Overview of 2017 tax changes affecting personal 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.

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

Premiums are deposited into an insurance policy. These premiums are used to cover current mortality and expenses.

Savings

The savings component is the remainder of the premium after mortality coverage and expenses. It is accumulated with interest to pay future benefits.

Payout

There are two ways one can get a payout from a life insurance policy: from a death benefit and/or through withdrawal (surrenders or loans).

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

Savings component impact

Savings limit

Investment earnings help to grow the savings within a life insurance policy. When held within a life insurance policy, these investment earnings have the advantage of not being subject to tax as long as the savings component is less than certain limits. This is referred to as an exempt policy. The amount of savings in an insurance policy is limited by the savings component of a hypothetical policy prescribed by the legislation called the Exempt Test Policy (ETP). The new legislation changes how to calculate the savings components of both the policy and the ETP such that a policyholder will be allowed to save less inside their insurance policy.

The 250% rule

The 250% rule was introduced to discourage, and thereby limit, large deposits (dump-ins) in the later years of a policy. The 250% rule works as follows: starting in year 10 of the policy, the insurer tests to ensure that the cash value is not greater than 250% of the cash value three years prior. In other words, the test in year 10 will look at the cash value of the policy in year seven. If a policy failed and the cash value was greater than 250% of the cash value three years prior, it would have significantly reduced the sheltering room in a policy for additional deposits. The new legislation actually relaxes the rules for both new business and in-force policies such that it will be more difficult to fail the 250% test. Further, if a policy fails, it is given time to readjust itself before testing starts again. The net result is that the relaxation of the rules could result in additional deposits into policies in the later years of the policy.

Payout component impact

Adjusted cost basis (ACB)

The ACB is the adjusted cost basis of a life insurance policy. It is used to determine the taxable gain upon withdrawal from a policy and to calculate the credit to the capital dividend account (CDA) of a private corporation upon death of the insured. The new legislation changes a few elements and adds new elements to the ACB.

Net cost of pure insurance (NCPI)

Generally, the ACB of a policy is increased by the premiums paid and reduced by the cost of insurance, referred to as the net cost of pure insurance (NCPI). The changes to the legislation result in a reduction in NCPI. Generally speaking, this will result in a higher ACB which will be beneficial for policy holders who surrendered their policies. The reduction in NCPI may also result in a lower tax deduction for life insurance policies assigned as collateral for a loan.

Substandard rating

Currently the calculation of the ACB does not include the effect of substandard ratings. After December 31, 2016, the ACB calculation will include the effect of substandard ratings. This means the ACB for life insureds who are rated will be higher in the initial years but will be decreased in the later years.

Fund value (FV) payout on multi-life universal life (UL) policies

A multi-life UL policy provides insurance coverage to different life insureds under one policy. Currently these policies will pay out the full fund value on the death of any of the insureds tax-free and without reduction to the ACB of the policy. The new legislation limits the tax-free fund value payout to the amount of the fund value had the deceased insured originally had a single life insurance policy. Further, the tax-free fund value payout will reduce the ACB, therefore, any subsequent fund value payout from the multi-life policy could result in a tax liability.

To summarize, the impact of the new legislation on life insurance policies may result in the following changes:

- A lower amount that can be saved inside a UL policy on a tax-advantaged basis.
- A relaxed 250% rule that will result in less failures of this test and may encourage more deposit at later durations.
- A reduction in the NCPI. This will mean a higher ACB with less taxable gains for withdrawal from a policy, but lower tax deductions for collateral loans. Also a lower amount can flow to a private corporation's CDA.
- Substandard ratings will increase ACB initially but will decrease in the later years.
- Fund value payout on multi-life policies will lose much of its tax advantages.

Grandfathered status

The new legislation will not apply to policies issued on or before December 31, 2016, meaning the policies are grandfathered, unless certain changes are made after December 31, 2016.

Let’s dig deeper into Grandfathering

Existing policies already in place will be grandfathered, so long as certain policy changes are not made on or after January 1, 2017. Note that there are some exceptions.

Examples of policy changes...

Where Grandfathered status is maintained

- reinstatement of a policy
- change from smoker status to non-smoker status
- guaranteed insurability option – underwritten on or before December 31, 2016 and provided coverage is added to the same policy

Where Grandfathered status is lost

Pre-2017 legislation will apply when:

- a policy is converted from one type of life insurance to another type of life insurance (i.e., term insurance to permanent insurance)
- addition of a new insurance coverage that requires underwriting
- increase in insurance coverage that requires underwriting
- a cost of insurance switch from annual renewable term to level cost of insurance where the net amount at risk increases and requires underwriting

An opportunity to reach out to clients

The upcoming legislation provides you with an opportunity to speak to your clients who are considering making changes to their in-force life insurance. Talk to your clients about making those changes now as certain changes made after December 31, 2016 may affect them.

For more information, connect with a member of our sales team.

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