VIEWPOINT 2015 DEC 15

BEST BEFORE 2017

HOW NEW INCOME TAX RULES FOR LIFE INSURANCE IMPACT ESTATE PLANS

WESTWARD ADVISORS

OVERVIEW

The December 1, 2015 issue of CPA Magazine includes an article, "Best Before 2017," discussing the federal tax changes affecting life insurance policies issued after 2016. Referring to life insurance as an important player in Canada's permanent tax shelter troika along with principal residences and TFSAs, the article discusses how, in most cases, the tax benefits of the current rules are more favourable. The window of opportunity may warrant performing insurance audits for clients in early 2016 to identify opportunities to acquire life insurance and benefit from the current rules before 2017.

Please contact Westward if you have any questions about the impact of the rule changes.

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New income tax rules for life insurance will come into effect in a little over a year, with significant impact on estate plans. Here are strategies ahead of time for your clients.

Joe, a 50-year-old, nonsmoking client at our wealth management firm, recently came to us seeking counsel on a number of estate-planning issues. Since life insurance was going to play an important role in his plan, we informed Joe that the income tax benefits of certain insurance strategies would be diminished if his plan were implemented after 2016.

In particular, Joe was evaluating an investment in a $5-million universal life insurance policy. He did not have a specific timeline for completing his plan, but he was interested in having the policy owned by his holding company. Joe wondered how his planning would be affected if he decided to wait until after 2016 to implement this insurance program.

We explained that the current Canadian income tax rules on life insurance would enable his holding company to distribute up to 100% of that $5-million death benefit tax-free to the new shareholders of the holding company should Joe die any time after he turned 73.

But new income tax rules for life insurance will take effect on January 1, 2017. These new rules will have a significant impact on estate plans. Under the new rules, if Joe were to die at age 73, his holding company would be able to distribute only $4.175 million of the death benefit proceeds on a tax-free basis. In Ontario, the tax cost of distributing the remaining $825,000 would be in excess of $300,000. The full $5 million would only be accessible to Joe's heirs if he were to die after age 90.

Unfortunately, as Joe came to realize, the pending income tax changes will diminish some of the tax advantages practitioners have come to take for granted in life insurance and annuity products.

As an important player in Canada's permanent tax shelter troika (the others are one's principal residence and TFSAs), life insurance has long performed a critical role in protecting, preserving and creating wealth for Canadians. For a while, however, there has been a desire by legislators to create tax rules that left less room for interpretation during the product design process. Moreover, improved life expectancy, combined with interest and inflation rate conditions very different from those of 1982, led the government to believe that the tax benefits of insurance were a tad too generous.

There is a bright side, though: grandfathering will be available for insurance policies put into place before December 31, 2016. This provides some lead time for CPAs, estate planners and other advisers to review their clients' situation and implement insurance planning strategies to capitalize on the current advantageous legislative environment.

Westward Advisors

Good Things Going

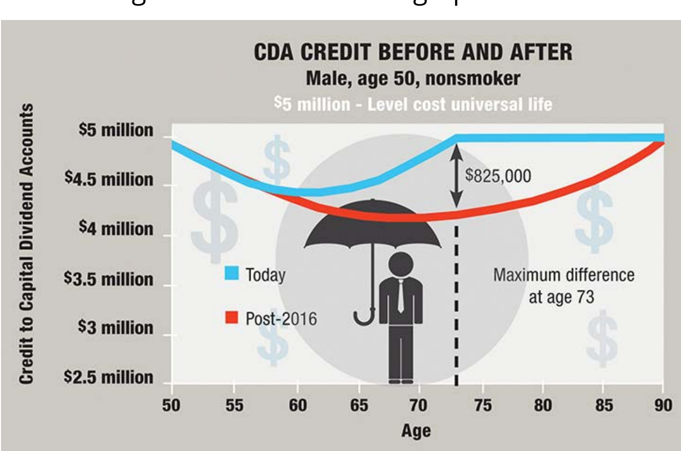
When the sun comes up on January 1, 2017, notable alterations to the taxation of life insurance will lead to changes that are quite technical (see "Technically Speaking" below):

- it will take a bit longer to "quick or prepay" a permanent insurance policy; whereas you might currently be able to prepay an insurance policy in about four years or less, depending on product design, it will take no less than eight after 2016;
- permitted exempt insurance policy cash value accumulation will initially increase and then be less than the current regime until clients reach their early 90s;
- for level cost products, the cost of insurance rates will likely increase; and
- if you purchase a prescribed annuity, more income will be taxable, thereby reducing the net yield.

Changes such as these always prompt client queries about their existing policies. Don't panic. Tax benefits for clients who have procured policies prior to January 1, 2017, will remain intact, as long as they don't purchase additional coverage requiring medical underwriting and as long as existing term insurance policies are not converted into permanent coverage after 2016.

Collateral Damage

After 2016, an insurance policy's annual net cost of pure insurance will be lower for standard mortality policies. As Joe came to learn, this technical change will ultimately alter the computation of the adjusted cost basis of an insurance policy. This rule change will lead to the creation of lower capital dividend accounts and ultimately lower tax-free distributable amounts in situations where life policies are corporately owned. The impact of these changes is illustrated in the graph below.



In addition to altering capital dividend account values at lower ages, the new rules will also do damage to an insurance strategy that Joe and other high-net-worth clients often call on. In this strategy, the cash value serves as collateral on loans used for investment purposes. If Joe uses the loan proceeds for business or investment purposes, he can benefit from collateral insurance and interest deductions.

Presently, assuming he has acquired a level cost universal life policy and his situation is structured for maximum benefit, Joe can deduct up to 58% of his premiums over the first 20 years of insurance financing strategy. On a $5-million policy, total tax deductions of $765,600 ($1.32 million of premiums paid x 58%) would be available during the first 20 years. At a 45% tax rate, the tax savings would amount to $344,520.

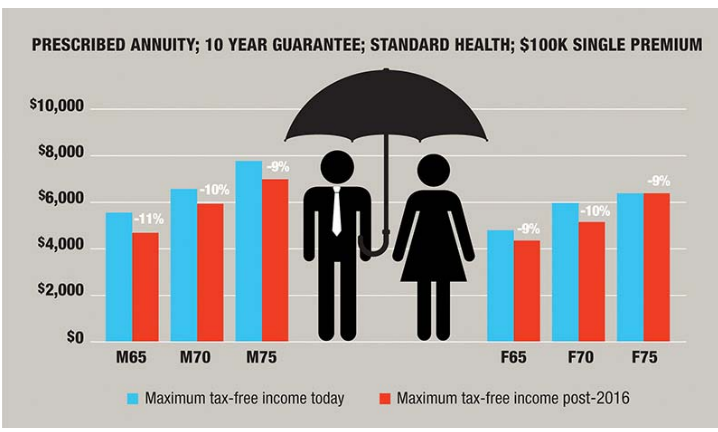
After 2016, the tax savings will only be $243,000, a maximum of 39% of the total premiums paid during the same time frame. In addition, due to the rule changes, it is estimated that Joe's annual premium will also be about 5% higher. In other words, reduced savings at a higher cost.

It's not all bad news. The immediate financing of life policies can still provide interesting benefits. And after 2016, though their longer-term growth will be slightly less tax sheltered, participating whole life policies will potentially have higher early cash values and thus more initial collateral value.

In a limited number of situations, deferring life insurance planning until after 2016 might actually benefit clients. For example, for individuals subject to substandard health ratings on their life coverage, the net cost of pure insurance may actually be higher under the new rules. This will lead to increased deductions from immediate finance strategies and earlier capital dividend account benefits.

Strategy Neutralized

The taxation of prescribed annuities will also change and that will neutralize the insured annuity, a popular strategy for clients over the age of 65, which involves the purchase of a life annuity in order to generate a guaranteed income for life. Concurrently, to preserve the capital that has been invested in the life annuity, the client would acquire a permanent life insurance policy with a death benefit equal to the amount invested in the life annuity. The annual cash flow from the annuity is used to finance the annual premium cost and provide the client with a net after-tax income that could often generate, depending on the age of the client, a pre-tax annual yield above 7%, guaranteed for life. At the time of death, the annuity income will cease and the client's original capital would be returned to his or her estate via the life insurance death benefit.



When 2017 hits, the attraction of such a strategy will be noticeably reduced. Investment income tax increases will likely affect the prices of guaranteed level cost life insurance products and increases in the taxation of prescribed annuities will reduce overall net yields (see graph above). For example, as the graph illustrates, a 65-year-old male will see his tax-free annuity income go down by 11%. Ultimately, after 2016, the strategy will likely provide a lower overall return to your clients.

Window of Opportunity

"Insurance" and "audit" are not an entrepreneur's favourite words. However, in 2016, an insurance audit could produce the kind of major tax savings likely to prompt your clients to actually suggest meeting more often. Working collaboratively with CPAs, lawyers and portfolio managers, an insurance adviser can determine if a client should consider implementing a strategy before December 31, 2016, or, in limited cases, after that date. Professionals should also ensure that existing life insurance policies are held in the right entities and are eligible for grandfathering.

A best-before date is now stamped on a host of popular insurance strategies. The lead time before the new rules kick in offers a unique planning window for professionals and their clients. In the coming months, we invite you to party like it's 1982.

Technically Speaking

On January 1, 2017, the taxation of life insurance will give way to the following changes:

- Differences in the calculation of the maximum tax actuarial reserve (MTAR) line, of the net cost of pure insurance (NCPI) and of policy adjusted cost basis (ACB).
- Limitations on the tax-free payment of the fund value upon the death of a first insured in a multi-life policy.
- Changes that will lead to an increase of the investment income tax (IIT) paid by insurers (with costs generally passed to policyholders). Updated Canadian mortality tables become the reference to determine the taxable portion of a prescribed annuity.

Article Acknowledgement

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