

2017 Individual  
*Life Insurance*  
tax changes

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ADVISOR  
**GUIDE**  
TO GRANDFATHERING

Life's brighter under the sun



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# WHAT IS GRANDFATHERING?

THE CURRENT RULES AROUND THE TAXATION OF LIFE INSURANCE POLICIES HAVE BEEN IN PLACE SINCE 1982. WHILE ONLY A HANDFUL OF CHANGES HAVE BEEN MADE TO THE RULES OVER THE PAST FEW DECADES, THE PRODUCTS THEY APPLY TO HAVE EVOLVED GREATLY. TO HELP MODERNIZE THE LEGISLATION, THE DEPARTMENT OF FINANCE REVISED THE LIFE INSURANCE EXEMPT TEST AND SOME OF THE RELATED RULES.

The new tax rules for life insurance policies will generally apply to policies issued on or after January 1, 2017 (post-2016). Policies issued before that date (pre-2017) will be exempt from the rules in the revised legislation, in other words grandfathered.

**Tip** - Given the long-term planning objectives that life insurance addresses, understanding and maintaining this grandfathering status is critical.

Life insurance products are developed according to the tax treatment that applies to them when they are created. When legislation changes, it's important that existing life insurance policies continue to operate consistently with clients' expectations. The death benefit and associated savings room illustrated with pre-2017 policies will likely form part of clients' comprehensive financial plans that could span many decades.

Grandfathering is intended to address this need, and is often offered when legislative changes are introduced. Typically, the government doesn't want to impact policy owners who purchased policies with long-term planning objectives in mind. However, there are certain exceptions to this – primarily involving aggressive tax-avoidance strategies. But grandfathering can be lost and clients need to be aware of the causes and how to avoid them. It may be in clients' best interest to make any changes well before January 1, 2017.

This guide focuses on maintaining grandfathering for policies issued before 2017. When the new rules come into effect on January 1, 2017, insurers will redesign their life insurance products to fit within the new legislative framework, potentially providing new opportunities previously unavailable. Clients purchasing policies after 2016 can be assured that they'll continue to have their choice of excellent protection options and tax-preferred saving features.

## WHAT POLICY CHANGES WILL CAUSE POLICIES TO LOSE GRANDFATHERING?

There are a number of policy changes clients can make that will cause their policies to lose grandfathering. If any of the changes below are being considered, it's in clients' best interests to make these changes well before January 1, 2017 to maintain their policy's pre-2017 tax regime.

As a general rule, anything that increases the amount of insurance coverage and requires medical underwriting on a pre-

2017 policy will cause that policy to lose grandfathering and be subject to the post-2016 tax rules. If a coverage is added to an in-force policy the entire policy is subject to the new tax rules, not just the additional coverage and grandfathering is lost.

Some life insurance products give clients the flexibility to make changes after the policy is issued. The following is a list of changes that, if made after 2016, will cause clients' policy to lose its current tax status or grandfathering:

- Anything that requires medical underwriting to increase the amount of life insurance coverage under the policy, such as:
  - adding an additional coverage or increasing the existing coverage on a universal life (UL) or term policy, where medical underwriting is required.
  - adding an insured person on a UL or term policy, where medical underwriting is required.
  - substituting an insured person on a UL policy, where medical underwriting is required.
  - changing the death benefit option on a UL policy, where the future net amount at risk increases and medical underwriting is required. For example, changing from a level death benefit to a face plus fund death benefit while maintaining the same base insurance amount.
  - adding a term benefit to a policy that requires medical underwriting. While some people may be under the impression that only the term benefit would be subject to the new tax rules, the addition of this benefit to a pre-2017 policy will cause the entire policy to lose grandfathering.
  - adding a spousal or other insured term benefit.
  - adding a child term benefit, if medical underwriting is required.
  - adding or re-starting plus premium benefit on a participating (Par) life insurance policy, where medical underwriting is required.
- If a client purchases a policy after 2016 with a guaranteed insurability benefit, and then exercises an option to increase the coverage on a separate pre-2017 policy, exercising this option causes the pre-2017 policy to lose its grandfathered status. In this case, even though the increase on the pre-2017 policy didn't require underwriting, the guaranteed insurability benefit used to obtain this option was medically underwritten post-2016.
- Term to term replacements on benefits that require medical underwriting will cause the entire policy to lose

grandfathering, even if they maintain the same face amount. For example, a client has a pre-2017 UL policy with a term 10 benefit and wants to change it to a term 20 benefit for the same face amount. Medical underwriting is required for the new term 20 benefit even though there's no increase in face amount. This transaction causes the full UL policy to lose grandfathering and the 2017 rules apply.

## CONVERSIONS

Life insurance conversions will also cause a policy to lose grandfathering. The legislation states the new rules apply to policies converted into "another type of life insurance" on or after the implementation date. The legislative wording of "another type of life insurance" may extend the definition beyond what is normally considered a term conversion.

Grandfathering will be lost to a pre-2017 policy in the following situations:

- A term policy converting to a new policy - If under the term contract, a term policy is converted to another type of life insurance post-2016, the resulting policy loses grandfathering and is issued under the post-2016 rules.
- A term policy converting to add additional coverage to a pre-2017 UL policy - Since term policy conversions lose grandfathering, if clients convert a term policy or term benefit (rider) into a UL policy issued before 2017 in order to add an additional coverage to that UL policy, the entire pre-2017 UL policy will lose grandfathering.
- A term policy converting to add an additional coverage to a post-2016 policy - The policy to which the coverage is being added will already be under the new rules, and the new rules will also apply to the new coverage resulting from the term conversion.

In addition to the above situations where the loss of grandfathering on conversion is quite clear, there are a few scenarios that aren't clearly defined in the legislation. The following policy transactions could potentially be considered conversions to "another type of life insurance" and may lose grandfathering:

- Joint last-to-die or Joint first-to-die policy changes to a single life policy - If a new policy is issued as a result of this transaction, the new policy may be issued under the 2017 tax rules.
- Joint first-to-die policy changing to a Joint last-to-die policy - If a new policy is issued as a result of this transaction, the Joint last-to-die policy may be issued under the 2017 tax rules.
- Partial conversions - It's uncertain if converting pre-2017 UL policy term benefit to a permanent policy would cause the original pre-2017 UL policy to lose grandfathering. The new rules apply to the policy resulting from the term benefit conversion, but Sun Life believes the original UL policy should remain grandfathered.
- Changing to reduced paid-up insurance - It's uncertain if changing a permanent life insurance policy to a reduced paid-up life insurance policy would retain its grandfathered status, or if it could be classified as a conversion into "another type of life insurance."

- Term 10 policy to a term 20 policy, without medical underwriting - Sun Life believes this would be classified as a conversion, causing the loss of grandfathering and the new rules would apply.

## WHAT POLICY CHANGES WON'T CAUSE POLICIES TO LOSE GRANDFATHERING?

There are some changes clients can make to policies issued before 2017 that won't cause the policy to lose grandfathering. These changes include:

- Changing ownership - While this change continues to be a factor in determining the rules applying to policies issued before December 2, 1982, it won't affect the tax rules for policies issued after December 2, 1982 and before January 1, 2017. The ability to change ownership without the loss of grandfathering is important to a number of clients, particularly parents who purchase life insurance on their children and plan to transfer the ownership to them when they become adults<sup>1</sup>.
- Exercising guaranteed insurability option - If clients have a policy with a guaranteed insurability benefit that was purchased and medically underwritten before January 1, 2017, they can continue to exercise the option at any point in time without losing grandfathering. Even though there will be an increase in coverage under the policy, it's allowed since the guaranteed insurability benefit was medically underwritten pre-2017.
- Smoking status changes - Policies won't lose grandfathering when clients undergo medical underwriting to change their smoking status. In addition, policies won't lose grandfathering if clients undergo medical underwriting to have a rating change.
- Addition of waivers and benefits - Clients will continue to be able to add non-life insurance benefits such as total disability waiver, accidental death benefit, and in some cases child term benefit, without losing grandfathering. Some child term benefits allow clients to add the benefit before children are born. Since there's no medical underwriting required, there's no loss of grandfathering.
- Reinstating lapsed policies - If clients' pre-2017 policies lapse on or after January 1, 2017 and they apply to reinstate a policy by undergoing medical underwriting, the reinstated policy won't lose grandfathering. With a reinstatement, the policy is put back in place as if it had never lapsed and continues to follow the pre-2017 tax rules. It's important to note that the reinstatement must be for the policy as it was pre-2017, without any changes in the coverage. If clients apply to increase coverage when they apply to reinstate, the entire policy loses grandfathering.

<sup>1</sup> While transfers of ownership will not cause the loss of grandfathering in these circumstances, it will continue to be a taxable disposition of the policy. A taxable gain may be reported to the original policy owner upon the transfer, unless a specific rollover provision in the Income Tax Act (Canada) applies.

- Switching dividend options - Clients can continue to switch dividend options on a policy where medical underwriting is required without losing grandfathering. For example, if clients choose to switch their dividend option from cash to paid-up additional insurance and undergo medical underwriting to do so, the policy won't lose grandfathering. Medical underwriting is required as the insurance coverage will increase, but because dividends are being used to purchase the increase in coverage, the policy will be protected from moving to the new rules.
- Retaining coverage after withdrawals - If clients have a pre-2017 UL policy with a level death benefit and make a withdrawal that increases the net amount at risk; clients can undergo medical underwriting after 2016 to maintain the coverage at the original insurance without losing grandfathering.

- Reducing the death benefit - Decreasing the death benefit on any pre-2017 life insurance policy after 2016 won't cause the policy to lose grandfathering.
- Overfunding UL - Clients can continue or start overfunding their UL policies without losing grandfathering. The funding may cause annual increases in their death benefit to a maximum of 8% per year. These increases don't require medical underwriting.

To summarize, clients can make any contractual changes they would like to their pre-2017 policies in the post-2016 world without losing grandfathering, provided changes don't require medical underwriting or are outlined above.

## IMPACT OF THE LOSS OF GRANDFATHERING

### UNIVERSAL LIFE (UL)

Universal life insurance policies provide one of the most flexible options for permanent life insurance available today. When clients purchase these policies, they're provided with protection, maximum tax-preferred savings, a variety of structures for paying the costs of insurance and a number of investment options to help maximize their return under the policy.

UL policies that lose grandfathering will be most impacted by the changes in the exempt test and related rules coming into effect on January 1, 2017. When the current rules were written and put into place in 1982, UL was relatively new to the Canadian marketplace, and the product type wasn't taken into account. Insurance companies were left to interpret the rules designed for more traditional types of life insurance, and apply them to UL based on those interpretations.

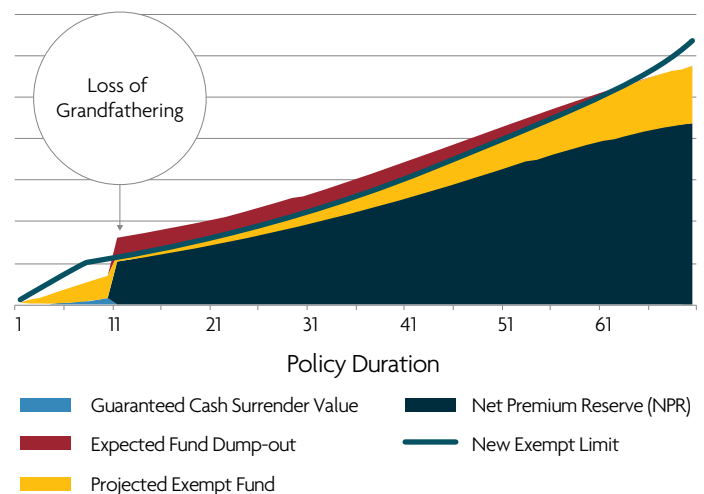
The one positive change achieved through the loss of grandfathering has already been extended to existing policy owners in the new legislation. The Department of Finance allowed for changes to the 250% rule to be extended to policies issued before January 1, 2017. This will likely result in fewer failures for minimum-funded policies. Existing policies will have access to this positive feature without losing grandfathering.

But overall the loss of grandfathering for UL policies will be mostly negative. Face plus fund with level cost of insurance policies will experience the most impact, and will no longer perform as originally illustrated.

If a UL policy loses grandfathering, the maximum funding room available will be reduced. This could result in transferring funds out of the policy to the side account to ensure the policy remains exempt. These transfers are a taxable disposition, with a taxable gain reported to the policy owner. When additional room opens up in the future, funds are moved back into the policy. These deposits are once again subject to provincial premium tax. The net result is several layers of unnecessary taxation to the policy owner due to the loss of grandfathering.

The following graph shows the impact of the loss of grandfathering in this situation.

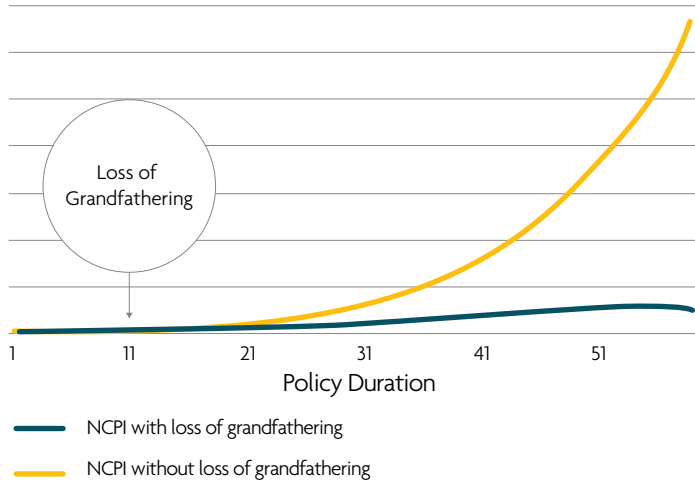
### 10 PAY UL WITH MAX PREMIUM FOR 10 YEARS LOSS OF GRANDFATHERING AT YEAR 10



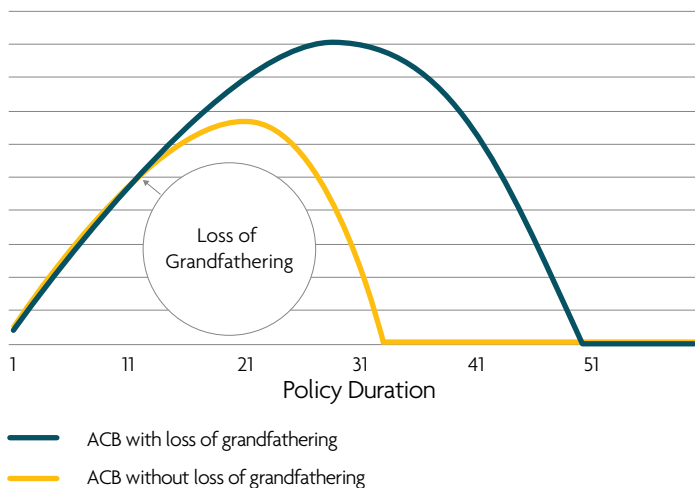
The 2017 rules for calculating the net cost of pure insurance (NCPI) and the adjusted cost basis (ACB) apply to UL policies that lose grandfathering. With the changes to the NCPI factors, the revised calculations will generally result in a lower NCPI amount. The NCPI of a life insurance policy is an important factor in determining the deductibility of life insurance premiums for tax purposes in certain situations. Life insurance strategies that involve leveraging may experience a decrease in the deductible amount available to clients for income tax purposes.

The changes to the formula used for calculating the ACB of a policy combined with the NCPI changes described above will also have a significant impact on the ACB. A lower NCPI results in a higher ACB for a longer period of time. While the exact impact will depend on when a policy loses grandfathering, applying the new ACB rules to an existing policy will cause the ACB to extend out – that is, not grind down to zero – for a longer period of time. For corporate beneficiaries, this will result in a lower Capital Dividend Account (CDA) credit being available to them.

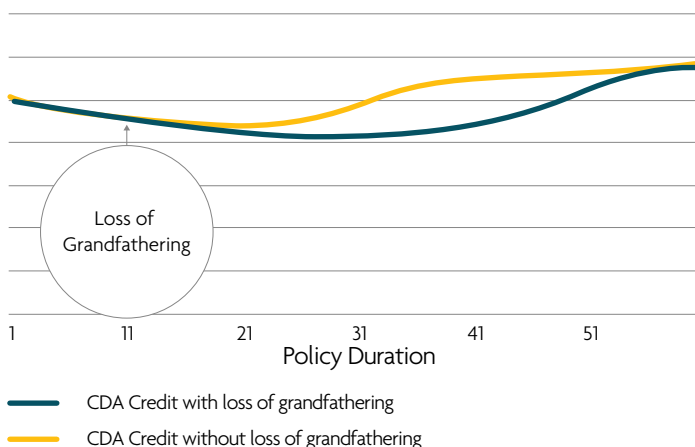
## NCPI IMPACT - LOSS OF GRANDFATHERING IN YEAR 10 LEVEL COI, MALE, NON-SMOKER, AGE 40



## ACB IMPACT - LOSS OF GRANDFATHERING IN YEAR 10 LEVEL COI, MALE, NON-SMOKER, AGE 40



## CDA CREDIT IMPACT - LOSS OF GRANDFATHERING IN YEAR 10 LEVEL COI, MALE, NON-SMOKER, AGE 40



When clients purchased UL policies, they may have insured multiple lives under one policy. The loss of grandfathering for multi-life policies will have a number of negative consequences. Policies subjected to the new rules will be tested at a life coverage level, rather than at the policy level. The result will be a reduction in the total funding room available within the policy,

In addition, multi-life policies currently allow for the payout of the full policy fund upon each death. With the loss of grandfathering, policies will only be able to pay the fund value that would have been associated with that life on a tax-free basis. Anything above this will report a taxable gain.

If any changes are needed to a multi-life policy that could jeopardize grandfathering, clients should be making them well before 2017 to avoid losing this valuable protection.

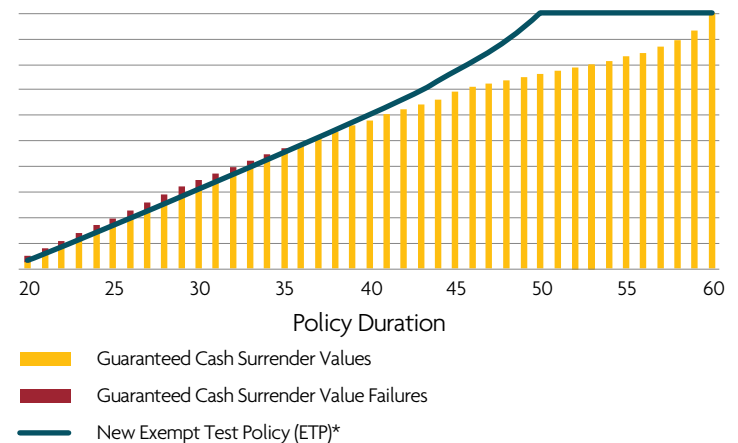
## PARTICIPATING LIFE INSURANCE

Certain benefits have been included in the legislation that will still allow for policy changes to occur without losing grandfathering. Medical underwriting to change dividend options won't cause the policy to lose grandfathering. This will provide continued flexibility to clients.

Par policies offer cash surrender values that are guaranteed in the contract and can't be altered by the insurer. If a policy loses grandfathering, these guaranteed cash surrender values could cause the policy to become non-exempt. The new rules offer a different exempt room pattern, while pre-2017 policies have been designed to work within the current tax rules. In many instances, the change in the exempt test policy line will result in a failure. There will be no recourse to change the policy back to an exempt policy, since the guaranteed cash values are specified by the contract. The insurer won't be able to make policy changes to prevent this from happening.

The following example illustrates how losing grandfathering could result in the guaranteed cash surrender values to cause the policy to fail the exempt test:

## SUN PAR PROTECTOR – AGE 40 COMPARE OF CURRENT GUARANTEED CASH SURRENDER VALUES AGAINST 2017 EXEMPT LIMIT DURATION 20+

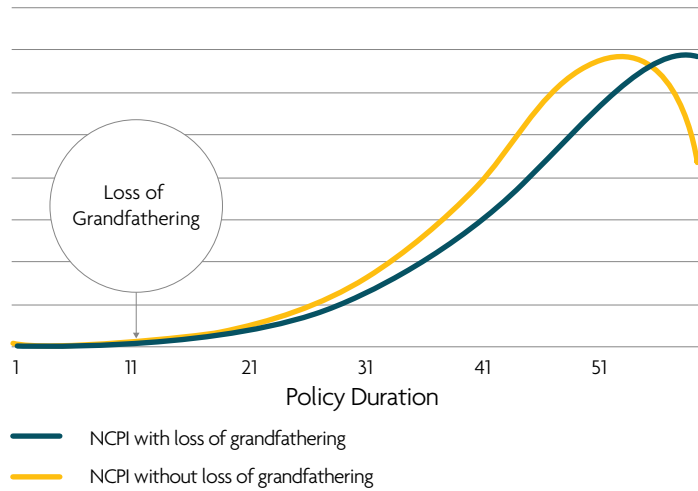


\*An exempt test policy (ETP) is a hypothetical benchmark that is set up at issue alongside the actual policy to measure the saving room in the policy. The higher ETP the more savings room there is in the real policy.

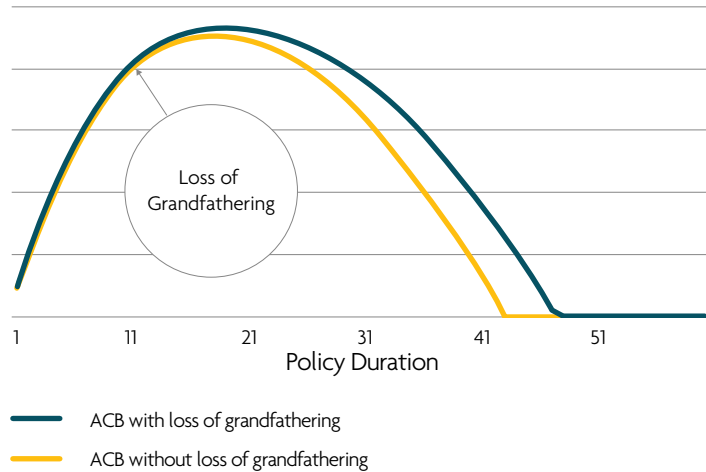


If these policies lose their grandfathering, the new rules for calculating the NCPI and the ACB will apply as described above. The lower NCPI will generally provide a lower deduction for collaterally assigned policies, and the higher ACB will result in a lower CDA credit for corporate beneficiaries for a period of time.

### NCPI IMPACT- LOSS OF GRANDFATHERING IN YEAR 10 PAR, MALE, NON-SMOKER, AGE 40



### ACB IMPACT - LOSS OF GRANDFATHERING IN YEAR 10 PAR, MALE, NON-SMOKER, AGE 40



## PERMANENT WHOLE LIFE INSURANCE

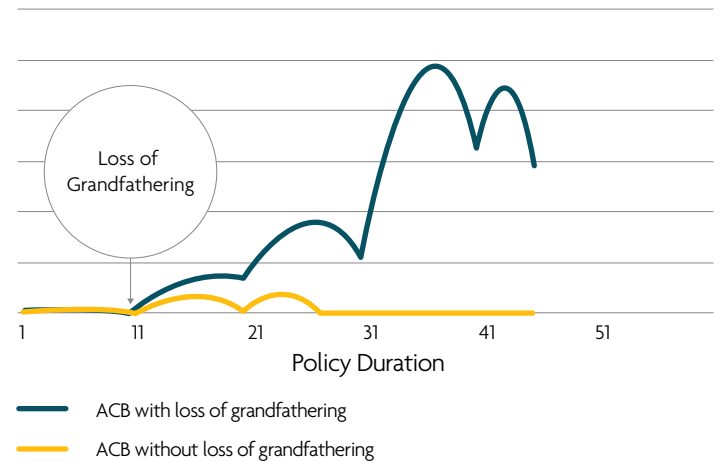
Similar to the situations described above, the guaranteed cash surrender values associated with permanent whole life insurance policies were developed using the current tax rules, and designed to stay within the current exempt test limits. The loss of grandfathering will result in a new pattern for exempt test rules, and the guaranteed cash values may not stay within these limits. Since these values are contractually guaranteed, there would be no recourse available in these situations. There's a risk that the policy could become non-exempt.

## TERM LIFE INSURANCE

Term life insurance policies will experience the least impact if grandfathering is lost. The main reason why a term policy would lose grandfathering is if it's converted to another type of life insurance, such as permanent insurance. The new policy will be subject to the new rules. Clients looking to convert their policy must do so before January 1, 2017 if they want the current tax rules to apply.

Term policies will also lose grandfathering if coverage requiring medical underwriting is added to the policy on or after January 1, 2017, or if there's a conversion to a different term length. An example of this is a term 10 to term 20 conversion. The impact to the converted policy will be limited given the lack of savings component associated with term policies. The new policy will fall under the 2017 rules for calculating the NCPI and ACB. For corporate beneficiaries, this may result in a lower CDA credit for a period of time. For policies that are collaterally assigned and eligible for the corresponding deduction, the deduction may be reduced due to the lower NCPI factor.

### ACB IMPACT - LOSS OF GRANDFATHERING IN YEAR 10 TERM 10 POLICY, MALE, NON-SMOKER, AGE 40



# WHY IS IT BETTER TO MAINTAIN A POLICY'S TAX-EXEMPT STATUS?

The tax-exempt status of life insurance policies is an extremely valuable feature, and can be jeopardized by the inadvertent loss of grandfathering. It's important to be fully aware of this risk before making any policy changes post 2016, and clients should generally avoid any policy transactions that would cause this to occur.

Policies that lose their tax-exempt status will become subject to accrual taxation, based on the excess of the accumulating fund over the ACB of the policy at each anniversary date. This means the annual investment earnings within the policy will be taxable each year to the policy owner. At death, any additional accrued income earned between the previous anniversary or reporting date and the date of death will be reported for tax purposes.

Maintaining the tax-exempt status of a life insurance policy is a critical component to ensure the policy continues to meet the client's original expectations and planning objectives.

Because of how integral and valuable the tax-exempt status is to a life insurance policy, Sun Life may decline to make policy changes to Par life, UL and permanent whole life policies that results in a loss of grandfathering and causes a policy to become non-exempt. If the requested change is contractually permitted, and the client still wishes to continue with the transaction, we may ask them to acknowledge the impact in writing before continuing with their request.

## ACTIONS TO TAKE IN 2016

As you've seen, it's in the clients' best interest to maintain their policies' pre-2017 tax status in the post-2016 world. Many policy contracts allow clients to make changes at any time. However, in 2016, it's important to ensure any medically underwritten changes are done to avoid the loss of grandfathering well before January 1, 2017.

If you're looking for opportunities to reach out to new or existing clients in 2016, here are some ideas.

### *Existing clients*

- If clients' term plans include converting term to permanent in the future, they should do it today so they can access the pre-2017 tax rules.
- If clients have a UL policy that offers the opportunity to add or increase coverages or add lives and they were considering doing so in the future, make sure they do this in 2016.

- If clients were considering an increase in coverage by adding a term benefit on themselves, a spouse or another insured, make sure they do this in 2016 so their entire policy maintains its grandfathered status.
- If clients have put off adding plus premium benefit to their Par whole life policy and they're allowed to do this after issue, make sure they add it in 2016.
- Now's the time for clients of young families to add a child term benefit.

### *New clients*

- Clients should purchase a UL policy today if they're looking to take advantage of maximum funding.
- Business clients who are looking to maximize the CDA credit on the insured person's death should have their policy issued before 2017.



# THE BRIGHT SIDE OF 2017

The tax changes taking effect on January 1, 2017, provide you with opportunities for sales in 2016.

- Reach out to existing clients who were considering making some changes.
- Approach clients who would benefit from the coverage today while taking advantage of the current tax rules.
- Increase the sense of urgency with respect to putting coverage in place for those clients who have been considering life insurance for a while.

The brighter side of 2017 is that products will be enhanced to incorporate the new tax changes. While there may be some

losses, there are a number of gains. For example, the new exempt rules allow for more funding up front, which may be appealing to clients who want to pre-fund their policies.

The tax changes provide opportunities for new and enhanced products.

*The products we offer today and what we'll offer in 2017 provide clients with sound value for their investment.*

The tax changes have provided an opportunity to create a sense of urgency for those clients that were putting off the inevitable.

## SUMMARY OF POTENTIAL IMPLICATIONS FROM LOSS OF GRANDFATHERING ON PERMANENT INSURANCE PRODUCTS

### Personal

- Potential for the policy to become non-exempt
- Loss of tax-preferred funding room
- Reduction in NCPI factors, lowering amounts available for deductions for eligible collaterally assigned policies
- For multi-life policies, losing out on the ability to pay out the full fund value on each death without tax consequences

### Corporate

- Potential for the policy to become non-exempt
- Loss of tax-preferred funding room
- Reduction in NCPI factors, lowering amounts available for deductions for eligible collaterally assigned policies
- Increase to ACB, resulting in a potentially lower CDA credit upon death of insured
- For multi-life policies, losing out on the ability to pay out the full fund value on each death without tax consequences



## 7 YEARS IN A ROW

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