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CHANGE IS COMING

PPI'S JOHN McKAY EXPLAINS PRUDENT INSURANCE PLANNING STRATEGIES FOR 2016

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OVERVIEW

The new exempt-test rules take effect in 2017. John McKay, an executive vice-president and actuary at PPI, explains some prudent insurance-planning strategies to implement while there's still time.

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The taxation of life insurance policies is about to change. To preserve certain advantages that exist under the present legislation, you'll need to take a closer look at the affected policies and take action.

The existing rules for the taxation of life insurance policies have been in place since 1982 and allow for the investment earnings associated with the cash value accumulation in an "exempt" policy to accrue without annual taxation. These rules are commonly referred to as the "exempt-test." They are in place to ensure that the favourable tax treatment of exempt policies is not available for products that are mainly investment driven with only an ancillary life insurance component.

The rules were in need of updating to reflect products that have emerged over the last 30 years, especially universal life with level cost of insurance. In addition, the rules needed to be modernized to reflect more recent mortality tables and to standardize assumptions used by insurers in doing policyholder tax calculations. In 2012, it was announced in the federal budget that the exempt-test rules were to be updated and simplified. Intensive consultations with the life insurance industry took place that year. Draft legislation was released August 23, 2013 to which the industry provided comments and recommended changes. Some of the recommendations suggested by the industry were incorporated into the next version of the legislations, which was released August 29, 2014 — however, the industry still had some concerns. The legislation was passed December 16, 2014, basically unchanged from the August 29, 2014 version, with an effective date of January 1, 2017.

What Is Changing?

While the death benefit (including the cash value accumulation) is still tax-free, there are changes to the actuarial assumptions and methods used to determine sheltering capacity. Universal life level cost of insurance (LCOI) policies will be affected the most by the changes, since the original exempt-test rules were written before the product was in the marketplace. The result is the amount that can be accumulated long term in an LCOI policy will be reduced under the new rules. This means that LCOI policies issued before January 1, 2017 will be able to accumulate larger fund values than those issued post-2016.

The reasons for the reduction in the amount of accumulation room are a result of changes to underlying actuarial assumptions, the removal of the surrender charges from the calculation of the accumulation room, and the inclusion of the COI "embedded reserve" in the calculation. The embedded reserve is used by the insurance company as a reserve against future death benefits, but is generally not available to the policyholder on surrender of the policy. These changes remove the advantage that LCOI policies had over other life insurance products, thereby creating a more level playing field.

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In addition, the use of more recent mortality tables will result in a lower net cost of pure insurance (NCPI), which is an annual amount that reduces the adjusted cost basis (ACB) of the policy. As a result, policy ACBs will generally be higher under the new rules. A higher ACB is beneficial when a policy is surrendered, as there is a disposition of the policy with the excess of proceeds over the ACB being subject to tax as income (not as capital gain). Policy loans will also benefit from the change to the NCPI, as larger loans will be available since the ACB will be higher for longer. But as we will see later, an adverse effect can occur for corporate-owned insurance.

Grandfathering

The good news is advisors still have time to take advantage of the existing rules since policies settled before January 1, 2017 will be grandfathered. However, care must be taken since grandfathering can be lost! This can occur if a term policy is converted to a permanent policy after 2016, or if additional insurance is added to a pre-2017 policy that requires new medical underwriting. Therefore, if it is desired, conversions from term to permanent should be completed before December 31, 2016 to obtain the benefits of grandfathered status.

There is still some uncertainty as to whether a policy purchased in 2016 but not settled until 2017 will be grandfathered. It's prudent to settle new policies this year if possible.

Multi-Life Policy Implications

There have been some changes with respect to “face plus fund” policies that provide separate coverages on two or more lives insured (e.g., multi-life policies). For such policies issued before 2017, the entire fund value of the policy can be paid out as a tax-free benefit on the death of an insured provided the fund value forms part of the death benefit under the terms of the policy. Let's consider policies issued after 2016 or ones that lose grandfathered status. If the fund value is paid out on the death of a life insured that causes the coverage to terminate but not the policy, there could be a taxable gain to the policyholder. To determine whether there is a gain, the amount of the fund value paid out is compared to the maximum amount that could have been paid out if the coverage had been issued as a stand-alone, exempt, face plus fund policy. Any excess is deemed to be proceeds of disposition. If the proceeds exceed the prorated ACB, then a taxable income gain will result.

Investment Income Tax

As a result of the changes noted above, the cost impact of the investment income tax (IIT) will need to be recalibrated by insurers for policies issued after 2016. The IIT is a tax that is paid by the insurance company on the accumulating fund of an exempt policy. The IIT is often passed on to the policyholder through increased policy charges, but this has not been the case for LCOI products in today's market. It is likely that insurers will reprice LCOI for new insurance issued after 2016. The price increase to LCOI could be in the range of three per cent to 10 per cent, with larger increases for the younger issue ages.

The benefits of retaining the pre-2017 exempt-test rules for LCOI policies can be significant for some clients. For clients who have additional insurance needs,, or who will eventually need to convert their term policies, engage them now to ensure they benefit from the current legislative regime.

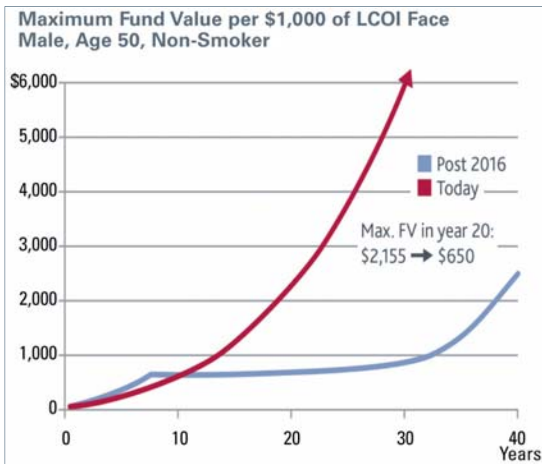
ACTION POINTS

Before January 1, 2017:

1. Considering doing term conversions
2. Add additional coverage that requires medical underwriting
3. Review client needs to see if there is a need for UL LCOI face plus fund products

TAX
IMPLICATIONS EXPLAINED

The change to the accumulation room for an LCOI policy issued pre-2017 and post-2016 is best illustrated with an example. Tom is a 50-year old Vancouverite. He is a non-smoker and has a $5 million term policy that he is thinking of converting to an LCOI policy. If he converts the policy before 2017, by age 70 he will have approximately $10.775 million in room. If he waits until 2017 to do the conversion and loses grandfathered status, he will only have approximately $3.25 million at age 70. By waiting to convert, he has lost $7.525 million in potential accumulation room!



Maximum Fund Value per $1,000 of LCOI Face
Male, Age 50, Non-Smoker

If Tom were to assign his policy as collateral for a loan, the amount that he could deduct will be less if he waits until 2017 to convert the policy. This is because the amount that a policyholder can deduct is calculated as the lesser premiums paid and the NCPI. As stated above, the new rules for 2017 will result in a lower NCPI amount. To qualify for this deduction, the owner and borrower need to be the same individual or entity, the loan must be from a financial institution, the policy must be assigned as collateral for the loan, and the interest on the loan must be deductible pursuant to the Income Tax Act, which means the expense must be reasonable and incurred to earn income from investment or business.

The following table summarizes the reduction in the amount of the premium that can be deducted depending on age of issue. For Tom who is 50 at issue, for the first 20 years the percentage of the premium he would be able to deduct decreases to 39 per cent from 58 per cent.

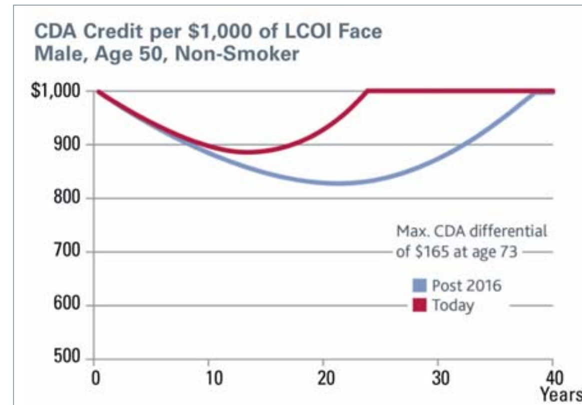
Cumulative Percentage of Total LCOI Premiums Deductible as CID over Period Indicated*

	1st 10 Years		1st 20 Years	
Issue Age	Post 2016	Today	Post 2016	Today
40	12%	16%	25%	38%
50	18%	27%	39%	58%
60	27%	44%	56%	72%
65	33%	52%	62%	76%
70	41%	56%	68%	78%
75	45%	96%	70%	98%

*Assumption: Loan balance at least equal to the LCOI face amount.

Corporate-Owned Policies

When life insurance proceeds are received by a corporation the amount of the proceeds paid on the death in excess of the ACB is added to the corporation's capital dividend account (CDA). Depending on the estate planning objectives and the terms of the shareholders' agreement, the corporation could pay a capital dividend to the surviving shareholders or the deceased shareholder's estate on a tax-free basis. For reasons mentioned earlier, the ACB of the policy will be higher for a longer period of time. This will reduce the amount that is credited to the corporation's CDA in comparison with a non-grandfathered policy. In general, as a result of the change to NCPI, the time it will take for LCOI policies to reach an ACB of zero will increase by seven to 17 years depending on the facts of each case. As can be seen in the following chart, the ACB of the policy subject to the post-2016 rules is not nil until almost age 90.



CDA Credit per $1,000 of LCOI Face
Male, Age 50, Non-Smoker

Continuing our example, let's say Tom Co. owns and is the beneficiary of the $5 million term life insurance policy on Tom's life, and that Tom Co. converts the policy post-2016. If Tom died at age 73, the amount that can be added to the corporation's CDA will be $825,000 less than what could have been added if the conversion had been completed by December 31, 2016. Absent from this additional CDA credit, to pay out this amount of the shareholder's estate, an ineligible dividend would likely have to be paid. This would result in personal income tax of $335,032 assuming current British Columbia rates.

About the Author

John McKay is an executive vice-president and actuary at PPI.