Summary of

New Exempt Policy Rules

Although the changes do not alter the fundamental values in the insurance purchase, they must still be taken into account. These changes are the most significant in 30 years, with wide reaching impact on planning.

When do rules come into effect ?

New rules will apply to policies coming into force January 1, 2017 or later.

Grandfathering rules ?

- Policies issued and in-force prior to December 31, 2016 are grandfathered to the current rules. In order to be grandfathered term policies must be converted prior to the end of 2016.

- Any changes/additions where medical evidence is required - after January 1, 2017 the new rules will apply. (See exceptions below).

Exceptions

- Smoker to non-smoker.
- Rated policy to standard policy.
- Single life to joint life.

These changes while requiring medical evidence are not expected to affect grandfathering.

October, 2016.

What do the changes mean to insurance planning ?

	Changes	**Impact on Post 2016 policies**
1.	Level cost (universal life) permanent insurance – higher IIT (investment income tax) at company level .	Anticipated increase in premiums of approximately 5 - 12%.
2.	New rules to limit the additional deposits that may be made to a policy over and above basic mortality charges.	Less permitted accumulation which can impact both retirement and estate planning as well as reduce leveraging potential.
3.	Companies must use a more recent mortality table to calculate the "net cost of pure insurance" (NCPI). NB New mortality table results in change in annuity taxation.	Higher ACB means = lower capital dividend account for corporate owned insurance. Longer time for ACB to grind to zero. Currently 12 -17 years; will be 25-30 years (estimate). Less tax if policy surrendered. More taxable income on annuities.
4.	Multi Life Policies.	Policies issued after December 31, 2016, may pay out only the accumulated value that would have been permitted on a single life policy.
5.	Lower NCPI.	Lower deduction permitted for policies assigned to a lender as collateral.
6.	Inclusion of medical ratings.	Higher deduction permitted for rated policies issued after Dec.31/16.

October, 2016.

Fund Value Accumulation

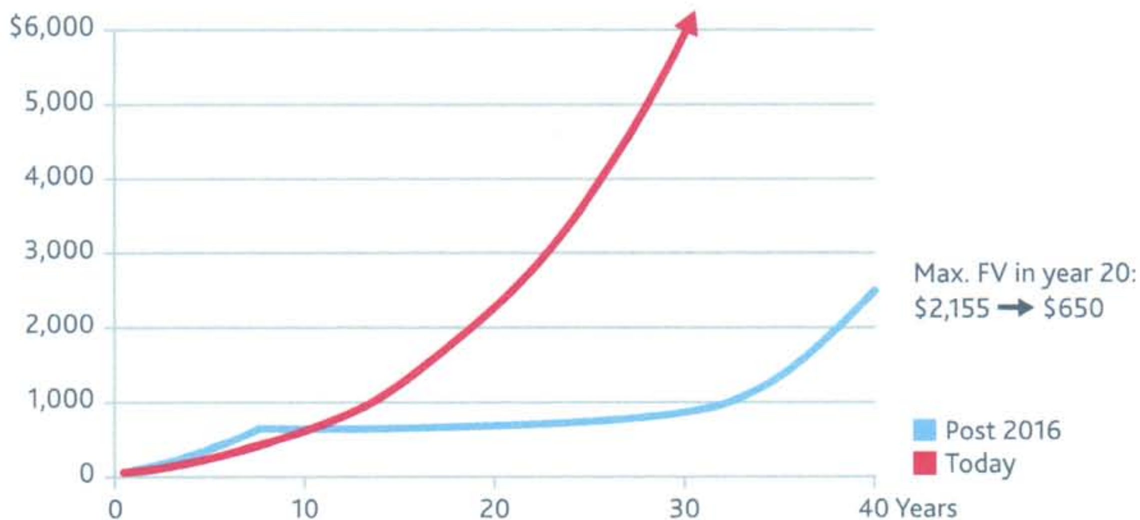
The *Act* allows policyholders to deposit funds into a policy over and above the premium needed to pay for the basic death benefit. Provided that the policy is an exempt policy for tax purposes, the additional deposited funds can grow without tax within the limits prescribed in the *Act*.

The new rules propose to limit the amount that can be deposited into the policy, which means that the amount not subject to tax will be reduced in comparison to policies issued before 2017. LCOI policies issued now (as opposed to after 2016) will be able to accumulate larger fund values than those issued beyond 2016, which means that there will be more funds available to the policyholder in the future for planning needs, such as estate planning, retirement planning and leveraging.

The example to follow shows the difference between fund value accumulations before 2017 and after 2016.

The PPI Toolkit lets you select the age, in ten year increments between 40 and 80 years, that you'd like to illustrate for the Fund Value Accumulation, Capital Dividend Account Credit and Collateral Insurance Deduction.

Maximum Fund Value per $1,000 of LCOI Face
Male, Age 50, Non-Smoker



See **Some Important Notes** at the end of this presentation.

Capital Dividend Account Credit

Another area that will be affected after 2016 is the Capital Dividend Account (CDA) credit. For life insurance owned by corporations, the policy proceeds paid on death to the corporation can be paid out to shareholders and/or their estates tax-free, to the extent of the CDA credit arising from the policy proceeds. Additionally, these capital dividends can be used to reduce or eliminate capital gains on death related to shares owned by the deceased person.

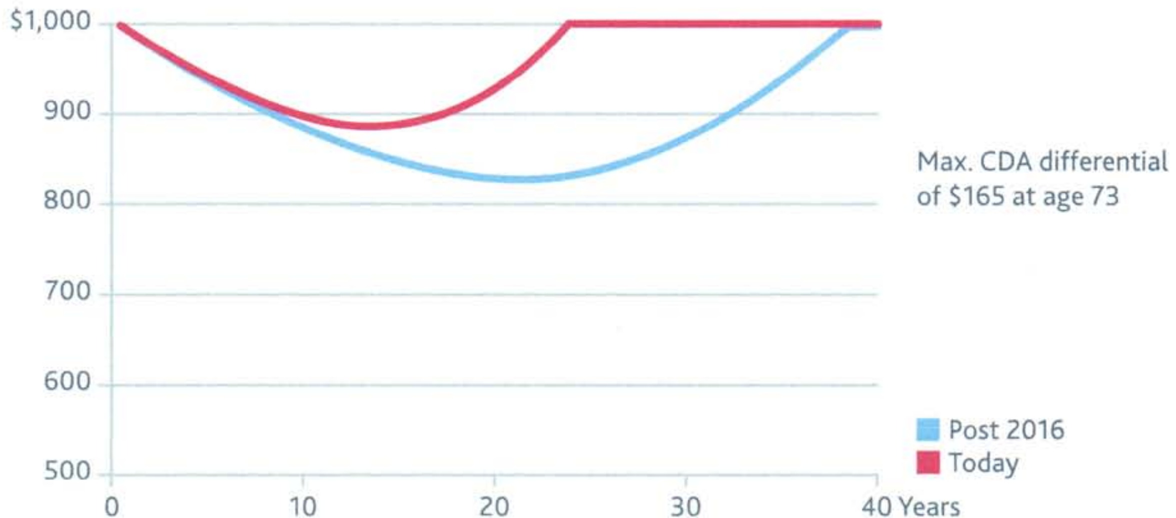
After 2016, the capital dividend account credit for LCOI policies will be reduced in comparison to the capital dividend account credit associated with pre-2017 policies.

Significant CDA Benefits for LCOI under Today's Rules

Issue Age	CDA greater by as much as
40	+14%
50	+17%
60	+20%
65	+23%
70	+26%
75	+36%

You can select the age to illustrate.

CDA Credit per $1,000 of LCOI Face
Male, Age 50, Non-Smoker



See **Some Important Notes** at the end of this presentation.

Collateral Insurance Deduction (CID)

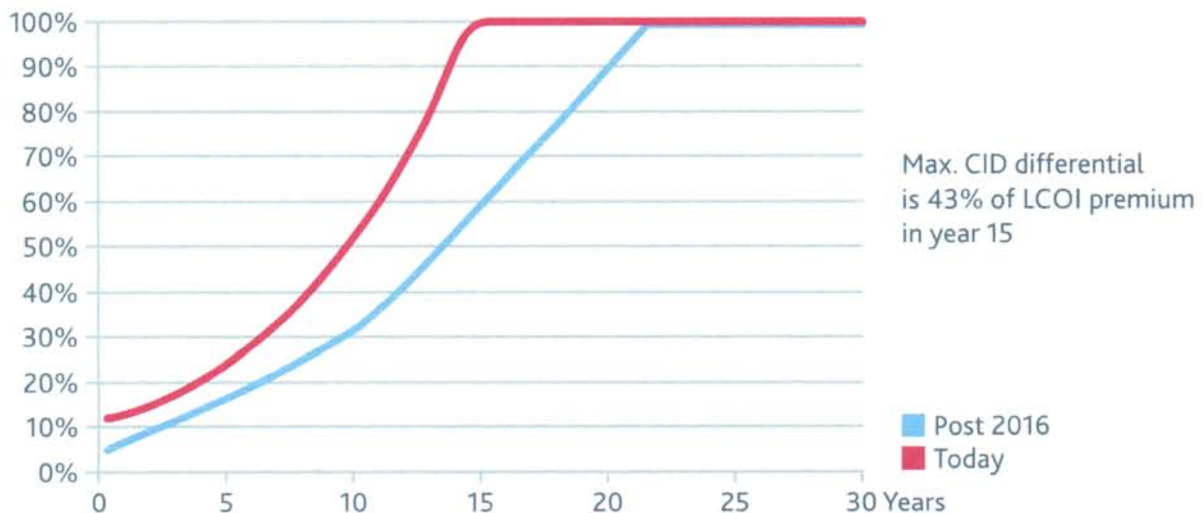
Policyholders who use their policies as collateral security for investment loans may be able to deduct a portion of the premium for the policy. After 2016, the amount of the deduction will be significantly reduced.

The effect of the change on LCOI policies can be seen in the following table.*

Cumulative Percentage of Total LCOI Premiums Deductible as CID over Period Indicated

Issue Age	1st 10 Years		1st 20 Years	
	Post 2016	Today	Post 2016	Today
40	12%	16%	25%	38%
50	18%	27%	39%	58%
60	27%	44%	56%	72%
65	33%	52%	62%	76%
70	41%	56%	68%	78%
75	45%	96%	70%	98%

Percentage of LCOI Premium Deductible Annually Male, Age 50, Non-Smoker



*Assumption: Loan balance at least equal to the LCOI face amount.

See **Some Important Notes** at the end of this presentation.

BY GLENN STEPHENS

Policy Changes

How will the new exempt test rules affect your clients' insurance policies?

Changes to the exempt test rules for life insurance policies were passed into law in December 2014, effective for policies issued after 2016. These changes were overdue, given that the previous rules were enacted in the early 1980s, before universal life (UL) policies assumed any prominence in the Canadian marketplace. Given this background, these changes, not surprisingly, have their greatest impact on UL policies, particularly those with level cost of insurance (LCOI) charges. Let's examine the details.

TAX SHELTERING

The key purpose of the exempt test is to calculate the amount that is permitted to accumulate within an insurance policy on a tax-sheltered basis. Two key changes may cause significant reductions in the tax sheltering capacity of LCOI policies: the exclusion of surrender charges and the inclusion of the "embedded reserve." The latter represents the part of the reserve within LCOI policies that is not available to the policyholder on surrender. While the recognition of this reserve will cause a loss of sheltering ability for LCOI policies, the changes create a more level playing field with other types of insurance policies, such as participating whole life, whose reserves were already being reflected under the pre-2017 rules.

CAPITAL DIVIDEND ACCOUNT

The amount of any life insurance proceeds received by a private corporation, less the policy's adjusted cost basis (ACB) to that corporation, is added to the corporation's CDA. Amounts credited to the CDA can be distributed as tax-free capital dividends to the shareholders. The ACB of a life insurance policy is determined by a number of factors, the most important of which are premiums paid, which increase the ACB, and the net cost of pure insurance (NCPI), which reduces the ACB. The NCPI is determined using a mortality table prescribed by the Income Tax Regulations. After the policy has been in force for a number of years, the impact of the NCPI is a declining ACB that may eventually be reduced to zero.

The new rules prescribe an updated mortality table for calculating the NCPI. Given improved mortality experience, the NCPI will, in most cases, be a lower amount than is currently the case. This means for most types of policies, the ACB will stay higher for a longer period of time. Depending on issue age and other factors, it will take from seven to 17 years longer for LCOI products to reach a zero ACB than under the current rules. The impact is even greater for LCOI policies, however, because of other changes that bring the calculations more in line with other products. This will typically result in lower CDA credits, and higher tax liabilities on dividends paid to shareholders, where corporate-owned policies are subject to the new exempt test rules.

POLICY DISPOSITIONS

While the updated ACB calculation negatively impacts the CDA calculation, it has a beneficial effect on the taxation of such policy dispositions as surrenders, withdrawals, and policy loans. In those circumstances, the difference between the proceeds of disposition and the policy's ACB is included in income. With a higher ACB, under the new rules the taxable income on policy dispositions will be correspondingly reduced.

COLLATERAL TERM DEDUCTION

Where a life insurance policy is assigned as collateral for certain loans, a policyholder may deduct the lesser of the policy premium and the NCPI. The basic requirements are as follows:

- The loan must be from a financial institution;
- Interest on the loan must be deductible as an expense incurred to earn investment or business income; and
- The policy owner and borrower must be the same person/entity.

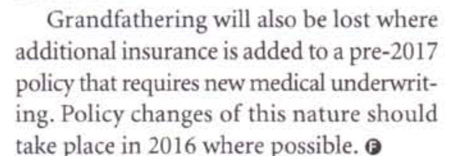
As discussed above, the NCPI for policies issued after 2016 will be lower in most cases, which in turn will reduce the collateral term deduction.

GRANDFATHERING

Clients may benefit significantly from having policies subject to the pre-2017 rules, which will motivate many to take action in 2016. The new rules will apply to policies issued after 2016, but some clarification is still needed as to whether, for example, grandfathering will be available for a policy issued in December 2016 but settled in January 2017. The prudent approach will be to ensure, where possible, that new policies are settled in 2016.

Policies issued prior to 2017 will become subject to the new rules on the happening of certain events. For example, where a pre-2017 term insurance policy is converted to a permanent policy in 2017 or later, the policy will become subject to the new rules. It is therefore critical to ensure that, where appropriate, conversions take place before 2017.

Grandfathering will also be lost where additional insurance is added to a pre-2017 policy that requires new medical underwriting. Policy changes of this nature should take place in 2016 where possible.



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