SSQ Financial Group

Values in the right place

2017 TAX CHANGES

What happens when a corporation owns an insurance contract?

Effective January 1, 2017, a number of changes will be made to tax rules affecting life insurance contracts following a series of measures adopted in the 2012 federal budget. **It is however often advantageous for corporations to own an insurance contract governed under the current tax rules, meaning the rules in place before January 1, 2017.**

One of the key areas impacted by the new tax rules is corporate-owned life insurance:

- Reduction in the maximum accumulation amount exempt from tax, especially for universal life products with level cost of insurance. This means that the maximum death benefit amount payable is reduced when the death benefit option is increasing;
- Impact on the adjusted cost basis (ACB) calculation. The ACB is used for tax purposes, specifically for calculating the credit that can be applied to the capital dividend account (CDA) when a private corporation owning an insurance contract is also the beneficiary of the death benefit.

CREDIT THAT CAN BE APPLIED TO THE CAPITAL DIVIDEND ACCOUNT (CDA)

The following changes may impact the CDA credit:

Net cost of pure insurance (NCPI)

The NCPI represents the mortality cost of an insurance contract. The NCPI calculation will be modified to reflect more recent mortality assumptions. These newer mortality assumptions combined with a lower net amount at risk also following changes, will generally result in lower NCPI amounts, at least for standard cases (non-rated).

Adjusted cost basis (ACB)

New elements will be added to the calculation of the ACB, but the formula can still be summarized as follows:

ACB = Total premiums paid – Total NCPI

The NCPI is still an important factor in calculating the ACB. Since NCPI is generally lower, the ACB will be higher and remain positive for a longer period of time.

Capital dividend account (CDA)

Upon the death of an insured whose beneficiary is a private corporation, the amount of the death benefit, minus the ACB, can be added to the CDA and then paid out as a tax-free dividend.

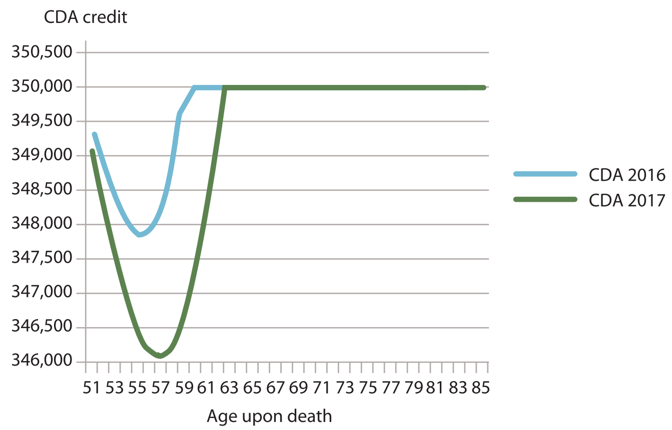
Since the ACB will be higher and remain positive for a longer period of time for contracts governed under the new tax rules, the amount that can be added to the CDA should be lower and it will take longer before the amount of the death benefit can be fully credited to the CDA.

COMPARISONS OF THE CREDIT THAT CAN BE APPLIED TO THE CDA

Below are two examples comparing the credit that can be applied to the CDA. CDA 2016 represents the credit that can be applied to the CDA at time of death for a newly issued contract governed under the current tax rules, meaning the rules in place before January 1, 2017. CDA 2017 represents the credit that can be applied to the CDA at time of death for a newly issued contract governed under the new tax rules, effective January 2017.

Male age 50 non-smoker, class 3

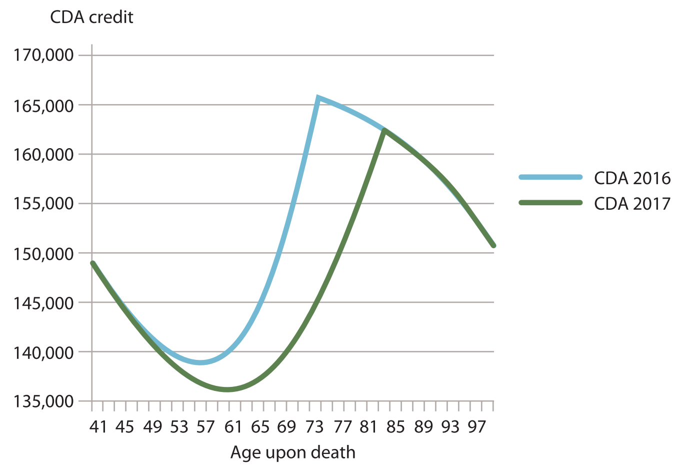
Term 20
Sum insured: $350,000



For illustration purposes only.

Female age 40 non-smoker

Universal Life
Increasing death benefit
Level cost of insurance
Sum insured: $150,000
Deposit of $1,500 per year for 25 years
Rate of return of 5%
Quebec



For illustration purposes only.

DISPOSITION AND TAXABLE PORTION

When there is a disposition of a life insurance contract, the taxable portion is the excess of the proceeds of disposition over the ACB. This applies regardless of contract ownership (individual or corporation). Since the ACB will be higher and remain positive for a longer period of time for contracts governed under the new tax rules, the taxable portion upon disposition will be lower, during the years the ACB is positive.

POLICY CHANGES AND IMPACTS

If a corporate-owned contract governed under the current tax rules is subject to a policy change, should the change be done within the same contract or not?

- The answer to this question depends on the needs and financial goals of your clients. As for any policy change, it must be in line with our administrative procedures. To this end, please refer to the document ***What changes can be made after 2016 to contracts governed under the tax rules in place before January 1, 2017?***;
- If the main objective is to distribute tax-free dividends to shareholders via the CDA, a policy change that could cause a loss of grandfathering should probably be avoided.

  Indeed, when a change is made to a contract that results in loss of grandfathering, the entire contract is subject to the new tax rules, including the new ACB calculation. The ACB accrued to the date of the loss of grandfathering is however preserved.

The fact remains that corporate-owned insurance contracts are still tax efficient, even considering the new tax rules.