

QUICK REFERENCE GUIDE

LIFE INSURANCE TAX REFORM

EFFECTIVE ON JANUARY 1, 2017

Background

Starting on January 1, 2017, new income tax rules will reduce the amount that can be placed tax-free by Canadian taxpayers into some life insurance policies. The changes will have an impact on both prescribed annuities and life insurance products.

Objectives of this tax reform:

- To reflect current mortality and interest rates
- To adapt the rules to Universal Life products
- To standardize tax calculations
- To correct undesirable tax inconsistencies

The new rules will ensure a more standardized tax treatment for universal life insurance products for all Canadian insurance companies.

Key tax changes

1. EXEMPT TEST

Main changes

- Updated Exempt Test Policy (ETP) parameters
- Creation of a new prescribed reserve (net premiums reserve)
- Exclusion of surrender fees from the Accumulated Fund
- Integration of substandard ratings in ETP and Accumulated Fund
- Application of the 8% rule at the coverage level (not per policy)
- Loosening up of the 250% test (this also applies to pre-2017 contracts)

Impacts on products

Universal Life:

- T100 / Whole Life: Less saving room, due to the reserve
- Elimination of the "Single Premium" on UL policies
- Term 1 and Term 1 savings maximizers: Minor impact
- Fewer 250% test failures

Traditional Life:

- A 10-Pay will pass the exempt test more easily (the new ETP is an 8-pay)



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2. ADJUSTED COST BASIS (ACB)

Main changes

- Substandard rating amounts included with the premiums paid in the Adjusted Cost Basis (ACB) calculation
- Substandard ratings taken into account in Net Cost of Pure Insurance (NCPI) calculations
- New updated mortality table for NCPI calculations
- New Net Amount At Risk definition for NCPI calculation
- Impact on ACB when death benefit is paid on multi-life policies and for the savings fund payable upon the first death for joint-last-to-die policies
- The disposition will be taxable if the savings fund paid upon the first death on a multi-life contract exceeds the maximum tax room of the deceased insured

Impacts

- **The ACB will generally be higher**; the tax impact on surrender will generally be lower
- **The NCPI will generally be lower** (unless rated); if the policy is used as collateral for a loan with tax-deductible interest payments, the deductible premium amount may be lower
- **If the beneficiary is a corporation**, the amount included in the Capital Dividend Account (CDA) upon the death of the insured could be lower (if the ACB is higher)
- Upon death, only the fund attributable to the insured (coverage) will be tax-exempt; any excess will result in a taxable disposition, **making multi-life policies less attractive**

3. PRESCRIBED ANNUITY CONTRACTS

Main changes

- New mortality table reflecting longer life expectancies
- Substandard risks are taken into consideration
- Pre-2017 annuities will be grandfathered

Impacts on products

- Increases the taxable amount of the annuity, as the capital is spread out over a longer period (except for substandard risks)

4. GRANDFATHERING OF PRE-2017 POLICIES

- The tax-exempt nature of life insurance policies is a valuable commodity that can be compromised if the grandfathering status is lost.
- **The old tax rules will continue to apply to policies issued before 2017.**

Grandfathering status will be lost if:

- A medically underwritten life insured is added
- The face amount is increased (if medically underwritten)
- Policy/coverage is converted
- Policy/coverage is replaced

Grandfathering status will NOT be lost if:

- A status is changed from smoker to non-smoker
- A face amount decreases
- Coverage is terminated
- A substandard rating is revised
- A policy is reinstated
- A leveling clause for insurance costs is exercised
- The face amount is indexed under a contract provision

After January 1, 2017, requests for coverage to be added to pre-2017 life insurance policies will cause a new **policy to be issued**, which will be subject to the new tax rules.

Immediate business opportunities

The old tax rules will apply to all **policies issued and delivered before January 1, 2017.**



PRODUCT SALES TO PROMOTE IN 2016

FOR INDIVIDUALS AND CORPORATIONS

Universal life insurance with a large savings component

It makes sense for clients to buy this product before the end of 2016, since there will be more tax room than for contracts issued starting January 1, 2017.

Universal life insurance with accelerated payments

For life insurance policies issued starting January 1, 2017, the accumulated funds will be based on the higher of the cash surrender value of the policy (surrender fees should not be considered) and the net premium reserve.

This new rule will eliminate single premiums and premiums payable in less than 8 years.

Multi-life policies (universal life with savings)

This product should be sold prior to January 1, 2017 because:

- There will be a limit to how much can be paid-out tax-free on the first death
- There will be a change to how the ACB is calculated after the first death

If the policy is used as collateral for a loan with tax-deductible interest payments

As the NCPI will generally be lower for contracts sold starting January 1, 2017 (unless they are rated), the deductible amount of premiums could be lower, so it makes sense to sell these in 2016.



PRODUCT SALES TO PROMOTE IN 2016

FOR CORPORATIONS ONLY

If the beneficiary is a corporation

The amount in the Capital Dividend Account (CDA) that can be withdrawn tax-free upon the death of the insured will generally be lower for contracts issued after 2017.



CONVERTING OR MODIFYING A PRE-2017 POLICY

Certain types of changes cannot be made to policies issued prior to 2017 if they are to **remain subject to the current tax regime**. So it makes sense to make the following changes before the January 1, 2017 deadline:

- Convert **term life insurance to permanent life insurance**
- **Add new term life insurance coverage** with a premium schedule or distinct fees (if medically underwritten)
- **Exercise a Guaranteed Insurability Option for an existing contract**
- **Substitute an insured**
- **Replace life insurance coverage** with another type of coverage with a lower premium
- **Add a new life insured (if medically underwritten)**
- **Increase the death benefit (if medically underwritten)**
- **Make any type of change** to a pre-2017 policy that **will require a new contract to be established** after December 31, 2016



PROMOTE THE SALE OF ANNUITY CONTRACTS IN 2016

- **Prescribed annuity**

The taxable amount of the annuity will increase in 2017 (except for some substandard risks).

- **Insured annuity concept**

Due to the increase to the taxable interest portion of prescribed annuities, an insured annuity concept may provide better results (net return) under the current tax rules



FOR SOME POLICIES, IT MAY BE BETTER TO DELAY THE CONVERSION OR CHANGES TO PERMANENT LIFE INSURANCE COVERAGE UNTIL AFTER JANUARY 1, 2017

Conversions and changes to permanent life insurance coverage **may be better after January 1, 2017 for some rated contracts** used as collateral for a loan.

SUMMARY

- **These changes won't affect pre-2017 policies** (exception: 250% rule – the change also applies to in-force policies), unless a change occurs to the grandfathered status.
- **Life insurance products and systems will have to be updated** to bring them into line with the new rules that will take force on January 1, 2017.
- Ultimately, **the tax impacts will be minimal for most products and most insureds**. The new tax room (ETP), while reduced, is more than sufficient for most clients.

Questions?

If you have any questions about the new tax rules, their impacts or the opportunities they open up for you, please contact your **Regional Sales Director**.