STEPUP

SALES TAX ESTATE PLANNING UNDERWRITING & PRODUCT NEWSLETTER

Federal Budget 2012
and impacts on Life Insurance products

The recent Canadian Federal Budget 2012 announced a number of changes that will impact the Insurance business and insurance policies they sell. Here is a handful of those changes.

1. The Government will introduce clarification on banking regulation and the separation of banking from insurance activities.
2. The tax treatment of group benefits like critical illness, long term care and accidental death and dismemberment is changing.
3. There will be tighter rules for Retirement Compensation Agreements (RCAs)
4. The Exempt Test for cash value accumulation policies is being overhauled.
5. Savings in a life insurance policy will be based on industry standard, updated Actuarial tables.

Banking and Insurance

The Government will introduce clarification in the Bank Act their intent that all banking activities in Canada are to be governed exclusively by the same high quality standards. The clarification will also serve to avoid the creation of local and possibly inconsistent rules that threaten uniform application of federal banking regulations.

In December, 2011, The Government announced that it will propose legislation to clarify the prohibition against banks offering life annuities or products of a similar nature. Budget legislation confirms a long standing policy separating insurance from banking.

Group Accident and Sickness Insurance Plans

Typically, when an employer contributes to a group insurance plan to provide benefits for an employee, an amount is included in the employee's income either when:

- The employer contribution are made (the premiums or payments made) or
- When the benefits are received
  - when they are not payable on a periodic basis or
  - are payable in respect of accident or sickness when there is no loss of employment.

The Government wants to neutralize and provide fairer tax treatment of beneficiaries/employees under a group accident or sickness insurance plan. Employer contributions will be included in an employee's income when made for contributions that are not in respect of a wage loss replacement benefit payable on a periodic basis. This will take effect for contributions made on or after Budget Day. (Mar. 29/12). Contributions made between Mar. 29 – Dec. 31, 2012 will be included in the employee's income for 2013.

Vol. 12, No. 05

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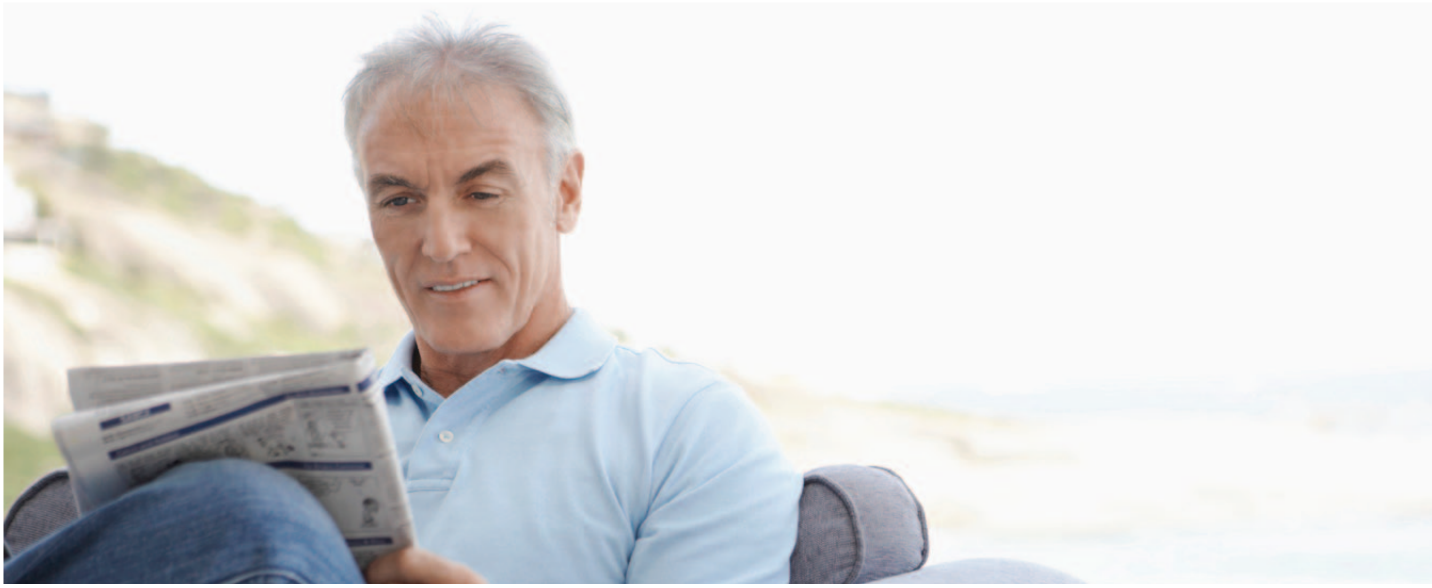

Private health services plans will not be affected nor other plans described in para. 6(1)(a) of the Income Tax Act (Canada).

It's too early to tell what the impact will be on Trust arrangements, though it appears that the fast track, easy to do grouped insurance arrangements could get caught.

Retirement Compensation Agreements

The Canada Revenue Agency (CRA) has identified a number of aggressive arrangements that from their perspective, seek to take advantage of various rules, including front end leveraging and allocating costs for insurance products between the plan and for providing benefits outside the plan. Non-arms length loan back arrangements will be prohibited as will investments similar to the rules for Tax Free Savings Accounts and RRSPs. RCA tax refunds will be restricted when the RCA property has lost value. The liability for penalties will extend to beneficiaries of the plans. (a 50% tax on the fair market value of any prohibited investment). The rules also cover corporate asset strip schemes including promissory note schemes.

For funding strategies using life insurance, CRA has a specific concern with shared ownership or split dollar arrangements. Specifically their concern focuses on structures where the RCA owns the cash surrender value of the policy, another person or entity owns the death benefit and the owner of the death benefit is not properly funding the related mortality costs.

These rules took effect on Budget day for new and existing plans.

Exempt test rules and Mortality Assumptions

The recent Federal Budget, 2012, included a major overhaul of the exempt test rules governing cash value life insurance. Here's a brief backdrop and proposed changes.

Exempt life insurance policies are defined under the Income Tax Regulations and for qualifying policies; the income earned on the savings component of an exempt life insurance policy is not subject to accrual taxation in the hands of the policyholder. This exemption test was implemented in 1982 and is now almost 30 years old. In the intervening time, while life insurance products have developed and changed, especially with the widespread use of universal life insurance products and product applications, the exempt test has remained largely the same.

Someone who owns a permanent life insurance policy is not subject to annual income taxation on the annual growth in the policy, so long as the policy in question is an "exempt" policy. Beneficiaries of an exempt life insurance policy receive death benefits on a tax-free basis, since the insurer, not the policyholder, bore the tax burden in respect of the policy over its lifetime.

The Regulations provide a test that is used to determine whether a particular permanent or "cash value" life insurance policy is an exempt policy and so is not subject to income taxation in a particular taxation year. The test's purpose is to differentiate between protection-oriented life insurance policies and investment-oriented products.

A life insurance policy is an exempt policy when the accumulating savings do not exceed the savings in a benchmark policy, referred to as the "exemption test policy" for any given taxation year. The accumulating fund of the actual policy is compared to the accumulating fund for the exemption test policy. The definition of the accumulating fund is based on a number of tests. The policyholder relies on the insurance company to ensure a policy remains tax exempt during the policy's lifetime.

Over the last three decades, a number of product innovations and strategies for life insurance have created interpretive issues and unintended tax consequences with respect to exempt policies.

Universal Life for instance, was a relatively new product when the original rules were implemented in the early 1980s. Universal life had a very flexible product design. This created challenges in applying the exempt test rules for both insurance companies and the Canada Revenue Agency (CRA). For example, in 1992, rules were changed to address interpretation of the exempt test for single premium universal life policies.

There have been several attempts to deal with interpretive issues of what constituted exempt policies, including submissions to the Department of Finance from industry groups in 1998 and 2009.

The Department of Finance has had other tax priorities which have prevented it from undertaking a major overhaul of these rules until now.

The Government is reviewing and revisiting the exemption test in order to determine whether it continues to serve its purpose and how it may be improved and modernized to better suit today's realities. It's too early to tell what the final effect the Federal Budget proposals will have on policies issued after 2013. This is how it's shaping up:

1. Surrender charges on policies will no longer impact the calculation of the exempt room in a policy. For a company like Empire Life, this means that there will be far less difference in how much can be accumulated in Trilogy, which has no surrender charges vs. Trilogy Plus, which has a five year, graded surrender charge schedule. Policies with surrender charges could be a lot less attractive. The differences between companies will be far less pronounced.
2. Revised and standardized policy assumptions for mortality and interest rate will also reduce differences between companies. Savings capacity will be based on a 3.5% interest rate.
3. The strategy of high prefunding of policies and very quick pay concepts will no longer work, certainly if the intent is to qualify the policies used as exempt policies.
4. Increasing the endowment age for the exempt test policy from 85 to 90 will decrease exemption room; the impact will vary by issue age and duration. This change reflects increased life expectancy.
5. Moving to an 8-pay benchmark model vs. the current 20 year funding model is expected to endorse payment periods as low as 8 years and increase exemption room for most ages in the first 20 years. This reflects current industry practices and the pay period used in other countries.
6. The overall level of long-term exempt accumulation room will typically be lower than what is available today for exempt policies. Some types of universal life policies will be impacted a lot.
7. The updated mortality charge assumption (using more recent Actuarial tables, specifically the CIA 1986-92 tables) will lower rates to better reflect lower mortality rates. Presumably they will be used to calculate the "net cost of pure insurance." This will impact the adjusted cost basis of a policy and will have a domino effect on calculations of tax-free loans, policy gains, the deductibility of premiums and credits to a corporate policyholder's Capital Dividend Account. The updated mortality assumptions are being introduced to improve consistency between the respective measurements of the savings in an actual policy and those in the exemption test policy.

8. The level of Investment Income Tax can increase for some policy designs and hence increase pricing for life insurance products. The Budget proposes a recalibration of the Investment Income Tax (IIT) that is levied on life insurers, where appropriate, in order to neutralize the impacts that the proposed technical changes described above may have on the Investment Income Tax base for policies that can now tax shelter more money in the early years.

The revisions to the exemption test and the recalibration of the IIT have not been finalized. They are intended to simplify the rules, standardize the approach taken by insurance companies and make them current to reflect today's marketplace realities. The Government will enter into a period of consultations over the next few months with key stakeholders regarding the Budget's proposed amendments. The Budget's proposed amendments will apply to life insurance policies that are issued after 2013.

From our perspective, our aim is to:

- ensure the new rules are fair and appropriate,
- that the rules protect the benefits of exempt life insurance policies and
- the strategies that appropriately rely on these benefits to meet the evolving needs of customers.

In summary, here is a bird's eye view of how the Federal Budget proposals will impact policies issued after 2013:

1. Surrender charges on policies will no longer impact the calculation of the exempt room in a policy. For a company like Empire Life, this means that there will be far less difference in how much can be accumulated in Trilogy, which has no surrender charges vs. Trilogy Plus, which has a five year, graded surrender charge schedule. Policies with surrender charges could be a lot less attractive.
2. The strategy of high prefunding of policies and quick pay concepts will no longer work, certainly if the policies are to qualify as exempt policies.
3. Exemption room will go up for most ages in the first 20 years drop but will drop overall.
4. Using more recent Actuarial tables will create some more exemption room. Presumably they will be used to calculate the "net cost of pure insurance" too. This will impact calculations of the adjusted cost basis of a policy, tax-free loans, policy gains, the deductibility of premiums and credits to a corporate policyholder's Capital Dividend Account.
5. Other changes hit the tax treatment of group accident and sickness benefits like critical illness, accidental death and dismemberment coverage, Retirement Compensation Arrangements.
6. Finally, the Government will introduce clarification on banking regulation and the separation of banking from insurance activities.