
Life insurance opportunities in 2016

Decisions to make in 2016
before tax changes in 2017

A REPORT FROM CANADA LIFE



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Part 1: Overview of opportunities in 2016

Background

One of the benefits of permanent life insurance is that the money in the policy can grow, exempt from taxes, while inside the policy. To remain exempt from annual taxation, the savings element of the policy must not exceed certain limits, which are set by tax legislation.

The current tax-exempt rules have been in place since 1982. The government has now updated the rules to reflect longer life expectancy and to increase consistency across life insurance companies and products. Bill C-43 updates the 1982 tax law and will go into effect Jan. 1, 2017.

What's changing

Starting Jan. 1, 2017, new tax rules will govern the savings element of life insurance policies. In general, the new rules will reduce the maximum amount of long-term tax-exempt savings allowed inside new policies. Existing policies will generally be grandfathered from the new tax rules. However, some opportunities available in 2016 will no longer be available starting Jan. 1, 2017. Other opportunities may not be as attractive as they are now.

What's not changing

The fundamental reason for buying life insurance will remain: financial protection in case of death. Permanent life insurance will also continue to provide excellent growth opportunities and valuable tax benefits. Insurance companies will continue to offer a range of products with different features to meet different needs.

Decisions to make in 2016

The average policyowner may experience little impact from the new tax rules. For other policyowners, however, there are opportunities to act now and benefit from the tax rules in effect in 2016.

Here is a list of some decisions available in 2016. They are summarized in the following table and discussed in the rest of this report.

Consider buying permanent life insurance in 2016, before the tax rules change, to:

- Increase potential tax deductions when using the policy as collateral for a loan, when the interest is deductible. (If the insured person has health problems, a different strategy may be better, as discussed later in this report.)
- Increase the potential amount of life insurance proceeds that may be distributed tax-free to shareholders of a private corporation.

For universal life insurance in particular, consider buying in 2016 to:

- Increase the amount of money that can be deposited into the policy (maximum funding) on a tax-exempt basis.
- Fund the policy more quickly.
- Reduce the cost of insurance.

For existing policies, consider making the following changes in 2016, so the policy will remain grandfathered from the new tax rules:

- Convert temporary insurance to permanent insurance.
- Add benefits or riders that require underwriting.
- Increase coverage that requires underwriting.

For retirement planning:

- To reduce taxes when withdrawing money from the policy to supplement retirement income: Consider buying temporary life insurance in 2016, to guarantee insurability, then converting to permanent insurance later, to reduce taxes on withdrawals.
- To potentially increase tax-free payments from a prescribed annuity: Consider buying it in 2016.

Taking these actions in 2016 could have a significantly different effect from taking the same actions in 2017. The timing can have a large impact on taxes, net worth and legacy. The actual impact depends on the type of policy, the insurance company's specific product, the insured person's age, the payment plan and other factors.

Opportunity: Policyowners should ask their advisors how the new tax rules affect their financial situation. They should decide what actions to take in 2016, before the new tax rules go into effect Jan 1, 2017. They should make sure these actions are completed before the end of 2016.

Table 1: Summary of life insurance opportunities in 2016

This table identifies life insurance opportunities in 2016 that are relevant to specific goals. For more technical details, see the discussion in part 2 of this report.

Goal	Increase tax-exempt savings inside policy
Changes in 2017	For life insurance policies issued in 2017 or later, the ceiling on tax-exempt savings will be lower in later years. However, for participating life insurance policies, the cash value pattern may be quite similar to today's products. For universal life insurance policies issued in 2017 or later, there will be less room for tax-exempt savings, lower maximum deposits and higher costs of insurance.
Opportunities in 2016	For universal life insurance, consider buying now to get the potential for more tax-exempt savings.
Goal	Reduce taxes on withdrawals
Changes in 2017	For policies issued in 2017 or later, the taxable portion of withdrawals and policy loans will generally be smaller.
Opportunities in 2016	First, consider buying term life insurance now, to lock in insurability. Then in 2017 or later, convert to permanent life insurance, to reduce taxes on withdrawals.
Goal	Increase tax deductions when policy is collateral for a loan
Changes in 2017	If interest on the loan is tax-deductible, then part of the premium can be deductible. For policies issued in 2017 or later, the potential deduction will generally be smaller.
Opportunities in 2016	Consider buying now to get the potential for larger deductions.
Goal	Receive tax-free payments from prescribed annuities
Changes in 2017	A portion of the annuity payment is considered a tax-free return of capital. For most prescribed annuities bought in 2017 or later, the tax-free portion may be smaller.
Opportunities in 2016	Consider buying prescribed annuities now, because more of the annuity payment may be tax-free.

<p style="text-align: center;">Goal</p> <p style="text-align: center;">Changes in 2017</p> <p style="text-align: center;">Opportunities in 2016</p>	<p>Distribute tax-free dividends to shareholders</p> <p>When a private corporation owns life insurance, it may be able to distribute some of the proceeds to shareholders as tax-free dividends. For policies issued in 2017 or later, the amount available to distribute as tax-free dividends will generally be smaller.</p> <p>Consider buying now to get the potential for larger tax-free dividends.</p>
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<p style="text-align: center;">Goal</p> <p style="text-align: center;">Changes in 2017</p> <p style="text-align: center;">Opportunities in 2016</p>	<p>Convert a term policy into a permanent policy</p> <p>The new permanent policy will be subject to the new rules. This will reduce the room for long-term tax-exempt savings inside the policy.</p> <p>Original age conversion: Term policies issued before the end of 2016 will no longer be able to convert to participating life insurance at the insured person's original age.</p> <p>Consider converting now. The permanent policy will be grandfathered from the new rules. You do not lose room for tax-exempt savings inside the policy.</p> <p>Original age conversion: If the term policy allows this, consider converting now. The permanent policy will have the cash value and policy dividends that would have accumulated if the policy had originally been a participating policy.</p>
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<p style="text-align: center;">Goal</p> <p style="text-align: center;">Changes in 2017</p> <p style="text-align: center;">Opportunities in 2016</p>	<p>Make changes to an existing policy</p> <p>Policies issued before the end of 2016 will be grandfathered from the new rules. However, some policy changes will trigger the loss of grandfathered status. This may reduce the room for tax-exempt savings inside the policy.</p> <p>Consider making these changes now, to not lose grandfathered status. For example:</p> <ul style="list-style-type: none"> • Add benefits and riders that require underwriting. • Increase coverage that requires underwriting.
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Part 2: Technical discussion of tax changes in 2017

Changes to the exempt test

The 2017 tax rules will change the exempt test. This test determines whether a policy has exempt status. When a policy has exempt status, the savings inside the policy are exempt from annual taxation, for as long as they remain inside the policy.

Every year, the exempt test compares a policy's savings element with the savings element of a theoretical benchmark policy. If the savings inside the actual policy will not exceed the savings inside the benchmark policy, then the actual policy is exempt.

A key concept here is the tax-exempt limit. This is the maximum savings allowed inside a policy at a given point in time, before it would lose its exempt status. It is equal to the savings element inside the benchmark policy at that same point in time.

A note about legal terminology: In tax laws and rules, the benchmark policy against which the actual policy is tested is called the exemption test policy (ETP). The savings element inside an actual or benchmark policy is called the accumulating fund (AF).

The 2017 tax rules will change the benchmark policy in three key ways.

- Change the assumed payment period from 20 years to eight years.
- Change the age when the savings inside the policy are equal to the death benefit. This is the endowment age. For most issue ages, the endowment age will change from age 85 to age 90.
- Specify the assumptions to use for mortality and interest rate, when calculating the savings inside actual and benchmark policies.

As the chart on this page illustrates, these changes will generally increase the tax-exempt limit in the early years and reduce it in later years.

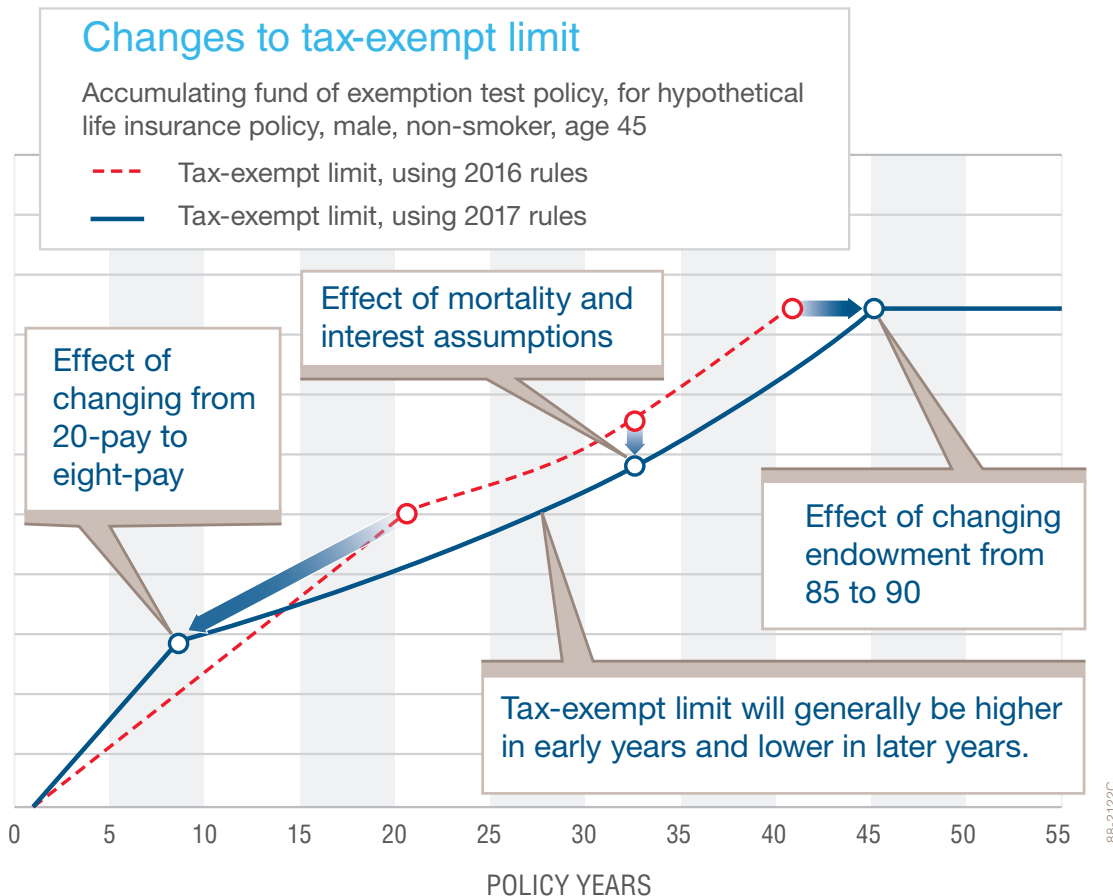
Other changes to the exempt test include:

- All types of life insurance will have the same tax-exempt limit. Currently the tax-exempt limit varies by product type.

- Savings inside the actual policy will be calculated differently, for exempt-test purposes. For example, the savings element includes a reserve component. Starting in 2017, the reserve will use the mortality and interest assumptions prescribed for the benchmark policy. This will generally increase the actual policy's savings element, for exempt-test purposes.

While the exempt-test changes are significant, it's important to keep them in perspective.

- For example, most owners of universal life insurance policies do not deposit the maximum possible into their policies. The new tax-exempt limit may not affect them.
- In addition, the exempt test's calculation of the savings inside actual policies will depend on many factors. These include the type of policy, the insurance company's specific product, the insured person's age, the premium payment period and other factors.



Grandfathering

A policy issued before the end of 2016 will be grandfathered from the new rules. It will remain subject to the rules in effect when issued. However, a policy will lose grandfathered status if certain changes are made to it in 2017 or later.

If a policy were to lose its grandfathered status, it would become subject to the new tax rules. It could lose significant tax advantages. It could even lose its exempt status.

- The policyowner could have taxable income from past growth. There would be a deemed disposition of the policy, equal to the policy's savings element, minus its adjusted cost basis.
- The policyowner could have taxable income from future growth. This would equal the increase in the savings element, minus premiums paid for life insurance, plus the net cost of pure insurance in that policy year.

These changes will trigger loss of grandfathered status, if done in 2017 or later:

- Increasing coverage, if underwriting is required.
- Substituting an insured person.
- Adding certain benefits or riders.
- For participating life insurance, adding an additional deposit option.
- Converting term coverage to permanent coverage, in the same policy.
- For policies issued before Dec. 2, 1982, conducting an arm's length transfer of ownership.

Opportunity: Policyowners should consider making certain policy changes before the end of 2016, to avoid loss of grandfathered status.

These changes are not expected to trigger loss of grandfathered status, whether done in 2016, 2017 or later:

- Changing from smoker to non-smoker, with no increase in death benefit.
- Changing to a more favourable risk rating (for example, from substandard risk to standard risk), with no increase in death benefit.
- Decreasing coverage or deleting benefits.
- Adding an accidental death benefit or waiver of premium.
- Reinstating the policy.
- For universal life insurance, changing the cost of insurance (COI) option, if no underwriting is required.
- Exercising a non-forfeiture provision known as reduced paid-up, with no increase in risk.
- Converting term coverage to a new policy. The original policy will not lose grandfathered status. However, the new policy will be subject to the new rules.
- For participating life insurance, changing the dividend option from cash or accumulating to enhanced or paid-up additions – provided accumulated dividends are not used to buy paid-up additions.
- Transferring ownership of policies issued after 1982.

Table 2: Details of life insurance tax changes in 2017

This table summarizes some of the technical details of the tax changes in 2017.

Policies issued before the end of 2016 will be grandfathered from the new tax rules.

Exemption test policy (ETP)	
	This is a theoretical benchmark policy, used in the exempt test. A policy is exempt if its savings element will never exceed the savings element of the exemption test policy.
Status in 2016	The exemption test policy is based on a 20-pay policy with endowment at age 85. For interest rates and mortality, it uses the insurance company's pricing assumptions.
Changes in 2017	The exemption test policy will be based on an eight-pay policy with endowment at age 90. It will use a 3.5 per cent interest rate. For mortality, it will use the appropriate Canadian Institute of Actuaries 1986-1992 (CIA 86-92) table. This will generally reduce average mortality rates.
Impact	The tax-exempt limit will be higher in earlier years and lower in later years.
Accumulating fund (AF)	
	This is the legal term for the savings element of a life insurance policy. A policy is exempt if its accumulating fund will never exceed the accumulating fund of the exemption test policy.
Status in 2016	The accumulating fund equals the cash surrender value, or a prescribed reserve, whichever is greater. Policy loans are ignored. For universal life insurance, where no reserve is calculated, the cash surrender value is the accumulating fund. Surrender charges reduce the actual policy's accumulating fund, for exempt-test purposes. So surrender charges create room for additional deposits and tax-exempt growth.
Changes in 2017	For universal life insurance, a reserve will be calculated. This may be greater than the actual cash value of minimum-funded universal life insurance policies. Surrender charges will not be subtracted when calculating the accumulating fund. So surrender charges will no longer create room for additional deposits or tax-exempt growth.
Impact	For universal life insurance, the actual policy's accumulating fund will be higher, for exempt-test purposes. <ul style="list-style-type: none"> • This will reduce the room available for additional deposits or tax-exempt growth. • Pay periods of less than eight years within the policy will no longer be possible. • Maximum deposit amounts will be lower. How much lower will depend upon how long the policyowner wants to pay the maximum premium.

Net cost of pure insurance (NCPI)

The NCPI is an estimate of the pure cost of the death benefit. The calculation is prescribed by law. It equals the net amount at risk, times the mortality rate. NCPI is used to calculate a policy's adjusted cost basis.

NCPI is also used to calculate the potential tax deduction if a policy is collateral for a bank loan or line of credit. If interest on the loan is deductible, then part of the premium can be deductible. The deductible amount is either the premiums paid or the NCPI, whichever is less, multiplied by the outstanding loan, divided by the death benefit.

Status in 2016

Mortality rates for the NCPI calculation are based on the CIA 1969-75 tables.

Net amount at risk equals the death benefit, minus the accumulating fund or cash surrender value.

For rated coverages, NCPI uses standard mortality rates.

Changes in 2017

Mortality rates will be based on the CIA 86-92 tables. This will reduce the mortality rate for most ages, assuming a standard rating.

For tax purposes, the net amount at risk will equal the death benefit, minus the reserve component of the accumulating fund for each coverage. For universal life insurance, this will reduce the net amount at risk and the NCPI.

For rated coverages, NCPI and the reserve will use substandard mortality rates.

Impact

For most policies, NCPI will be lower. This will cause the adjusted cost basis to decrease more slowly. It will also reduce potential deductions for collateral loans.

For rated coverages, on the other hand, NCPI may increase. This will reduce the adjusted cost basis faster. Notably, it may increase potential deductions for collateral loans.

Adjusted cost basis (ACB)

This is the value of premiums paid into the policy that have not yet been used to pay for the net cost of pure insurance (NCPI). Surrenders and withdrawals in excess of the pro-rated adjusted cost basis are taxable.

The adjusted cost basis is increased by premiums paid, excluding premiums for non-life insurance riders or subsidiary benefits. It is reduced by the NCPI each Dec. 31. As NCPI increases over time, the adjusted cost basis tends to reduce to zero.

For policies owned by private corporations, proceeds from the death benefit, minus the adjusted cost basis, are credited to the corporation's capital dividend account (CDA). Money in this account can be distributed to shareholders as tax-free dividends.

Status in 2016

For rated coverages, the adjusted cost basis does not include the extra premiums due to substandard ratings.

Changes in 2017

For most policies, NCPI will be lower. This will cause the adjusted cost basis to decrease more slowly. As a result, the adjusted cost basis will be higher in most years and take longer to reduce to zero.

For rated coverages, the NCPI will include the extra premiums due to substandard ratings. This will cause the adjusted cost basis to decrease faster.

Impact

If the policyowner wants to take cash value out of the policy, the higher adjusted cost basis will be beneficial. It will reduce the taxable portion of partial and full surrenders and policy loans.

For corporately owned policies, the higher adjusted cost basis will not be beneficial. It will reduce the credit to the capital dividend account, and so reduce the potential for tax-free shareholder dividends.

Eight per cent test

Growth in death benefit in excess of eight per cent does not create additional room for tax-exempt savings.

Status in 2016

The test applies to the total of the policy's death benefits.

Changes in 2017

There will be two eight per cent tests. One test will apply to each insured person's death benefit. The other test will apply to the total death benefit of the policy, including the fund value, if any.

Impact

For policies covering multiple insured people, the maximum death benefit for each insured person will be the amount they could get with a single-life policy.

250 per cent test

This test begins in policy year 10. The accumulating fund must not have grown more than 250 per cent, compared to three years earlier.

If the policy fails the test, corrective action to withdraw cash value can be taken within 60 days of the policy anniversary. If no corrective action is taken, the exemption test policy is reset. This results in either the loss of exempt status or a significant reduction in the exempt room, depending on the product.

Status in 2016

This can be a problem for universal life insurance policies that are minimum-funded through year 7 or beyond. If the policyowner then decides to fund at a higher level, the exemption test policy will be reset and future growth limited.

Changes in 2017

To address this problem, a second step will be introduced. The policy will pass this step if its accumulating fund does not exceed three-eighths of the exemption test policy's accumulating fund. If the policy passes either step, it will pass the 250 per cent test.

Impact

Fewer universal life insurance policies will need to have money withdrawn or their exemption test policies reset.

Investment income tax (IIT)

Investment income tax is charged to the insurance company based on the growth inside policies. The cost is passed along to policyowners.

Status in 2016

For life insurance, this tax is based on the cash surrender value or the prescribed reserve, whichever is greater. For universal life insurance, this tax is always based on the cash surrender value.

Changes in 2017

For universal life insurance, this tax will be based on the cash surrender value or the prescribed reserve, whichever is greater. For participating life insurance, the tax will not change.

Impact

For universal life insurance policies, this tax will increase. This will increase the cost of universal life insurance.

Original age conversion

If a term policy offers this benefit, it can be converted to a participating life insurance product at the insured person's original age, as a continuation of the same policy.

The policy gets credit for the cash value and dividends it would have received if it had been a participating product all along. The participating product must have been available when the term policy was issued. As part of the conversion, the policyowner pays the additional premiums that would have been payable earlier for the participating product, with interest.

Status in 2016

Contractual original age conversions can still be completed in 2016.

Changes in 2017

Term policies issued before the end of 2016 will no longer be able to convert at original age. This is because the participating products available when the policy was issued will no longer be available.

Term policies issued in 2017 or later will be able to offer original age conversion to participating products available at that time.

Impact

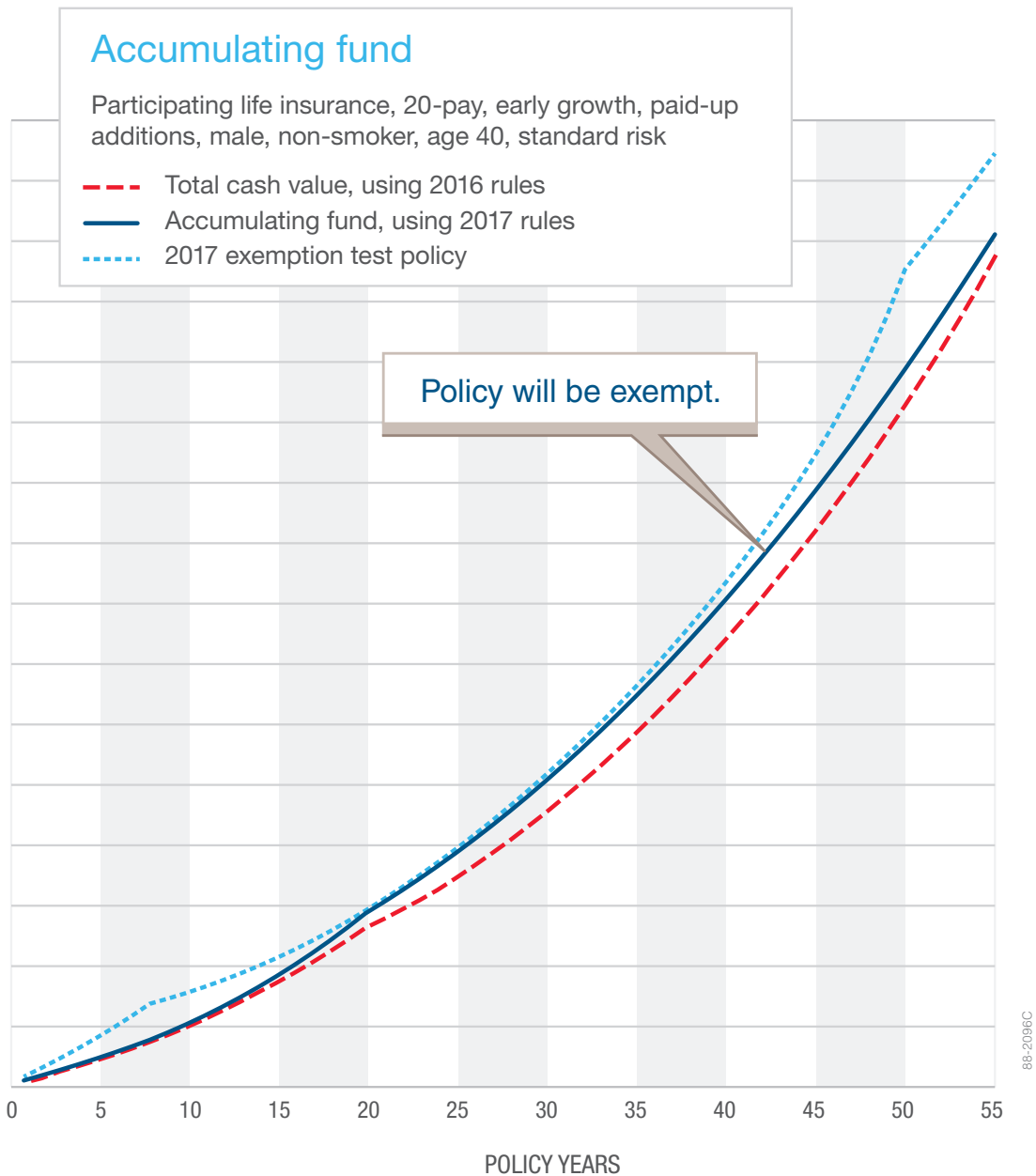
Term policies issued before the end of 2016 must complete original age conversion before the end of 2016.

Part 3: Examples of impact of tax changes in 2017

Use these examples to understand the potential impact of the 2017 tax changes in a variety of situations.

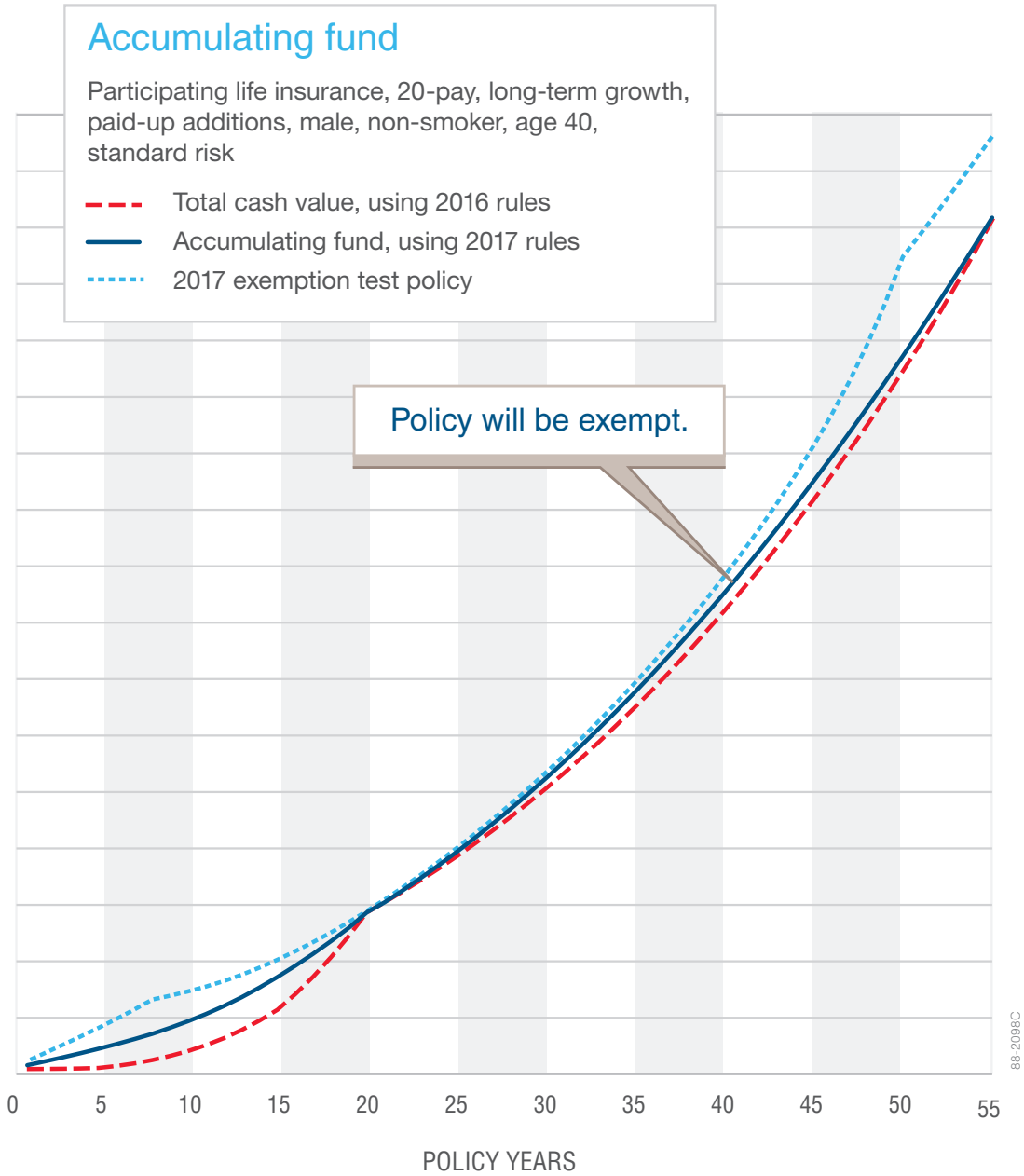
Example 1: Participating life insurance with early growth

For tax-advantaged growth, there may be little practical difference between buying in 2016 or 2017.



Example 2: Participating life insurance with long-term growth

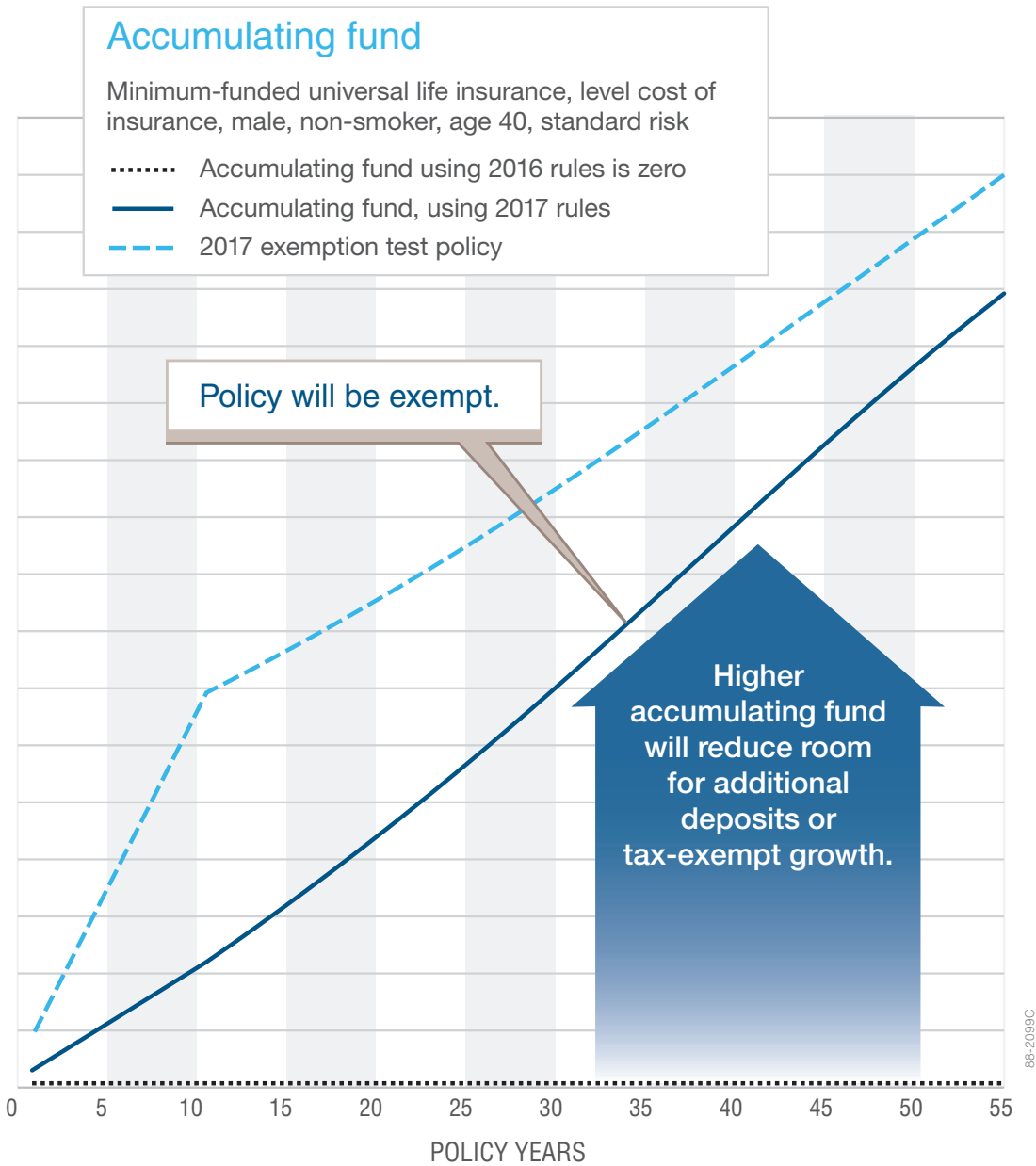
For tax-advantaged growth, there may be little practical difference between buying in 2016 or 2017.



Example 3: Minimum-funded universal life insurance

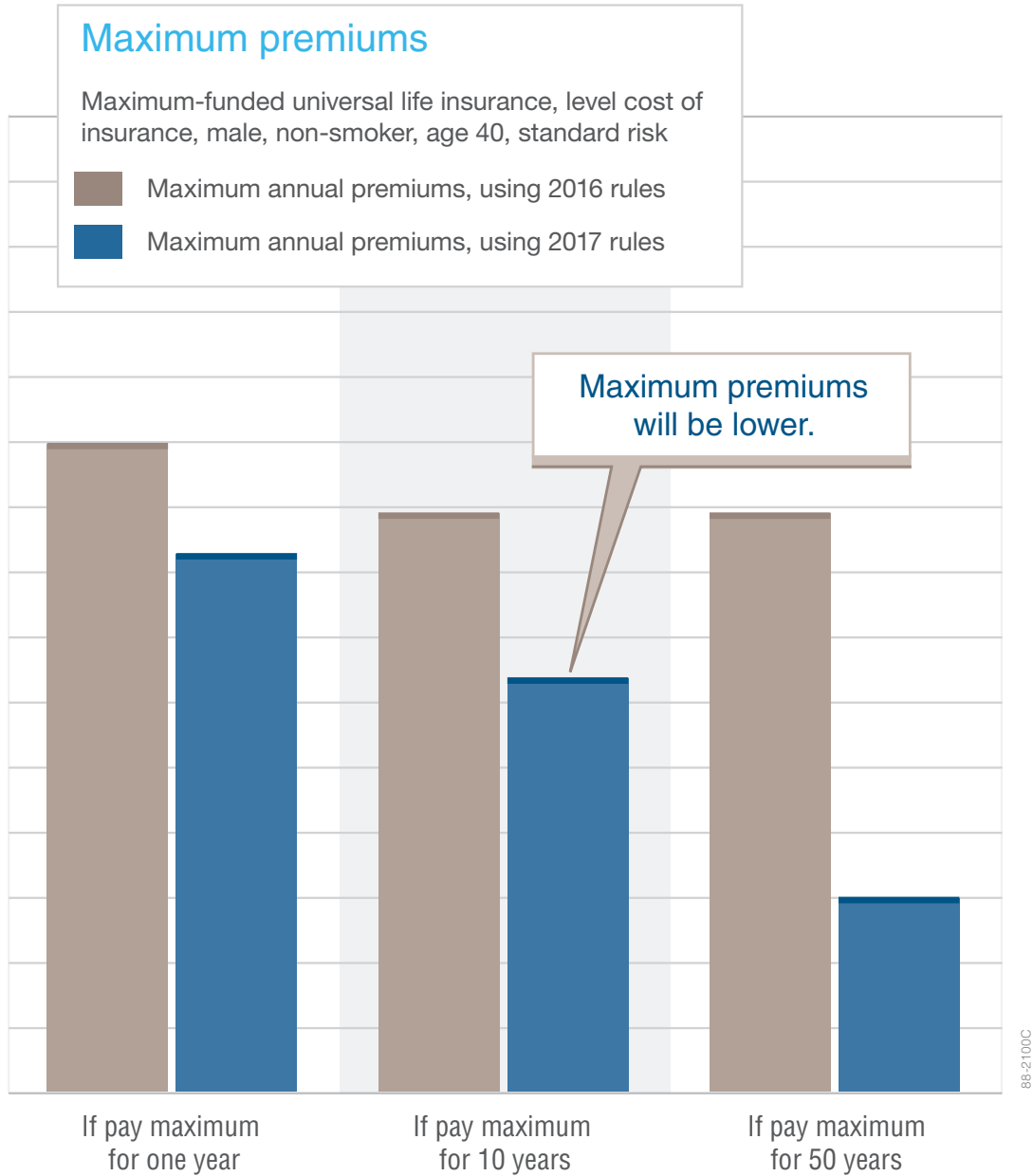
Minimum-funded universal life insurance policies will be exempt.

The accumulating fund will be larger, for tax-exempt purposes. This will leave less room for additional deposits or tax-exempt growth.



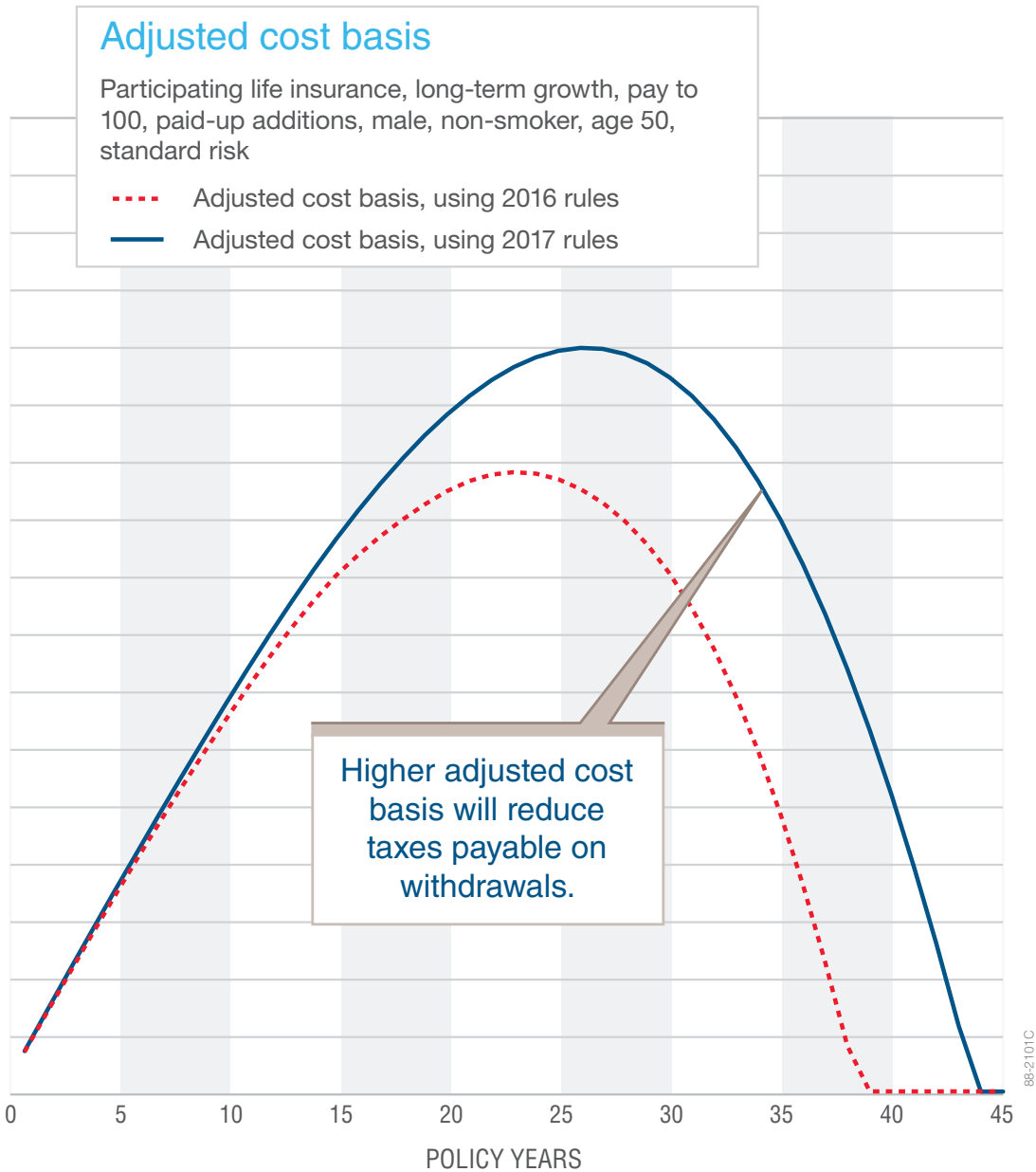
Example 4: Maximum-funded universal life insurance

For universal life insurance policies issued in 2017 or later, maximum premiums will be lower. This is because the policies' accumulating funds will be higher, for tax-exempt purposes.



Example 5: Reduced taxes on withdrawals

Withdrawals in excess of the adjusted cost basis are taxable income. For policies issued in 2017 or later, the adjusted cost basis will be higher. This will reduce taxes payable on withdrawals, including partial and full surrenders and policy loans.



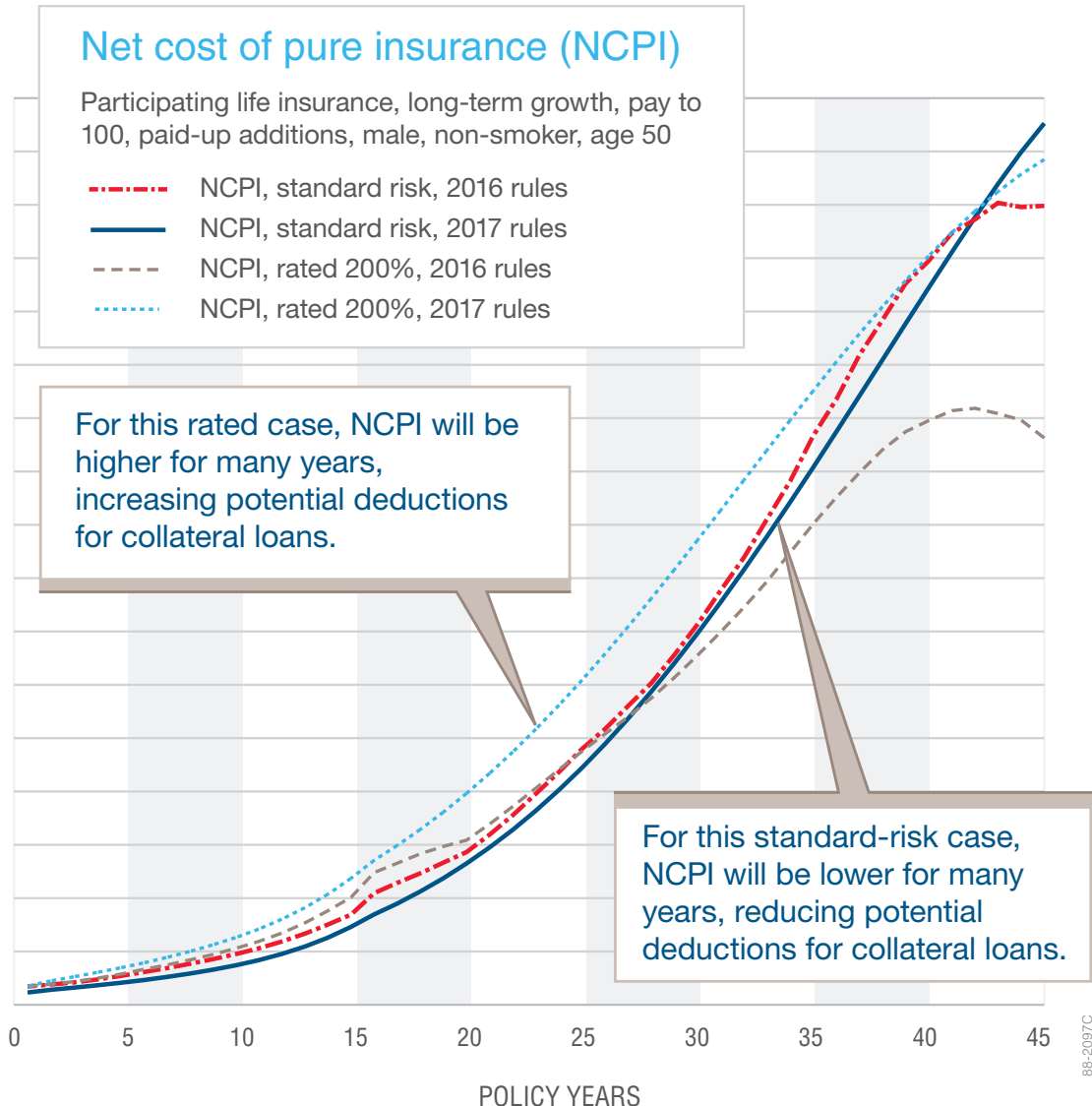
Example 6: Tax deductions for collateral loans

If a policy is assigned as collateral for a bank loan or line of credit, and interest on the loan is deductible, then there is a potential tax deduction related to the policy. The potential tax deduction is equal to the premium payable, or the net cost of pure insurance (NCPI), whichever is less, multiplied by the ratio of the loan balance to the death benefit.

Example of NCPI for policy with long-term growth

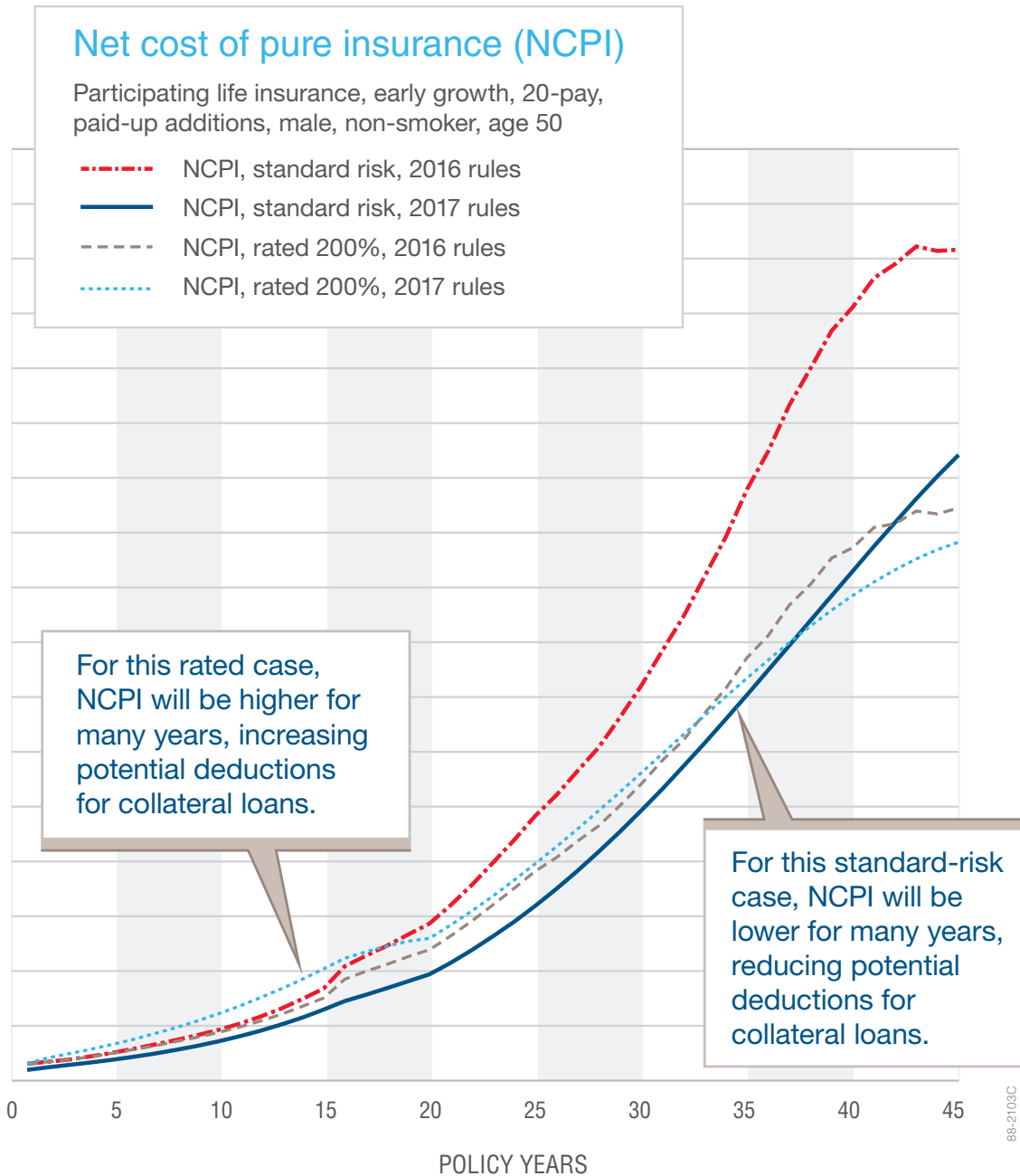
For many policies issued in 2017 or later, the NCPI will be lower for many years. This may reduce the potential tax deductions in those years for policies assigned as collateral for a loan.

However, if the coverage is rated a higher-than-standard risk, the NCPI may be higher for many years. This can increase the potential tax deduction in those years for policies assigned as collateral for a loan.



Example of NCPI for policy with early growth

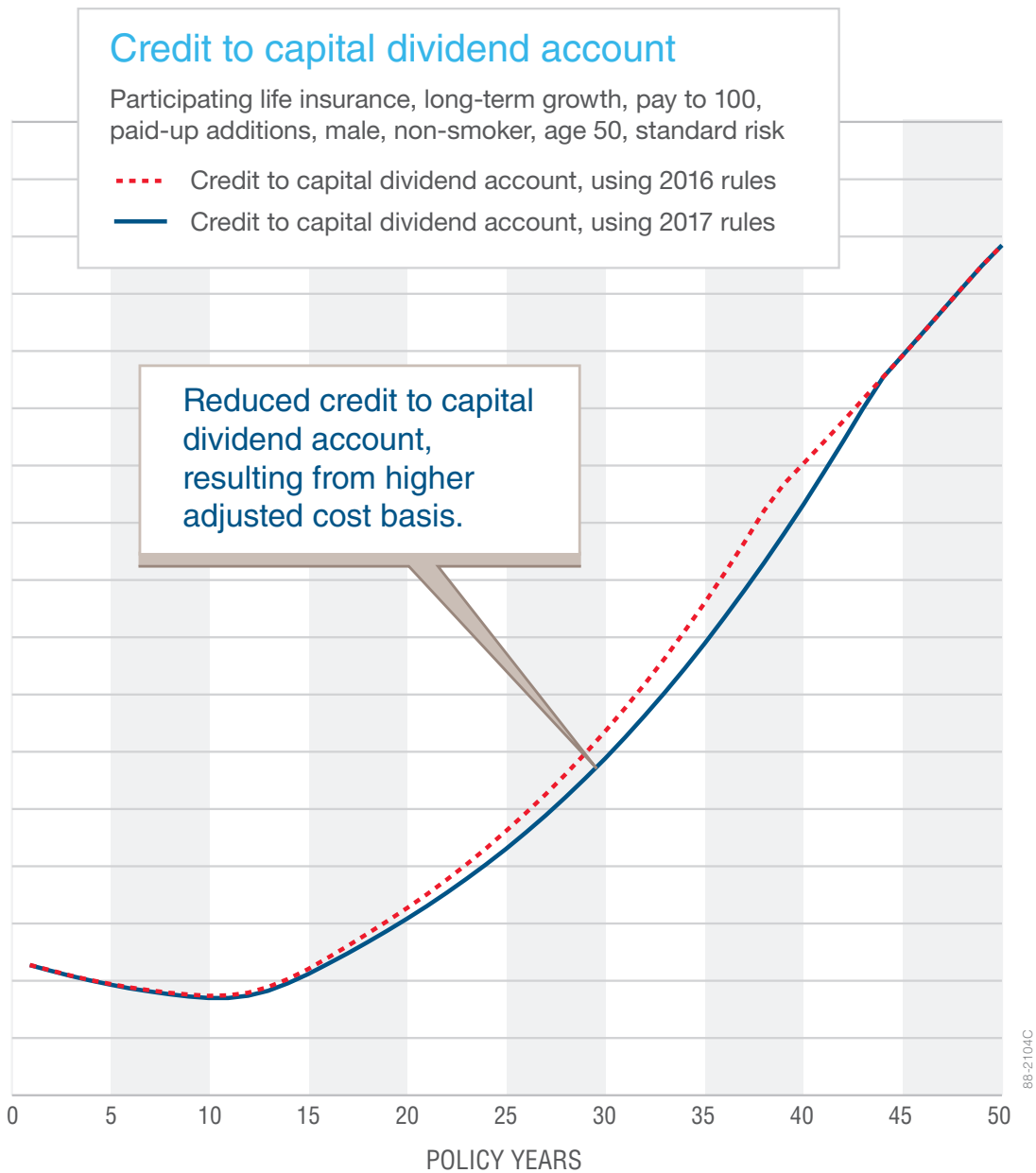
The change in NCPI will be different for an early-value participating product versus a delayed-value participating product. But generally, the NCPI will be lower than today for a standard policy and has the potential to be higher than today for a rated policy.



Example 7: Tax-free capital dividends to shareholders

For policies owned by private Canadian corporations, the proceeds from the death benefit, minus the adjusted cost basis, can be credited to the corporation's capital dividend account (CDA). To the extent of the capital dividend account balance, tax-free capital dividends can be distributed to shareholders.

For policies issued in 2017 or later, the adjusted cost basis will be higher. This will reduce the credit to the capital dividend account, and so reduce the amount that can be distributed to shareholders as tax-free capital dividends.



Appendix

Important considerations

The examples in this report are for illustrative purposes only. Different policies and scenarios may not vary from old to new in the same proportions. Situations will vary according to specific circumstances. An exempt life insurance policy is defined in regulations 306 and 307 of the Income Tax Act. Generally, the Income Tax Act provides that the savings element of the policy is exempt from annual accrual taxation, provided certain conditions, as set out in the regulation, are met. The information provided is based on current tax legislation and interpretations for Canadian residents and is accurate to the best of our knowledge as of the date of publication. Future changes to tax legislation and interpretations may affect this information.

For more information

For more information about the topic of this report and how it may apply to your situation, contact your advisor, lawyer or accountant. You can contact Canada Life at canadalife.com.

About Canada Life

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