Upcoming changes to insurance taxation rules in Canada

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The income tax rules in respect to the taxation of life insurance policies are changing effective January 1, 2017.

Policies issued after 2016 will be subject to the new tax rules outlined below and policies issued prior to 2017 will be subject to the existing rules. Policies issued before 2017, however, may lose their grandfathered status and become subject to the new rules. Changes that can cause the loss of grandfathered status include conversions and the addition of new coverage that requires medical underwriting. This article addresses two of the changes that will have the biggest impact on the consumer: the maximum cash value allowed and the adjusted cost basis of a life insurance policy.

Maximum cash value

A life insurance policy is exempt from annual taxation on the investment growth on its cash value, as long as the cash value is maintained below a maximum amount as defined in the Income Tax Act (maximum tax actuarial reserve). The maximum amount is currently defined as the cash value arising on a life insurance policy that required 20 annual premiums to endow the contract at the life insured's age 85. Starting in 2017, the maximum amount will be defined as the cash value arising on a life insurance policy that required eight annual premiums to endow the contract at the life insured's age 90.

In addition to the change in the maximum amount of cash value, life insurance companies will no longer be able to use surrender charges to reduce the maximum amount of cash value that can be held in a life insurance policy.

The changes to the maximum cash value mean that policies issued after 2016 cannot be funded with fewer than eight annual premiums.

Adjusted cost basis

In general terms, the adjusted cost basis (ACB) of a life insurance policy is the sum of premiums paid less the accumulation of the net cost of pure insurance (NCPI) of the policy. This means that the ACB of a life insurance policy grows to a certain point where the annual NCPI is greater than the premium paid, at which time the ACB of the policy slowly shrinks down to zero.

The NCPI is determined annually by multiplying a mortality factor from a prescribed mortality table times the net amount at risk of the policy for that year. The mortality table used in the calculation is being updated with the new tax rules and will reflect more current mortality experience. The net impact is that mortality factors are being reduced by as much as 30% depending on issue age and duration.

The definition of the net amount at risk will also change. The majority of life insurance companies define the net amount at risk as the difference between the death benefit and the cash surrender value of the policy, however, the new tax rules will define the net amount at risk as the difference between the death benefit and the reserve of the policy. The impact is that the net amount at risk is going to be smaller under the new tax rules.

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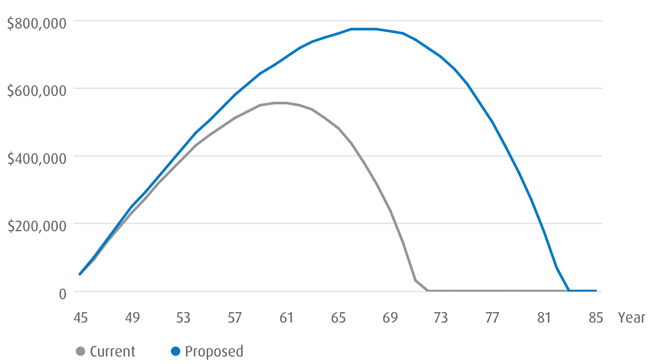
The combination of a lower mortality factor and a small net amount at risk means that the ACB will grow to a higher level and will take longer to shrink to zero.

The following graph illustrates the ACB of a $5,000,000 universal life insurance policy issued to a male (50, non-smoker) who funded the policy with a level for life premium. Under the old tax rules, the ACB would rise to approximately $500,000 and would shrink to zero by age 75. Under the new tax rules, the ACB will rise to approximately $800,000 and will shrink to zero by age 91.

$5,000,000 minimum funded level COI universal life



A higher ACB could be an advantage for a personally owned life insurance policy because the policyholder would experience lower policy gains when transacting with their policy. Here are some of the circumstances under which a policy gain would be realized:

- A full surrender of a policy: The policy gain would be equal to the cash surrender value in excess of the ACB. Note that a loss is not allowed.
- A partial surrender of the policy: When the policyholder takes out some of the cash surrender value and a portion of the ACB is used to determine the policy gain realized.
- Taking a policy loan under the policy: The policyholder realizes a policy gain when a policy loan is in excess of the ACB of the policy.

A higher ACB could be a disadvantage when the policy is corporate owned. A company is entitled to credit its capital dividend account (CDA) when receiving the proceeds of a life insurance policy. In general, the credit is equal to the excess of the life insurance proceeds received and the company's ACB in the policy. A high ACB means a lower credit to the company's capital dividend account. A capital dividend can be received by the shareholder on a tax-free basis.

How to Prepare for the Changes?

Insurance portfolios should be reviewed to ensure that the amount is reasonable and in the correct place for the long term.

Term insurance conversions should be reviewed before the end of 2016 and conversions should be completed in order to continue the new permanent policy under the old tax rules.

The Bottom Line

Life insurance policies provide an important vehicle in estate planning and will continue to be a valuable planning tool long into the future. The change in tax rules creates an opportunity to be able to choose which tax rules are better for the individual.

For more information, please contact your BMO Nesbitt Burns Investment Advisor who will refer you to an Estate & Insurance Advisor (in Quebec, Financial Security Advisor) from BMO Nesbitt Burns Financial Services Inc.

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