Canada Life™

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Tax and planning

Life insurance

Commentary on the 2013 proposed legislative changes to the life insurance policy exempt test

Executive Summary

Draft legislation was released by the Department of Finance on August 23, 2013. The industry has been, and is, in contact with the Department of Finance to ask for clarification and simplification for certain proposals. As the legislation and explanatory notes are very technical, the following 4 page executive summary of the proposed changes has been prepared.

The *Income Tax Act* (the "Act") contains rules regarding the taxation of the income earned on the savings in a life insurance policy (a 'policy'). In the case of a policy other than an annuity contract, the tax treatment differs depending on whether a policy is classified as an "exempt policy". A test (the exemption test) is applied each year to determine whether a policy is an exempt policy. The exemption test measures the extent to which a life insurance policy is protection-oriented (e.g., an exempt policy) or savings-oriented (e.g., a non-exempt policy).

Income earned in a non-exempt policy is taxed at the same rates as interest income and on an accrual basis at the policyholder level. In contrast, income earned in an exempt policy is not taxed on an accrual basis at the policyholder level. Instead, it is subject to a minimum tax (the Investment Income Tax) that is paid by the insurer.

These income tax rules, including the exemption test, were introduced in the early 1980s. The August 23 proposals would amend four key aspects of the rules relating to the tax treatment of life insurance policies:

1. **The determination of whether a policy is an exempt policy:**
   A single prescribed mortality and interest basis for the reserve components is to be applied to all life insurance products for the purposes of the exemption test. The same assumptions are prescribed for both the actual policies and the benchmark exempt test policies. Net premium reserves are mandated for all insurance products based on duration of the coverage as well as the pattern and duration of premiums or cost of insurance rates. If the proposed legislation becomes law, surrender charges on new policies will be explicitly excluded for purposes of the exemption test for universal life policies. The prescribed payment period for exemption test policies has been shortened from 20 years to 8 years and the assumed endowment age has been lengthened from age 85 to age 90.

   The combined result of these changes, relative to the current rules, is that there will be more funding room in the early policy durations, but lower funding room in the later policy durations, and the higher reserve component together with not reducing the cash value by surrender charges will extend the minimum premium paying period.

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An Anti-avoidance rule applicable only to life insurance policies has also been proposed. If the proposed legislation becomes law, the anti-avoidance rule will apply to a new policy if a transaction or an arrangement is undertaken specifically to increase the available "funding room" under the policy.

2. **The determination of what types of transactions give rise to a disposition of an interest in a policy:**
   Changes have been proposed to the calculation of a policy's adjusted cost basis (ACB) which is used to calculate a policyholder's gain on policy dispositions such as partial or full surrenders, policy dividends, transfers' of ownership, and policy loans. These changes include a smaller decrease to the ACB for the Net Cost of Pure Insurance (NCPI) and new ACB decreases for the payment of certain benefits such as some types of disability benefits. The result of the smaller decrease to the ACB (leaves a higher ACB because of the lower NCPI reduction) will generally be lower taxable income, and the result of the new ACB reductions (a lower ACB) will be larger taxable income for policy owners from policy dispositions. For most policies the ACB will be higher than it is today so the taxable income on dispositions will be lower. However the higher ACB negatively affects the amount that can be credited to the capital dividend account of private corporations that may be distributed as tax free dividends.

   The proposed rule changes to the exemption test and disposition tax regime would also apply to multiple life policies. In addition to other consequences, these changes would impact the allocation of the fund death benefit for the benchmark policies and the exemption test room, reduce the ACB of a policy when a life insurance death benefit is paid on each multi-life coverage, and result in the possible taxation of part of the death benefit for policies with multiple coverages (e.g. a multi-life policy where the account value paid on death results in more than could have accumulated under a separate exempt policy).

3. **Amendment to the Investment Income Tax consequential on some of the other amendments:**
   A proposal is also being introduced to ensure the Investment Income Tax (IIT) applies equitably to Universal Life Policies (and other policies which do not have specified premiums). Finance is introducing this change to address the concern that insurers have not been paying a "fair share" of IIT on such policies. IIT is a tax imposed on the insurer on the theoretical "annual increase in the savings element" of policies. The tax is not directly paid by the policyholder, however IIT effectively reduces the rate of internal growth in the policy as it is usually reflected in the administrative costs of a universal life policy or is included in the premium amount of a participating policy. Consequently, if the proposed legislation becomes law, IIT paid by insurance companies on UL policies will increase.

4. **Amendment to the rules that determine the capital element of annuity payments for certain annuity contracts:**
   The taxable portion of annuity payments from prescribed annuity contracts will increase because the legislative proposals update the prescribed mortality table used to calculate the non-taxable portion of each annuity payment.

Grandfathering

In the past, legislative amendments to the rules regarding the tax treatment of life insurance policies have typically been accompanied by grandfathering for existing (issued) policies. Grandfathering is also proposed in respect of the August 23 legislative amendments. If the proposed legislation becomes law, there will be three different grandfathering statuses. As a result, the manner in which each of the grandfathering rules applies depends upon the date on which an interest in the policy was last acquired and, in some cases, the date of issuance of the policy.

The following table was provided in the explanatory notes for the draft legislation. It summarizes grandfathering in respect of the accrual taxation rules and the exemption test for life insurance policies other than annuity contracts:

Policy Acquisition/Issuance Date	Income Tax Treatment
Policies issued before 2016 an interest in which was last acquired before December 2, 1982.	Exempt from accrual taxation unless prescribed premium is paid and certain other conditions met. If grandfathering is lost, annual or triennial accrual applies depending upon taxpayer and whether policy is an exempt policy. Exempt policy status is determined after 2015 as if policy were issued after 2015.
Policies issued before 2016 an interest in which was last acquired after December 1, 1982 and before 1990.	Annual or triennial accrual taxation depending upon taxpayer, unless policy is an exempt policy, as determined under rules applicable to a policy interest last acquired after December 1, 1982 and before 1990. If grandfathered status is lost after 2015, exempt policy status is determined as though the policy were issued after 2015.
Policies issued before 2016 an interest in which was last acquired after 1989.	Annual accrual taxation, unless policy is an exempt policy, as determined under rules applicable to policies an interest in which was last acquired after 1989. If grandfathered status is lost after 2015, exempt policy status is determined as though the policy were issued after 2015.

Loss of grandfathering for taxation of dispositions

Under the legislative proposals, new subsection 148(11) of the Act suspends grandfathered status of life insurance policies issued before 2016 if:

- in the case of a policy last acquired before December 2, 1982, a prescribed premium is paid under the policy and the policy is not an exempt policy or there is a prescribed increase in any death benefit under the policy; or
- in any other case of a policy issued before 2016, life insurance is underwritten in respect of which a particular schedule of premium or cost of insurance rates applies.

The public consultation period on the legislative proposals is open until Nov. 6, 2013. Depending on the responses that Finance receives, there could be further changes to these legislative proposals. We'll continue to keep you informed as additional information or details become available.