Overview of 2017 tax changes affecting corporately owned life insurance

The current legislation governing the tax treatment of life insurance policies was created in the 1980's. Since then, new generations of products, particularly universal life products (UL) have added features that the original legislation did not contemplate. The Department of Finance has been working with the insurance industry over many years to update the legislation. The new legislation will affect life insurance policies issued after December 31, 2016. Policies issued before January 1, 2017 will be grandfathered under the current tax rules.

Policyholder taxation

To better understand the tax rules for life insurance policies, a policy can be viewed in three components: Deposits and Savings which affect Payout.

Deposits

The Income Tax Act outlines the amount policyholders can deposit into a policy over and above the premium needed to pay for the basic death benefit.

Savings

The savings component is the remainder of the deposit after mortality charges and expenses. Provided the policy qualifies as tax exempt, the savings component can grow without being subject to annual taxation.

Payout

There are two ways to get a payout from a life insurance policy. The first is from a death benefit and the second is through withdrawals, in the form of surrenders or policy loans. For life insurance owned by corporations, the proceeds paid on death to the corporation can be paid out as a tax free Capital Dividend, to the extent of the Capital Dividend Account (CDA) credit.

The following elements within each component are affected by the changes to the legislation:

The new rules propose to limit the amount that can be deposited into a tax exempt policy. In addition, policy owners who use their policies as collateral security will have the amount of the deduction significantly reduced.

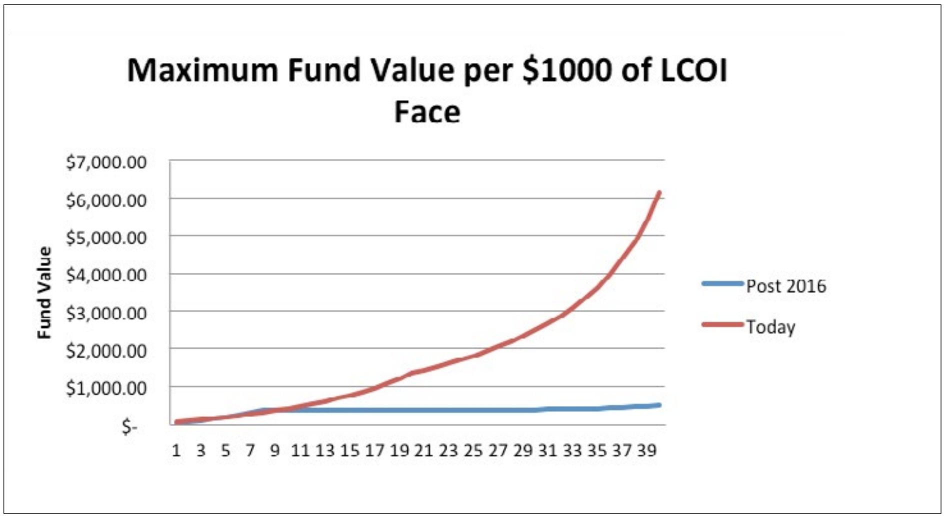
The new rules will reduce the amount of the savings that can be accumulated on a tax deferred basis.

After 2016, the capital dividend account credit will be reduced when compared to the current rules. This will result in the reduced availability of tax-free Capital Dividends.

Impact on corporately owned policies

Deposits and savings accumulation

The new rules limit the amount that can be deposited into a tax exempt policy, which means that the amount not subject to tax will be reduced in comparison to policies issued before 2017. The following example shows the difference between the maximum tax deferred savings limit for policies issued before and after Jan 1, 2017.

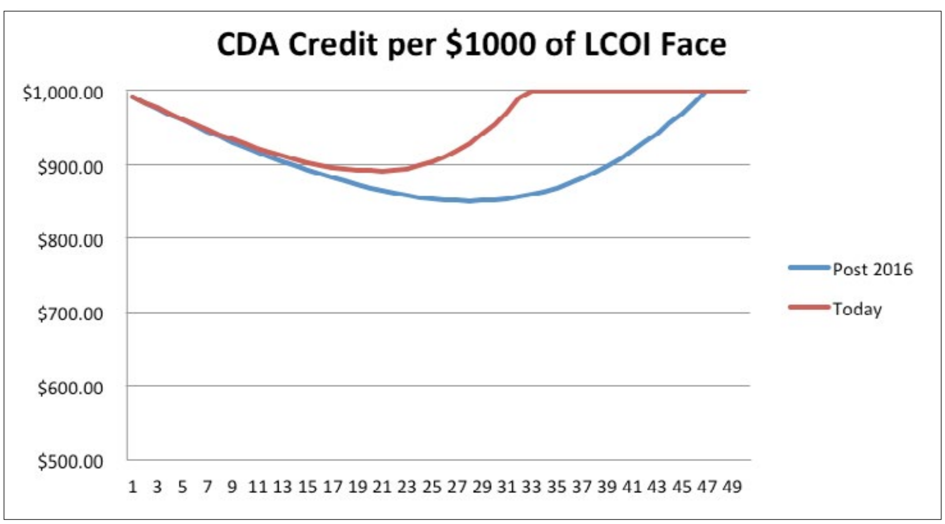


Policies issued before 2017 will be able to accumulate larger fund values than those issued after 2016, which means policies can be prepaid in less time and that there will be more funds available for future planning needs, such as estate planning and retirement.

Capital Dividend Account (CDA)

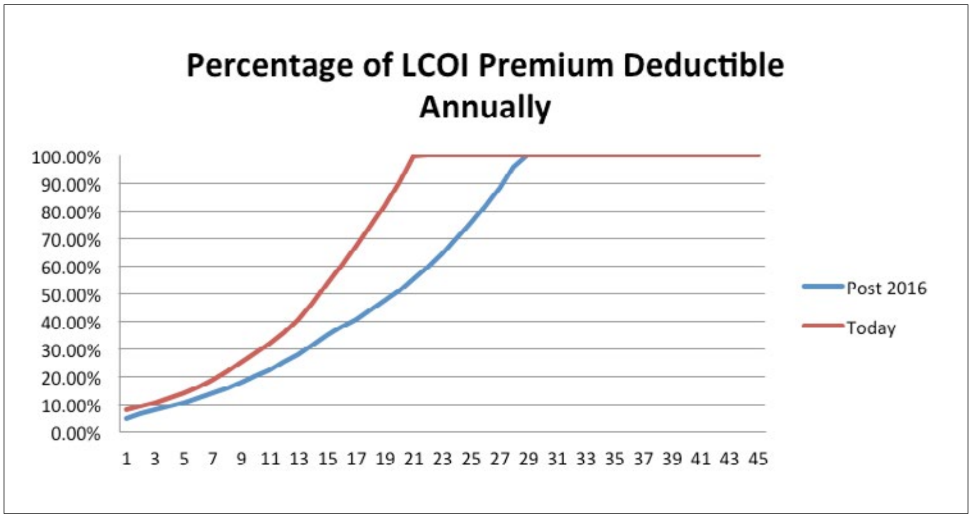
The amount of any life insurance proceeds received by a private corporation, less the policy's Adjusted Cost Basis (ACB), is added to the corporations CDA. Amounts credited to the CDA can be distributed as tax-free capital dividends to the shareholders.

The new rules will result in a higher ACB which will result in a lower amount being credited to the CDA for premature deaths.



Collateral insurance deduction

Where a life insurance policy is assigned as collateral for certain loans, a policyholder may deduct the lesser of the policy premiums and the Net Cost of Pure Insurance (NCPI). For policies issued after 2016, the new rules prescribe an updated mortality table be used to calculate NCPI. Given improved mortality experience, the amount of the collateral insurance deduction will be significantly reduced.



In summary

Corporately owned policies issued before January 1, 2017 can provide significantly better financial benefits to policyholders than policies issued after the new rules become effective.

Benefits include:

- **More deposit room and ability to prepay in less time**
- **Ability to accumulate larger tax deferred fund values**
- **More favourable CDA credit**
- **Larger collateral insurance deduction**

LP1831 8/16