Expert ADVICE

2016 - An Important Year to Revisit Your Life Insurance Portfolio

When structured properly, life insurance is not only a risk-mitigation tool, but also a versatile financial instrument which can provide significant benefits during lifetime.

Over the past three decades, the Canadian insurance marketplace has changed dramatically. There was a time that life insurance was acquired primarily by the family breadwinner to provide a financial cushion for their family or to pay off debts and pay for funeral expenses. However, over the years, other types of needs have arisen which require life insurance. Some examples are the payment of capital gains tax, estate equalization and charitable bequests. On the corporate side, it is to provide funding for buy-sells, share redemption, key person insurance, CDA maximization, insurance to cover loans and a few other strategies which can be extremely beneficial to the corporate business owners and incorporated professionals.

Consequently, the types of insurance policies now available have multiplied, along with their attributes. Today, depending on needs, the consumer can choose from a wide array of products. At the same time, the level of complexity of these policies has risen considerably.

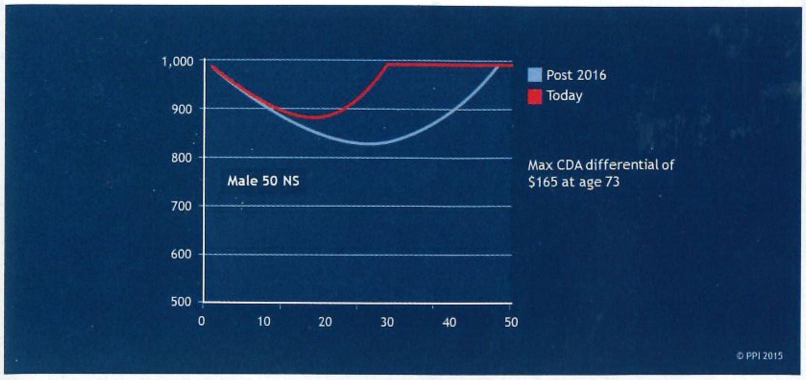
Many Canadians are using life insurance policies as wealth enhancement vehicles in addition to the traditional investments. Currently, the Income Tax Act relating to the taxation of life insurance policies allow substantial accumulation of funds in a tax-sheltered environment within permanent policies. However, these exempt test rules have been in place since 1982.

In the 2012 Federal Budget, it was announced the Department of Finance was planning to make changes to update the exempt test rules. After extensive negotiations with the life insurance industry, Bill C-43 was passed into law in December, 2014 with an effective date of January 1, 2017. This move by the Department of Finance was initiated to reflect the more recent actuarial assumptions and to ensure consistency across all insurance companies and products.

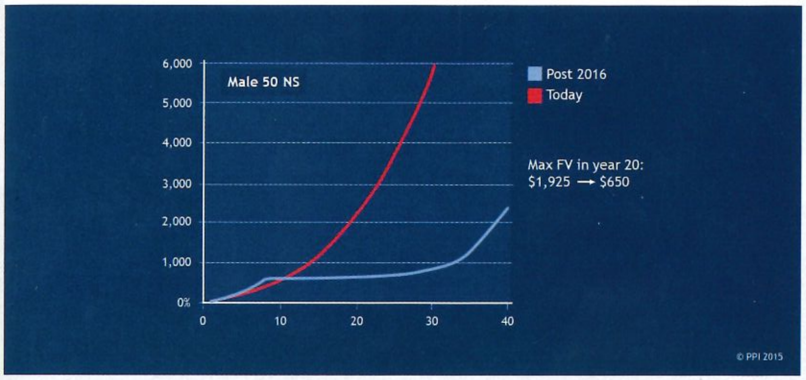
There will be a number of negative consequences for consumers because of these new rules. The good news is all existing policies and policies issued and settled before January 1, 2017 will be grandfathered. However, in certain circumstances this grandfathering can be lost on existing policies, so policy owners should seek expert advice before making any changes to their policies.

Universal life policies with Level Cost of Insurance (face plus funds) designs will be the most adversely affected under the new rules.

CDA Credit per $1,000 of LCOI Face



Max FV per $1,000 of LCOI Face



Under the new exempt test regime:

- Single premium policies will be a thing of the past. Minimum period to prepay policy premiums will be eight years.
- The permitted room for policy cash values to grow on a tax-sheltered basis will be a bit higher initially, but significantly less in the long term.
- The cost to acquire this product will be higher.

For corporate owned policies:

- The greatest impact will be on the Capital Dividend Account (CDA) credit. The CDA is a notional account available to private corporations through which death benefit proceeds as well as certain other tax-free amounts received by the corporation can be distributed to the shareholders as tax-free capital dividends. The death benefit proceeds are paid out tax free to the corporation on the policy of which it is the beneficiary; however, the credit to the CDA is the death benefit less the policy's adjusted cost basis. Therefore, a lower ACB means a higher CDA credit. As of 2017, the ACBs of almost all types of policies will be higher, which would mean a lower CDA credit (see Graph 1). It would also take a longer time for the ACB grind down.
- In cases of collateral term deduction, where policies are assigned to financial institutions to cover business loans, the deduction available will be lower.

While active business income (up to $500,000) in an incorporated business (CCPC) or a professional corporation is taxed at the small business rate, invested retained earnings and surplus are treated as passive income and are taxed at the highest marginal tax rate. Some incorporated professionals and business owners are effectively using corporate-owned life permanent life insurance policies for tax-sheltering a portion of their corporation's retained earnings and surplus. There are a number of ways to access the cash out of the policies, in some cases tax-free via leveraging.

Once the new rules come into effect, the contribution room will be drastically reduced for incorporated clients who would like to implement the above mentioned strategy and want to use Level Cost Universal Life policies (see Graph 2).

Also affected would be prescribed annuities. Currently, the taxable portion of payments from a prescribed annuity is lower, but going into the next year they will be higher, thus reducing the net yield. Some popular strategies such as the Insured Annuity will become less attractive. However, the taxable portion will be less, which will be a huge plus for substandard annuities.

In summary, 2016 is an important year to revisit your insurance portfolio. With proper advice, clients can avail the benefits of existing rules to make their estate, corporate or individual insurance plans more tax-efficient before the new rules kick in.

At Parwez Financial Group, we take pride in designing and providing unique, innovative and tax-efficient insurance solutions for our clients in collaboration with their legal and tax advisors. Our focus is strictly on the analysis, audit and implementation of appropriate strategies involving risk management products from top rated insurance carriers in Canada for our clients' personal and corporate needs. We work in collaboration with our seasoned associates who specialize in their respective fields of financial and investment planning. ■

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