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# New rules for life insurance

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New tax rules for life insurance policies will become effective on January 1, 2017. In most cases, the tax benefits under the new rules will be reduced compared to policies issued pre-2017. If you are considering the purchase of life insurance as part of your estate plan that means you should act soon to avoid falling under the new regime.

The changes are intended to modernize the tax rules for life insurance, which were last revised in 1982. Since then, people are living longer, interest and inflation rate conditions have changed and a vast array of new insurance products have emerged[1].

The most significant revisions involve modifications to the regulations used to determine the maximum amount that can be invested to satisfy the exempt test[2] for life insurance policies. Tax-exempt life insurance products are often used for estate planning purposes. One of the biggest changes is that post-2016 policies will have less tax-exempt room over the long run, resulting in lower funding room and a reduced tax-free benefit on death—with the impact felt most by universal life insurance policyholders.

In general, policies issued before January 1, 2017 will be "grandfathered" and will continue to follow the current exempt test and policyholder taxation rules. However, there are certain triggers that could remove the grandfathering status of an in-force policy. For example, if life insurance coverage is added to the policy, with medical underwriting that occurs after 2016, the policy will no longer qualify for grandfathering. Also, if term insurance is converted into permanent insurance after 2016, the grandfathering will cease.

## What are the key changes to the rules?

### Corporate-owned life insurance

One significant change relates to corporate-owned life insurance and the amount that will get added to the capital dividend account (CDA) on the death of the shareholder. This is important since the amount in a CDA can be distributed tax-free to shareholders.

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[1] e.g., universal life insurance

[2] A policy is exempt where the internal growth of the cash value (i.e., investment income attributed to the policy) is not subject to annual accrual taxation. Virtually every policy issued in Canada is structured so that the policy growth falls within the parameters required to be an exempt policy.


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For policies issued after 2016, an insurance policy's annual net cost of pure insurance will generally be lower. This change will ultimately alter the adjusted cost base (ACB) of the insurance policy and will result in lower additions to the CDA.

If you are considering a corporate-owned life insurance policy, perhaps to assist with the buy-out of shares under a shareholders' agreement, consider acquiring the policy before the end of 2016.

### Using life insurance policies as collateral for loans

Life insurance policies with a cash surrender value (such as universal and permanent life policies) are often used as collateral to provide funding for business or investment purposes. This is often referred to as "leveraging" the life insurance policy. One advantage is that, where the policy is assigned to the financial institution as a condition of the loan, a portion of the insurance premiums may be deductible. The amount deductible is based on the lower of the premium paid in the year and the net cost of pure insurance in respect of the year.[3]

Under the new rules, where life insurance policies are used as collateral for a loan, a reduced percentage of premiums paid will generally qualify for a tax deduction.

### Insured annuities

Insured annuities can be a suitable investment strategy for older investors who have a significant amount of non-registered funds which they don't want to put at risk. They are looking for a steady income stream, but they want to leave an estate for their children or grandchildren, and current GIC rates are too low.

The insured annuity involves the purchase of a life annuity to generate a guaranteed income for life. A permanent life insurance policy is then acquired with a death benefit equal to the amount invested in the life annuity. The annual net after-tax yield from the annuity is higher than could be earned in a GIC and is guaranteed for life. On death, the annuity income ceases and the original capital is returned to the estate as a life insurance death benefit.

The new rules will result in an increase in the taxable portion of annuity income payments, which will reduce their tax effectiveness. As such, if you are interested in an insured annuity, you should consider a pre-2017 acquisition to take advantage of their current tax-efficiency.

## Conclusion

If you or your business require life insurance products as part of your overall investment portfolio, or if you need to put life insurance in place to meet other requirements, we would be pleased to work with you and your insurance advisor before the changes take place to help you maximize your tax benefits and meet your business objectives.

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[3] Paragraph 20(1)(e.2) of the Income Tax Act


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