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October 25, 2013

To: All CALU Members

**Re: October 18 Release of Final Budget Legislation -
An Update on Legislation Governing 10-8 and LIA Policies**

CALU has now reviewed the legislation governing 10-8 and LIA policies (and explanatory notes) that was released as a Notice of Ways and Means Motion on October 18 ("final legislation").[1] We have also compared the final legislation with both the original 2013 federal budget proposals and the draft legislation of September 13 ("draft legislation").

We are pleased to announce that there have been a number of changes to the final legislation resulting from CALU's submissions in May and September, as well as those made by the CLHIA. Set out below is a summary of those changes for your information:

Rules Governing 10-8 Policies

1. **Transition period for in-force 10-8 policies:** The budget proposals provided no grandfathering for 10-8 loan arrangements in effect before the budget date of March 21, 2013. Instead, Finance deferred the application of the new rules until 2014, with the expectation that this would provide sufficient time for policyholders to either repay 10-8 loan arrangements and/or replace such loans with "compliant loan" arrangements. Finance also proposed a time-limited deduction under draft subsection 148(5), which would essentially permit cash withdrawals from 10-8 policies on a tax-free basis for the purpose of repaying the 10-8 loan provided such withdrawals were made after March 20, 2013, and before 2014.

   In its May 2013 submission on the 10-8 budget proposals, CALU expressed concerns with the short timeframe being allowed to wind-up 10-8 loan arrangements, as well as concerns with the design of the deduction under subsection 148(5). Subsequent discussions with Finance made it very clear that they were opposed to any extension past the end of 2013, noting that any delays would encourage the Canada Revenue Agency (CRA) to continue its current audit program relating to the 10-8 policies. Given Finance's position, in our September 2013 submission CALU did not pursue a further delay in the implementation of the rules, but instead proposed that the deduction under subsection 148(5) be extended to April 2014.

   We are pleased to advise that Finance has agreed to the extension as proposed by CALU. As a result, policyholders who require more time to consider how to deal with their 10-8 loan arrangements will have an additional three-month period to take advantage of the deduction under subsection 148(5). It should, however, be noted that maintaining a 10-8 loan arrangement will result in the denial of the interest expense for amounts paid or payable after 2013. As well, policyholders need to be aware that Finance did not agree to the netting of the deduction under subsection 148(1). As a result, making a

[1] This legislation is now part of Bill C-4 which received first reading in the House of Commons on October 22.

withdrawal from the policy to repay the loan and claiming a deduction under subsection 148(5) may alert the CRA to the fact that the policy is a 10-8 policy and invite further scrutiny.

2. **Paragraph 20(1)(e.2):** Both the legislation and explanatory notes now make it clear that the disallowance of the collateral insurance deduction will only apply **during the period** in which the policy is a 10-8 policy. In other words, if the loan secured by the policy becomes a "compliant loan", the collateral insurance deduction may be available.

3. **Subsection 20(2.01)**: This provision as originally drafted would disallow an interest expense on **any loans secured by life insurance**, not just interest on loans under 10-8 policies. While the explanatory notes to the draft legislation made it clear that the intent was for subsection 20(2.01) to only apply to 10-8 policies, CALU asked that this be further clarified in the final legislation. We also wanted to ensure the interest disallowance would not apply if the loan became a "compliant loan".

   Finance has modified the final legislation relating to the disallowance of interest expense in two important respects. First, the final legislation confirms that the interest disallowance only applies to loans on 10-8 policies and not more generally to all loans secured by life insurance. Second, the interest expense disallowance will generally only apply to interest that is paid or payable at a time when the policy is a 10-8 policy. However, the final rules differentiate between interest that is "paid" versus "payable" after March 20, 2013. If interest is **paid** after March 20, 2013, and when the policy is a 10-8 policy, in respect of a period after 2013, the interest expense will be disallowed even if the policy is not a 10-8 policy during the relevant period to which the interest relates. This prevents the "prepayment of interest" on a 10-8 policy, with the intent of deducting such interest after 2013 and at a time when the policy is no longer a 10-8 policy. If interest is **payable** after March 20, 2013, in respect of a period after 2013, and the policy is no longer a 10-8 policy at the relevant time period, the interest will be deductible.

4. **Definition of "capital dividend account" in subsection 89(1)**: The definition is being modified to reduce the capital dividend account (CDA) credit by an amount equal to that portion of the death benefit attributable to the borrowing under a 10-8 policy that exists at the time of death (which is in effect the cash value of the policy securing the loan). Based on CALU's submissions, this proposal has been modified in two ways. First, the credit to the CDA will not be reduced by any policy loan outstanding at the time of death, as the insurance death benefit for purposes of computing the CDA will already have been reduced by the amount of any outstanding policy loan. Second, the final legislation makes it clear that this reduction only applies if the policy is a 10-8 policy "immediately before death". In other words, if the loan is a "compliant loan" at the time of death, the death benefit attributable to the cash value securing that loan will be included in determining the credit to the CDA.

5. **Subsection 148(5)**: As discussed in section 1 above ("Transition period for in-force 10-8 policies"), the deduction under subsection 148(5) has been extended by three months to include withdrawals made after March 20, 2013 and **before April 2014.** It should also be noted that the provision has been amended from the original budget proposals to further limit the deduction to any gain arising from a withdrawal from the special investment account securing the collateral or policy loan. It is therefore very important to ensure that the withdrawal is made from the special investment account (and not any other investment account) in order to claim this deduction.

6. **Definition of 10-8 policy:** Both the budget proposals and draft legislation indicated that a life insurance policy would be a 10-8 policy if an amount becomes payable under a collateral borrowing involving an assignment of a life insurance policy, or under a policy loan, where either:

a. The rate of interest earned on an investment account under the policy is determined by reference to the rate of interest on the borrowing or policy loan; or
b. The maximum amount of the investment account in respect of the policy is determined by reference to the amount of the borrowing or policy loan.

The intent of these two requirements was to ensure that both the credited rate to the investment account under the insurance policy and the loan rate are determined by "market forces". However, there was a concern that the first test (the rate of interest on the investment account cannot be determined by the rate of interest on the loan or policy loan) could result in the 10-8 policy definition applying to certain older Universal Life (UL) policy loan structures, even though the investment account backing the policy loan was generally available to all policyholders, thereby ensuring a market rate being credited to the investment account. Finance has addressed this concern by modifying the first test, so it will only apply if the return credited to an investment account in respect of the policy is determined by the rate of interest on the borrowing or policy loan, **and such return would not be credited to the account if the borrowing or policy loan were not in existence.** In other words, if the investment account is available to a policyholder, whether or not a collateral loan or policy loan has been taken, the policy will not be a 10-8 policy, even if there is a linkage between the rate of return of the investment account and the loan interest rate.

Rules Governing LIA Policies

The one notable change, based on CALU's representations, is the following reference in the explanatory notes which is designed to clarify the extent of grandfathering for LIAs in place before March 21, 2013.

> *"An LIA policy does not include a policy in respect of which the amount of borrowings outstanding as of March 21, 2013 does not increase after that date."*

It is CALU's understanding that the intent of this language is to permit the extension and/or refinancing of loan arrangements in place as of March 21, 2013, provided the borrowing is not increased. As well, it is our understanding that changes to the annuity or life insurance policy securing the loan will not have an effect on the grandfathering of the arrangement.

In Conclusion

We are very pleased with the fact that Finance listened to a number of CALU's concerns relating to the 10-8 and LIA proposals, and responded with changes to the final legislation and explanatory notes. Given these changes and the targeted nature of the legislation, the CALU Board has determined that ***CALU will not express further concerns or objections with the 10-8 or LIA legislation as it moves through the legislative process.***

Should you have any questions or comments please don't hesitate to contact me at kwark@calu.com or Terry Zive, CALU's Chair of Government Relations, at terry@zfi.com.

Regards,

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President, CALU