

NEW LAW WILL IMPACT INSURANCE TAX BENEFITS

Pierre Ghorbanian / May 15, 2015



The government has introduced new tax legislation that's designed to modernize life insurance exempt testing. The legislation, which reflects the fact that people are living longer and that their insurance policies will pay out later, received royal assent on December 16, 2014 and comes into effect as of January 1, 2017.

Under that legislation, insurance products will fall under one of the following tax generations:

- G1, which refers to policies issued or last acquired before December 2, 1982;
- G2, which refers to policies issued or last acquired after December 1, 1982 and before January 1, 2017; or
- G3, which refers to policies issued after 2016, or policies that have lost their G1 or G2 status due to lack of grandfathering.

Many G1 and G2 policies will be grandfathered based on their existing exempt test and policyholder taxation rules.

But, the new G3 legislation has identified certain triggers that would remove the grandfathering status on an in-force policy. For example, life insurance coverage added to the policy, with underwriting that occurs after 2016, won't qualify for grandfathering.

However, the biggest impact you will see for your affluent clients will be less exempt room over the long run. The new rules will also impact corporate-owned life insurance policies

Here are three impacts to be concerned about for G3 policies.

1 YOU CAN NO LONGER INCREASE EXEMPT ROOM IN INSURANCE POLICIES BY USING SURRENDER CHARGES

In the current insurance environment, high surrender charges can increase the amount of maximum deposit in a policy. Under new G3 rules, surrender charges will have no effect on a policy's exempt room. This will result in much lower tax-deferred room, and standardize maximum deposit levels amongst insurers.

For insurers, this will impact product design, along with the structures of existing permanent products. Universal Life T100 LCOI policies will be impacted most under the new rules. Table 1 (below) shows the impact on maximum premiums.

Table 1			
Estimated reduction in maximum premium	Male, 30, non-smoker	Male, 45, non-smoker	Male, 60, non-smoker
Life pay	56%	54%	19%
10-pay	7%	0%	9%
Source: CLHIA, "Proposed Changes: Exempt Test & Policyholder Taxation," May 15, 2014			

The impact on YRT UL and whole life contracts won't be as severe as it will be on LCOI T100 policies, since the rules will have a greater impact on products with higher prepay COI guarantees. But, the exempt room for LCOI T100, YRT and whole life will decrease. Limited Pay ULs will not see as much of a decrease, mainly due to the fact that current products are already designed to have no surrender charges. Therefore, a client will not be able to deposit as much money into a policy on a tax-

exempt basis as he can currently. Put another way, the client has to buy more insurance coverage to shelter the same amount of money post-2017.

Advisors should also know that quick-pay policies with less than eight deposit years will no longer be compliant with the new exempt rules, according to the Ministry of Finance. In Table 2 (below), you can see how a single premium UL policy would look under the current legislation, assuming a 95% surrender charge in year one.

Table 2									
Year/Age	Deposit amount	Fund balance	Cash value	Side account balance	Total death benefit	Sum insured	Net amount at risk	Total charges	Total charges to fund ratio
1/51	\$100,000	\$102,038	\$7,038	\$0	\$303,480	\$281,000	\$201,442	\$840	0.82%
Source: BMO									

Table 2 also shows the amount of insurance (a.k.a. the sum insured or face amount) is only \$281,000 on a Level DB basis, and the cost of insurance is only \$840 in the first year. To put it another way, it costs less than 1% (82 bps, to be exact) to maintain the exempt status.

Under the new legislation, these strategies will lose their tax efficiency, diminishing their viability for both insurers and consumers.

Call to action: Advisors should be educating clients on these changes. If they have any interest in buying quick-pay policies or in overfunding universal life policies, now is the time to act.

2 CORPORATE OWNED LIFE INSURANCE POLICIES & CAPITAL DIVIDEND ACCOUNT STRATEGIES MAY TAKE LONGER TO BE EFFECTIVE

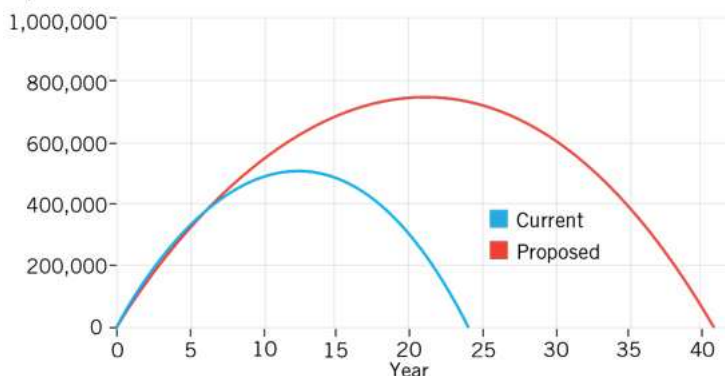
Corporate Owned Life Insurance (COLI) policies are attractive to Canadian-controlled private corporations (CCPCs) because the total death benefit, minus the Adjusted Cost Basis (ACB), creates a credit in the corporation's Capital Dividend Account (CDA). Credits to CDAs allow corporations to efficiently transfer cash out to the shareholders' estates on a tax-free basis.

Under the new legislation, it will take much longer for the ACB to reach zero. This will impact the marketability of COLI concepts, such as Corporate Asset Transfer Plans, Corporate Insured

Retirement Plans or Insured Corporate Financing Strategies (which allow for immediate financing arrangements).

Figure 1 (opposite) shows it will take at least an additional 18 years before the ACB reaches zero under the new rules. The Net Cost of Pure Insurance (NCPI = probability of death X Net Amount of Risk) will be smaller for standard lives (people paying regular premiums), and higher for rated lives (people paying higher premiums). That’s because, in 2017, NAAR will be calculated based on a higher accumulating fund value instead of using the current method, which is death benefit minus the cash surrender value. As a result, leveraged strategies using collateral deduction will need to be re-evaluated, such as corporate-owned immediate financing arrangements.

FIGURE 1
\$5 MILLION MINIMUM-FUNDED LEVEL COI UNIVERSAL LIFE



Call to action: Investors should be educated on the changes to the ACB. If they need corporate-owned life policies, they should buy now. The new rules won’t be the end of COLIs, but they won’t be as attractive as they are now.

3 CLIENTS WILL PAY MORE TAX WITH INSURED ANNUITIES

The benefits of both insured and prescribed annuities will change. The new rules will result in an increase in the taxable portion of income payments, and that will reduce their tax effectiveness (see Tables 3 and 4, below). Still, annuities can retain their value as a product that helps mitigate the risk of living too long, even as their tax efficiency lessens. So, advisors should educate clients on the changes to the taxation of prescribed annuities.

Call to action: If clients have sizable amounts of non-registered assets, they may consider buying insured annuities prior to 2017 to take advantage of the current tax-efficiency.

Male age	Monthly income	Monthly taxable portion (before)	Monthly taxable portion (after)	Inclusion rate (before)	Inclusion rate (after)
65	\$545	\$88	\$135	16.1%	24.8%
70	\$623	\$79	\$132	12.7%	21.1%
75	\$712	\$70	\$129	9.8%	18.1%
80	\$795	\$60	\$120	7.5%	15.1%

Female age	Monthly income	Monthly taxable portion (before)	Monthly taxable portion (after)	Inclusion rate (before)	Inclusion rate (after)
65	\$499	\$96	\$131	19.2%	26.2%
70	\$565	\$76	\$122	13.5%	21.6%
75	\$646	\$51	\$107	7.9%	16.6%
80	\$738	\$35	\$93	4.7%	12.6%

Source for Tables 3 and 4: quotes based on BMO Insurance rate basis as of Sep. 18, 2014, \$100,000 single premium, guarantee period 10 years.

MORE PRODUCT CHANGES

Investment Income Tax (IIT) is paid by insurance companies on tax-exempt funds, and the cost is reflected in premiums and UL MERs. IIT charges will be increasing and may result in an increase to LCOI rates on UL plans. Yet, there will be little, or no, impact on yearly renewable term UL plans.

Further, policies with guaranteed cash values will need to be reviewed based on the lower exempt room on policies, which will impact limited pay products, universal and whole life products. On whole life policies, the new rules will likely result in lower cash values.

Finally, the special death benefit, or fund value at first death on multi-life policies, will only pay out the proportional amount for each coverage. For instance, say you have a policy with \$1 million in coverage for a male and \$1 million on a female. The total fund value is \$500,000. Under current rules, if the female dies, \$1 million is paid out, and the full \$500,000 is paid out tax-free.

1.2%

The Consumer Price Index for March was up from one year ago.

Source: Statistics Canada

After January 1, 2017, only \$250,000 of the fund value will be paid out tax-free (half the fund value, since there were two people covered). If the survivor wants the other \$250,000, he must withdraw cash from the policy. That withdrawal might be taxable, depending on the policy's ACB at the time. With the complexities of administering multi-life policies, you may find many insurers no longer offering them under the new rules. That's because it'll be costly to update back-office systems, especially considering that these policies haven't been widely popular to begin with.

CONCLUSIONS

The three strategies mentioned have been used to preserve and transfer clients' wealth from one generation to the next. But since the preferential tax treatment of these strategies will be reduced as of January 1, 2017, you need to educate clients now, and explain their investment options.

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