Overview of 2017 tax changes

Grandfathering Rules for In Force Life Insurance Policies

BMO Insurance

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The rules which originally governed the taxation of life insurance were implemented in the early 1980's and didn't anticipate the newer features and benefits which had been introduced on products like universal life insurance. As a result, the Department of Finance modernized the rules to reflect the insurance industry's innovations.

Effective January 1st, 2017, a new set of rules became effective for life insurance and prescribed annuities. It's important to note that life insurance will continue to play a valuable role in financial planning but you should be aware of these rules and the potential implications that they may have on long term planning objectives involving insurance.

! Life insurance continues to be a valuable financial planning tool after the tax changes in 2017.

Impact of the 2017 rules on Life Insurance

- Insurers are expected to be more consistent in their interpretation of the tax rules.
- Generally speaking, there will be less tax-deferred savings room in UL policies over the long term due to the changes in the exempt test.
- Business owners may receive a smaller tax-free payout of a death benefit when it is paid out through the Capital Dividend Account (CDA) primarily due to the changes in the Net Cost of Pure Insurance (NCPI) and the associated Adjusted Cost Basis (ACB) calculations.
- If a policy owner uses his/her policy as collateral for a third party loan, he/she may still qualify to deduct premiums from their taxable income, but the amount will be limited by the new NCPI amounts under the G3 rules which will generally be lower.
- "Single deposit" or lump sum deposit scenarios (like on BMO® Insurance's MaximizerElite) will disappear!
- On multi-life policies, if the death benefit of any coverage includes the Fund Value, the tax-free payout of the Fund Value will be limited to the amount that would be paid if it was the only coverage on a policy. Any excess amount will need to be reported as a taxable gain to the policy owner or his/her estate.

Grandfathering Rules

The new (G3) tax rules will apply to policies issued after December 31st 2016. However, policies issued on or before December 31st, 2016 will be "grandfathered" and retain their existing (G1 or G2) tax status unless certain changes are made on these policies in which case the grandfathered status of the policies would be lost and the new G3 rules would be applicable.

Policy Tax Generations

"G1" Policies last acquired prior to December 2, 1982

"G2" Policies issued or last acquired after December 1, 1982 and before 2017

"G3" Policies issued after 2016 or which have lost their G1 or G2 status (i.e. those policies which follow the "new 2017" rules)

The Importance of Grandfathering

Life insurance is typically meant to cover long term financial objectives. The insurance coverage and any associated savings in a policy are typically part of an overall financial plan which could extend over a number of years... or even decades. That's why the idea of "grandfathering" (or retaining the legislative rules associated with these plans) is often introduced to address this need. It protects policy owners and minimizes the impact that legislative changes could have on their long term plans such as the tax treatment of certain aspects of their coverage.

Grandfathering Rules for In Force Policies (in effect since 2017)

Generally speaking, any increase in life insurance coverage on an in force policy (which requires medical underwriting) or exercising a conversion option on an existing term insurance policy issued before 2017 will cause a loss of grandfathering and necessitate actions to treat the policy under the new tax rules.

On the other hand, there are certain types of transactions which will not cause a loss of grandfathering, despite the need for medical underwriting (see below). If in doubt, contact BMO Insurance to determine the implications of any transaction on any of our in force policies. Based on this information, clients along with their insurance and tax advisors should determine the advantages and disadvantages of proceeding with such a change.

The Impact of Losing Grandfathered Status

A loss of grandfathering could have adverse tax consequences for the policy owner such as:

- A loss of the tax-exempt status of a policy with guaranteed cash values (e.g. whole life) which would cause the policy to become subject to annual accrual taxation.
- A reduction of tax-deferred room on a universal life policy's Fund Value.
- A lower than expected tax-free payout of the policy's death benefit (e.g. on a multi-life policy OR for business owners via a corporation's CDA credit).
- A less than expected amount of each premium that can be deducted from their taxable income in the case of a collaterally assigned policies.

Given the importance of retaining a policy's tax status, if a policy owner wishes to proceed with a contractually allowed policy change which would prompt a loss of grandfathering, BMO Insurance may request the policy owner's signed acknowledgement of the impact of such a change before completing the transaction.

The Impact on In Force BMO Insurance Policies

Changes that WILL CAUSE a Loss of Grandfathering after 2016 on a G1 or G2 policy

Type of BMO Life Insurance Policy	Type of Change	BMO Insurance Procedure
Term	Exercising a conversion option.	At the time of conversion, a new permanent policy will be issued from the list of eligible permanent plans using rates in effect at time of conversion which will follow the G3 rules. *Note: the process of issuing a new policy is no different than BMO Insurance's current practice.*
Universal Life	Exercising a Substitution of Life provision.	The existing policy (along with its original issue date) will be retained but the G3 tax rules will apply as of the date we approve the new life insured.
	Adding additional universal life coverage on any UL policy.	As per the contractual terms of these types of BMO Insurance policies, we will issue a new policy for the additional amount of coverage using the rates and available plans in effect at the time of the change. We will waive the policy fee on the new policy as per the contract provisions. The original policy and its associated coverage(s) will retain their tax status but the G3 tax rules will be used on the new policy with a new issue date for the additional coverage.
	Adding a new life insurance coverage on a policy (such as a term life insurance rider).	BMO Insurance will issue a new G3 policy (with its own policy fee) for the amount of the additional coverage. The original policy will retain its tax status and original issue date.
	Exercising a conversion option on a term rider.	As is our current practice, BMO Insurance will issue a new policy for the additional amount of permanent coverage using the rates and available plans in effect at the time of the change; the permanent coverage will not be added to the existing policy. The original policy and its associated coverage(s) will retain their tax status. The G3 tax rules will be used on the new policy with a new issue date for the new permanent coverage.
Whole Life	Adding a new life insurance coverage on a policy (such as a term life insurance rider).	BMO Insurance will issue a new G3 policy (with its own policy fee) for the amount of the additional coverage. The original policy will retain its tax status and original issue date.
	Exercising a conversion option on a term rider.	As is our current practice, BMO Insurance will issue a new policy for the additional amount of permanent coverage using the rates and available plans in effect at the time of the change; the permanent coverage will not be added to the existing policy. The original policy and its associated coverage(s) will retain their tax status. The G3 tax rules will be used on the new policy with a new issue date for the new permanent coverage.

Changes that WILL NOT CAUSE a Loss of Grandfathering on Life Insurance Policies

- A change from Smoker to Non-Smoker rates on a policy.
- Adding the following riders on a policy (even though medical evidence of insurability may be required): Accidental Death Benefit, Critical Illness rider, Waiver of Premium, any other "non-life insurance" benefit or rider.
- A reduction or elimination of substandard ratings on an in force policy.
- Correcting a misstatement of age/sex.
- Policy reinstatements.
- A switch from Yearly Renewable Term (YRT) to Level cost of insurance on the same UL policy.
- A change in ownership of a policy (e.g. from a corporate business owner to an individual or vice versa).
- Exercising the Joint Last to Die Conversion rider option (i.e. a switch from a single life or Joint First to Die coverage on a UL policy) as long as both lives insured were medically underwritten at the time that the rider was issued on the policy.
- Exercising the Term 10 Exchange option: on policies where this feature is available, a new Term 20 policy will be issued for the switch (without further evidence of insurability) using rates in effect at the time of exchange. Please note, however, that the new Term 20 policy will follow the G3 tax rules as far as the NCPI and ACB calculations
- Exercising an increase in coverage via a Business Guaranteed Insurability Option (BGIO) rider which was purchased at the time that the original policy was issued as long as the amount of future increases was medically underwritten at issue of the original policy (financial evidence of insurability may be required at the time of the increase). As per the contractual provisions of the BGIO rider, the additional amount of coverage will be issued as a new (G3) term policy: it will not be added as an additional coverage on the original policy.

  Note, however, if a new BGIO rider is added to an in force G2 policy after 2016, and the addition of the rider requires medical underwriting, a loss of grandfathering would occur on the entire policy.
- Increases in coverage as a result of Paid-Up Additions (PUA) or any other change in dividend options on Participating Whole Life policies as long as no underwriting is required.
- Increases in Sum Insured on a universal life or whole life policy due to the exempt test (i.e. "MTAR" increases).
- Increases in coverage as a result of Paid-Up Additions (PUA) on non-participating Whole Life policies as long as no underwriting is required.

Key Terms in Life Insurance Taxation

Adjusted Cost Basis (ACB): This is the amount used to calculate the taxable gain in a life insurance policy (e.g. term, universal life or whole life) when certain transactions are made. Generally speaking, the ACB is equal to the cumulative sum of premiums paid less the Net Cost of Pure Insurance (see below).

Some transactions where the ACB is used:

- Full cash surrender: when the policy is surrendered for its full Cash Surrender Value (CSV), a policy gain is equal to the excess amount of the cash surrender value above the ACB.
- Partial cash withdrawal: when a portion of the CSV is withdrawn in cash, a policy gain is equal to the amount of the withdrawal less a proportionate amount of the ACB.
- Policy loan: a policy gain is equal to the amount of the loan in excess of the ACB.
- A change in ownership of a policy (e.g. from an individual to a corporate business owner or vice versa)

Capital Dividend Account (CDA): This is a notional account that appears on the company's financial statements which can have a significant benefit for owners of a Canadian-Controlled Private Corporation (CCPC).* Any balance in the CDA can be paid out to shareholders as a capital dividend, and therefore be exempt from tax. Items that can be credited to the CDA include the tax-free amounts from the sale of eligible capital property, the non-taxable portion of capital gains, any capital dividends received from other CCPCs or trusts resident in Canada, and any life insurance death benefit, subject to a specific calculation.

When it comes to life insurance, the amount that can be credited to the CDA is the death benefit received less the Adjusted Cost Basis (ACB) of the policy.

Net Cost of Pure Insurance (NCPI): This is the insurance 'cost' of the policy derived, in part, from a prescribed mortality table tabulated by the Canadian Institute of Actuaries. It's an important element of the ACB calculation but should not be confused with the cost of insurance which is the actual charge deducted by the insurance company for the coverage in place.

Tax Exempt Test: this is an annual test that determines whether the fund value in the policy can remain exempt from accrual taxation. If the policy fails the test, any excess funds must be withdrawn out of the policy (taken in cash or put into a taxable side account). Alternatively, the amount of life insurance can be increased (within limits) to maintain the policy's tax exempt status and therefore pass the test.

*Certain conditions have to be met to be classified as a Canadian-Controlled Private Corporation.

Let's connect

To find out more about BMO Insurance products, please call your MGA, contact the BMO Insurance regional sales office in your area or call 1-877-742-5244.

BMO Life Assurance Company, 60 Yonge Street, Toronto, ON M5E 1H5

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1-800-608-7303	1-866-217-0514	1-877-877-1272

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