periodic payments from the PAC would be used to fund the premiums on the insurance policy. The insurance policy would provide capital on death and the PAC payments (which are only partly taxable) would generally provide a better after tax rate of return than a typical GIC (whose income is fully taxable).

Since the taxable portion of most PACs will increase for annuities issued after 2016 and the premiums on the insurance policy may rise, this strategy will need to be examined in close detail prior to implementation, if being contemplated after 2016.

Grandfathering

Most insurance policies issued before January 1, 2017 will be grandfathered, which means that the current rules, rather than the new rules, will apply.[5]

If you're contemplating a purchase of permanent insurance, be sure to consider the tax rule changes discussed above before deciding whether to purchase the policy in 2016 or delay until 2017.

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[1] *Life and Taxation: Impact of New Rules on Products & Sales Concepts*; http://www.advocis.ca/alc.

[2] Ibid.

[3] Note that insurance premiums are generally not deductible.

[4] Some expect the combined change charges and rates to be as high as 6-9% for those at younger ages, and dropping to a 3% increase for those over the age of 60. See Kevin Wark, "Recent Developments Impacting Insurance" in *2015 Ontario Tax Conference* (Toronto: Canadian Tax Foundation 2015).

[5] There will be some exceptions to these rules, in most cases where there is a change to a policy issued before January 1, 2017 that is considered significant enough to cause it be subject to the new rules.