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The Next Phase of Life Insurance Policyholder Taxation Is Nigh

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PRÉCIS

Le 1er janvier 2017 marquera le début d'une nouvelle ère pour les règles fiscales canadiennes régissant l'exonération des polices d'assurance vie après une longue période de consultation entre le ministère des Finances et l'industrie de l'assurance vie. Les modifications marquent la première grande mise à jour en 30 ans du critère d'exonération et des règles fiscales s'appliquant aux titulaires de police. Ces changements complexifient un peu la compréhension de l'imposition des polices d'assurance vie, mais clarifient dans de nombreux cas le traitement fiscal de titulaires de police. La nouvelle législation s'appliquera aux polices souscrites après 2016, tandis que les règles actuelles continueront (en grande partie) de s'appliquer aux polices souscrites avant 2017. Les polices souscrites avant 2017 peuvent toutefois être assujetties au nouveau régime si certaines modifications prévues par la loi sont apportées à ces polices après 2016. Les auteurs de cet article décrivent les règles actuelles et celles qui s'appliqueront à compter de 2017, et présentent les principaux changements et les occasions de planification pouvant en découler.

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L'article s'amorce par une introduction à l'importance, aux circonstances et au mode de l'exonération de l'impôt des polices d'assurance vie et aux règles de disposition qui peuvent déclencher l'imposition des gains accumulés. Les auteurs passent ensuite en revue les modifications apportées aux diverses règles touchant les polices exonérées et leur incidence sur les polices souscrites avant 2017 et celles souscrites après 2016. Un certain nombre d'exemples montrent comment les nouvelles règles s'appliqueront dans la pratique aux nombreux calculs nécessaires pour assurer l'obtention du statut de police exonérée. Les auteurs examinent également les nouvelles règles qui touchent le calcul du produit de la disposition, le prix de base rajusté d'une police, les dispositions partielles, les polices d'assurance vie conjointes, les contrats de rente prescrits, et l'impôt sur le revenu de placements.

ABSTRACT

January 1, 2017 will mark the beginning of a new era in the Canadian taxation rules governing exempt life insurance policies following an extensive period of consultation between the Department of Finance and the life insurance industry. The changes mark the first major update of the exemption test and policyholder tax rules in more than 30 years. Although these changes add some complexity to the understanding of the taxation of life insurance policies, they also provide greater certainty with respect to the tax treatment of policyholders in many situations. The new legislation will apply to policies issued after 2016, while the current rules will (for the most part) continue to apply to policies issued before 2017. However, pre-2017 policies may come under the new regime if certain prescribed changes are made to those policies after 2016. The authors of this article describe both the current rules and those that will apply starting in 2017, highlighting the main changes and planning opportunities or issues that may arise.

The article begins with a primer on the significance, circumstances, and manner in which life insurance policies are exempt from taxation and the disposition rules that may trigger taxation of accumulating gains. The authors then review the changes to various rules affecting exempt policies and their impact on policies issued before 2017 and those issued after 2016. There are a number of examples of how the new rules will apply in practice to the many computations necessary to ensure exempt status. The authors also review new rules affecting the computation of proceeds of the disposition, the adjusted cost basis of a policy, partial dispositions, multi-life policies, prescribed annuity contracts, and the investment income tax.

KEYWORDS: INSURANCE ■ INSURANCE COMPANIES ■ INSURANCE POLICIES ■ LIFE INSURANCE ■ CAPITAL DIVIDEND ACCOUNT ■ TAX-FREE

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BACKGROUND

The taxation of products offered by life insurance companies can be very complex. An understanding of insurance products and their role in managing financial risks is required to fully appreciate the tax legislative framework that applies to these products and their various tax and estate-planning applications. Recently enacted changes will significantly change the rules for life insurance policies issued after 2016, and the transitional rules applicable to existing policies will add further complexity to the area.

Understanding the basis for the rules in the Income Tax Act[1] governing the tax treatment of insurance policies will ease the burden on those who wish to prepare

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

themselves and their clients for the impact of the various rule changes on insurance planning in the future. As well, with the panoply of vehicles for saving and investment facing today's Canadian investors and the varying tax treatments of each,[2] understanding the benefits offered by exempt policies will assist advisers and their clients in evaluating where such policies fit into a taxpayer's wealth management strategy.

This article will therefore provide an overview of the rules governing the taxation of exempt policies and the policyholder tax rules in general for current life insurance policies, and discuss the implications of the new rules for both existing policies and new policies that are issued or deemed to be issued after 2016.

LIFE INSURANCE PRIMER

Introduction

Products offered by life insurance companies include life insurance, living benefits products,[3] annuities, and wealth management products. In some cases, the lines between various insurance products can appear to be blurred—for example, in the case of an insurance policy that has a savings component. Accordingly, insurance products and the innovation around them can test the limits of the rules governing pure savings products. Since 1969, special rules have applied to tax gains realized on the disposition of an insurance policy. Prior to that time, neither the savings component nor the death benefit from a life insurance policy was taxed. Over the intervening decades, the rules have been tightened to impose limits on the amount that a policyholder is able to accumulate on a tax-free basis within a policy prior to death.[4] The one thing that has endured is the tax-free benefit on death.

The Exempt Policy Rules

Current rules distinguish between a policy designed primarily to provide insurance protection (an "exempt policy") and a policy designed primarily to deliver investment accumulation (referred to as a "non-exempt policy"). Exempt policies are not subject to annual accrual taxation,[5] and provided that the policy maintains its exempt status, all benefits on death are tax-free. The exemption is significant, since the rules still permit a certain amount of tax-free accumulation in the policy.[6] This accumulation can be used to subsidize future premiums, increase the benefits on death, or

2 For example, non-registered funds, registered plans, tax-free savings accounts, debt instruments, equity instruments, preferred shares, trust units, and segregated fund policies.

3 These traditionally include disability insurance, critical illness insurance, and long-term care insurance policies.

4 Value accumulates in an insurance policy from premiums and investment returns over and above the cost of insurance and administrative costs.

5 There is a specific exemption in paragraph 12.2(1)(a).

6 As a practical matter, most insurance policies sold by life insurance companies are exempt policies because of this preferential tax treatment.

be available for future partial withdrawals or policy loans. This preferential tax treatment fulfills a longstanding industry objective of facilitating long-term funding of life insurance protection with the assistance of tax-free investment returns, thus ensuring that the policyholder will be less likely to allow the policy to lapse owing to an inability to fund it later in life.[7]

While life insurance policies have many unique features that set them apart from other investment-related vehicles, the principal distinguishing feature is that they provide a contractually guaranteed benefit on death.[8] Beneath all of the jargon that surrounds life insurance taxation, the core taxable element is the annual increase in the accumulating fund[9] of the policy. The accumulating fund is intended to represent the savings element in the policy and has historically been the greater of (1) the cash surrender value and (2) the present value of future benefits less the present value of future premiums payable under the policy (effectively the reserve that can be claimed by the insurer in respect of the policy).

For Canadian tax purposes, the accumulating fund determines whether the policy is exempt from the annual accrual rules for life insurance policies,[10] and, if it is not exempt, how much is included in income. There are a number of different policy designs that may provide little or no cash value but can create a significant accumulating fund. For example, in a universal life level cost of insurance (UL LCOI) policy, the mortality charges in the initial years will exceed the annual mortality costs, and such excess is not available to the policyholder as part of the cash surrender value. However, in later years, the excess is available to effectively subsidize the cost of insurance when the policy mortality charges are below the actual mortality cost.

In order for a life insurance policy to qualify as an exempt policy, the inside buildup of value in the policy, as measured by the accumulating fund of the policy, must not exceed certain limits when compared with its benchmark policy. The benchmark policy is known as the "exemption test policy" (ETP). A policy can have several ETPs deemed to have been issued in respect of that policy. Provided that the actual accumulating fund does not exceed the sum of all of the ETPs deemed to have been issued in respect of the policy, the accumulation of funds in the policy will not be subject to annual accrual taxation, and any benefit on death will not be taxed.

The regulations to the Act specify the actuarial and other assumptions that must be used in determining the accumulating fund of the actual policy and that of corresponding ETPs. Generally, an insurance policy issued before 2017 will be exempt so

7 The 2012 federal budget noted that "[l]ife insurance plays an important role in meeting the financial needs of Canadians by helping to protect against the financial risks of premature death." See Canada, Department of Finance, 2012 Budget, Budget Plan, March 29, 2012, at 400.

8 This is due to the risk-pooling principle—the insurance company collects premiums for a large group of life-insured individuals and uses this pool of premiums and accumulated income to fund benefits on the death of each life-insured.

9 Regulation 307(1).

10 Subsection 12.2(1).

long as its accumulating fund does not exceed that of a policy whose face value endows at age 85 based on 20 equal premium payments made from the date of issue. Most policies with a savings element issued since 1983 have been designed as exempt policies. As discussed below, for exempt policies issued after 2016, the premise is that the accumulating fund will not exceed a policy whose face value endows at age 90 based on 8 equal premium payments. Life insurers are also generally required to pay a special 15 percent investment income tax (IIT)[11] on the inside buildup of investment income in exempt policies. As discussed further below, the IIT has been expanded to include, inter alia, the embedded reserves for UL LCOI policies issued after 2016.

Considerable effort is made by life insurers to ensure that policies designed as exempt policies maintain that status and generally undertake to warrant such status. In reality, only insurance companies can interpret and manage the exemption test on behalf of their policyholders.[12]

Rules Governing the Disposition of a Policy

While holders of exempt policies are not subject to annual accrual taxation during the term of the policy, dispositions of policies other than on death (or other limited circumstances) may be taxable. The taxation of dispositions of life insurance policies is covered by a special regime in section 148, and the resulting income is taxed similarly to interest income and not as a capital gain.[13] When a life insurance policy is disposed of, taxpayers are subject to tax on the difference, if any, between the proceeds of the disposition and the adjusted cost basis[14] (ACB) of the policy, discussed in greater detail below. Proceeds on death, however, are not taxable,[15] except for any increase in the accumulating fund of a non-exempt policy since the last anniversary. Losses from the disposition of an exempt policy are not deductible by the policyholder.[16]

11 Part XII.2, discussed below.

12 See, for example, CRA document no. 2013-0497901E5, July 24, 2013, wherein the Canada Revenue Agency (CRA) states, "The rules for determining whether any particular life insurance policy is an exempt policy under section 306 of the ITR are very complex. The application of the rules in section 306 of the ITR requires actuarial calculations and information that only the issuing insurer will possess."

13 The definition of a capital gain specifically excludes a disposition of "an insurance policy." See subparagraph 39(1)(a)(iii), which includes "a life insurance policy, except for that part of a life insurance policy in respect of which a policyholder is deemed by paragraph 138.1(1)(e) to have an interest in a related segregated fund trust."

14 Note the subtle difference in terminology for determining the proceeds (proceeds of the disposition versus proceeds of disposition) and the tax cost of insurance policies (adjusted cost basis) as distinguished from the tax cost of capital property (adjusted cost base).

15 See paragraph (j) of the definition of "disposition" in subsection 148(9). But note that the payment of a death benefit under a multi-life policy issued after 2016 may trigger reporting of income in certain circumstances, as discussed below.

16 However, losses under a non-exempt policy are deductible to the extent that they represent amounts previously included in income under the annual accrual rules (subsection 20(20)).

THE EVOLUTION OF POLICYHOLDER TAXATION IN CANADA

When the Department of Finance announced in the 2012 federal budget that "technical improvements" were required to update and simplify the exemption test and to recalibrate the IIT,[17] it was no surprise, since the last substantive refreshment of the exempt policy rules occurred almost 30 years ago. Originally the 2012 federal budget noted that the changes would affect policies issued after 2013; however, given the significance of the changes to come, it has taken until 2017 to finalize and apply the new rules.

Recent History

The most recent enactments began with the release from Finance of a consultation paper to the Canadian Life and Health Insurance Association (CLHIA) and the Conference for Advanced Life Underwriting (CALU).[18] It was evident from that paper that the announced "technical improvements" were going to be more far-reaching than those that were initially described in the 2012 federal budget papers, and would also include changes to the insurance policy disposition rules in section 148. From May to November 2012, the insurance industry engaged in intensive consultations with Finance, recommending a number of changes to the proposals outlined in the consultation paper, including the delay of the effective date.

The next phase saw the release of draft legislation on August 23, 2013,[19] followed by further consultations that continued through November 2013. The industry provided additional input on the design of the new rules, with the intent of clarifying the draft legislation and ensuring that the new rules did not create a significant administrative burden for either the industry or policyholders, or create inequities in the tax treatment of different types of insurance products.

A revised version of the draft legislation was released on August 29, 2014,[20] with a 30-day comment period. The industry continued to respond with impact analyses and recommended changes to specific areas, and noted other areas of concern. Legislation contained in a notice of ways and means motion was released on October 10, 2014,[21] and addressed some of the industry concerns. However, Finance

17 See the 2012 Budget Plan, supra note 7, at 401.

18 The Department of Finance released the consultation paper to the CLHIA and CALU in May 2012.

19 Canada, Department of Finance, "Government Invites Comments on Legislative Proposals To Modernize the Life Insurance Policy Exemption Test," *News Release* 2013-105, August 23, 2013 and accompanying *Legislative Proposals Relating to the Life Insurance Policy Exemption Test* (Ottawa: Department of Finance, August 23, 2013).

20 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax and Sales Tax* (Ottawa: Department of Finance, August 29, 2014).

21 Canada, Department of Finance, Notice of Ways and Means Motion To Implement Certain Provisions of the Budget Tabled in Parliament on February 11, 2014 and Other Measures, October 10, 2014.

indicated a willingness to continue discussions after the legislation was enacted. This legislation was incorporated into Bill C-43, which received royal assent on December 16, 2014.[22] The final legislation did not include an originally proposed specific anti-avoidance rule to combat perceived tax abuse. However, the government has legislated against leveraged insured annuity products (LIA policies) and 10/8 policies, and has also introduced proposals to curb certain planning involving corporate-owned life insurance.[23]

In the Beginning . . .

Canada's first income tax legislation was introduced in 1917 with the enactment of the Income War Tax Act, 1917.[24] This legislation contained an express exemption from tax for

> the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract.[25]

The exemption was retained until 1948, when the statute was amended to remove it.[26] However, in introducing this change, the minister of finance noted that "earnings on life insurance policies are exempt from taxation, and properly so."[27] Thus, although the exemption was removed, the tax treatment of insurance policies remained the same—that is, gains on death or on the maturity or surrender of an insurance policy were not subject to taxation.

Changes in the 1960s—The Carter Commission

By the early 1960s, there were a number of concerns with the fairness of the Canadian income tax system. One concern, in particular, was the use of various corporate tax-planning strategies (so-called surplus-stripping strategies) to convert taxable dividends into tax-free capital gains.

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22 Bill C-43, Economic Action Plan 2014 Act, No. 2, SC 2014, c. 39; royal assent December 16, 2014.

23 See, for example, amendments to subsection 148(7) for certain non-arm's-length transfers of insurance policies. In *R v. Golini*, 2016 TCC 174, the CRA succeeded in challenging a structure and a complex series of transactions involving annuities, insurance, and reinsurance. Campbell Miller J dismissed the taxpayer's appeal on the basis that a shareholder benefit applied, and if it had not, the general anti-avoidance rule would have applied, because the arrangement constituted an abuse of subsection 84(1). The *Golini* decision has been appealed by the taxpayer.

24 SC 1917, c. 28.

25 Ibid., subsection 3(1).

26 SC 1948, c. 52.

27 Canada, House of Commons, *Debates*, June 1, 1948, at 4639.

The federal government responded by appointing the Royal Commission on Taxation under the guidance of Kenneth Carter. The Carter commission's mandate was to review the entire federal tax system and report back with recommendations. Four years and six volumes later, the commission put forward its view that the tax system was too complicated and laden with loopholes. The commission recommended a vast overhaul of the tax rules with a view to making the system fairer by levying taxes based on a taxpayer's increase in economic power, however acquired.

This philosophy carried through to life insurance policyholder taxation, for which the following recommendations were put forward:[28]

- Premiums paid for an individual life insurance policy should generally not be deductible from income.
- The property income accumulated for the benefit of the policyholder should generally be included in income in the year in which it accumulates in the hands of the insurer. Alternatively, the income would be subject to a withholding tax when accrued by the insurer, and that tax would be refunded when the income was taxed to the policyholder. (This proposal is the precursor to the IIT, discussed below.)
- The entire policy dividend payable on a participating insurance policy should be included in the income of the policyholder and be subject to a 15 percent withholding tax.
- Mortality gains and losses should eventually be recognized in the income of policyholders. (A deferral was recommended to allow time for the impact of the other proposed changes to work their way through the system.)

The government responded almost immediately by enacting two significant tax changes affecting policyholder taxation:[29]

1. Gains resulting from a disposition of an insurance policy were to be included in the policyholder's income. A "disposition" was defined to include a surrender or maturity of a policy, but not proceeds received as a consequence of death.[30] The taxable portion was equal to the amount of the proceeds of the disposition less the ACB of the policy (which in most cases is the sum of all

28 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1967), at 452-54.

29 SC 1968-69, c. 44, section 28, added sections 105R through 105U (Income Tax Act, RSC 1952, c. 148, as amended). The stated rationale for these changes was that to maintain tax equity between various forms of savings, persons who save in the form of insurance policies must bear some level of taxation on the investment income that they receive from the insurance company.

30 SC 1968-69, c. 44, section 20, adding paragraph 79D(10)(c). There were relieving rules for policies issued on or before October 22, 1968; however, such policies were not fully grandfathered from the application of the new disposition rules.

premiums paid). A disposition would also arise as a consequence of the payment of a policy dividend, but in this case there would be no taxation until the total dividends received exceeded total premiums paid (or there was otherwise a taxable disposition).

2. The government also considered taxing the investment income allocated to a policy by the insurance company. However, it was felt that this would be too difficult to implement, and instead a 15 percent tax was imposed on the "taxable Canadian investment income" of life insurance companies. In effect, this was a proxy tax on the investment income attributable to insurance policies that was accumulating on a tax-deferred (or tax-free) basis. The amount of the tax payable by insurers would be reduced by any taxable income reported to the policyholder as a result of a policy disposition.

The Next Decade—1971 to 1981

The report of the Carter commission not only sparked changes to the tax treatment of policyholders but also led to the introduction of Bill C-259 in 1971, representing the most significant reform of the income tax statute since its enactment in 1917. Included in this bill was the introduction of taxation of capital gains as well as new rules governing the taxation of corporations and their shareholders.

Another important change occurred in 1974 with the introduction of the $1,000 tax exemption for interest income earned by individuals.[31] This exemption was broadened in 1975 to include dividend income and again in 1977 to include capital gains. This latter change played a role in the development of additional proposals relating to the taxation of insurance policies, as discussed below.

In the 1977 federal budget, the finance minister noted that the introduction of the $1,000 exemption for investment income created an inequity for those taxpayers who were saving through insurance policies.[32] This resulted from the fact that the taxation of investment income earned through insurance policies was effectively captured by the 15 percent IIT on insurance companies, rather than a direct allocation of that income to, and taxation in the hands of, the policyholder. As a result, it was proposed that the IIT on insurance policies be repealed, with the effect that the investment income under the policy could accumulate on a tax-free basis.

However, while giving with one hand, the finance minister proposed to take away with the other by imposing a tax on the investment income realized by a policyholder on the death of the life-insured (subject to a $10,000 exemption). The budget also proposed that policy loans be included in the definition of disposition, which would trigger taxable income should the policy loan exceed the ACB of the policy.

The life insurance industry (with the support of the general public) was able to convince the government to retreat on its proposal to tax the death benefit of a life

31 SC 1974-75-76, c. 26, section 70.

32 Canada, Department of Finance, 1977 Budget, Budget Document, March 31, 1977, at 43.

insurance policy.[33] However, the remaining proposals were implemented by the government.[34]

In summary, the following changes resulted from the 1977 federal budget:

- The IIT under part XII was repealed, with the result that the investment income of insurance policies could accumulate without any form of taxation unless there was a "disposition" of the policy.
- A "policy loan" made after March 31, 1978 was treated as a disposition of an interest in a life insurance policy.[35] As a result, a policy gain would arise if a policy loan exceeded the ACB of the policy.
- Consequential changes were made to the definition of "adjusted cost basis"[36] to reflect this new tax treatment of policy loans.

An uneasy truce now existed between Finance and the insurance industry in terms of policyholder taxation. With the repeal of the IIT and the federal government's retreat from its proposal to tax the insurance death benefit, it was now possible for an insurance policy to be used for long-term savings on a tax-deferred basis. Indeed, if the policy was held until death, the full amount of savings within an insurance policy would be received by the beneficiaries on a tax-free basis. It could not be expected that this situation would be allowed to persist, and the truce was broken in 1981.

CHANGES INTRODUCED BETWEEN 1981 AND 2012

The 1981 Federal Budget

On November 11, 1981, the Honourable Allan J. MacEachen, then deputy prime minister and minister of finance, presented his ill-fated and infamous 1981 budget. The budget proposed three major changes to the tax treatment of life insurance policies issued after November 12, 1981:

1. Individual policyholders would be subject to triennial tax reporting, and corporate policyholders to annual taxation, in respect of the accrued income within the insurance policy.
2. Any untaxed accumulated income within such policies would be taxed on death.
3. In determining the gain arising from the disposition of an insurance policy (including policies issued prior to the budget date), the ACB of the policy would

33 Formally, the government indicated that tax on death benefits was withdrawn pending "further study."

34 SC 1977, c. 1; royal assent December 15, 1977.

35 Ibid., section 74(5), amending subparagraph 148(9)(c)(ii) (Income Tax Act, SC 1970-71-72, c. 63, as amended).

36 Paragraph 148(9)(a) of the 1977 statute.

be reduced by the policy's "net cost of pure insurance"[37] (NCPI), which would result in higher gains on the disposition of the policy.

These proposals created a significant backlash for the government, not only from the insurance industry but from the general public as well. This in turn resulted in a number of changes to the proposals, which were eventually enacted in March 1983.[38] The most important change was the recognition of a special class of insurance policies, known as "exempt policies," which would not be subject to accrual taxation. As well, very broad grandfathering rules were put in place to maintain the existing tax rules for policies issued before December 2, 1982.[39] The following provides a summary of the main elements of these policyholder taxation rules, which in most respects remained unchanged until the introduction of new rules that will apply to policies issued after 2016.

Tax Treatment of Non-Exempt Policies

The tax rules that became effective on December 2, 1982 essentially differentiate between two classes of life insurance policies: those that qualify as "exempt policies"[40] and those that do not (referred to as "non-exempt policies"). Non-exempt policies issued after December 1, 1982 are subject to annual accrual taxation under subsection 12.2(1).[41] The amount subject to accrual taxation is equal to the excess of the policy's accumulating fund over its ACB[42] at that time. The accumulating fund of the policy is essentially defined to be the maximum tax actuarial reserve that the insurer may hold for the policy, which generally reflects the policy reserve that may be deducted by the insurer for tax purposes.[43] As well, non-exempt policies are deemed to have been disposed of immediately before the death of the life-insured for proceeds equal to the policy's accumulating fund.[44] The effect of these rules is to tax any policy gains that have arisen since the last accrual reporting date.

37 See regulation 308. The NCPI is designed to reflect the annual costs of pure term insurance protection and increases as the policyholder grows older. The result is that the ACB of the policy is reduced to nil after a period of time.

38 The new rules were generally effective for life insurance policies issued after December 1, 1982.

39 See subsections 12.2(9) (repealed but still effective for policies acquired before 1990) and 12.2(10) (as amended), and regulation 309.

40 Defined in regulation 306.

41 Annual accrual taxation for individually owned policies was introduced in 1989 effective for policies issued and last acquired after 1989. Non-exempt policies issued to individuals after December 1, 1982 and last acquired before 1990 are subject to triennial accrual taxation.

42 "Adjusted cost basis" is defined in subsection 148(9) and is affected by a number of policy transactions, including the payment of premiums, dispositions, and the NCPI charge for the policy.

43 Regulation 307(1)(b).

44 Paragraph 148(2)(b).

Subsequent Tax Changes of Importance to the Insurance Industry

The following is a brief review of other tax changes that occurred subsequent to the enactment of the current policyholder tax rules but before the tax changes to the exempt policy rules initiated by the 2012 federal budget.

Capital Dividend Account

Around the same time as the introduction of the exempt policy rules, the federal government announced changes to limit the ability of private corporations to pay out insurance proceeds to shareholders on a tax-free basis. The original proposals were subsequently modified and implemented through the introduction of the life insurance capital dividend account (LICDA).[45] This innovation is now merely of historical interest since the LICDA was repealed two years later. Since then, the practice has been that insurance proceeds are credited to a corporation's capital dividend account (CDA) and can be paid-out tax free to shareholders.[46]

In a somewhat similar vein, but with much longer-lasting impact, the so-called stop-loss rules were introduced in 1995. A discussion of these rules is beyond the scope of this article, but generally they limit the carryback of capital losses arising in an estate where corporate-owned life insurance is used to facilitate a share redemption from the estate of a deceased shareholder.[47]

Reintroduction of an Investment Income Tax

In 1987, the $1,000 investment income deduction was eliminated, sparking new debate on the taxation of income accumulating within an exempt life insurance policy. Ultimately, it was decided to reintroduce a modified IIT to ensure that the investment income within an exempt policy is subject to a reasonable level of tax.[48] In effect, the IIT represents a "minimum tax" on the accumulating fund of an exempt policy and is effectively borne by the policyholder through increased policy charges and/or reduced investment returns.

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45 SC 1980-81-82-83, c. 140, section 22.

46 By virtue of the definition of "capital dividend account" in subsection 89(1), generally the difference between the death benefit received and the ACB of the policy to the beneficiary corporation is added to the corporation's CDA.

47 Subsection 112(3.2) effective April 26, 1995.

48 The new IIT was proposed as part of the 1987 tax reform proposals (Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, June 18, 1987), at 128) and introduced in the 1988 federal budget. The current rules governing the IIT are found in part XII.2 of the Act. See the appendix to this article for a discussion of the earlier version of the IIT.

Single-Premium Policies

In the early 1990s, a small number of insurance companies marketed a "short-pay" universal life policy by assuming an increasing death benefit under the policy, based on a strict interpretation of the income tax regulations. The insurance industry reviewed this product design with Finance and recommended that the regulations be clarified to prevent this interpretation. The regulations were subsequently amended to prevent indexed policies from benefiting from more advantageous tax treatment, with grandfathering for all policies issued before March 26, 1992.[49]

The experience since 1982 has led to the current changes for policies issued after 2016, originally announced in the 2012 federal budget.

CHANGES AFFECTING FUTURE POLICIES—2012 AND AFTER

The 2012 Federal Budget

The 2012 federal budget promised "to make technical improvements to update and simplify" the exempt policy test for life insurance policies.[50] As noted above, the new rules proposed as a result of the 2012 budget have now been enacted. While policies issued before 2017 remain subject to the existing exempt policy rules,[51] new rules will apply to policies issued after 2016. While the new rules simplify certain computations, restructure and modernize the legislation, and resolve some uncertainties, the benefits that exempt policies can bring to the management of financial risks continue to be significant. These changes are highlighted in the discussion below. Throughout the remainder of the article, we will refer to "current policies" as those to which the rules for policies issued before 2017 apply, and "future policies" as those to which the rules for policies issued after 2016 (including policies that lose their grandfathering status) apply. The appendix highlights some of the concerns raised by Finance and the industry during the consultation process.

The Exempt Policy Rules

As noted above, the exempt policy rules are the means by which it is determined if the level of accumulation within an insurance policy is or has become so great that the annual accrual taxation rules should apply.[52] Exemption test policies (ETPs) are used to track the allowable accumulation within an exempt policy. Key to maintaining exempt status is ensuring that the accumulating fund of the policy is below the accumulating fund of all ETPs in respect of the policy. An ETP is a notional policy that is deemed to have been issued on the date of issuance of the actual policy (or the

49 Amendments to regulation 306 by the Income Tax Regulations, Amendment, SOR/94-415.

50 See the 2012 Budget Plan, supra note 7, at 401.

51 Unless a current policy loses its eligibility for grandfathering under the rules discussed below.

52 See supra note 4.

date of subsequent changes to the policy), using prescribed assumptions. The ETP (or ETPs) represents the projected fund balance at any point in time that eventually fully funds the policy by the prescribed endowment date[53] for the relevant policy.

An exempt policy is a life insurance policy (other than an annuity contract, an LIA policy,[54] or a deposit administration fund policy) that meets both of the following conditions:

1. the accumulating fund of the actual policy at the time of issue and thereafter does not exceed the accumulating fund of all the ETPs[55] deemed to have been issued in respect of the policy; and
2. assuming constant terms and conditions, it is reasonable to expect that condition 1 above will be met—in the case of current policies, on each policy anniversary thereafter, and in the case of future policies, by the next anniversary.[56]

The second condition is known as the "pre-testing" rule, and the significant change here for future policies is that the rule now requires only a one-year pre-test. This requires the insurance company to project the accumulating fund values to the following policy anniversary, using the most recent information available to the insurance company and without regard to any automatic adjustments made at the policy anniversary date to keep the policy exempt. For current policies, the rule requires that it be reasonable to conclude that the pre-test will be met at all times in the future, including post-endowment. In either case, a policy must meet the pre-test requirements at all times in the past, and once a policy is offside, it can never get back onside. However, practically speaking, insurance companies will take certain steps to ensure that the policy meets the pre-test in order to maintain its exempt status.

The rules create additional separate ETPs in respect of the policy to the extent that the benefit on death exceeds 108 percent of the policy's benefit on death at the last anniversary date. Any excess death benefit results in the deemed issuance of a separate ETP at that time.[57] This new layer of death benefit will have less accumulation room than it would if it were part of the ETP that was created when the original policy was issued because the accumulation room is based on the issue date of the

53 Regulation 310 generally defines the endowment date of a future policy to be the later of 15 years after the date of issue of the policy and the year in which the policyholder attains the age of 90.

54 An "LIA policy" is defined in subsection 248(1) and generally is an insurance policy that is used in combination with a life annuity to secure borrowings after March 20, 2013. Most of the tax benefits associated with an LIA policy were eliminated for taxation years that end after March 20, 2013.

55 Regulation 306(1)(a). Multiple ETPs may be deemed to have been issued if new coverages are added to the policy or if the policy fails certain tests, such as the 8 percent test or the 250 percent test described below.

56 Regulation 306(1)(b).

57 Regulations 306(3) and (7).

new ETP. This effectively limits the ability to make a large deposit or premium payment to fund the increased death benefit.

To illustrate the mechanics of the 8 percent rule, consider the following example.

Example 1

Assume that a life insurance policy is issued with $1 million of coverage. Further assume a savings element of $3,527, so that the benefit on death at the end of year 4 is $1,003,527. At that stage, year-over-year increases in the benefit on death do not breach the 8 percent threshold (because $1,003,527 is less than the original death benefit increased by 1.08). Now assume that $100,000 is deposited and a yield is earned in year 5 that increases the end-of-year death benefit to $1,114,639. Because this increase is greater than the 8 percent allowed, two ETPs will be created. One has a death benefit of $1,083,808 (108 percent of $1,003,527) and exempt-limit attributes based on the original issue age and the necessary accumulation in the fifth year of the ETP. The second ETP has a death benefit of $30,831 ($1,114,639 − $1,083,808) and exempt-limit attributes based on the attained age at the time the additional ETP was created (the original issue age plus five years in this case) and an accumulating fund of zero. To determine whether the policy will still be exempt, the aggregate savings element is determined for each of these two ETPs, and those amounts are then summed and compared with the policy's actual accumulating fund.

One significant change to the ETP rules is the application of these rules at the coverage level under the policy rather than at the policy level. This will further restrict the amount of tax-free accumulation within an exempt policy. The coverage-level requirements apply only to policies issued after 2016. This is accomplished by creating the notion of "coverage" under a policy and defining it for the purposes of the ETP rule.[58]

The effect of applying the ETP rule at the coverage level rather than the policy level can best be illustrated by the following example.

Example 2

Assume that a policy covers the lives of two individuals, one with a death benefit of $700,000 and the other with a $300,000 death benefit. Under the current rules, when the 8 percent test is applied at the policy level, the benefit on death can increase in respect of either coverage so long as the benefit on death under the policy as a whole does not increase by more than $80,000. For future policies, any increase in the benefit on death of any coverage under the policy is limited on its own by the 8 percent limit; accordingly, a coverage with an increase in the benefit on death below the 8 percent limit cannot be applied to shield an increase in excess of 8 percent on any other coverage under the policy. In the example, the benefit on death in respect of the $700,000 coverage cannot increase by more than $56,000, and the benefit in respect

58 Regulation 310, paragraph (a) of the definition of "coverage" applies a wide definition for the purposes of the ETP rules in regulation 306, whereas for the purposes of regulations 307 and 308, the definition of "coverage" in regulation 1401(3) applies.

of the $300,000 coverage cannot increase by more than $24,000. One impact of these changes is that adding coverage to an existing policy will create no more deposit room than buying a new stand-alone policy.[59]

When a fund value benefit decreases, special rules allocate the reduction across ETPs essentially on a last in, first out (LIFO) basis. As a consequence of the amendment of the coverage rules, new rules exist to allocate any reduction to ETPs for each coverage, effectively on a LIFO basis, relative to the coverages under the policy.[60]

Insurers typically warrant that a policy will remain exempt through its term. Accordingly, they monitor the status of their policies closely, since there are a number of additional checks and balances on the amount that can be accumulated within an exempt policy.

In addition to the so-called 8 percent test, another rule currently applies to limit the size of deposits made to the policy after the policy has been in force for 10 years or longer. This is accomplished by comparing the accumulating fund of the actual policy on the 10th and every subsequent policy anniversary with the accumulating fund of the actual policy on the 3d preceding policy anniversary. If the ratio of the accumulating fund in the current year to the accumulating fund on the 3d preceding anniversary exceeds 250 percent (the so-called 250 percent test), the ETPs of the policy are deemed to have been reissued on the later of the 3d preceding policy anniversary and the date on which the relevant ETP was issued. This "re-dating" of the ETP will reduce the amount that can be accumulated in the actual policy, because the policy will have an accumulating fund based on a policy that has been in force for only 3 years. In situations where the policy has been funded at a minimum level, this could potentially make it difficult for the policyholder to make sufficient deposits to result in the policy being "paid-up"[61] at a later date. Traditionally, this re-dating of ETPs has been avoided by ensuring that the policyholder withdraws funds from the policy prior to the application of the test.[62]

Finance describes the current 250 percent test as an "anti-avoidance rule" designed to limit the increase in savings within a policy if savings were not contributed in the earlier years of the policy.[63] As noted above, shorter durations allow for less accumulation, and where the 250 percent test applies, the ETP is re-dated to a more

59 If this coverage is added to a policy issued before 2017, the grandfathered status of the policy also may be affected, as discussed below.

60 Regulation 306(5)(b).

61 A "paid-up" policy is one that has sufficient cash values that the premiums or cost of insurance can be funded now and in the future by the policy's internal values. In other words, the policyholder does not expect to pay any further premiums or make additional deposits to the policy to keep it in force.

62 The amount withdrawn would have to ensure that the policy no longer fails the 250 percent test.

63 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, Excise Tax Act, Excise Act, 2001 and Related Legislation* (Ottawa: Department of Finance, October 29, 2014), at 161.

recent year, thus shortening the duration. The new test continues to apply to policies starting in their 10th or later policy anniversary year but is relaxed in a number of ways for all policies regardless of the issue date, commencing in 2017. ETPs in respect of the policy will need to be re-dated if the policy fails both of the following tests:[64]

1. the accumulating fund of the policy exceeds 250 percent of the accumulating fund on its 3d preceding anniversary; and
2. for policies issued before 2017, the accumulating fund of the policy exceeds 3⁄20 of the accumulating fund of the ETPs or, in the case of policies issued after 2016, 3⁄8.

If both tests are failed, the issue date of each ETP is reset to the 3d anniversary prior to the current anniversary. A final change ensures that a re-dated policy does not need to be retested for another 7 years, giving that policy a full 10 years before retesting.[65] These changes are expected to help ensure that modest prefunding of policies can be achieved without running afoul of the above-noted rule in regulation 306(6)(b).[66]

The mechanics of the revised 250 percent test can be illustrated by the following example.

Example 3

Assume that a $1 million policy is issued and the policyholder has been funding the policy with minimum contributions, effectively covering only the cost of insurance. After 10 years, the policy has an accumulating fund of $3,000 while the accumulating fund of the ETP in respect of the policy at the end of 10 years is approximately $200,000. The policyholder wishes to increase funding to the policy to allow the inside buildup to cover the cost of insurance and effectively pay up the policy. The policyholder has $50,000 of funds available in each of the next 3 years to deposit into the policy. Assuming that the policy had an accumulating fund of $2,000 at the end of year 7, a contribution to the fund of $50,000 would clearly breach the 250 percent rule (because 250 percent of $2,000 is $5,000, and the fund has accumulated a further $1,000 in the intervening 3-year period). Accordingly, if there were no re-dating of the ETP, only an additional $2,000 could be paid into the policy in policy year 10 while preserving its exempt status. Further, the current rules would limit funding in each of the subsequent years to similarly nominal amounts without re-dating the policy's ETPs, since the 250 percent rule currently applies at each policy anniversary after the 10th anniversary.

As noted above, starting in 2017 for current and future policies, the 250 percent rule continues to apply, but the second part of the test allows for accumulations based

64 Regulations 306(6)(b) and (c).

65 Regulation 306(6)(c)(ii).

66 Although, as noted above, Finance identifies the retesting rule as an anti-avoidance rule, this regulation seems to lack the hallmarks of such a rule and simply provides a prefunding limitation. It is hard to imagine prefunding a policy as a tax-avoidance technique.

> on the allowable accumulating fund of the ETPs in respect of the policy. Accordingly, the accumulating fund of the policy at the end of year 10 can be up to 3⁄20 (for policies issued before 2017) or 3⁄8 (for policies issued after 2016) of the accumulating fund of the ETP in respect of the policy. Assuming that the accumulating fund of the ETP is $200,000, this amounts to $30,000, or $75,000 depending on the policy issue date. If the policy were to fail the new 250 percent test, the ETPs would be deemed to have been reissued on the 3d preceding policy anniversary (thus potentially restricting the accumulating fund and requiring a withdrawal). Funding in subsequent years can then be made without regard to the 250 percent test for the next 6 years. In any event, the relaxation of this rule allows more scope to pay up the policy in later years.

The rules allowing a policy that would otherwise cease to be an exempt policy to be restored within 60 days of its policy anniversary are preserved as well.[67]

For current policies, it is impossible for policyholders to compute the accumulating fund of each ETP or the accumulating fund of the actual policy that is used to test the status of the policy as exempt. This is because, under the current rules, the accumulating fund of the actual policy is based on the assumptions used by the insurance company in developing the premiums for the specific policy and the application of what is referred to as the 1.5-year preliminary term method for determining the policy reserves. (This methodology takes into account acquisition charges in determining the reserve basis for the policy, resulting in a lower accumulating fund in the early years of the policy.) As well, for some policies, the cash surrender value of the policy (rather than the actual fund value of the policy) is utilized in the determination of the policy's accumulating fund.

For current policies, the accumulating fund of each ETP is also based on the assumptions used to determine the premiums of the actual policy, modified as follows:

- the minimum interest rate that can be used is 4 percent;
- if the mortality assumptions used to determine the premium are unknown, the insurer is to use the Society of Actuaries' Commissioners 1958 Standard Ordinary Mortality Table; and
- in the first 20 years of the policy, the ETP is to be "interpolated" from the accumulating fund of the ETP value in year 20 using the current death benefit.[68]

There are significant changes to the calculation of the accumulating fund for the ETP for future policies. Instead of using the pricing basis of the actual policy, the insurance companies must use fixed assumptions for interest (3.5 percent) and mortality

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67 Regulation 306(8).

68 The interpolation is done to create a "straightline" accumulating fund of the ETP value in the first 20 years of the policy. This creates a higher accumulating fund of the ETP in the first 20 years, which benefits policyholders who want to "maximum-fund" their policies during that period of time.

(using the Canadian Institute of Actuaries' [CIA] 1986-1992 mortality tables).[69] As well, an 8-year payment period is to be used instead of the current 20-year payment period with the assumption that the policy endows at age 90 (instead of age 85 under the current rules).[70] The exemption test rules have also been clarified to ensure that the test continues to apply beyond age 90.[71]

Similarly, the accumulating fund of the actual policy will no longer be based on product-pricing assumptions but will use fixed-interest and mortality assumptions on the same basis as the accumulating fund of the ETP (3.5 percent interest and the CIA 1986-1992 mortality tables).[72] In addition, the cash surrender value of the policy will be determined before surrender charges.[73] The reserve basis of the policy will change from the 1.5 year preliminary term methodology to a "net premium reserve" (NPR) basis.[74]

By comparison with the current rules, the accumulating fund of the ETP will be higher in the first 10 to 12 years of the policy but trending lower thereafter until age 90. On the other hand, the accumulating fund of the actual policy will generally be higher at all policy durations by comparison with the current rules. The net effect (in relation to current policies) will generally be similar to higher accumulation room in the first 10 years and then a reduction in the maximum amount that may be accumulated. However, the impact of these changes will be significantly greater for UL LCOI policies, since surrender charges will now be ignored and the embedded reserve will be included in determining the accumulating fund of the actual policy.

It is difficult to provide a more detailed analysis since the overall impact will depend on the type of product, the policyholder's age, and the expected funding pattern. For example, the impact will be more pronounced for UL LCOI "life-pay" policies at younger ages and have less of an impact on policies with higher premiums paid over a shorter period of time. It should also be noted that only a small percentage of policyholders pay premiums to achieve the maximum permitted accumulation room over the lifetime of the policy. As a result, in the majority of situations, policyholders will not experience any practical impact from these changes to the exemption test.

There are a number of other changes designed to clarify the application of the rules to joint policies and multi-life policies;[75] the definitions also clarify the intended

69 Regulations 1401(1)(c) and 1401(4). The mortality rates to be used for substandard and joint life policies are also clarified in regulations 1401(4)(b)(i)(C) and (ii), respectively.

70 See the definitions of "interpolation time" and "endowment date" in regulation 310.

71 See the definitions of "pay period" in regulation 310.

72 Supra note 69.

73 Regulation 1401(1)(c). It is anticipated that this will result in insurance companies re-evaluating the calculation of surrender charges since they provide no accumulation advantage to policyholders.

74 See the definition of "net premium reserve" in regulation 1401(3).

75 This is accomplished by moving from a policy basis to coverage basis for applying the exemption test. See the definition of "coverage" in regulation 310.

application to fixed-premium policies (such as participating whole life, traditional non-participating whole life, and term policies) and variable deposit products (such as universal life).[76]

In their totality, these changes will harmonize the exempt policy rules as they apply to various products and the types of coverages under those policies (single, joint, multi-life), as well as eliminating much of the differentiation that may currently exist in how the exemption test is being applied by various insurance companies.

Changes to the Insurance Disposition Rules

Disposition Rules Applicable to Current Policies

While exempt policies are not subject to the annual accrual rules[77] and, as mentioned above, gains on insurance policies in general are excluded from the definition of a capital gain, gains from dispositions of insurance policies are still potentially subject to tax under a separate tax regime. Paragraph 56(1)(j) includes in a taxpayer's income any amounts required to be included under subsection 148(1) or (1.1)—essentially, gains from dispositions of life insurance policies. Because gains on dispositions of life insurance policies (other than on death) are subject to tax at ordinary rates, taxpayers who own policies and their advisers need to be aware of any situations that could inadvertently or otherwise trigger taxable gains.

As mentioned previously, the death benefit under an exempt policy is generally not taxable. This is accomplished by carving out payments under exempt policies from the term "disposition."[78] In the case of non-exempt policies, recall that the annual accrual rules in subsection 12.2(1) include in a taxpayer's income, on each anniversary date of a life insurance policy,[79] the amount, if any, by which the accumulating fund in respect of an interest in the policy exceeds the ACB of the policy[80] on that date. Where a policyholder dies owning a non-exempt policy, paragraph 148(2)(b) deems the policy to have been disposed of immediately before death. In addition, the definition of "proceeds of the disposition" of an interest in a life insurance policy deems a disposition under paragraph 148(2)(b) to have occurred at an amount equal to the accumulating fund.[81] In effect, this captures any accrued income that has been earned between the previous anniversary/reporting date and the date of death, and would otherwise have been included in income by virtue of subsection 12.2(1), but excludes from taxation any portion of the death benefit.

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76 This is accomplished in the regulations by the use of terminology specific to these types of policies, such as "premiums or cost of insurance charges."

77 Subsection 12.2(1).

78 Paragraph (j) of the definition of "disposition" in subsection 148(9).

79 For a policy last acquired after 1989.

80 Discussed in more detail below.

81 See the definition of "proceeds of the disposition" in subsection 148(9).

In addition, certain events will give rise to proceeds of disposition and the realization of potentially taxable gains on an exempt or non-exempt insurance policy.[82] Such events currently include policy dividends, policy loans, change in tax status (exempt to non-exempt), or partial dispositions. Policy dividends give rise to deemed proceeds from the disposition of an interest in the policy[83] and will ordinarily result in a reduction in the ACB of the policy;[84] however, where the amount is used to pay a premium under the policy or to repay a policy loan, as provided under the terms of the policy, the proceeds are reduced by that amount.[85]

Policy loans are also regarded as a disposition[86] and will result in a reduction of the ACB of the policy.[87] The proceeds of the disposition will be equal to the lesser of the amount of the loan (other than the part used to pay a premium under the policy) and the cash surrender value of the policy less any policy loans outstanding at that time.[88] A policy loan in excess of the ACB of a policy will result in a policy gain, which can be claimed as a deduction when repaid.[89]

A policy that ceases to be exempt (other than as a consequence of the death or total and permanent disability of the insured) will give rise to a deemed disposition and reacquisition at the value of the accumulating fund at that time.[90]

Proceeds of the Disposition

The definition of "proceeds of the disposition"[91] of an interest in a life insurance policy applies in determining the amount that is required to be included in income under subsection 148(1) upon the disposition of the interest. The definition also contains detailed rules to deal with specific types of policy transactions, such as the surrender or maturity of the policy, policy loans, and dispositions on death.

Paragraph (a) of the definition provides that the proceeds of the disposition on the surrender or maturity of the policy is the cash surrender value of the policy less certain amounts, including an amount payable in respect of a policy loan. In effect, the amount of any outstanding loan reduces the proceeds of the disposition and possible tax reporting, on the basis that the ACB of the policy has already been reduced upon the taking of the policy loan.

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82 Since non-exempt policies are subject to annual accrual taxation, only gains accumulated since the last policy anniversary will be included in the policyholder's income.

83 Deemed proceeds under paragraph 148(2)(a).

84 Element *H* of the definition of "adjusted cost basis" in subsection 148(9).

85 Subparagraph 148(2)(a)(ii).

86 Paragraph (b) of the definition of "disposition" in subsection 148(9).

87 Elements *J* and *K* of the definition of "adjusted cost basis" in subsection 148(9).

88 Paragraph (b) of the definition of "proceeds of the disposition" in subsection 148(9).

89 Paragraph 60(s).

90 Paragraph 148(2)(d).

91 Defined in subsection 148(9).

However, owing to concerns with potential tax avoidance, this provision has been amended with respect to future policies, to provide that the specified amount by which the cash surrender value is reduced by the policy loan is only that portion of the policy loan applied, immediately after the loan, to pay a premium under the policy. The discussion of subsection 148(4.01) and example 5 below illustrate the impact of this change.

Adjusted Cost Basis

The "adjusted cost basis"[92] to a policyholder of the policyholder's interest in a life insurance policy is made up of many different elements, but for most policies, it represents the premiums paid under the policy less the NCPI (net cost of pure insurance), which is designed to reflect the mortality costs of such a policy. The ACB is important in determining the taxable gain that might arise on the disposition of a policy,[93] as well as the extent to which policy dividends and policy loans can be received tax-free. The ACB of the interest is also relevant in determining the amount that will be added to the CDA of a private corporation arising from the receipt of insurance proceeds.[94]

The definition in the Act is expressed using the following daunting formula:

$$(A + B + C + D + E + F + G + G.1) - (H + I + J + K + L + M + N + O).$$

The recent amendments have modified or added some of these elements to take into account certain policy transactions, including the repayment of policy loans, premiums or cost-of-insurance (COI) charges for ancillary benefits, capital disability or death benefits, and benefits on death resulting in the termination of coverage under a multi-life policy. The various changes to the ACB calculation are discussed below.

Revised Element E

Currently, element *E* permits an increase in the ACB of the policy for the repayment of policy loans in limited circumstances. However, there is no increase in the ACB of the interest upon the repayment of a policy loan that was originally used to pay a premium under the policy not otherwise reflected in the ACB of the policy. For policies issued after 2016, an increase to the ACB will be permitted, except to the extent that the repayment of the policy loan has previously been "applied" to reduce the proceeds of disposition in accordance with the revised definition of "proceeds of the disposition" (as described above). In other words, the policy loan must be repaid with funds external to the insurance policy to obtain an ACB increase. For policies

92 Defined in subsection 148(9).

93 Subsection 148(1) and paragraph 56(1)(j).

94 Paragraph (d) of the definition of "capital dividend account" in subsection 89(1).

that are deemed to have been issued at a particular time after 2016 because of subsection 148(11), the amendment applies only to repayments of a policy loan after that time.

The point here is narrow but important, since the ACB of a policy governs the potential tax impact on a disposition of the policy.

New Element M

Element *M* has been added to ensure that only premiums or COI charges that relate to the benefits on death are included in the ACB calculation. It should also be noted that the term "benefit on death"[95] includes an endowment benefit but excludes other ancillary benefits. As well, the current definition of "premium" in subsection 148(9) will not apply to policies issued after 2016. The net effect of these changes, for policies issued after 2016, is to ensure that only that portion of the premiums or COI charges relating to the death benefit will be included in the ACB of the policy.[96] All other ancillary risk charges (such as disability, critical illness, waiver of premium, guaranteed insurability, and accidental death and dismemberment benefits) will be excluded from a policy's ACB calculation.

New Element N

Insurance companies currently offer life insurance policies that allow the accumulated value of the policy to be paid out on the death or disability of the life-insured.[97] The insurance industry relies on specific exemptions under the definition of "disposition" to treat such amounts as a tax-free payment.[98] As a consequence, the payment of such benefits has no impact on the ACB of the policy.

However, for policies issued after 2016, element *N* is designed to reduce the ACB of a policyholder's interest in a policy upon the payment of a benefit on death[99] where such payment is funded by the cash value of the policy and does not result in the termination of a coverage (for example, where a death benefit is paid on the first death under a joint second-to-die policy,[100] or where a disability benefit is paid under single/joint or multi-life coverage and the life insurance coverage continues). The ACB reduction is not to exceed the greater of the amount by which the cash

95 Defined in regulation 1401(3).

96 Extra premiums for substandard or rated life insurance risks will also increase the ACB of the policy.

97 Such policies are typically universal life (UL) policies.

98 See paragraphs (h) and (j) of the definition of "disposition" in subsection 148(9).

99 Defined in regulation 1401(3).

100 The payment of a death benefit from fund value under a multi-life policy issued after 2016 is also governed by the rules in paragraph 148(2)(e) as well as element *O* of the definition of "adjusted cost basis" in subsection 148(9), discussed below.

surrender value of the policy and the fund value of the insurance policy is reduced by the amount paid.[101]

New Element O

New element *O* is intended to reduce the ACB of an interest in a life insurance policy issued after 2016 where a benefit on death[102] has been paid under a coverage and the coverage has terminated, but the policy itself remains in effect. In particular, this element is applicable to a multi-life policy, including a policy with a spousal or child term rider, where a death benefit has been paid in respect of one of the insured and the coverage on that life has terminated, but the policy otherwise continues to be in effect.

The ACB adjustment under element *O* consists of the following elements:

$$[P \times (Q + R + S)/T] - U.$$

These elements may be summarized as follows:

- P = the ACB of the policyholder's interest immediately before the termination of coverage,
- Q = the fund value benefit paid in respect of the coverage on termination,
- R = the present value of the fund value of the coverage,[103]
- S = the amount determined on that policy anniversary as the NPR of the coverage,[104]
- T = the amount determined on that policy anniversary as an element of the NPR of the policy, and[105]
- U = the amount of ACB already allocated to a payment in respect of a fund value benefit under paragraph 148(2)(e) and subsection 148(4) (discussed above).

101 As defined in regulation 1401(3). The fund value of the policy is the total value of all investment accounts and therefore ignores surrender or other charges.

102 Supra note 95.

103 Determined, for the purposes of regulation 307, on the last policy anniversary on or before the termination of the coverage if the fund value of the coverage was equal to the fund value of the coverage on termination.

104 The amount determined under paragraph (a) of the description of element *C* in the definition of "net premium reserve" in regulation 1401(3) in respect of the coverage, if the benefit on death under the coverage and the fund value of the coverage on that policy anniversary were equal to the benefit on death under the coverage and the fund value of the coverage on the termination.

105 The amount determined by the definition of "net premium reserve" in regulation 1401(3) in respect of the policy, if the fund value benefit under the policy, the benefit on death under each coverage, and the fund value of each coverage on that policy anniversary were equal to the fund value benefit, the benefit on death under each coverage, and the fund value of each coverage under the policy on the termination.

Multi-Life Policies

It is possible for an insurance company to issue a life insurance policy that covers more than one life-insured (known as a "multi-life policy").[106] For example, a corporation may apply for insurance on the lives of three shareholders for the purpose of buy-sell funding. Purchasing one policy covering all three lives, rather than separate policies on the life of each shareholder, often results in lower administrative expenses being charged by the insurance company.

As is the case with any exempt insurance policy, amounts can be accumulated in a multi-life policy on a tax-deferred basis.[107] A number of insurance companies permit the accumulated values under a multi-life policy to be paid out on the death of each life-insured. The Canada Revenue Agency (CRA) has historically accepted that the payment of the accumulated value on the death of a life-insured (whether the policy is on a single life, joint life, or multi-life basis) will be treated as a tax-free death benefit.[108] However, both Finance and the CRA were concerned that the ability to pay out the accumulated value of the total policy on each death created the incentive to use a multi-life policy, instead of purchasing separate policies, in order to convert what would otherwise be taxable income (if withdrawn from the policy) into a tax-free death benefit (discussed below).

New paragraph 148(2)(e) is meant to deal with this potential planning opportunity. It applies to a situation where an insurance death benefit is paid that results in a termination of coverage but not termination of the policy—that is, there are other coverages under the policy that remain in effect. If the fund value benefit[109] that is paid out exceeds the maximum amount permitted in respect of the terminated coverage,[110] a policyholder with an entitlement to the excess portion is deemed to have disposed of a "part of an interest" for proceeds equal to that excess portion. This creates the potential for taxation of a portion of the benefit paid out of the policy's fund value on the death of an insured under a multi-life policy. It is important to note that there are related changes under revised subsection 148(4) (discussed below) and element *O* of the ACB formula in subsection 148(9) (discussed above).

106 A multi-life policy must be distinguished from a joint life policy, where there is only one insurance coverage that is dependent on the death of one ("joint first to die") or both ("joint second to die") of the life-insured.

107 Multi-life policies are typically UL policies.

108 See paragraph (j) of the definition of "disposition" in subsection 148(9) and CRA document no. 2000-0033885, September 11, 2000.

109 As defined in regulation 1401(3).

110 Under regulation 306(4)(a)(iii). This amount is to be determined on the date of death, or the first date that follows the date of death, of the life-insured.

The following example illustrates the impact of a death benefit on the ACB of a multi-life policy.

Example 4

Corporation A purchases a multi-life policy after 2016 with the following coverages:

- life-insured 1—$1 million;
- life-insured 2—$100,000.

Assume that on the fifth anniversary of the policy, the total cash value is $120,000 and the ACB of the policy is $80,000. Further assume that if the insurance coverage had been issued separately, the maximum fund value at the fifth policy anniversary for the coverage on life-insured 1 would have been $120,000, and for life-insured 2 it would have been $20,000.

If we assume that life-insured 2 dies at this point in time, corporation A will receive a death benefit of $220,000, consisting of the $100,000 coverage on this life-insured and the $120,000 fund value.

As discussed below, paragraph 148(2)(e) will deem $100,000 of the fund value death benefit to be proceeds of the disposition. In determining the taxable amount of the proceeds, subsection 148(4) will require an allocation of the ACB of the policy as follows:

$80,000 (full ACB) × 100,000/120,000 = $66,667.

This will result in a taxable gain of $33,333 ($100,000 proceeds less $66,667 ACB).

Applying the formula in element O of the definition of ACB, $[P \times (Q + R + S)/T] - U$, will produce the following adjustments to the ACB of the policy:

P = $80,000 (ACB prior to the termination of coverage on life-insured 2),
Q = $120,000 (fund value benefit paid on termination of the coverage on life-insured 2),
R = nil (there is no fund value of the coverage for life-insured 2),
S = $20,000 (assumed NPR of the coverage on life-insured 2 immediately before death),
T = $140,000 (assumed NPR of the entire policy owned by corporation *A*), and
U = $66,667 (ACB of the "taxable" fund value benefit paid on the death of life-insured 2 as determined above).

Thus, the ACB adjustment is calculated as

[$80,000 × ($120,000 + nil + $20,000)/140,000] – $66,667 = $13,333.

The total ACB of the policy after these various adjustments would be

$80,000 – $100,000 (proceeds of the disposition under paragraph 148(2)(e)) + $33,333 (taxable gain on disposition) – $13,333 (element O) = nil.

Under the current rules, which continue to apply to policies issued before 2017, the full $220,000 payment will be treated as a tax-free death benefit. As well, since the payment of the death benefit is not considered to be proceeds of the disposition, the ACB of the policy remains at $80,000.

Partial Dispositions

Subsection 148(4) applies on a partial disposition (other than one arising from a policy dividend or policy loan) of a taxpayer's interest in a life insurance policy. With a partial disposition, the ACB of the interest is prorated according to a formula set out in this subsection, and this prorated ACB is used to determine whether there is a taxable gain under subsection 148(1).

Subsection 148(4) is amended for life insurance policies issued after 2016 and modifies the formula to use the policy's cash surrender value (less policy loans) rather than the accumulating fund of the policy.[111] This change deals with a concern expressed by the industry that as a result of the new accumulating fund definition, the reportable income arising from a series of partial dispositions could exceed the reportable income on a full disposition.

Subsection 148(4.01) is a new provision that complements changes made to the definition of "proceeds of the disposition" discussed above. The overall purpose of these changes is to ensure that the partial disposition rules in subsection 148(4) cannot be avoided by first making a policy loan and then effecting a partial disposition of the policy. Subsection 148(4.01) will adjust the ACB of the interest in the policy to avoid the potential for double taxation of the same gain in the future. In particular, where a partial surrender of the policyholder's interest in the policy reduces the amount payable by the policyholder in respect of a policy loan, subsection 148(4.01) deems the partial surrender of the interest to be a repayment of the policy loan immediately before the partial surrender takes place. This in turn will increase the ACB of the interest in the policy for the purposes of determining any gain arising from the partial surrender. It should be noted that this result will arise only if the partial surrender is not otherwise considered to be a repayment of the policy loan and does not reduce the proceeds of disposition (that is, the policy loan being repaid by the partial surrender was not originally used to pay a premium under the policy).

The following example shows the interaction of changes in the definition of "proceeds of the disposition" (discussed below), new subsection 148(4.01), and subsection 148(4) for policies issued before 2017 and after 2016.

Example 5

Policy Issued Before 2017

Assume that Mr. B has a policy with an ACB of $40,000 and a cash surrender value of $120,000. Mr. B withdraws $30,000 from the policy. This withdrawal constitutes proceeds from the disposition of an interest in the policy. Under subsection 148(4), the pro rata ACB associated with this disposition is $10,000 ($40,000 × $30,000/$120,000). This results in a taxable gain of $20,000 (proceeds of $30,000 − ACB of $10,000). The

111 For policies issued before 2017, the formula will use the accumulating fund of the policy. However, where the accumulating fund was indeterminable, the cash surrender value is used in practice.

ACB of the policy is now $30,000, being reduced by the proceeds of disposition and increased by the taxable gain reported on that disposition, and the cash surrender value of the policy has been reduced to $90,000.

Now assume that instead of taking a partial withdrawal of $30,000 from the policy, Mr. B first takes a policy loan for $30,000. While a policy loan is treated as a disposition of an interest in the policy, subsection 148(4) does not apply to prorate the ACB of the policy. As a consequence, since the ACB of the policy exceeds the amount of the policy loan, there is no reportable gain on the taking of the policy loan. However, the ACB of the policy is reduced from $40,000 to $10,000.

Assume that Mr. B subsequently makes a withdrawal from the policy to repay the policy loan. This would initially result in proceeds of disposition of $30,000. However, the definition of "proceeds of the disposition" reduces these proceeds by the amount used to repay the policy loan ($30,000),[112] resulting in nil proceeds of disposition. The end result is that Mr. B has been able to withdraw $30,000 from the policy without any amount being included in income (in effect, avoiding the ACB proration rules in subsection 148(4)). The ACB of the policy at this point remains at $10,000, and the cash surrender value is $90,000. Consequently, there remains $80,000 of accrued gain that would be taxable upon a subsequent disposition of the entire policy.

Policy Issued After 2016

The definition of "proceeds of the disposition" has been amended so that the proceeds arising from a partial withdrawal will not be reduced by the amount of any policy loan outstanding where the policy loan has previously been taken in cash (rather than used to pay premiums).[113] As a consequence, the partial withdrawal by Mr. B to repay the policy loan will result in proceeds of disposition of $30,000. Subsection 148(4) will then apply, and the ACB of the interest in the policy will need to be prorated to determine whether there is a policy gain. In determining the ACB of the policy, subsection 148(4.01) deems the policy loan of $30,000 to have been repaid immediately before the partial surrender. As a consequence, the ACB of the policy will increase from $10,000 to $40,000 and the prorated ACB will be $10,000 ($40,000 × $30,000/$120,000), resulting in a $20,000 policy gain. As well, the ACB of the policy will be adjusted to equal $30,000. Note that this is the same result as under the initial fact pattern, where there was no policy loan taken in advance of the policy surrender.

Net Cost of Pure Insurance

The NCPI of a policy reduces the ACB of policies last acquired after December 1, 1982.[114] This has the effect of reducing the ACB of a policy over time to nil, thereby increasing the taxable portion of funds received upon a policy disposition. The NCPI

112 See subparagraph (i) of element *C* of paragraph (a) of the definition of "proceeds of the disposition" in subsection 148(9).

113 Ibid.

114 The total of all annual NCPI charges reduces the ACB of the policyholder's interest in a policy by virtue of element *L* of the definition of "adjusted cost basis" in subsection 148(9). The rules for calculating the NCPI of an interest in a life insurance policy are set out in regulation 308.

is also a limiting factor in calculating the collateral insurance deduction under paragraph 20(1)(e.2).[115] The NCPI is meant to approximate the cost of the annual mortality risk under the policy and is calculated according to a formula in which the probability of death in the year for the life-insured (using a prescribed mortality table) is multiplied by the net amount at risk in respect of the taxpayer's interest at the end of the year. Generally, the NCPI determined for an insurance policy will increase every year as the life-insured grows older. For "level-pay" insurance policies,[116] this creates a pattern in which the ACB of the policy increases in the early years (as a result of premium or deposit payments and lower NCPI deductions) but at later durations the ACB is reduced to nil (as a result of an NCPI charge that exceeds the premium or deposits paid into the policy).

There are a number of changes in the NCPI calculation for policies issued after 2016:

- The annual mortality risk is to be determined using the CIA 1986-1992 mortality tables.[117]
- Generally, if the policy is substandard, the mortality rates are to be adjusted to take into account the rating on the life-insured.[118]
- Generally, if the policy is a joint policy insuring two or more lives, the joint mortality rates are to be derived on the basis of the CIA 1986-1992 mortality tables, using the pricing methodology of the issuer of the policy.[119]
- Generally, the net amount at risk of a coverage at the end of the year is the difference between the benefit on death of the coverage at the end of the year and the NPR of that coverage.[120]

The implications of these changes are as follows:

1. In most cases, the mortality rate for standard lives will be lower, owing to the use of the more recent mortality tables, and the net amount at risk for any specific coverage will also generally be lower. As a result, the ACB of a policy will generally be higher in earlier durations, and it will take longer for the

115 The deduction cannot exceed the lesser of the premium paid and the NCPI determined for the policy in respect of the year.

116 For example, guaranteed whole life, participating life, and UL LCOI policies.

117 Regulations 308(1)(b), element *A*, and 1401(4)(b)(i)(B). See also Canadian Institute of Actuaries, "Memorandum and Table: Extension of CIA 86-92 Tables to Issue Age 90," October 2015 (www.cia-ica.ca/docs/default-source/2015/215081e.pdf).

118 Regulations 308(1)(b), element *A*, and 1401(4)(b)(i)(C).

119 Regulations 308(1)(b), element *A*, and 1401(4)(b)(ii).

120 Regulation 308(1)(b), element *C*. The NPR is subject to certain adjustments. Most companies currently use the policy's cash surrender value to determine the net amount at risk, which in many cases will be lower than the NPR for a policy.

ACB to be reduced to nil as a result of the NCPI adjustment, by comparison with the current rules. This will be beneficial from a tax perspective where a policy is surrendered, since the higher ACB will reduce the amount of the policy gain. However, the higher ACB will also reduce the CDA credit[121] where insurance proceeds are received by a private corporation. As well, the deduction permitted under paragraph 20(1)(e.2) will be lower until such time as the NCPI amount equals or exceeds the loan interest.

2. The annual mortality rate for substandard policies will be higher, potentially resulting in a higher deduction under paragraph 20(1)(e.2) than would be available under the current rules. The higher NCPI amount determined for a substandard life-insured will be offset by the inclusion of the extra premium charge for a substandard life policy in determining the ACB of the policy.

Changes to the Tax Treatment of Prescribed Annuity Contracts

A payout annuity is subject to annual accrual reporting[122] unless it qualifies as a prescribed annuity contract (PAC). A PAC is eligible for level income taxation based on rules in regulation 300 for determining the capital element of the payment.[123] Where the payments under the annuity depend upon the survival of the annuitant (a "life annuity"), regulation 300(2) contains rules for determining the expected number of capital payments under the contract based on a prescribed mortality table.[124] This offers some deferral of tax reporting and, especially for older aged annuitants, may result in a significant portion of each payment being treated as a non-taxable return of capital.

Effective for PACs issued after 2016, the mortality table used for determining the capital portion of income payments from prescribed annuities has been updated from the 1971 Individual Annuity Mortality Table to the Annuity 2000 Basic Mortality Table.[125] The new mortality table, which reflects the lengthening of life expectancies since 1971 (approximately 1.5 to 2 years at older ages), will result (all things remaining equal) in a higher portion of each payment being taxable under a PAC, as illustrated by the following example.

Example 6

For prescribed life annuities, achieving level taxation requires dividing the adjusted purchase price (essentially the annuity deposit) of the taxpayer's interest in the annuity

121 Paragraph (d) of the definition of "capital dividend account" in subsection 89(1).

122 Subsection 12.2(1).

123 The requirements for a PAC are set out in regulation 304. PACs are generally available only to individuals and certain types of trusts.

124 As published in volume XXIII of the *Transactions of the Society of Actuaries*. See regulation 300(2)(a)(i)(A).

125 As published in the *Transactions of the Society of Actuaries, 1995-96 Reports*. See regulation 300(2)(a)(i)(B).

> contract by the life expectancy of the annuitant. In the case of a 65-year-old male, the current (1971) mortality table would provide for 17.3 years of life expectancy. As a result, for each $1,000 of annuity deposit, the current mortality table would allow for $57.80 of capital repayment tax-free under the contract. The new (2000) mortality table, applicable to prescribed life annuities issued after 2016, provides for 19.6 years of life expectancy. As a result, each $1,000 of annuity deposit will yield capital repayments of $51.00. Thus, the tax-free return of capital will be reduced by $6.80 ($57.80 – $51.00) for a PAC issued on January 1, 2017 as compared with a PAC issued on December 31, 2016.
>
> Assuming that every $1,000 annuity deposit generates an annual annuity payment of $65.00, under the current mortality table this would result in annual taxable income of $7.20 ($65.00 – $57.80). Under the new mortality table, the annual taxable income for each $1,000 of annuity deposit would be $14.00 ($65.00 – $51.00), effectively doubling the taxable element of each payment.

There are grandfathering provisions for annuities issued before 2017, which are discussed below.

The rules will also be amended to recognize substandard annuities in determining the capital portion of payments under the annuity.[126] Under these rules, the age to be used is the annuitant's rated age at the time the annuity was issued. The net effect of this change will be to reduce the taxable portion of the payments that would otherwise arise from using the actual age of the annuitant. Anyone looking at annuitizing a deferred annuity policy or purchasing a life annuity before 2017 should consider the impact of the updated annuity tables, which could significantly affect the amount of taxable income to be reported in relation to annuities issued after 2016.

A further change relates to who can own prescribed annuities. Currently, an individual (other than a trust), a specified trust,[127] or a testamentary trust can be the holder of a PAC provided that certain conditions are met. However, changes to the rules effective for prescribed annuities issued after 2015 will prevent most testamentary trusts from acquiring a prescribed annuity.[128] However, an annuity issued after 2015 may qualify for prescribed annuity status if the holder is a "qualified disability trust"[129] in the year in which the annuity was issued. The term of such an annuity must not extend beyond a fixed period defined by reference to the life of an individual

126 A substandard annuity is generally available to individuals whose state of health is expected to reduce the individual's life expectancy, resulting in higher monthly or annual payments under the annuity. A substandard annuity is not recognized under the current rules for the purposes of determining the capital element of the annuity payment; therefore, any increase in payments attributable to the rating will be fully taxable to the owner of the annuity.

127 This would include an alter ego trust, a joint spousal trust, or a common-law partner trust (paragraph 104(4)(a)).

128 A spousal testamentary trust can still qualify to be the holder of a prescribed annuity.

129 Defined in subsection 122(3) and including testamentary trusts.

who is an "electing beneficiary"[130] of the trust in the year in which the annuity is issued.[131] A further requirement for a PAC is that the holder's rights under the contract not be disposed of before the trust ceases to be a testamentary trust or before the death of the specified individual. This rule is extended to all trusts to include, after 2015, qualified disability trusts.

The Investment Income Tax[132]

As discussed above, in response to the Carter commission's recommendations relating to the taxation of life insurance policyholders, in the late 1960s the federal government considered taxing the investment income accumulating within life insurance policies. However, it was felt that this measure would be too difficult to implement, and instead a 15 percent tax was imposed on the taxable Canadian investment income of life insurance companies.[133] In effect, the IIT was intended to be a proxy tax on the investment income attributable to insurance policies that was accumulating on a tax-free basis. The amount of IIT payable by insurance companies would be reduced by any taxable income reported to the policyholder as a result of a policy disposition.

Over the following years, the IIT was repealed[134] and subsequently reintroduced[135] in a format substantially similar to the prior version. The 2012 federal budget announced that there would be further modifications to the IIT to deal with concerns about its application to certain insurance policies. For future policies, the IIT will be "recalibrated" in the following respects:[136]

- For policies issued after 2016, the embedded reserve for UL LCOI policies will be included in determining the IIT base, if it is not already included.
- The policy reserve will continue to use the 1.5-year preliminary term method based on cash surrender value or pricing assumptions, including lapses for lapse-supported products.

It is expected that the change in IIT on UL LCOI policies, if flowed through to policyholders, will have a significant impact on COI rates at younger ages (in the range of 6 to 9 percent), gradually decreasing at older ages (for example, 3 percent or less for insured individuals over the age of 60). There will also be an impact on level limited-pay universal life policies (whether on a level cost or yearly renewable

130 Defined in subsection 122(3).

131 Regulations 304(1)(c)(iii)(A), 304(1)(c)(iv)(B)(II)(2) through (4), and 304(1)(c)(iv)(C)(III) and (IV).

132 Part XII.3 of the Act.

133 See supra notes 28-29 and the related text.

134 See supra note 34 and the related text.

135 See supra note 48 and the related text.

136 Regulations 1401(1)(c) and (5).

term cost). However, there should be no impact on other types of permanent insurance products.[137]

Grandfathering Rules

New subsection 148(11) sets out circumstances applicable to policies issued before 2017 (other than annuity contracts, or for the purposes of regulation 306(9) or for certain purposes of the IIT) in which such policies will lose their grandfathered status and become subject to the rules applicable to future policies. The issue date of a policy becomes important for determining whether the current or future rules apply to the policy. Industry practice seems to vary with respect to the date governing the issue date of a policy, and accordingly the policy anniversary date. Since the transitional rules to the new system look to the "issue date" of the policy, and that term is not explicitly defined, some confusion exists on the precise cutoff point between the current system and the future system.

The 1982 transitional rules regard the date of submission of an application in good form (that is, where a policy is eventually issued in accordance with the application) as the "issue date" of the policy for tax purposes and ensures a clean system cutoff consistent with previous changes in the rules.[138] Provincial insurance acts govern policy and policyholder matters, and explicit (though varying) rules exist governing the timing of issuance of a policy. The CRA has provided guidance that the following factors will be considered in determining whether a policy is "issued before 2017":[139]

- The application for the policy signed by the applicant(s) is received by the insurer in 2016 with all the information required for the insurer to begin underwriting of the insurance applied for.
- The premiums are calculated from the date of effect of the policy in 2016, and costs of insurance apply from that date.
- A payment in respect of the premium(s) is made in 2016.
- All the conditions (other than medical underwriting) for the issuance of the policy are met in 2016.
- The insurer is legally obligated to pay the death benefit under the policy if the conditions for the payment of the death benefit are met in 2016.
- The policy is delivered to the applicant(s) by March 31, 2017.
- The policy or application does not define the issue date as a date other than a date in 2016.

137 While UL LCOI products issued after 2016 will be subject to a higher IIT cost, this change is intended to correct a deficiency in the current application of the IIT to these products.

138 Subsection 12.2(9). This provision was repealed in 1990 (SC 1990, c. 39, section 5(4)) but still applies to life insurance policies last acquired before 1990.

139 CRA document no. 2016-0651181E5, October 13, 2016.

- The first anniversary day of the policy must be as defined in subsection 12.2(11) and must be in 2017.

The following discusses the application of the grandfathering rules to policies issued before 2017.

The Exempt Policy Rules and Section 148 Rules

Life Insurance Policies Last Acquired Before December 2, 1982

For policies last acquired before December 2, 1982, the grandfathering rules enacted when the exempt policy rules were first introduced in 1982 will continue to apply. Therefore, such policies will be treated as having been "last acquired after December 1, 1982"[140] if there is a prescribed premium paid after December 1, 1982 and the policy fails the exemption test, or if there is a prescribed premium or a prescribed increase in any death benefit under the policy after December 1, 1982.[141] An arm's-length transfer of a pre-December 2, 1982 policy will also result in the policy being "last acquired after December 1, 1982" with a loss of grandfathering.[142] However, such policies will not become subject to the new rules applicable to policies issued after 2016 unless there is a policy transaction after 2016 that is governed by subsection 148(11), as discussed below.

Policies Last Acquired After December 1, 1982

For policies last acquired before 2017 (including those last acquired before December 2, 1982), the policy will be deemed to have been issued after 2016 (and therefore subject to the new exemption test and section 148 rules) at a particular time after 2016 at which life insurance (in respect of which a particular schedule of premium or COI rates applies) either

- if the insurance is term insurance, is converted to permanent insurance within the policy; or
- is added and is medically underwritten after 2016.[143]

140 And consequently subject to the exemption test and policyholder tax rules for policies issued before 2017.

141 A prescribed premium or a prescribed increase in a death benefit is generally an increase in the premium or death benefit that is not contemplated under the contractual terms of the insurance policy. See regulations 309(1) and (2) for more details.

142 Paragraph 148(10)(e) provides an exception for non-arm's-length transfers of policies.

143 Canada, Department of Finance, *Legislative Proposals Relating to the Income Tax Act and the Income Tax Regulations and to Related Legislation* (Ottawa: Department of Finance, September 16, 2016).

With respect to the second condition, there is an exception where the additional insurance is paid for with policy dividends or is reinstated. As well, there is an exception if the additional insurance is medically underwritten to obtain a reduction in the premium or COI rates.[144]

On the basis of the industry's understanding of the application of the rules in subsection 148(11), the following transactions after 2016, in and of themselves, would not result in the loss of grandfathering of a policy issued before 2017:

- underwriting a change from smoker to non-smoker status or substandard to standard rating;
- changing from a yearly renewable COI rate to a level COI rate (provided that no additional coverage is added to the policy);
- adding a coverage to a universal life policy without medical underwriting to retain exempt status, provided that this is allowed under the terms of the contract;
- the purchase of term or paid-up insurance with policy dividends;
- exercising a guaranteed insurability option that has been underwritten before 2017, provided that the coverage is added to the same policy; or
- reinstating a coverage.

As well, since the new rules are based on the policy issue date, the transfer of a policy issued before 2017 to a new owner will not in itself result in the loss of grandfathering.

However, on the basis of the wording of the legislation, it appears that the following transactions after 2016 would result in a loss of grandfathering:

- conversion of a term policy issued before 2017 to a permanent policy after 2016;
- conversion of a term rider issued before 2017 to a permanent policy or to permanent coverage in the same policy;
- the addition of a new life coverage or term rider that is underwritten after 2016 and has a particular separate schedule of premium or COI charges;
- issuance of a new policy as a result of the exercise of a guaranteed insurability option issued before 2017;
- the substitution of a new life under an insurance policy issued before 2017 where underwriting is required post-2016, even if there is no increase in premium or death benefit;
- replacement of a term rider issued before 2017 with another term rider with underwriting to obtain a lower premium;

144 Paragraph 148(11)(b).

- the "disaggregation" of multi-life policies issued before 2017 into separate policies (except that if a coverage is removed but the original multi-life policy continues, the original policy would continue to be grandfathered, while any new policy for the coverage that was removed would not be grandfathered); and
- generally, any change to a life insurance policy issued before 2017 that results in a new life insurance policy being issued after 2016.

It should also be noted that the insurance industry is seeking modification of the rules as they apply to conversions, to ensure that only term conversions taking place after 2016 will result in a loss of grandfathering.

It is not clear whether the following transactions after 2016 will result in a loss of grandfathering:

- conversion of a policy issued before 2017 from single-life coverage to joint-life coverage, provided that the underwriting of the new life was completed prior to 2017;
- exercise of a non-forfeiture provision to have a policy issued before 2017 become reduced paid-up;
- exercise of a non-forfeiture provision to have a policy issued before 2017 go to extended term; or
- conversion of a term policy or rider issued before 2017 with one renewal period (say, 10 years) to a term policy or a rider with another renewal period (say, 20 years) while keeping all other terms the same.

Implications for Advisers

The key takeaway for advisers for the grandfathering of existing policies is that unlike the tax changes in 1982, which meant that the policies were either subject to the annual accrual rules or not, the loss of grandfathering under the new rules will generally be less dramatic. However, generally the tax-free accumulation under the new exemption test rules will be lower at later durations. Given the triggers for loss of grandfathering, it is less likely that a pre-2017 policy will fall under the new rules unless deliberate action is taken to convert a term policy or add coverage with medical underwriting, which in both cases requires action on the part of the insurer.

The IIT

As noted in the discussion of the IIT above, policies issued before 2017 will generally continue to be governed by the current IIT rules. However, regulation 1401(5)(b) deems certain changes or additions to a life insurance policy issued before 2017 to be a separate life insurance policy issued at a particular time after 2016 for IIT purposes. This provision is similar to subsection 148(11) and applies if the particular time is after 2016 where life insurance (in respect of which a particular schedule of premium or COI rates applies)

- is term insurance that is converted to permanent life insurance within the policy; or
- is added to the policy.[145]

Again, with respect to the second condition, there is an exception where the additional insurance is paid for with policy dividends or is reinstated. As well, there is an exception if the additional insurance is medically underwritten to obtain a reduction in the premium or COI rates.

Life insurance will also be deemed to be a separate coverage issued after 2016 if it is part of a rider deemed to be a separate policy issued at that particular time.[146]

Prescribed Annuity Contracts

The updated mortality table discussed above[147] will apply to an annuity issued before 2017, unless on December 31, 2016 the annuity is a PAC or an annuity that would be a PAC but for the fact that annuity payments have not commenced before the end of the taxation year that includes December 31, 2016. In the latter situation, there is a further requirement that the annuity rates under the annuity are fixed and determined before 2017, and the contract cannot be terminated except on the death of an individual whose life is the measuring life under the contract.[148]

This grandfathering is favourable since it not only preserves the current tax treatment of prescribed annuities in effect before 2017, but also includes certain types of "locked-in" deferred annuities issued before 2017 that become payout annuities after that date.

WHAT WAS NOT CHANGED BY THE 2012 BUDGET?

It should be noted that the following rules are not altered by the new legislation:

- *The rules relating to gifts, distributions by a corporation, and non-arm's-length transfers.*[149] Special rules apply where an interest in a life insurance policy is disposed of by way of gift, by distribution from a corporation, or by operation of law to any person with whom the policyholder does not deal at arm's length. Prior to March 22, 2016, the policyholder was deemed to have disposed of the policy for proceeds equal to the cash surrender value (not the ACB or fair market value of the policy) and the person who acquires the policy is deemed to

145 Supra note 143.

146 Subsection 211(2).

147 See supra note 125 and the accompanying text.

148 Regulation 300(2)(a)(i)(A).

149 Subsection 148(7).

have done so for an amount equal to the policy's cash surrender value. However, the 2016 federal budget proposed that subsection 148(7) be amended for dispositions after March 21, 2016. Final legislation contained in Bill C-29 will deem the proceeds of the disposition to be equal to an amount that is the greatest of (1) the fair market value of any consideration given for the interest, (2) the interest's value at the time of transfer, and (3) the ACB of the transferor's interest in the policy immediately before the transfer, and the transferee will be deemed to have acquired the policy for an amount equal to the transferor's deemed proceeds.[150]

- *The tax treatment of transfers between spouses and children.*[151] Another set of rules generally provides that certain transfers of life insurance policies to a spouse, common-law partner, child, or grandchild will be deemed to have taken place for proceeds of disposition equal to the ACB of the policy, and the person will be deemed to have acquired the policy for proceeds equal to the policy's ACB.
- *The tax treatment of dividends and policy loans.*[152] The general rules in section 148 will continue to treat the payment of dividends and policy loans as a disposition of the policy, and there will be no taxable gain unless such payment exceeds the ACB of the policy. There are also a number of other rules in section 148 that effectively treat such a payment as not resulting in proceeds of disposition or affecting the ACB of the policy, where the dividend or policy loan is retained in the policy to pay premiums or purchase additional paid-up insurance.
- *The treatment of insurance as a credit to the CDA of a private corporation.*[153] As noted above, insurance proceeds payable to a corporation create a credit to the CDA to the extent that such proceeds exceed the ACB of the policy to the recipient corporation.[154] While the 2012 budget made no changes relating to the CDA credit for life insurance, legislation relating to 10/8 and LIA policies, as well as the 2016 federal budget proposals, contains rules that will affect the availability and/or determination of the amount of the CDA resulting from the receipt of life insurance proceeds.[155] The CRA has also indicated that it may apply the

150 This legislation will also affect non-arm's-length insurance transfers before March 22, 2016. A more complete discussion of these changes is beyond the scope of this article.

151 Subsections 148(8), (8.1), and (8.2).

152 Subject to modifications to the rules where a policy loan is repaid in accordance with the changes in subsection 148(4), element *E* of the definition of "adjusted cost basis" in subsection 148(9), and the definition of "proceeds of the disposition" in subsection 148(9).

153 See the definition of "capital dividend account" in subsection 89(1).

154 See CRA document no. 2004-0065461C6, May 4, 2004.

155 See subsection 248(1) for definitions of 10/8 and LIA policies. The 2016 federal budget contained proposals relating to amendments where insurance is owned by one corporation and the beneficiary is a separate corporation, as well as rules applicable to non-arm's-length transfers. A discussion of those rules is beyond the scope of this article.

general anti-avoidance rule[156] where certain structures are used to enhance the CDA credit arising from insurance proceeds.

- *The collateral insurance deduction.* Paragraph 20(1)(e.2) permits a limited deduction for the lesser of the life insurance premium and the NCPI where the life insurance policy is assigned to a financial institution as collateral security for a loan, and the interest on such loan is deductible in computing the policyholder's income.[157] While the calculation of the policy's NCPI for the purposes of determining the amount of the deduction will change for future policies, the criteria for qualifying for this deduction will remain the same.

CONCLUSION

Legislation enacted in 2014, effective for policies issued after 2016, will give effect to Canada's third major reform of life insurance policy taxation since policies became taxable in 1968. Each reform has incrementally tightened the taxation rules for accumulation policies in fundamental ways, in step with other non-registered savings products, and has modified the tax rules governing dispositions of policies. The amendments coming into force for policies issued after 2016 represent the most significant changes in the past 30 years.

While it is always prudent to review policies, coverage, and conversion options annually, it will be particularly important for clients to meet with professional advisers to determine what impact, if any, the changes will have and whether any action is warranted before the end of 2016. Impacts may stem from changes in exempt funding levels, updated actuarial tables, or the preservation of current taxation status.

Despite the extent of these changes, exempt life insurance policies and annuity products will continue to play a vital role in helping Canadians to manage the financial risks associated with death and to ensure that they have sufficient financial resources available later in life. Exempt life insurance policies, with their ability to provide a tax-free death benefit, as well as accumulate a certain amount of income free of tax, can play a unique and complementary role to other tax-assisted savings plans in securing the financial future of Canadians.

156 Subsection 245(2).

157 Note that the draft revised definition of NCPI will affect the calculation of the deductible amount of the premium.

APPENDIX DEPARTMENT OF FINANCE AND INDUSTRY CONCERNS WITH THE CURRENT POLICYHOLDER TAX RULES[158]

This appendix reviews the main goals and objectives of both the Department of Finance and the insurance industry in updating the exemption test and policyholder tax rules. While in many respects the stated goals of the government and the industry are very similar, it is important to be aware of certain nuances and goal conflicts in order to better appreciate the design of the final legislation.

Accumulating Fund of the Actual Policy and Exemption Test Policies

Under the current rules, the accumulating fund of the actual policy is based on the assumptions used by the insurance company in developing the premiums for the specific policy and applying what is referred to as the 1.5-year preliminary term method for determining the policy reserves. (This methodology takes into account acquisition charges in determining the reserve basis for the policy, resulting in a lower accumulating fund in the early years of the policy.) As well, the greater of the cash surrender value of the policy (rather than the actual fund value of the policy) and the reserves in respect of the policy is utilized in the determination of the accumulating fund of the policy. In the case of certain permanent insurance policies, the reserves in respect of the policy are not easily determined, and the cash surrender value is used as a proxy pursuant to a Canada Revenue Agency (CRA) technical interpretation.[159] The accumulating fund of the exemption test policy (ETP) is also based on the assumptions used to determine the premiums of the actual policy, modified as follows:

- the minimum interest rate that can be used is 4 percent;
- if the mortality assumptions used to determine the premium are unknown, the insurer is to use the Society of Actuaries' Commissioners 1958 Standard Ordinary Mortality Table; and

158 This is a lightly edited version of an appendix that originally appeared in Kevin Wark, "Review of Proposed Changes to the Exempt Test Legislation," in *2013 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2013), 13A:1-16. Readers will notice that some of the material in the appendix repeats information contained in the body of the article.

159 CRA document no. 2005-0145821E5, March 28, 2006: "Where an insurer can support it's [sic] position that no reasonable amount can be determined under paragraph (b) of the definition of 'modified net premium' in respect of its universal life insurance policies, then we will accept that the amount determined under paragraph [regulation] 1401(1)(c) in respect of those policies is the amount determined under subparagraph [regulation] 1401(1)(c)(i) for the purposes of computing the insurer's liability under Part XII.3 and its income for purposes of Part I of the Act."

- in the first 20 years of the policy, the ETP is to be "interpolated" from the accumulating fund of the ETP value in year 20, using the current death benefit.[160]

Finance's Perspective

The concerns of the Department of Finance include the following:

1. The current interest and mortality assumptions used to determine the accumulating fund of the ETP need to be updated to reflect the current interest rate environment and improvements in mortality over the past 30 years. Similarly, the mortality table used to determine the net cost of pure insurance (NCPI)[161] needs to be updated.
2. The use of actual pricing assumptions makes it virtually impossible for the CRA to audit insurance companies to determine whether the correct accumulating funds were being calculated. Challenges would exist in extracting the pricing assumptions since each company would have different assumptions.
3. There are concerns that insurance companies could potentially manipulate pricing assumptions to enhance the maximum premium that could be paid into a policy while treating the policy as an exempt policy.
4. The use of a policy's cash surrender value in determining the accumulating fund of the actual policy encouraged the design of policies that had very high surrender charges in the early years of the policy, which suppressed the accumulating fund of the actual policy.[162] This allowed larger deposits in the early years of the policy and facilitated "short-pay" policies, which are not intended under the exemption test rules. These types of products also resulted in the collection of less investment income tax (IIT), to the detriment of federal coffers.
5. The full reserve component was not being properly included in the policy accumulating fund for UL LCOI coverages. This resulted in the understatement of accumulating fund for these policies, increasing maximum premiums and reducing the amount of IIT.
6. Finance's view is that the "pre-test" rule for universal life policies permits too much flexibility and might allow a policyholder to deposit amounts in excess of what normally would be allowed under the exemption test rules; those funds could then be withdrawn in the 60-day period after the anniversary date to maintain the exempt status of the policy. This would allow funds to

160 See supra note 68.

161 The NCPI of a policy is relevant for the purposes of determining the adjusted cost basis (ACB) of an insurance policy under section 148, as well as the collateral insurance deduction under paragraph 20(1)(e.2).

162 These types of policies were typically UL policies.

accumulate tax-deferred until withdrawn, and raise the possibility that any withdrawn amounts would be redeposited into the policy.

7. The current rules do not specify how the exemption test applies to certain policy designs or attributes, such as substandard policies, joint policies, and multi-life policies and non-life risk coverages,[163] resulting in differing interpretations and the potential for unintended tax results.
8. Despite updating of the legislation to deal with the various deficiencies in the exemption test rules, the insurance industry would continue to develop new product designs and features that could provide undue tax-deferred accumulation room, and Finance may not be able to react quickly enough by making changes to the regulations.

The Insurance Industry Perspective

In general, the industry supported the proposed update to the exemption test rules, as evidenced by earlier attempts to encourage Finance to review and revise these rules. However, there was general anxiety, as well as some specific concerns with the announced exemption test review, given the complexity of the rules, possible approaches that could be followed by Finance, and the variety of different products that would be affected. These concerns are summarized below:

1. The new rules could impose an inflexible regime on the industry. The industry believes that it is important to maintain a flexible approach in the application of the exemption test rules to various product designs. This would permit more innovative and flexible product features that respond to different economic situations and changing consumer needs. However, it is also recognized that the rules need to operate in a similar manner for all products in order to ensure a more level playing field, and that tax biases should not exist to influence consumer behaviour.
2. Finance, in its attempts to revise the exemption test to deal with these various concerns, might go "too far" and place overly restrictive limits on the tax-deferred accumulation room of exempt policies. This would reduce the ability of policyholders to "prefund" insurance charges and in turn adversely affect the financial protection available to the policyholder.
3. UL LCOI products (which have undergone several price increases in the past few years, owing to lower interest rates) would become uncompetitive as a result of tax changes designed to reduce the tax-deferred accumulation room and increase the IIT load.
4. The benefit of using pricing assumptions in determining the accumulating fund of the actual policy and of ETPs is that it allows for flexibility and can be

163 For example, critical illness insurance and long-term care insurance.

adjusted to take into account future changes in interest rate levels and mortality. If the prescribed interest rate is higher than the rate that the insurer would otherwise use for pricing, the insurer might have to reduce the guaranteed cash values on traditional products so that they would not exceed the accumulating fund of the ETP calculated using the higher interest rate.

5. The proposed method of calculating the reserve, together with the prescribed assumptions, could result in the reportable accrual income on non-exempt policies[164] being excessive, and the taxable income from the partial surrender of an exempt policy exceeding the taxable income resulting from a full surrender of the policy.
6. The compliance costs associated with developing new products and marketing systems, as well as administrative and tax systems, would place a significant financial burden on insurance companies that would ultimately be passed on to policyholders. Any changes, however minor, would in fact require insurers to administer three different blocks of business from a tax perspective: (1) products that were last acquired before December 2, 1982; (2) products that were last acquired after December 1, 1982 and before the effective date of the new legislation; and (3) policies issued after the effective date. As well, depending on the nature of the grandfathering rules for in-force policies, insurance companies would have to be able to track and manage policy changes that could result in the policy losing its grandfathered status under the new rules.
7. A related issue was ensuring that the industry had sufficient lead time to make the various product, administrative, and system changes before the new rules became effective. The industry requested at least a two-year window from the final legislation to ensure that all products and systems would be compliant with the new rules.
8. Finance's desire to "fix" the pre-test rule for universal life policies could also create significant administrative costs, which would ultimately increase the cost of these products and indirectly create a tax bias.
9. The current 250 percent test results in the unfair treatment of certain policyholders by significantly limiting future contributions to a policy that are needed to ensure that the policy remains in force at later policy durations.
10. The industry wanted to ensure that policies issued before the effective date of the new legislation would continue to benefit from the current rules, and that there was a bright-line test for when grandfathering might be lost, in order to protect against an in-force policy inadvertently becoming subject to the newer, more restrictive rules.

164 Subsection 12.2(1).

Concerns Relating to the Policyholder Tax Rules[165]

As discussed above, although a policy may be exempt for accrual tax purposes, tax reporting of the accumulating gains may arise from certain transactions that cause a "disposition" of an interest in a policy. Over the years, the CRA has provided technical interpretations relating to the rules in section 148, which have in turn identified concerns and issues with the application of these rules to certain situations. As part of the exemption test review, Finance indicated that it was also considering various changes to these rules.

Finance's Perspective

Finance's concerns include the following:

1. Section 148 contains a number of special rules relating to policy loans. For example, a policy loan is not subject to the partial surrender rules,[166] with the result that a policyholder can take a policy loan up to the amount of the adjusted cost basis (ACB) of the policy without any tax consequence or reporting. As well, if a policy loan is taken to pay a premium, there is no tax reporting,[167] and if the policy loan is subsequently repaid through a partial surrender, the repayment reduces the proceeds of the disposition.[168] While in most situations these rules ensure the appropriate tax treatment of policy loans and their repayment, there are circumstances in which the policyholder could either be disadvantaged or receive an unintended tax advantage.
2. The payment of certain life and disability benefits (referred to as "capital benefits") that result in a reduction in the policy's cash surrender value is considered to create undue tax benefits, because such payments are excluded from the definition of a policy disposition.
3. The rules relating to the determination of a policy's ACB need to be updated in several respects, in particular with respect to ancillary benefits, capital benefits, multiple life policies, and substandard policies.

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165 These rules are set out primarily in section 148. However, there are other provisions dealing with the deductibility of insurance premiums (paragraph 20(1)(e.2)) and the tax treatment of insurance proceeds received by a private corporation (the definition of "capital dividend account" under subsection 89(1)) that are very important to the tax treatment of policyholders.

166 Subsection 148(4). These rules apply to the partial surrender or disposition of a policy and result in a pro rata allocation of the ACB of the policy. Thus, if a policy is in a gain position, there will be tax reporting on a partial disposition even though the amount withdrawn is less than the total ACB of the policy.

167 Subparagraph (b)(i) of the definition of "proceeds of the disposition" in subsection 148(9).

168 See subparagraph (i) of element *C*, paragraph (a) of the definition of "proceeds of the disposition" in subsection 148(9).

4. The mortality table relating to the calculation of the capital element of a prescribed annuity contract (PAC) is outdated.[169]
5. It is necessary to "recalibrate" the IIT to ensure that the embedded reserve in universal life policies, as well as the cash value of the policy before surrender charges, is included in the tax base.

The Insurance Industry Perspective

The industry has identified the following concerns with respect to any further changes to the rules:

1. Ensure that any changes to section 148 and the PAC rules do not adversely affect policies issued before the effective date of the legislation.
2. Ensure that the new IIT definition does not inadvertently increase the tax cost for policies that were not intended to be affected.
3. Confirm that any changes made to section 148 do not have unintended tax results and do not create any tax biases that would adversely affect some product designs more than others.
4. Make the changes in a manner that keeps the cost of changes to tax and administrative systems as low as possible.
5. As part of this process, revise certain other insurance-related provisions that the industry has previously identified as not operating correctly, to the detriment of policyholders.

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Kevin Wark and Michael O'Connor, "The Next Phase of Life Insurance Policyholder Taxation Is Nigh" (2016) 64:4 *Canadian Tax Journal* 705-750.

169 A PAC is defined in regulation 304 and is generally a non-registered payout annuity owned by an individual or by certain types of trusts. Under a PAC, each payment consists of a return of capital and a taxable income element. The capital portion of each payment is determined under regulation 300 by dividing the original premium by the number of expected payments. For a life annuity, the expected number of payments is based on a prescribed mortality table and the annuitant's age at issue. This tax treatment spreads the income (and capital) equally over the term of the payments and allows for some deferral of tax.