PPI Advisory

TAX TALK

What your clients need to know about the updated exempt test for insurance

By John McKay, Executive Vice-President and Actuary, PPI

The exempt test rules for life insurance policies are being modernized to reflect more recent mortality tables, to provide standardization across insurance companies and products and to take into account the new products that have emerged in the marketplace over the last 30 years, specifically universal life and level cost of insurance. These rules exist to ensure that the favourable tax treatment of exempt policies is not available to a policy that is mainly an investment vehicle with only an ancillary insurance element. The proposed changes to the exempt test rules were first announced in the 2012 Federal Budget and, after consultations with the life insurance industry, were passed into law in December 2014.

The rules will apply to life insurance policies issued on or after January 1, 2017. As there are a significant number of changes and the legislation is very complex, this article will highlight three items of interest to advisors: grandfathering, the impact on funding room and the adjusted cost basis for level cost of insurance (LCOI) policies, and multi-life policies.

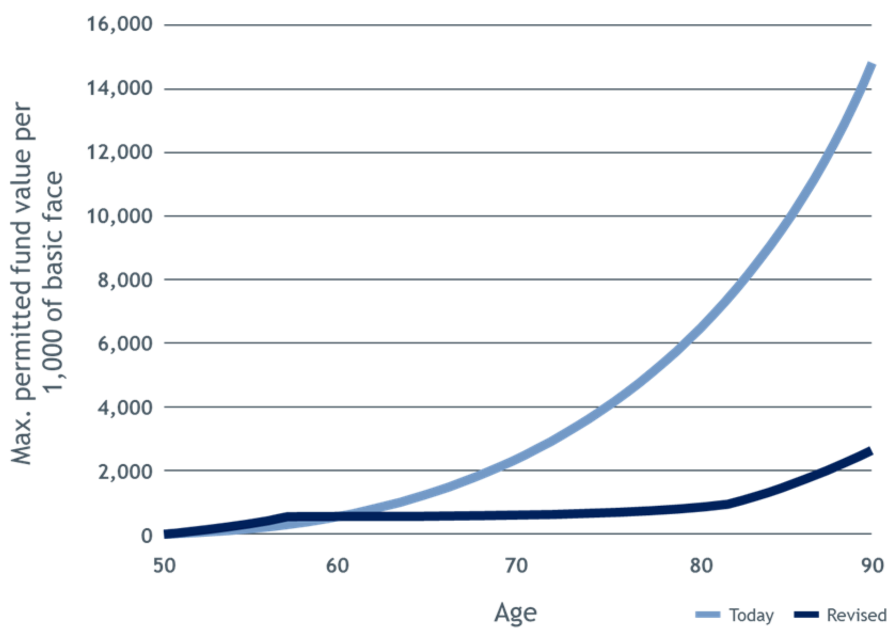
Grandfathering

Generally, policies issued before January 1, 2017 will be grandfathered; however, in certain circumstances, grandfathered status can be lost after 2016. The insurance industry is still reviewing the legislation to fully understand all the circumstances under which grandfathering can be lost. Generally, a pre-2017 policy will no longer be grandfathered if a term policy is converted to a permanent policy after 2016 or if additional coverage is added to the policy after 2016 that is the result of medical underwriting completed after 2016. As a result, any conversions from term to permanent insurance should be completed before January 1, 2017. Changes made after 2016 for smoker to non-smoker status, substandard to standard rating and from single life to joint life are not expected to affect grandfathered status. There are significant benefits to retaining grandfathering status as is highlighted by the next two items.

Impact on Universal Life LCOI policies

If a life insurance policy is exempt, then there is no accrual taxation on the investment income attributed to the policy. There are several proposed changes to the calculations used to determine the amount that can be invested in a policy and still retain exempt status. Two of the proposed changes that will greatly reduce the long-term maximum funding available for LCOI "face plus fund" products are: 1) the exclusion of surrender charges in the calculation of the accumulation room and 2) the inclusion of the LCOI embedded reserve into the calculation. The embedded reserve is generally not available to the policyholder on surrender of the policy but it is utilized by the insurance company to offset the costs of insurance as the insured ages. The exclusion of this reserve from the calculation allowed for more accumulation room for LCOI policies. These revised rules have significantly decreased the accumulation room for LCOI policies but have created a level playing field for permanent products. Based on past experience, the full accumulation room available under the old rules was seldom utilized after the first ten policy years so the real impact of the revisions is not as significant.

Maximum fund value per thousand of LCOI face for a 'face plus fund' policy – Today vs Revised



The new rules also require the use of more recent mortality tables which will result in a lower net cost of pure insurance (NCPI) than under the old rules. Since the NCPI is deducted when calculating the adjusted cost basis (ACB) of a policy, this change will result in higher ACBs for insurance policies in the earlier years. The lower NCPI, in conjunction with some other changes to the net risk calculation, lengthens the time period before the ACB of the policy is reduced to nil. For most LCOI products, the nil ACB point is reached 7-17 years later. The higher ACB is a positive result for individually owned policies where withdrawals are made in the early years but in corporate owned insurance situations where the owner and beneficiary are the same entity, this change will result in a lower amount added to the capital dividend account (CDA) for premature deaths. The CDA is beneficial as a dividend paid out of this account is received tax free by the shareholder.

Multi-life Policies

The current rules for "face plus fund" multi-life policies permit the entire fund value of the policy to be paid out as a tax-free death benefit on the death of an insured if that death also triggers a death benefit payment under a coverage included in the policy. This provided a planning opportunity for accessing the policy's fund value on the first death.

For new multi-life policies issued after 2016, or policies that lose grandfathered status, the new rules will limit the amount of the tax free fund value payment received on the death of an insured to the maximum amount that could have been paid out if the coverage had been issued as a stand-alone face plus fund policy on the insured.

A favourable change that affects multi-life policies is in the calculation of the ACB. The current rules did not allow for a deduction from the ACB in respect of the proceeds paid out on a death which could result in the ACB being counted twice for CDA purposes if the other insured(s) died before the ACB was reduced to nil. The new rules will reduce the ACB of the policy to appropriately account for the tax free fund value and death benefits received.

The new exempt test rules have the greatest impact on universal life policies, and in particular LCOI policies. Since the new rules do not come into effect until January 1, 2017, advisors have almost 2 years to review their clients' estate planning and insurance needs and decide whether to make changes to existing insurance policies or purchase permanent insurance, especially LCOI.

John McKay is a Fellow of the Canadian Institute of Actuaries and a member of the PPI Planning Services group of lawyers, accountants and actuaries, who provide tax and estate planning expertise and support to help advisors build customized insurance solutions for high net-worth clients.

About PPI

PPI is a leading marketer of insurance solutions, offering actuarial, tax and specialized expertise in all aspects of life insurance, and specifically in its design and custom application. PPI has two complementary marketing channels: PPI Advisory is dedicated to the high net-worth market whose complex estate and tax planning needs demand sophisticated insurance strategies; PPI Solutions is a national resource for insurance advisors who serve the broader Canadian market offering proprietary technology tools, a comprehensive product suite, unparalleled insurer relationships and competitive compensation. www.ppi.ca.