canada life™

A practical view of the exempt test changes effective 2017

New rules relating to tax treatment of life insurance policies (commonly referred to as exempt test rules) will take effect from 2017 and raises questions about how the changes will impact insurance planning.

Before discussing the impact of the changes, it's worth noting that generally the new rules will apply to policies issued after 2016. Policies issued before 2017 are grandfathered - meaning they will continue to be governed by the tax rules in effect when the policies were issued. However, certain changes to such policies after 2016 will result in the loss of grandfathered status, meaning the new rules would apply.

The purpose of this article is to generally describe the impact of the new rules in simplified language without getting caught into too much technical detail. Hence, the discussion below broadly explores what's changing and how it would impact life insurance policies.

Exempt status of a life insurance policy

To benefit from tax-advantaged growth in policy's savings element or accumulating fund (many times commonly referred to as cash value), the cash value must not exceed limits set by *Income Tax Act*.

To determine whether the cash value exceeds this limit or not, the exempt test compares the cash value of the actual policy to the cash value of a benchmark policy (called the exemption test policy) at every anniversary of the actual policy. If the cash value inside the actual policy never exceeds and is never expected to exceed the cash value of the exemption test policy, the actual policy has exempt status.

When a policy has exempt status, the growth in cash value inside the policy is exempt from annual taxation, for as long as they remain inside the policy.

Changes to the exempt test rules after 2016

In most cases, under the current rules, the premium period for the exemption test policy is 20 years, and the assumed endowment occurs at age 85 – meaning the cash value of the exemption test policy will grow at such a rate that it will be equal to the face value (e.g., death benefit) of the policy at age 85. The interest rates and mortality used in this calculation are the insurer's pricing assumptions.

Under the new rules, the calculation is to be performed based on an eight-pay endowment at age 90 policy using prescribed interest rate and mortality assumptions.

Effect of the changes

1. The reduction in the premium payment period (from 20 years to eight years) means a greater amount can be contributed to the policy earlier under the new rules. For policyowners who wish to contribute premiums more quickly, this is a welcome change. However, some changes to the calculation of the accumulating fund of the actual universal life policy will reduce this favourable outcome.

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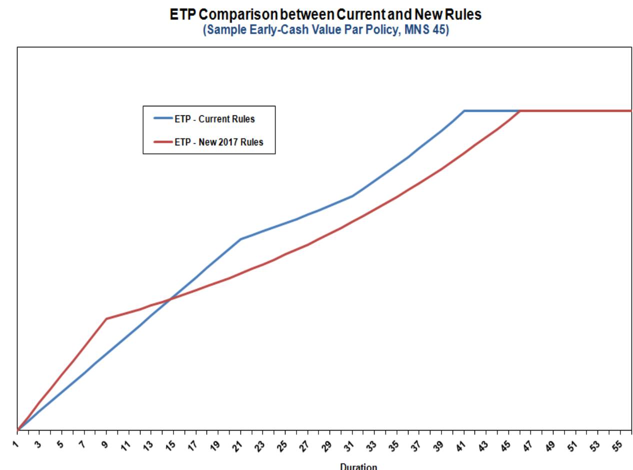
2. Assuming the insurance policy is designed to achieve maximum permissible growth in cash value every year, the increase in endowment age would mean that the tax-advantaged growth in cash value of the policy would be restricted in later years – i.e. more time is required for cash value to be equal to policy's death benefit.

For actual participating life insurance policies, where cash value growth does not closely follow the maximum allowed under the current rules, the impact of new rules may be accordingly less significant.

In summary, under the new rules, a policyowner may be able accumulate more money within the policy over a shorter period of time, but the maximum amount of long-term tax-advantaged savings allowed inside the policy would be restricted. The simplified chart below demonstrates this point.



Net cost of pure insurance

Generally speaking, the net cost of pure insurance (NCPI) is a government-prescribed estimate of the actual cost of insurance protection. The NCPI is independent of the pricing assumptions used by life insurance companies and doesn't represent the actual cost of insurance. However, for income tax purposes it's an important concept.

A life insurance policy is not a capital property, but like many other assets, it also has a cost base – referred to as the adjusted cost basis (ACB). The annual NCPI reduces the ACB of an insurance policy every year, which may be summarized as follows:

- Higher annual NCPI = higher annual reduction in ACB = lower ACB at the end of the year
- Lower annual NCPI = lower annual reduction in ACB = higher ACB at the end of the year

Changes to the NCPI rules after 2016

A simplified version of the formula used to calculate the NCPI under the current rules may be described as follows:

- (Death benefit less **cash surrender value**) x the probability of death at specific issue age and duration since issue.

Under the new rules, the simplified formula changes to:

- (Death benefit less **accumulating fund reserve component**) x the probability of death at specific issue age and duration since issue.

While a discussion of calculating a policy's cash surrender value and accumulating fund reserve component is beyond the scope of this article, the accumulating fund reserve component is generally expected to be greater than the cash surrender value. This means a smaller factor will be used in the above formula to calculate the NCPI after 2016.

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Another change is a newer mortality table – the Canadian Institute of Actuaries 1986–92 mortality tables will be used to determine the probability of death at a specific age.[1] This table, compared to the currently used table (the Canadian Institute of Actuaries 1969–75 mortality table), reflects the improved life expectancy of individuals (e.g., longevity). In other words, for standard rated insureds, this table generally reflects a lower probability of death at specific ages and thus, another lower multiplication factor in the above formula.

Effect of the changes after 2016

In general, the greater deduction from the death benefit (accumulating fund reserve component compared to cash surrender value) coupled with using the lower mortality factors for standard rated insureds in the Canadian Institute of Actuaries 86–92 table, results in a smaller NCPI amount in any given year.

As mentioned above, a lower NCPI would mean a higher policy ACB. It also means that ACB of the policy will exist for a longer period of time.

Another consideration would be the potential tax deduction for a portion of the premium paid on a life insurance policy that is assigned as collateral for a loan. If the interest on the loan is deductible for income tax purposes, a portion of the premium (e.g., the lesser of (i) the premium paid, and (ii) NCPI) relating to the loan balance divided by the death benefit may also be deductible for tax purposes.

Again, a lower NCPI would mean a lower potential collateral insurance deduction for tax purposes.

Adjusted cost basis

The indirect effect to the ACB resulting from the changes in the NCPI calculation is worth exploring.

The ACB of a policy is important in the following two calculations:

1. Determining the taxable policy gain arising on the disposition of a policy (including transfers of ownership, policy loans and partial or full surrenders). The proceeds of the disposition to a policyowner are reduced by the policy's ACB (or proportionate ACB in the case of a partial surrender) to arrive at the taxable policy gain. Only positive policy gains are taxable. If the policy gain is a negative number, it is ignored.
2. The credit to the capital dividend account of a private corporation. For a life insurance policy owned by the corporation, the amount of the policy's death benefit received by the corporation less the ACB of the policy is credited to the corporation's capital dividend account.

Effect of the changes after 2016

A higher ACB would result in a lower taxable policy gain if there is a disposition of the policy. This would be favourable if a policyowner (individual and corporation) was to take a policy loan, partially surrender or fully surrender the policy. This is favourable news if a policyowner plans to access the value of their life insurance policy while the insured is alive.

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[1] The changes require use of these tables for policies issued after 2016 for income tax purposes. It is very unlikely that insurers will determine their product pricing using these tables.

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However, a higher ACB would also mean a smaller credit to the capital dividend account of a private corporation, and consequently a lower amount could be paid as a tax-free capital dividend to Canadian resident shareholders. This is not favourable news for a private corporation planning to maximize its capital dividend account.

Investment income tax

While not technically precise, in general terms the investment income tax (IIT) is a tax the federal government collects from life insurance companies on the growth inside an exempt life insurance policy. Life insurers factor in this expense when determining the insurance premium payable by policyowners.

Currently, IIT is based on the cash surrender value or the prescribed reserve, whichever is greater. For universal life insurance, IIT is only based on the cash surrender value.

From 2017, for universal life insurance, IIT will be based on the cash surrender value or the prescribed reserve, whichever is greater.

The impact for universal life insurance policies is the increased IIT will increase the cost of universal life insurance.

For participating life insurance, the tax will not change.

Calculating maximum premiums

Under the current tax rules, the maximum amount that may be paid into a universal life insurance policy depends upon the cash surrender value of the life insurance policy. The cash value can take into account surrender charges under the policy. Surrender charges reduce the cash surrender value of the policy. In theory, this means higher surrender charges may provide an opportunity to contribute larger amounts to a universal life insurance policy.

Changes to the exempt test rules after 2016

Under the new tax rules, the cash surrender value is to be calculated ignoring the surrender charges and policy loans.

Effect of the changes after 2016

The surrender charges will have no effect on a policy's accumulating fund, which consequently limits the maximum amount that may be paid into a universal life insurance policy.

Impact on life insurance policies

Based on the above discussion, the new tax rules may result in the following changes to life insurance policies:

- Reduction in maximum tax-advantaged growth in the policy over a long term; see the simplified chart above. The impact may be minimal on cash values of participating life insurance policies. For universal life policies this would mean lower maximum cash value.
- Reduction in the additional deposit option for participating life insurance
- Lower NCPI for standard lives, and therefore, a lower collateral insurance deduction
- Generally, higher ACB for standard lives, and for a longer period of time; meaning the policyowner may be able to withdraw more money out of a policy tax free (as a policy loan or surrender); and a lower credit to a private company's capital dividend account

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- A reduction in maximum amount that may be paid as premiums (more impact on universal life insurance policies)
- A potential increase in the cost of insurance due to changes in computing the applicable amount of the IIT (only impacts universal life insurance policies)

Conclusions

These changes create an ideal opportunity to review client situations. Consider the following points:

- Individuals planning to enhance their legacy using universal life insurance may consider buying a policy before 2017 for potentially greater growth in cash values.
- Similarly, for private corporations, buying an insurance policy before 2017 may provide an opportunity to obtain a greater credit to its capital dividend account.
- If a client is more likely to access the cash value through partial surrenders or a policy loan, life insurance policies governed under the new tax rules would have a higher ACB, and consequently, would result in a lower taxable policy gain.
- Due to the change in the way the IIT will be calculated on universal life insurance policies, the cost of insurance is likely to increase.

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