canada life™

Other policyholder taxation changes affecting policies issued after 2016

There are many policyholder taxation changes coming into effect in 2017. Most of the attention surrounding the new rules has been given to the changes affecting the tax-exempt accumulation room and the adjusted cost basis (ACB) of policies issued after 2016.

These are the main changes coming into effect next year, though there are other changes worth highlighting, including:

- The impact of investment income tax (IIT) to universal life insurance cost of insurance rates
- Taxation of partial dispositions applied to policy loans
- Taxation of account value payments in multi-life benefit universal life insurance policies

Impact of IIT

Cost of insurance rates for level cost universal life insurance will generally increase for policies issued after 2016 as a result of the changes to the calculation of IIT.

IIT is charged to the insurer based on the growth inside individual life insurance policies. Insurers generally pass this cost along to policyowners as part of their insurance premiums. Currently, IIT is based on the cash surrender value or the prescribed reserve, whichever is greater. In the case of universal life insurance, most life insurance companies interpreted the formula to mean that IIT is always based on cash surrender value, as there was no way to determine the reserve since the premiums are determined by the policyholder and there are no mortality, interest or lapse assumptions used in that determination. As a result, level cost universal life insurance policies with nominal or no cash value currently do not attract IIT.

The formula for calculating IIT for universal life insurance will change for polices issued after 2016. It will still be based on the cash surrender value or the prescribed reserve, whichever is greater; however, the calculation of the reserve will change. Mortality, interest and lapse assumptions used to determine the cost of insurance rates will now be used to calculate the reserve. As a result, level cost universal life insurance policies will lead to increased IIT costs for insurers, which will be passed along to policyowners.

If cost of insurance rates are changed on level cost universal life insurance policies on the sole basis of passing on the IIT costs to the policyholders, rates would notably increase for younger issue ages and slightly increase for older issue ages.

However, since our pricing will also consider the impacts of other assumptions, such as expenses and interest, as well as competitive positioning, the actual cost of insurance rate changes will differ from this pattern.

Partial dispositions and policy loans

A partial disposition of a life insurance policy would occur when a policyowner:

- Withdraws cash from a policy's account value, in the case of a universal life insurance policy
- Surrenders paid-up additions (PUA), in the case of a participating whole life insurance policy

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- Surrenders the policy's guaranteed cash value, if any, in the case of both universal life insurance and participating whole life insurance policies.

In each case the policyowner is withdrawing cash from the policy. This is a taxable transaction that could result in a policy gain if the proceeds of the disposition arising from the transaction exceed the pro-rated ACB attributed to that amount.

Currently, the proceeds of the disposition are generally equal to the cash withdrawn from the policy less amounts used to repay a policy loan.

The Department of Finance was concerned that an aggressive two-step planning strategy was being used by policyowners to avoid realizing potential policy gains on partial dispositions. The strategy involved taking a policy loan and then repaying it by either surrendering PUAs, withdrawing account value or surrendering guaranteedcash value, as the case may be. Using the internal policy funds to pay down the policy loan reduces the proceeds of the disposition arising from the partial disposition which, as a result, could reduce or eliminate a policy gain that otherwise would be realized on the transaction. To address this type of planning, the federal government amended the definition of "proceeds of the disposition" in the Income Tax Act so that it's no longer reduced by policy loan repayments except in the case where the policy loan was applied to pay a premium under the policy.

This amendment could result in double taxation if the policy loan that was repaid by the partial disposition also gave rise to a policy gain. To prevent this situation a related amendment will increase the ACB of the policy where a partial disposition is used to repay a policy loan and the policy loan was not applied to pay a premium under the policy.

These amendments apply to policies issued after 2016. These amendments do not affect certain internal policy transactions where policy dividends are either applied to pay premiums or to repay a policy loan.

Account value payments on death in multi-life policies.

Generally, at the time of applying for coverage under a universal life insurance policy, certain policyowners have options for facilitating a tax-free payment of the account value to a beneficiary prior to the termination of the policy:

- For joint universal life insurance policies, they may choose to have all or a portion of the policy's account value paid out as a tax-free benefit to a beneficiary on the first death of a life insured under the policy.
- For joint universal life insurance policies, they may use the multiple lives benefit option (a "multi-life policy") that allows up to five additional lives insured on the policy and provides the option of having all or a portion of the policy's account value paid out as a tax-free benefit to a beneficiary on death of each of the multiple lives insured.
- For universal life insurance policies with either single or joint lives insured, they may use the disability lump-sum benefit rider to facilitate all or a portion of the policy's account value to be paid out as a tax-free benefit to a beneficiary in the event a primary or joint life insured becomes disabled under the terms of the rider.

The definition of "disposition" of a life insurance policy in the Income Tax Act supports these policy features as it relates to polices issued before 2017. However, in the case of multi-life policies, the Department of Finance became concerned that these types of policies were chosen over single-life policies as a means of extracting funds tax-free from a policy that otherwise would have been taxable. To address this concern, the federal government added a new provision in the Income Tax Act applicable to multi-life policies issued after 2016 that effectively limits the tax-free benefit to an amount equal to the maximum amount of the account value that could be held in a standalone policy.

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This amendment only applies to multi-life policies issued after 2016. It does not affect the tax treatment of either the account value payout at first death for joint life policies or the disability lump sum benefit payment for polices that have single or joint lives insured.

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