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Get the most out of your life insurance policies before 2017!

Sylvain Campeau, CPA, CA *is a tax partner in the Ottawa/Gatineau offices of Collins Barrow.*
Ilham Fuad *is an accountant in the Ottawa/Gatineau offices of Collins Barrow.*

Life insurance rules have remained relatively intact since 1982, but that's about to change. Starting January 1, 2017, new income tax legislation will come into effect that will change some taxation aspects of life insurance policies. These modifications will impact taxpayers' estate planning, and more specifically, cases where life insurance policies are purchased through a corporation.

Life insurance, playing an important role in any estate planning, will see its benefits decreased to a certain extent. The majority of the changes coming into effect impact permanent life insurance products and have very little effect on temporary life insurance policies. As a result of the new rules, now is a good time to review your estate planning objectives and the role life insurance plays within them, in order to maximize tax benefits before these new rules come into effect.

Today's legislation

Currently, income received through life insurance policies is generally not subject to corporate taxes when a corporation receives life insurance proceeds, following the death of a taxpayer. The tax free component is a function of the life insurance proceeds and the adjusted cost base of the life insurance policy. Generally speaking, life insurance proceeds are added to the capital dividend account of the corporation, which in turn the corporation can distribute out to shareholders on a tax free basis.

Under today's income tax rules, if a taxpayer passes away after reaching the age of 73, all the life insurance proceeds would generally flow to the capital dividend account. On top of the tax sheltered growth within the insurance policy, avoidance of personal income tax on the withdrawal of the proceeds from the corporation, has made insurance products extremely appealing.

Tomorrow's rules

New legislation will come into effect that will curb some of the benefits life insurance provides. Specifically, the rule changes take into account taxpayers' longer life expectancies and items such as the maximum tax actuarial reserve; as a result, the net cost of pure insurance and the cost base of insurance will be impacted.

During the earlier years of an insurance policy, the addition to a corporation's capital dividend account would be lowered, thereby decreasing the amount that could be distributed tax free to shareholders. If a taxpayer was insured under insurance purchased prior to January 1, 2017, as indicated earlier, the life insurance proceeds received on death would normally all flow to the capital dividend account (if this person was to pass away at the age of 73). Under the new rules, that same result would not be achieved until the taxpayer reaches the age of 90.

The upcoming changes will also have the following repercussions:

<u>Longer prepay period for insurance policies</u>: this will decrease the amount of tax sheltered funds within policies.

<u>Different cash value accumulation</u>: Compared to the current regimes, the investment component of insurance products will generally be lower until the insured is 90 years old.

<u>Net cost of insurance</u>: There will generally be a decrease to the net cost of insurance as a result of new mortality tables.

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Before you start to worry about the impact of these alterations to the income tax rules, you can take comfort in the fact that previously issued policies are grandfathered. Any purchase of a permanent life insurance policy prior to December 31, 2016 will continue to be treated under the existing rules. That being said, taxpayers should note that changes to policy terms and/or conditions can be deemed as the issuance of a new policy. As a result, taxpayers are advised to seek out assistance to ensure any changes they may wish to implement don't impact the taxation of their life insurance policies.

These changes will change the calculation for the insurance policy ACB, which leads to a decrease in the capital dividends accounts – so fewer tax-exempt distributions. Life insurance values will generally be lower under the new rules but will continue to provide tax sheltered growth.

These modernized new rules will evidently affect many taxpayers but not all in a bad way. For new policies issued after January 2017, the policies will have a higher initial cash value. This can provide added benefits to taxpayers who use these types of assets as security for business loans.

Expired strategy?

One of the strategies affected by these rules changes is insured annuities. Taxpayers would invest in a life annuity and would then purchase a life insurance policy that had a death benefit equal to the investment in the annuity. The income generated from these prescribed annuities would pay the life insurance premium costs and there would be very little of the annuity to be taxed, as the distribution would be considered mostly a return of capital.

With this strategy, taxpayers could usually generate a pre-tax annual yield of more than 7%. However, this strategy will lose most of its appeal once these new rules are in effect: life insurance costs will likely increase, while taxation on prescribed annuities will also increase. Consequently, the overall net yield will decrease, thereby decreasing its appeal. All this will come as a result of new mortality tables to be used for these various products.

Time for action…

The opportunity still exists to purchase insurance or annuity products under the existing rules. In order to properly assess your personal situation, please contact your Collins Barrow advisor.

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