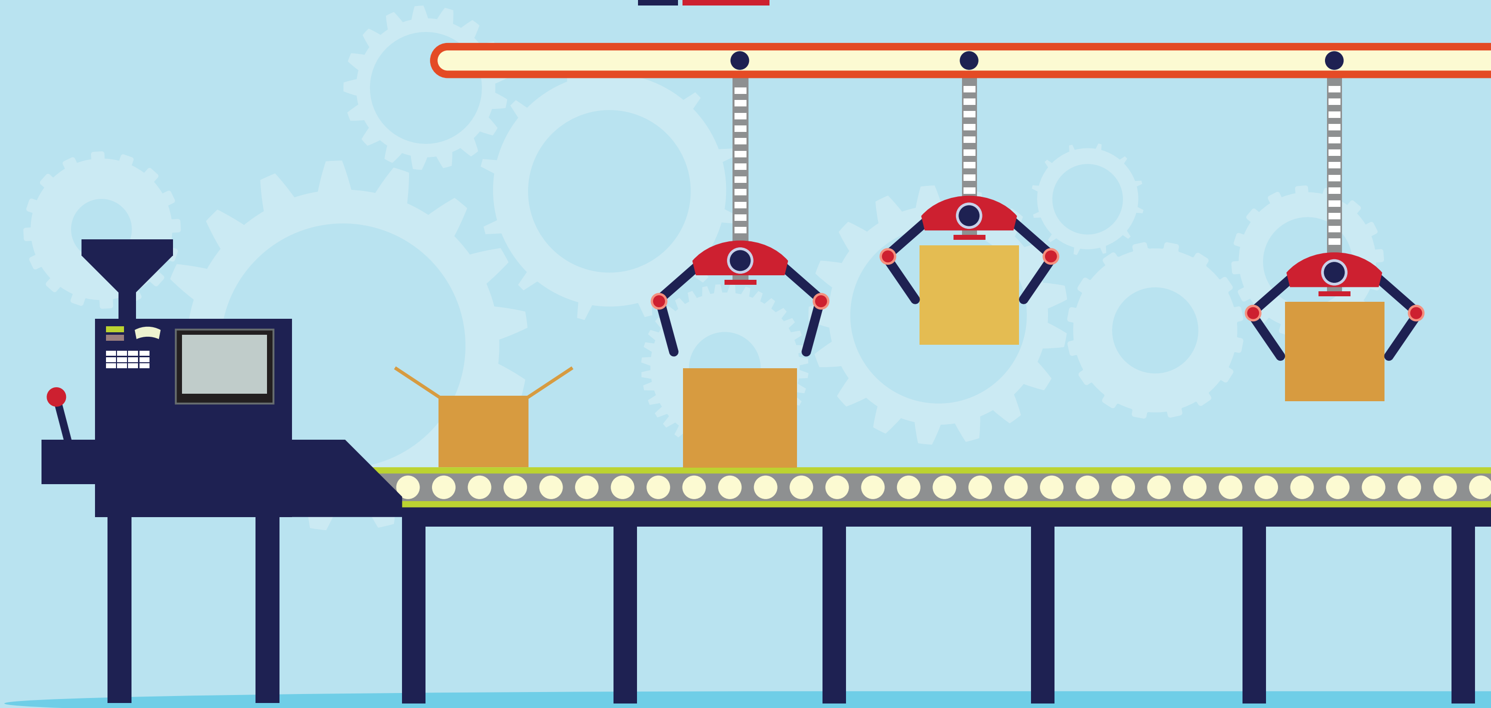


Plus ça change?

KEVIN WARK EXPLORES RECENT DEVELOPMENTS AFFECTING LIFE INSURANCE POLICIES AND ESTATE PLANNING IN CANADA

KEY POINTS

WHAT IS THE ISSUE?
There have been two key developments in Canadian tax law: new rules governing the taxation of exempt life insurance policies, and a reversal of certain changes to the tax treatment of so-called 'life interest trusts'.

WHAT DOES IT MEAN FOR ME?
The changes to the tax rules governing exempt life insurance policies can affect clients who currently own life insurance issued by a Canadian life insurance company, or are contemplating such a purchase.

WHAT CAN I TAKE AWAY?
Exempt life insurance policies issued before 2017 generally continue to benefit from the rules in effect before 2017, but care should be taken to preserve their tax status. The trustees and advisors to life interest trusts need to understand how changes introduced in 2014 will continue to impact the tax treatment of trusts where the death of the life interest beneficiary occurs after 2015.

ALTHOUGH THE TAXATION of life interest trusts in Canada has essentially reverted to the rules in effect before 2016, there are several important changes that can impact planning strategies on the death of the life interest beneficiary. Exempt policies issued after 2016 will be subject to additional limits and anti-avoidance rules, but will continue to be an important tool for tax and estate planning.

THE BASIC TAX RULES

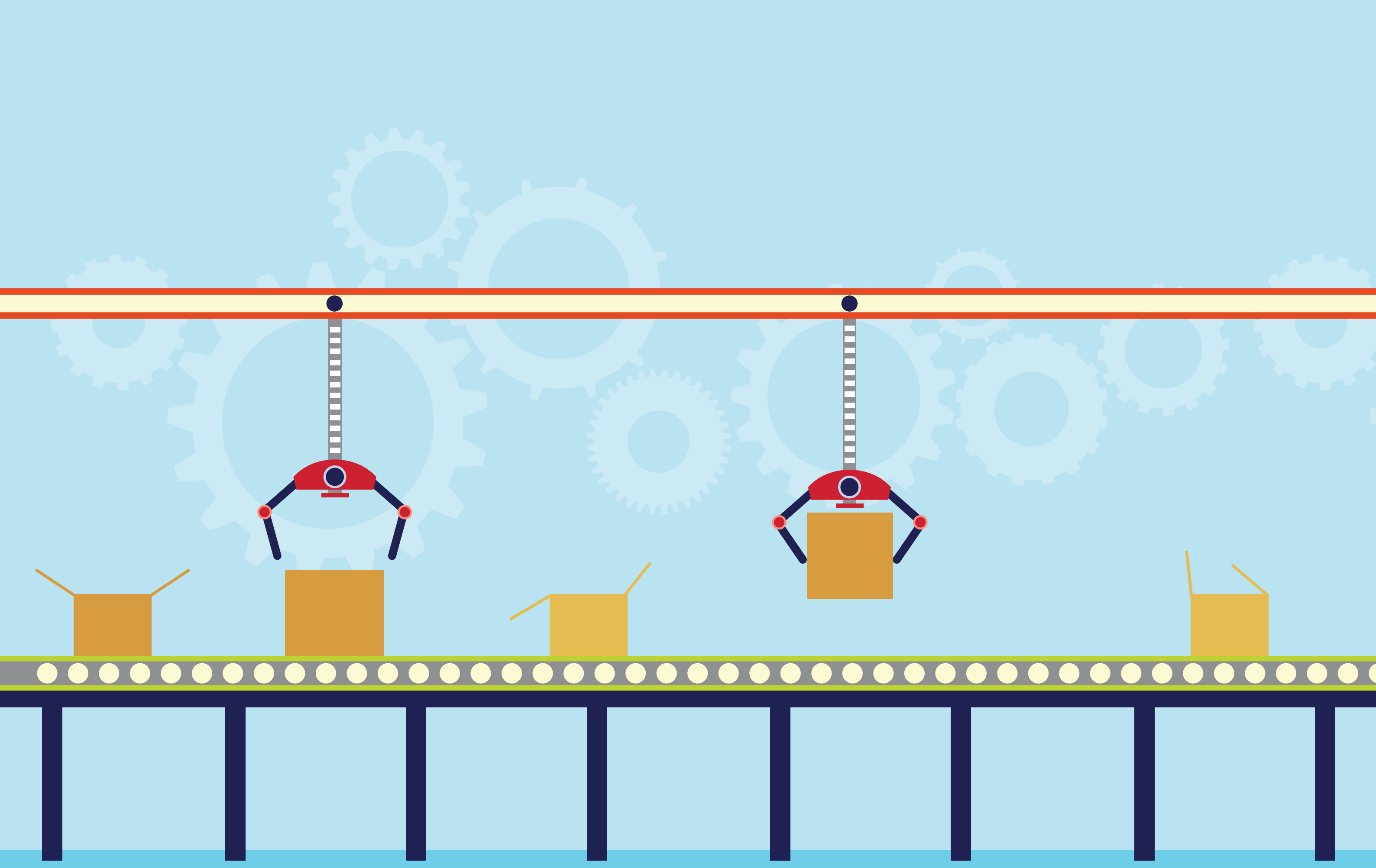
THE EXEMPT TEST

The underpinnings of the current Canadian tax rules governing life insurance policies were put in place in the early 1980s.[1] These rules differentiate between policies designed primarily for insurance protection ('exempt' policies) and those designed primarily for investment purposes ('non-exempt' policies). The exempt status of an insurance policy is monitored by the insurance company, ensuring that the policy reserve, which includes the cash value of the policy, does not exceed limits established under the *Income Tax Act* (the Act). An exempt policy obtains preferential tax treatment, as, unlike non-exempt policies, any growth in policy values is not subject to accrual taxation.[2] In addition, any tax-deferred growth in the policy that becomes part of the death benefit is generally received by the beneficiaries on a tax-free basis.[3]

This tax-deferred accumulation can be used to help pay future premiums and/or provide for additional death benefits, and the cash values can be accessed in a variety of ways by the policyholder while the insured is alive.

TAXATION ON POLICY DISPOSITIONS

While an exempt policy is not subject to annual accrual taxation, certain policy transactions arising while the insured is still alive may trigger a taxable disposition. For example, a partial or full surrender of the policy, a policy dividend, a policy loan, a gift of the policy or a policy transfer will be treated as a disposition of the policy.[4] However, as noted, the payment of the



policy's death benefit,[5] as well as the assignment of a policy as collateral security for a loan, will not typically result in a disposition.[6]

Where there is a policy disposition, the difference between the proceeds received and the policy's adjusted cost basis (ACB) will be included in the policyholder's income.[7] For example, if a policy is surrendered for its cash value of CAD100,000, and the policy's ACB is CAD40,000, there will be taxable income of CAD60,000 reported to the policyholder.

The ACB of an insurance policy can become a complex calculation influenced by certain policy transactions (such as the payment of dividends or taking of policy loans).[8] But, in many situations, the ACB of a policy is simply the sum of all premiums paid into the policy less the accumulated net cost of pure insurance (NCPI) charges. The NCPI of a policy is meant to represent the cumulative mortality costs of the policy, as determined by a formula established under the Act.[9] Thus, if a policyholder pays ten annual premiums of CAD1,000, and the aggregate annual NCPI charge at the end of ten years is CAD7,000, the ACB of the policy would be CAD3,000. NCPI charges for a policy typically increase as the insured grows older, and exceed premiums paid at later policy durations. This means that, eventually, the ACB of the policy is reduced to nil, resulting in the full amount of a policy's cash value being taxable upon surrender.

THE INVESTMENT INCOME TAX

Another important element of the Canadian insurance tax rules is that the underlying reserve of an exempt policy is subject to an investment income tax (IIT).[10] Insurance companies are responsible for computing and paying the IIT, which is based on the underlying value of their insurance policy reserves. The IIT is passed on to policyholders through higher policy charges or lower investment returns. The IIT represents an indirect tax on the tax-deferred growth within an exempt policy.

'The ACB of an insurance policy can become complex'

THE NEW TAX RULES

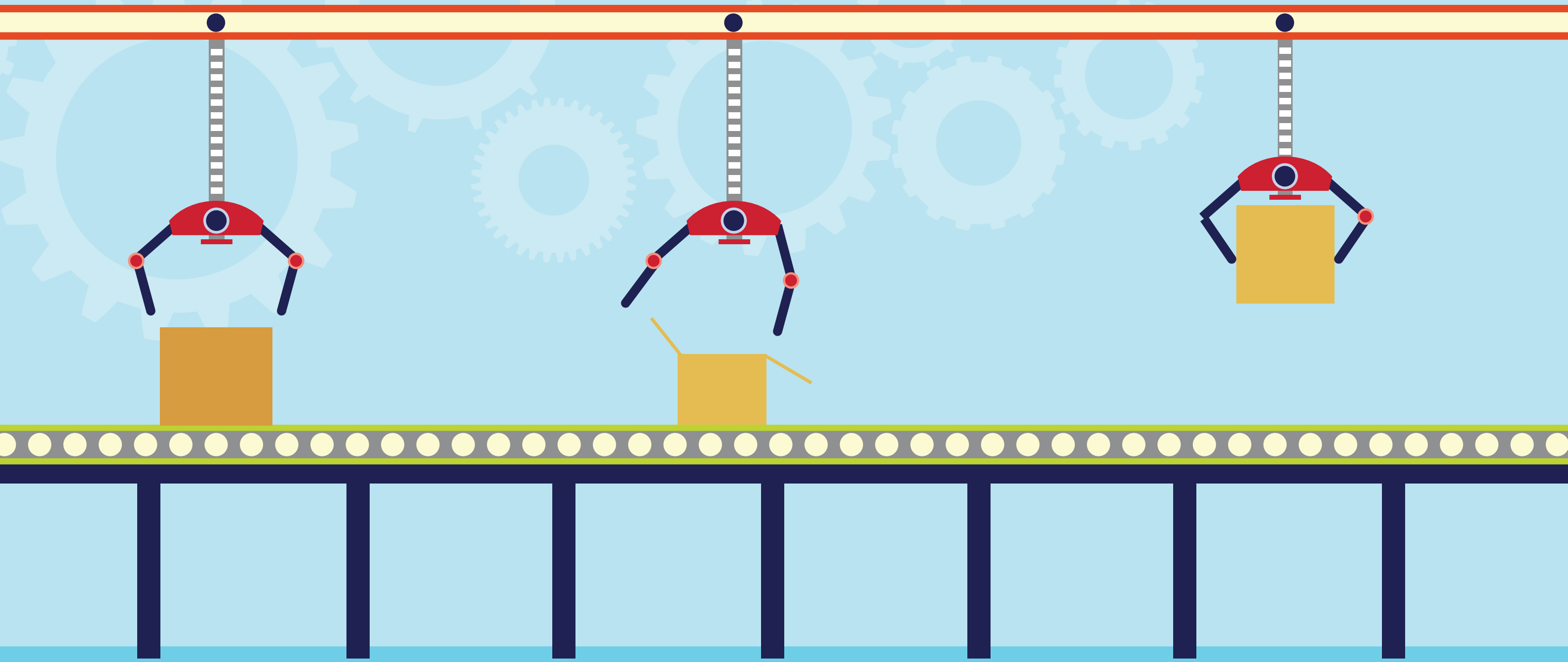
The tax regime introduced in the early 1980s continued virtually unchanged until recently. However, in that time period, new insurance products and policy benefits were released that did not fit neatly into those rules. This created interpretative challenges for both insurance companies and the Canada Revenue Agency, which is responsible for the administration of these rules. The Department of Finance became concerned that these new products, features and marketing strategies could result in unintended tax advantages, and concluded that new legislation was needed to address these issues.

It was in this environment that the Department of Finance announced, in the 2012 federal budget, that it would undertake a consultation process with the insurance industry. The stated purposes were to update the underlying assumptions used in determining the exempt status of a policy; make sure such rules applied fairly and equitably across different types of products; and eliminate opportunities to use these rules to create unintended tax benefits.

Due to the scope and complexity of the rules, it took more than two years to complete the consultation process and introduce new legislation. A further two years were allowed to the insurance industry to permit time to redesign products, as well as update marketing, administration and tax systems to comply with the new rules.

The new rules have now taken effect, applying to all policies issued after 2016. The rules in place before 2017 continue to apply to any policies issued before 2017, unless certain transactions take place after 2016 in respect of such policies (e.g. the addition of new insurance coverage on an underwritten basis).[11] In the latter situation, the policy will be deemed to be issued after 2016 and, therefore, will be subject to the new rules.

The changes have had a significant impact on particular product designs, as well as the tax benefits associated with certain products or marketing applications, which may be summarised as follows:



- **The amount that can be accumulated within an exempt test policy on a tax-deferred basis is lower for all permanent products at later policy durations. However, the reduction in permitted accumulations has been more significant for certain universal life designs, including those policies with high early-surrender charges.**
- **Certain planning opportunities involving 'multi-life' policies (coverage on more than one life within the same policy) have been eliminated.[12]**
- **The formula for determining a policy's NCPI has changed, generally resulting in lower annual NCPI charges.[13] This, in turn, results in higher policy ACBs over a longer period of time. This is generally beneficial for personally owned polices, as a higher ACB means lower taxable gains on a policy disposition. While this is also true for corporate-owned policies where there is a disposition prior to death, it can have a negative effect on death, as the ACB of a policy will reduce the amount of the death benefit that can be distributed by the corporate beneficiary to shareholders on a tax-free basis.[14]**
- **Although the amount of IIT payable on most permanent products has not changed, certain universal life policies have become subject to higher IIT, which has resulted in higher charges and/or lower cash-value accumulations in these policies.**

Despite these various changes, exempt life insurance continues to play an important role in the estate and business succession plans of many Canadians. Exempt life insurance products still permit tax-deferred accumulations and the payment of tax-free death benefits to fund liabilities that arise on death. In addition, corporate-owned insurance remains a cost- and tax-effective way to hold life insurance for business and estate planning purposes. And, as noted, owners of policies issued before 2017 continue to benefit from the tax rules that were in place when their policies were purchased.

CHANGES TO THE TAXATION OF LIFE INTEREST TRUSTS

Due to recent tax changes, Canadian tax rules are in harmony in their application to *inter vivos* and testamentary trusts. Transfers of property into trusts are deemed to take place at fair market value (FMV). To prevent trusts from being used to indefinitely hold capital property and avoid capital gains taxation, there is a deemed disposition of capital property within a trust every 21 years (the 21-year deemed disposition rule),[15] with any resulting tax payable by the trust.

A notable exception to these rules applies to so-called 'life interest trusts'. These trusts are established for the spouse (or common-law partner) of the settlor (a spousal trust); the settlor (an alter ego trust); or the settlor and their spouse/partner (a joint partner trust). In the case of an alter ego or joint partner trust, the settlor must have attained the age of 65. A spousal trust can be either an *inter vivos* or a testamentary trust.

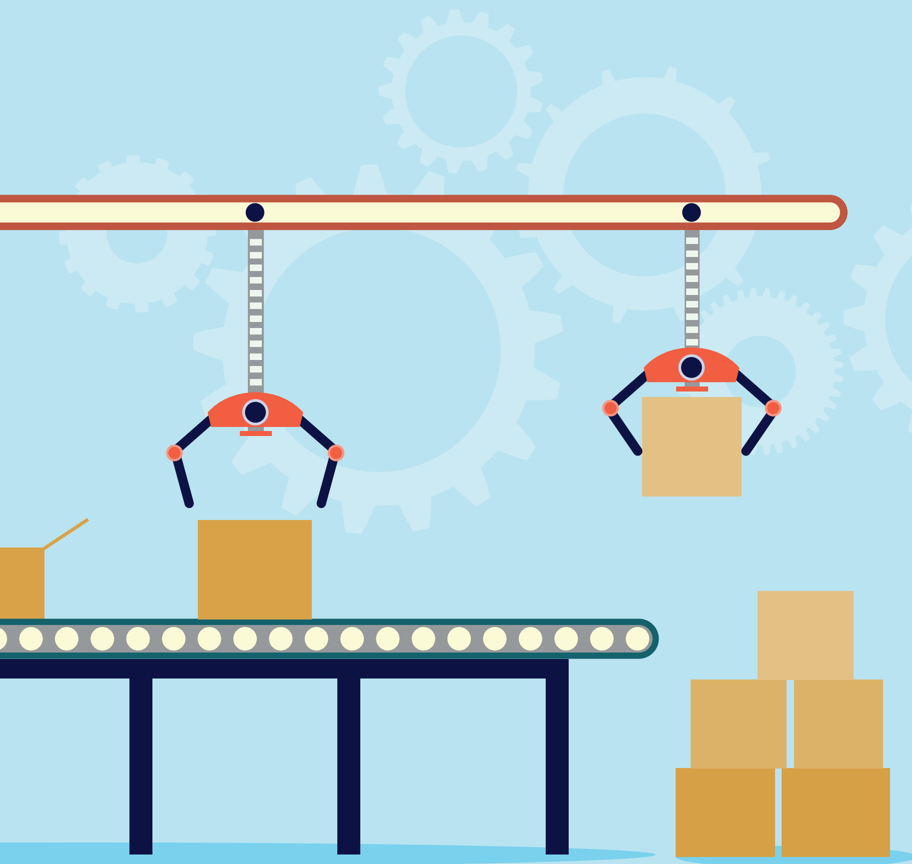
Other requirements to qualify are that all life interest beneficiaries must reside in Canada and be entitled to all of the income of the trust while alive; and no person except a life interest beneficiary may receive or otherwise use the income or capital of the trust while those beneficiaries are alive.

The main tax benefit of qualifying as a life interest trust is that capital property transferred into the trust by the settlor/testator can take place on a rollover basis, with any gains on such property being deferred until an actual or deemed disposition of the property at a future date. In addition, the 21-year deemed disposition rule is suspended, with the first deemed disposition of trust property (at FMV) taking place on the death of the surviving life interest beneficiary under the trust.[16] Prior to 2016, all such income arising from the deemed disposition would be taxable to the life interest trust in the year of death.[17] In other words, that income (and any resulting tax liability) could not be shifted to the estate of the deceased life interest beneficiary.

2014 CHANGES TO THE TAXATION OF LIFE INTEREST TRUSTS

Proposals released as part of the 2014 federal budget resulted in a number of changes to the taxation of life interest trusts, including:

- **The trust would have a deemed year end on the death of the life**



> *'The estate planning community objected based on a lack of consultation'*

interest beneficiary (or the surviving beneficiary under a joint partner trust). This could impact the ability of the trust to implement post-mortem planning to manage the tax liability arising from the death of the life interest beneficiary.[18]

- **The trust's income arising from the deemed disposition of trust property at FMV, due to the death of the life interest beneficiary, would be deemed payable to the life interest beneficiary in the year of death and included in that individual's terminal tax return.[19]**
- **The trust would no longer have the ability to offset capital gains arising from the deemed disposition of shares of private corporations by using the deceased life interest's remaining capital gains exemption.**

These changes were to be effective where the death of the life interest beneficiary occurs after 2015. In other words, existing life interest trusts were not grandfathered from these changes, and would be subject to the new rules upon the death of the life interest beneficiary. This could disturb planning that was already in place to manage the tax liability of the trust that would otherwise arise on the death of the life interest beneficiary.

The estate planning community objected to these changes based on a lack of consultation and the costs that would fall on clients to revise planning arrangements already undertaken; and because the beneficiaries of the life interest beneficiary would bear the cost of the tax on death, while they may not actually benefit from the property held in the life interest trust (which could arise in second marriage situations).

Fortunately, the Department of Finance listened to these concerns and, in February 2016, draft legislation was released that proposed the following changes to these rules:[20]

- **Subject to one minor exception, any income arising from the deemed disposition of property arising on the death of the life interest beneficiary will be included in the income of the life interest trust and not the terminal return of the deceased life income beneficiary.[21]**
- **Any donations made by a life interest trust within 90 days of the end of the calendar year in which the life income beneficiary dies can be claimed in the life interest trust's taxation year that ends on the date the life interest beneficiary dies.[22]**

It is important to note that the life interest trust will still have a deemed year end on the death of the life interest beneficiary, and the life interest trust no longer has access to the remaining capital gains exemption of the deceased life interest beneficiary to offset gains arising from the deemed disposition of shares in a private corporation.

1 These rules are primarily set out in Regulations 306–310 and s148 of the *Income Tax Act* (the Act). All references in this article are to the Act unless specified otherwise
2 s12.2
3 Para (j) of the definition of disposition in subsection 148(9)
4 Paras (a)–(d) of the definition of disposition in subsection 148(9)
5 *Supra* note 3
6 Para (f) of the definition of disposition in subsection 148(9)
7 Subsection 148(1)
8 See the definition of ACB in subsection 148(9)
9 Regulation 308
10 s211
11 Subsection 248(11)
12 Para 148(2)(e)
13 *Supra* note 9
14 The difference between the life insurance death benefit and the ACB of the policy is credited to the capital dividend account of a private corporation (see paragraph (d) of the definition of capital dividend account in subsection 89(1)). Capital dividends paid by private corporations are received tax-free by Canadian resident shareholders (subsection 83(2))
15 Subparagraphs 104(4)(b) and (c)
16 Para 104(4)(4)(a)
17 Para 104(6)(b)
18 Para 104(13.4)(a)
19 Para 104(13.4)(b)
20 These changes were included in *Bill C-29*, enacted in December 2016
21 Para 104(13.4)(b.1)
22 Clause 118.1(1)(c)(ii)(C)

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