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WESTWARD ADVISORS

2012 FEDERAL BUDGET PROPOSES
EXEMPT POLICY CHANGES

THE ISSUE

On March 29, 2012, the Federal Budget announced that the life insurance policy exemption test in the *Income Tax Act* (the "Act") will be overhauled and will apply to policies issued after 2013.

The "exemption test" establishes the maximum amount of money that can be deposited to a life insurance policy in any given year while retaining the policy's tax exempt status under the Act.

The Budget proposes six technical amendments to the exemption test:

1. Assume death occurs no later than age 90 versus age 85;
2. Assume an interest rate of 3.5% versus 4.0%;
3. Assume a reduced mortality rate;
4. Assume a premium payment period of 8 years versus 20 years;
5. Ignore surrender charges; and
6. Include level cost insurance reserves.

The Budget also proposes to "recalibrate" the investment income tax ("IIT") payable by insurers to *"neutralize the impacts of the proposed technical improvements on the IIT base."*

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WESTWARD'S POSITION

Tax Exempt Life Insurance is Alive and Well

The Conference for Advanced Life Underwriting ("CALU") first approached the Department of Finance suggesting changes to the exemption test formula in 1998, and then again in 2009*. **The Budget proposals reflect many of the CALU recommendations** to Finance designed to address inequities caused by the evolution of life insurance products and the improvement in mortality rates since the exemption test formula was created in the early 1980's. Consequently, the Budget proposals are not an attack on the tax advantages afforded life insurance policies under the Act. Quite to the contrary, the Budget proposals reaffirm the government's commitment as a matter of tax policy to support tax exempt life insurance.

Impact of Amendments on Deposit Room

The impact of the six exemption test formula amendments on the amount of money that can be deposited to tax exempt life insurance policies can be summarized as follows:

1. Items 1 to 4 represent small impacts, both favourable and unfavourable, that probably cancel each other out to result in a **nominal overall impact** on policy deposit room.
2. Ignoring surrender charges (Item 5) **reduces policy deposit room on policies with surrender charges** and closes a loop-hole that otherwise enables single-pay or near single-pay tax exempt life insurance policies.
3. Including level cost insurance reserves (Item 6) **reduces policy deposit room on level cost insurance policies**.

The actual impact of the exemption test changes will probably not be known until late 2012. Finance needs to consult with the life insurance industry before releasing specific changes to the exemption test formula.

Transition Date

The proposals will affect life insurance policies issued after 2013. The life insurance industry is already concerned that there is insufficient time to implement systems changes to accommodate the new exemption test formula. They will lobby the government for an extension to the transition date.

Grandfathering Life Insurance Tax Changes Reaffirmed

Once again, tax changes affecting life insurance policies will grandfather existing life insurance policies. The grandfathering concept is important as a matter of tax policy because life insurance policies are acquired as long term financial risk protection products. Forcing the change or replacement of life insurance policies could incur significant costs to policyholders. In some cases, policyholders will completely lose their financial protection because replacement becomes impossible for health reasons. It is comforting to see Finance reaffirming the grandfathering principle for taxation changes affecting life insurance.

* See *"Exempt Test Review: A CALU Perspective"*, CALU, November 10, 2009.