Tax memo

Canadian tax updates

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2012 Federal budget: What does it mean for insurers?

Considers 2012 federal budget measures of particular relevance to insurers

July 24, 2012

On March 29, 2012, the Federal Minister of Finance, Jim Flaherty, presented the majority government's budget, which included a number of tax initiatives that are particularly relevant to the insurance industry. These tax initiatives are reviewed in this *Tax memo*.

Life insurance policy exemption test

The budget proposes technical improvements to update and simplify the test that determines whether a life insurance policy is an exempt policy. Based on the exemption test implemented in the early 1980s, a life insurance policy is an exempt policy when the accumulating savings (or the accumulating fund) in the policy does not exceed the accumulating fund in a benchmark policy (or an exemption test policy).

Current rules

Under current rules, the accumulating fund in an exemption test policy generally is calculated using prescribed mortality and interest rates, the rates used in determining the premiums, or the cash surrender value of the actual policy. The accumulating fund in an actual policy issued by a life insurer is measured using an amount that is equal to the greater of the cash surrender value of the policy and the modified net premium reserve in respect of that policy.

Budget proposal

The budget proposes technical improvements that the government considers necessary to update and simplify the exemption test, and to improve consistency between the measurement of the accumulating fund in an actual policy and the measurement of the accumulating fund in the exemption test policy.

The following changes to the exemption test are proposed for life insurance policies issued after 2013:

- measuring the accumulating fund in an actual policy and the exemption test policy using:
  - the Canadian Institute of Actuaries 1986-1992 mortality tables (instead of the 1969-1975 mortality tables, currently used for purposes of the exemption test policy); and
  - an interest rate of 3.5% (instead of the current prescribed rate of no less than 4.0%), to better reflect mortality rates and investment returns;

- increasing the endowment time of the benchmark policy from age 85 years to 90, to reflect increased life expectancy;
- measuring the accumulating fund in an actual policy using the greater of:
  - the cash surrender value of the policy (before the application of surrender charges); and
  - the net premium reserve in respect of the policy; and
- reducing the pay period of the benchmark policy to 8 years from 20, to better reflect current industry practices and the pay period used in other countries.

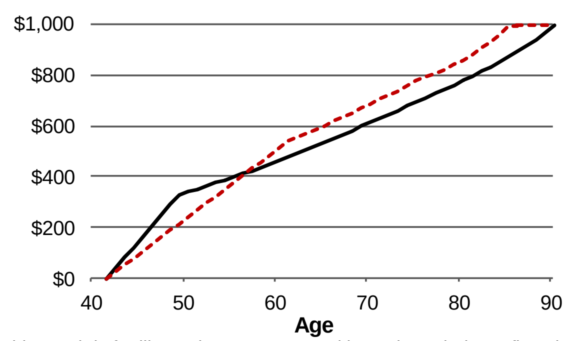
Over the coming months, the government will hold consultations with key stakeholders on these improvements.

Effect of budget changes

The graph below illustrates the difference in the accumulating fund of the exempt test policies between the current and the proposed changes. The revised exempt test assumptions create more room in the early policy durations. This additional room is offset by the removal of surrender charges in measuring the actual policy cash surrender value. The removal of the surrender charge effectively eliminates the very short pay UL contracts that pass the exempt test because of high early duration surrender charges.

The graph compares the current exempt test amount (per $1,000) to the exempt line under the proposed assumptions, for a sample issue aged 40.

Exemption test policy accumulation fund



This graph is for illustration purposes and is not intended to reflect the change in measuring the accumulating fund in an actual policy.

Investment income tax

Current rules

The *Income Tax Act* (Canada) currently levies a 15% tax on the taxable Canadian life investment income of a life insurer (the IIT).

Budget proposal

The budget proposes to recalibrate the IIT, when appropriate, to neutralize the effects of the proposed technical improvements to the exemption test. The recalibration of the IIT will be subject to the consultations mentioned above. Proposed amendments resulting from these consultations will apply to life insurance policies issued after 2013.

Group sickness or accident insurance plans

Current rules

Currently, wage-loss replacement benefits that are payable on a periodic basis under a group sickness or accident insurance plan to which an employer has contributed are included in an employee's income for tax purposes when those benefits are received.

However, no amount is included in an employee's income, either when the employer contributions are made or the benefits are received, to the extent that benefits:

- are not payable on a periodic basis; or
- are payable in respect of a sickness or accident when there is no loss of employment income.

Budget proposal

The budget proposes to provide for more neutral and fair tax treatment of beneficiaries under a group sickness or accident insurance plan. It requires the amount of an employer's contributions to a group sickness or accident insurance plan to be included in an employee's income for the year in which the contributions are made, to the extent that the contributions are not in respect of a wage-loss replacement benefit payable on a periodic basis.

This measure generally will apply in respect of employer contributions made after March 28, 2012, relating to coverage after 2012. The budget indicates that it will not affect the tax treatment of private health services plans or other plans described in paragraph 6(1)(*a*) of the *Income Tax Act*.

Insuring long-term disability plans

The budget proposes to require federally regulated private sector employers (such as banks, airlines and telecommunications companies) to acquire insurance coverage, on a go-forward basis, in respect of any long-term disability plans they offer to their employees.

Need more help?

For more information on the implications of these proposals, please contact and of the following individuals:

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