CALU REPORT

JUNE 3, 2013

Budget 2013 – CALU Submissions to Finance re 10-8s and LIAs

On March 21, 2013, the Minister of Finance released proposals relating to 10-8 arrangements ("10-8 programs") and leveraged insured annuities ("LIAs") as part of the 2013 Budget (referred to collectively as the "Budget Proposals"). CALU has now completed two submissions to the Department of Finance ("Finance") and these are available on the member-only side of the CALU website. However, given the importance of these two issues, the content of those submissions is reprinted here to facilitate distribution of this information to your clients and centres of influence.

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Discussion of Proposals Relating to 10-8 Policies

1. Introduction

Annex 2 of the 2013 Budget Papers (at page 360) indicates that a 10-8 arrangement involves investing in a life insurance policy with a view to borrowing against the investment for the purpose of creating an interest expense deduction over a long period of time (typically until the death of the life insured under the policy).

Annex 2 (at pages 360 and 361) notes that the following tax benefits arise from these arrangements:

- an annual interest expense deduction in respect of borrowings against the policy;
- an annual deduction for a portion of the premiums paid under the policy; and
- an increase, up to the total amount borrowed, in the capital dividend account of a private corporation that is a beneficiary under the policy.

It is our understanding from both the Budget Papers (Annex 2 at page 360) and from discussions with the Department of Finance that the intention of the 10-8 proposals is to ensure that unintended tax benefits are not available in relation to 10-8 arrangements. There also appears to be a desire to avoid costly challenges to these arrangements under existing income tax rules by the Canada Revenue Agency (CRA).

To accomplish these goals, a "10-8 policy" will be defined to be a life insurance policy where the policy, or an investment account under the policy, is assigned as security for a loan and either:

- the interest rate payable on an investment account under the policy is determined by reference to the interest rate payable on the borrowing; or

- the maximum value of an investment account under the policy is determined by reference to the amount of the borrowing (referred to in this submission as a "linked-loan arrangement").

Where a life insurance policy falls within the definition of a 10-8 policy, the following rules will apply:

- no deduction will be permitted for interest paid or payable that relates to a period after 2013;
- no deduction that relates to a period after 2013 will be allowed under paragraph 20(1)(e.2) of the Act; and
- any increase in the capital dividend account of a private corporation after 2013 will be denied to the extent that such increase is associated with the borrowing.

To facilitate the termination of existing 10-8 arrangements before 2014, it is also proposed that a deduction be allowed to the extent a policy withdrawal is made on or after the Budget Day and before 2014 to repay the borrowing where such withdrawal otherwise results in a taxable gain under subsection 148(1) of the Act.

It is further noted in Annex 2 (at page 362) that the Government will monitor developments to see if structures or transactions are developed to undermine the effectiveness of these measures. If this type of activity does occur the Government will determine if further legislative action is warranted, with possible retroactive application of any such legislation.

2. Specific Comments

a) Application of the 10-8 Proposals to Arrangements in Place before March 21, 2013

(i) Grandfathering of In-Force Policies

Unlike the proposals applicable for LIA policies, only limited grandfathering is provided to existing 10-8 arrangements. In effect, an existing linked-loan arrangement must be suitably modified or repaid by the end of 2013 to avoid the application of the new rules.

CALU is very concerned, as a general matter, with any legislative amendment that does not provide full grandfathering where life insurance is concerned. It is a long standing principle that "taxpayers should be able to expect stability and continuity in the tax rules" and "they should be able to expect certain tax results when they plan their investments on the basis of the rules as they know and understand them."[1] Nowhere is this tax principle more important than in the realm of life insurance contracts, where changes in medical status of the measuring life or lives may preclude replacing an existing contractual arrangement with an alternate contract, or make the cost of replacing a pre-existing contract prohibitive. As a result, policyholders should reasonably expect that their existing arrangements would be grandfathered, at least until the renewal of their existing loan arrangement.

However, for reasons discussed below, CALU is not advocating full grandfathering for existing 10-8 arrangements, even though the changes that are being proposed in relation to 10-8 policies clearly reflect a change in the tax rules governing these arrangements. We understand there are a number of reasons why full grandfathering was not extended to these arrangements, including:

- the proposed changes do not impact the insurance policy but the loan arrangement;
- unlike the LIA loan program, a 10-8 loan arrangement can be repaid at any time without interest or penalty;
- the annuity under an LIA program cannot be surrendered, cancelled or modified;

- under the 10-8 program, the policyholder can access the cash within the policy to repay the loan, and if this is done before 2014, there will be no tax liability arising from the withdrawal; and
- grandfathering such arrangements would necessitate the reporting of policyholder information to the CRA for monitoring purposes, which in turn could expose policyholders to ongoing assessment activity. This would also run counter to one of the stated goals of these proposals, which is to relieve CRA from time-consuming and costly challenges of existing arrangements.

In response, we would note that there remains the potential for a number of "costs" associated with winding up the linked-loan arrangement, particularly when policy values are used to repay the loan. For example:

- Some of these policies may be subject to surrender charges, which will be triggered if funds are withdrawn from the policy to repay the loan;
- A number of 10-8 arrangements involve private corporations and shareholders, and the repayment of the loan, through either policy values or use of other assets, may trigger shareholder benefit issues;
- While these loan arrangements may continue for a long period of time, in practice the policyholder enters into the arrangement expecting to repay the loan prior to death using external funds (such as proceeds from the sale of an investment or business). The cash value is retained in the policy and used to either reduce the net amount at risk under the policy and/or pay future cost of insurance charges. The repayment of the loan to avoid the 10-8 proposals negates this long-term objective and may jeopardize the insurance coverage when it is needed the most; and
- If the policyholder wants to retain the funds within the policy, other assets may have to be sold to repay the loan, with resulting disposition costs as well as possible negative tax consequences.

Notwithstanding all of these factors, CALU has fully considered the issues and concluded that it would not be in the best interests of either Government or the industry to have a situation where policyholder information must be released to the CRA, which in turn results in ongoing audit activity. We are therefore not requesting the Government reconsider its current position relating to grandfathering of in-force 10-8 programs.

(ii) Extension of the Transition or Wind-up Period

While we are prepared to accept that full grandfathering will not be extended to in-force 10-8 programs, there remains the ongoing concern that affected policyholders and insurance companies will not have sufficient time to wind-up the linked-loan arrangements on a favorable basis by the end of 2013.

From a policyholder perspective, the life insurance policies underlying a 10-8 arrangement are typically part of a more comprehensive estate or business succession plan which may have taken several years to implement with the involvement of accountants, lawyers and other professional advisors. It would seem fair and appropriate to allow these policyholders sufficient time to consult with these advisors, review options and then take steps to either restructure the loan or repay it, possibly with other investment assets. This may extend well past the end of 2013 despite concerted efforts by a policyholder to meet this deadline.

At the same time, the affected insurance companies have a significant interest in supporting policyholders who want to transition out of their current linked-loan arrangement without necessarily having to withdraw the cash from their policies or dispose of other assets. They will therefore be exploring the development

of loan and investment account structures that comply with the proposals, and the transition of existing policyholders into such arrangements. Given the other regulatory and business issues impacting the insurance industry including the imminent release of the draft legislation relating to the exemption test and policyholder tax rules, however, there may not be sufficient time before the end of the year to both develop and implement compliant loan arrangements.

At the same time, we understand that an extension of the transitional period past 2013 may trigger 10-8 policyholder reporting requirements on the part of the insurance companies as well as ongoing audit activity of 10-8 programs by the CRA. As noted above, the continuation of assessment activity by the CRA does not appear to be in the best interests of the Government, the industry or the affected policyholders from both a cost and time perspective.

CALU is attempting to obtain assurances from the affected insurance companies that they will be able to offer and implement compliant loan programs before the end of the year. We are also waiting for confirmation from the CRA in terms of their ongoing assessing position relating to in-force 10-8 programs. Once we have this information we¡¯ll be in a better position to communicate with you on whether an extension of the transition period past 2013 is required or appropriate.

To conclude on this point, if we can receive assurances from the insurance companies that they can implement compliant loan arrangements by the end of 2013, and that the CRA will not pursue the assessment of arrangements in place prior to Budget Day, our concerns in this area will have been substantially addressed.

One final comment relates to what is required to ensure that an existing insurance policy that is part of a 10-8 arrangement will not be treated as a 10-8 policy after 2013. We would note that while the number of existing policies with linked-loan arrangements currently in place is relatively small, there are a much larger number of insurance policies which contain contractual provisions permitting such loans. We understand the intent is to not require all these policies to be amended to remove such contractual language provided there is in fact no linked-loan arrangement in place after 2013. We would ask that the Explanatory Notes to the legislation make this clear and avoid the possibility of future CRA assessment activity.

b) General Application of the Proposals to 10-8 Arrangements

Appendix A to this letter sets out CALU¡¯s suggested changes to the various clauses in the NWMM relating to 10-8 policies. Below is a short discussion of those various changes:

Clause 36(2) ¨C this change is intended to clarify that the rules only apply during the time the life insurance policy is a 10-8 policy. For example, if the linked-loan arrangement is repaid, whether or not a new compliant loan arrangement is entered into, it is our understanding that the policy will no longer be treated as a 10-8 policy.

Clause 36(3) ¨C as noted, draft subsection 20(2.1) effectively denies an interest deduction under paragraph 20(1)(c) for all collateral and policy loans as it does not specify that the loan is in respect of a 10-8 policy. The provision should therefore be amended to clarify this provision only applies if the policy is also a 10-8 policy at that time.

Clause 38(1)(iv) ¨C similar to the change to Clause 36(2), "immediately before death" should be inserted to ensure that the CDA reduction only occurs if the insurance policy is a 10-8 policy at that time. As well, since the policy loan is already netted against the insurance death benefit in determining the CDA it should not be subtracted again under this provision. Accordingly, the provision should be further revised to exclude a policy loan in respect of a 10-8 policy.

Clause 39 ¨C we recommend that this deduction be incorporated into the determination of the policy gain under subsection 148(1), with the result that the insurance company reports only the net amount of the gain, if any, in the year. Our reasons are as follows:

- the insurance company has all the information required to make this determination;
- it would simplify tax reporting for the policyholder and eliminate the potential for errors;
- without further amendments to the Act, there will be an improper add-back to the adjusted cost basis of the policy as any gain reported under subsection 148(1) is subsequently offset by the proposed deduction;
- without further amendments to the Act, the insurance company will realize an inappropriate reduction in its IIT base as a result of the income reported on the policy disposition under subsection 148(1); and
- we are concerned that making this a separate deduction may result in costly CRA audit activity, which the 10-8 proposals are intended to avoid.

Clause 40 ¨C The first bolded change is again designed to ensure that the definition applies at a particular point in time where a linked-loan arrangement is in place.

With respect to the second bolded change, the definition of "policy loan" in subsection 148(9) already includes a reference to "in accordance with the terms and conditions of the life insurance policy" and therefore this does not need to be repeated.

We are also of the view that the highlighted clause (b)(i) of the definition of a 10-8 policy is not required (shown in blue in this electronic version). It appears that the limitation under clause b(ii) would deal with the concerns expressed by Finance relating to the ability of the insurance company to manipulate either the loan rate or credited rate to the policy. As well, it is our understanding the clause b(i) of the definition may apply to certain existing policy loan arrangements that were not intended by the Government. If this clause is retained, we are recommending the third bolded change which more properly reflects how interest is credited to investment accounts.

As a final comment, we understand that the Government does not have any issues with loan arrangements secured by life insurance cash values provided there is no direct linkage between the loan interest rate and the credited policy rate or the amount that can be accumulated in the investment account that secures the loan. However, there is the statement in Annex 2 that Finance will monitor developments and introduce new legislation where required, possibly with retroactive effect. It would be extremely helpful if the Explanatory Notes to the legislation could confirm that the Government is generally not concerned with loan arrangements secured by life insurance cash values, whether such loans are in the form of policy loans or collateral loans, and whether made by an outside institution or by the insurer. It is in our view only fair to provide such guidance, given Finance¡¯s indication that it is prepared to resort to the severity of retroactive legislation.

We appreciate the opportunity to provide you with our feedback on these proposals and look forward to further dialogue on these issues.

Endnote

[1] Department of Finance Session Paper 8512-351-79, September 1995, Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts at p. 15.

Appendix A

Suggested Revisions to 10-8 Proposals (Bolded)

Leveraged Life Insurance Arrangements

36. (2) Subparagraph 20(1)(e.2)(ii) of the Act is replaced by the following:

(ii) the net cost of pure insurance in respect of the year (other than in respect of a period after 2013 **during which** the policy is a 10-8 policy), as determined in accordance with the regulations, in respect of the interest in the policy referred to in clause (i)(A),

(3) Section 20 of the Act is amended by adding the following after subsection (2):

(2.01) For the purposes of paragraphs (1)(c) and (d), interest does not include an amount that is paid or payable on or after Budget Day in respect of a period after 2013 **during which the policy is a 10-8 policy** and that is described in paragraph (a) of the definition ¡°10-8 policy¡± in subsection 248(1). **[Should only deny interest deductions after 2013 in respect of periods during which the policy is a ¡°10-8 policy¡±. The current reference effectively denies all interest deduction whether or not the policy in question is a ¡°10-8 policy¡±.]**

(4) Subsections **36(1)** to **(3)** apply to taxation years that end on or after Budget Day.

38. (1) The portion of paragraph (d) of the definition ¡°capital dividend account¡± in subsection 89(1) of the Act after subparagraph (ii) is replaced by the following:

(ii) all amounts each of which is the proceeds of a life insurance policy (other than an LIA policy) of which the corporation was not a beneficiary on or before June 28, 1982 received by the corporation in the period and after May 23, 1985 in consequence of the death of any person

exceeds the total of all amounts each of which is

(iii) the adjusted cost basis (within the meaning assigned by subsection 148(9)) of a policy referred to in subparagraph (i) or (ii) to the corporation immediately before the death, or

(iv) if the policy is a 10-8 policy **immediately before the death** and the death occurs after 2013, the amount outstanding, immediately before the death, of the borrowing (other than a policy loan) that is described in paragraph (a) of the definition ¡°10-8 policy¡± in subsection 248(1) in respect of the policy, **[the prior reference to ¡°or the policy loan¡± can be removed.]**

(2) Subsection **38(1)** applies to taxation years that end on or after Budget Day.

39. (1) Section 148 of the Act is amended by adding the following after subsection (4):

(5) If a policyholder has on or after Budget Day and before 2014 disposed of an interest in a 10-8 policy because of a partial or complete surrender of the policy, the policyholder may deduct in computing the policyholder¡¯s income for the taxation year in which the disposition occurs an amount that does not exceed the least of

(a) the amount included under subsection (1) in computing the policyholder¡¯s income for the year in respect of the disposition,

(b) the total of all amounts each of which is an amount, to the extent that the amount has not otherwise been included in determining an amount under this paragraph, of a payment made on or after Budget Day

and before 2014 that reduces the amount outstanding of a borrowing or policy loan, as the case may be, described in paragraph (a) of the definition ¡°10-8 policy¡± in subsection 248(1) in respect of the policy, and

(c) the total of all amounts each of which is an amount, to the extent that the amount has not otherwise been included in determining an amount under this paragraph, that the policyholder is entitled to receive as a result of the disposition and that is paid after Budget Day and before 2014 **and reduces an** investment account described in paragraph (b) of the definition ¡°10-8 policy¡± in subsection 248(1) in respect of the policy. **This deduction should be incorporated into the determination of the gain under subsection 148(1), and the net amount is required to be reported by the insurance company.**

(2) Subsection **39(1)** applies to taxation years that end on or after Budget Day.

40. (1) Subsection 248(1) of the Act is amended by adding the following definitions in alphabetical order:

¡°10-8 policy¡± **at any particular time** means a life insurance policy (other than an annuity) where

(a) an amount is or may become

(i) payable, under the terms of a borrowing, to a person or partnership that has been assigned an interest in the policy or in an investment account in respect of the policy,
or

(ii) payable (within the meaning assigned by the definition ¡°amount payable¡± in subsection 138(12)) under a policy loan (as defined in subsection 148(9)) [the phrase ¡°made in accordance with the terms and conditions of the policy¡± is redundant] and

(b) either

(i) the rate of interest **credited in respect of** an investment account in respect of the policy is determined by reference to the rate of interest payable on the borrowing or policy loan, as the case may be, described in paragraph (a), or

(ii) the maximum amount of an investment account in respect of the policy is determined by reference to the amount of the borrowing or policy loan, as the case may be, described in paragraph (a);

(2) Subsection **40(1)** applies to taxation years that end on or after Budget Day.

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Discussion of Proposals on Leveraging Insured Annuities

1. Introduction

Annex 2 of the 2013 Budget Papers (“Annex 2”, at page 359) describes an LIA as an investment product that is acquired with borrowed funds and provides a fixed and guaranteed income to an investor until the death of an individual, at which time the capital invested in the annuity is returned in the form of a tax-free

death benefit. However, each element of an LIA is treated separately for tax purposes which results in multiple tax benefits that are not available in relation to comparable investment products.

It is our understanding from both the Budget Papers (Annex 2 at page 358) and from discussions with Finance that the intention of the LIA proposals is to improve the integrity and fairness of the tax system by eliminating these multiple and unintended tax benefits.

The specific tax benefits relating to LIAs are described in Annex 2 (page 359) as follows:

- part of the income earned on the capital is tax-free due to the fact that an exempt policy is used as part of the arrangement;
- the interest on the borrowed funds is generally tax deductible;
- a deduction is allowed for part of the capital that is invested (relating to the policy premium);
- for closely held private corporations and their owners, the arrangement results in the elimination of tax on retained earnings in the corporation by avoiding taxation on capital gains on the death of the owners; and
- there is also an elimination of tax on dividends paid after the death of the owners as a result of the capital dividend account arising from the life insurance proceeds.

To deal with these concerns, the Budget Proposals define a life insurance policy issued on the life of an individual to be an "LIA policy" if:

- a person or partnership becomes obligated on or after March 21, 2013 (the "Budget Day") to repay an amount to another person or partnership (the lender) at a time determined by reference to the death of an individual; and
- an annuity contract, the terms of which provide that payments are to continue for the life of the individual, and the life insurance policy on that individual, are assigned to the lender.

Where a life insurance policy falls within the definition of an LIA policy, the following rules will apply:

- the insurance policy will be treated as a non-exempt policy and subject to accrual taxation;
- no deduction will be allowed under paragraph 20(1)(e.2) of the Act;
- the capital dividend account of a private corporation will not be increased by the death benefit received in respect of the LIA policy; and
- for purposes of the deemed disposition rules on death, the fair market value of the annuity contract assigned to the lender in connection with an LIA policy will be deemed to be equal to the premium paid under the contract.

It is further noted in Annex 2 (at page 360) that the Government will monitor to see if structures or transactions are developed to undermine the effectiveness of these measures. In particular, it is stated that if this type of activity does occur the Government will determine if further legislative action is warranted, with possible retrospective application of any such legislation.

2. Specific Comments

a) Application of the LIA Proposals to Arrangements in Place before March 21, 2013

Clause 40 of the Notice of Ways and Means Motion (the "NWMM") released with the Budget Papers indicates that the a life insurance policy is only an LIA policy where a person or partnership "becomes obligated on or after Budget Day to repay an amount to the [lender]…." Annex 2 (at page 360) further indicates that "this measure will not apply in respect of LIAs for which all borrowings were entered into before Budget Day". In other words, it is intended that the LIA proposals won´t apply where the loan arrangements were in place prior to March 21, 2013 (a "grandfathered LIA policy").

There are a number of transactions that may take place with respect to a grandfathered LIA policy on or after the Budget Day, as noted below:

- the loan is for a fixed term and its term is subsequently extended by the same lender under similar terms and conditions and the amount of the loan is not increased;
- the loan is replaced with another loan from a new lender under similar terms and conditions and the amount of the loan is not increased;
- the loan amount is subsequently increased pursuant to its terms – for example, if interest payable is added to the principal amount of the loan;
- the terms of the life insurance policy that has been assigned to the lender are modified according to its contractual terms;
- the amount of coverage under the life insurance policy that is assigned to the lender is increased or decreased, with or without underwriting; and
- the life insurance policy that is assigned to the lender is replaced with a different life insurance policy issued by the same or different insurance company.

Based on the current language in the NWMM and Annex 2 it is unclear whether these transactions or events would result in a grandfathered LIA policy losing such status and becoming subject to the new rules. Accordingly we would ask for confirmation that the above transactions will not impact the status of a grandfathered LIA policy. We would also ask that the grandfathering rules be confirmed in the legislation to be introduced to address these possible transactions, or that the technical notes accompanying such legislation make it clear that such transactions will not affect the status of a grandfathered LIA policy.

b) Application of the LIA Proposals to New Arrangements

(i) Tax Policy Underlying these Rules

As indicated in the Introduction, it appears that the Government´s main concern with LIA policies is the ability of the policyholder to obtain multiple tax benefits. In other words, the combination of an annuity, life insurance and loan would not be attractive to policyholders absent the various tax benefits. It is therefore intended that these tax benefits be eliminated, and by doing so, ensure the tax treatment is similar to other types of guaranteed investment programs, whether owned by an individual, a partnership or a private corporation.

As a starting point, we believe it is important to note that the annuity and life insurance policy underlying an LIA arrangement are not part of a "structured investment product". The annuity and life insurance policy typically originate from separate and arm´s-length insurance companies, while the loan is advanced by an arm´s-length financial institution. The risks associated with the annuity and life insurance is separately underwritten and the issuance of one product is not dependent on the other. As well, the terms and conditions of the loan are negotiated independently and based on market rates and terms available at that time.

Assuming that it is appropriate that the tax treatment for LIA policies should be similar to that accorded comparable investment products, we are concerned that the rules as currently proposed could in fact put

LIA arrangements in a worse position than comparable investment products. This concern is increased where such an arrangement is established within a closely held private corporation because of the application of specific elements of the LIA proposal to those situations.

We are also concerned that the proposed rules create compliance issues and burdens for both the policyholder and the insurance company providing the insurance policy, as discussed further below. Finally, the cautionary statement in Annex 2 warning that retrospective legislation might follow if “structures or transactions emerge that undermine the effectiveness of the [LIA policy] measure” is problematic as there is currently little guidance to the industry which allows it to determine precisely what structures and changes in tax consequences, would be considered to undermine the effectiveness of the measure.

In substantiating these concerns, we believe it is helpful to break down the components of a corporate owned LIA arrangement and review in detail why these components may or may not offer unintended tax benefits as suggested in Annex 2.

The Life Annuity

As part of a typical corporate LIA arrangement, the corporation will convert some of its assets (typically fixed income investments) into a life annuity where the measuring life is the controlling shareholder. The payments received under the life annuity will consist of both a return of the original invested capital as well as income earned on the life annuity.

The purported tax benefit of this arrangement is that, unlike the original fixed income assets, the value of the annuity immediately before the death of the annuitant may be significantly lower than the original capital that is used to fund the annuity. As a result, it is postulated that the conversion of the fixed income investments into a life annuity will reduce the capital gain that otherwise arises on the death of the controlling shareholder as the value of the shares of the corporation will have been reduced by the amount “removed” through the acquisition of the annuity. However, this analysis ignores the fact that if the annuitant lives to his or her life expectancy (as determined by the life insurance company), all of the original capital will typically be returned to the corporation as it makes up a part of each annuity payment received by the corporation. In this situation the value of the shares will not be diminished by the full amount of the annuity premium for purposes of determining their value immediately before the death of the shareholder/life insured even when the payment of insurance premiums is factored in.

The proposal to include the amount of the premium paid on the annuity contract, in valuing the shares of the private corporation on death, could therefore lead to “double counting”, and as a consequence double taxation of a portion of the original capital, given that over time the annuity premium will be returned to the corporation as part of the annuity payments and reflected in its share value, even after taking into account the payment of insurance premiums.

As an alternative approach, we would propose that this rule be amended to include only the accumulating fund of the annuity in determining the fair market value of the shares. The accumulating fund in effect reflects the remaining amount of the annuity premium after reflecting the “repayment” of capital amounts to the corporate owner of the annuity. Otherwise, the stated goal of greater tax parity between an LIA arrangement and other corporate owned investments would not be achieved.

Exempt vs. Non-Exempt Policies

Annex 2 indicates that an LIA policy is an “investment product” and that one of the tax benefits is that policyholders benefit from the “tax-free” growth within an exempt insurance policy. To deal with this concern, such policies will be treated as non-exempt policies.

We have several comments/concerns with this proposal, as discussed below.

First, it is important to recognize that the vast majority of policies that have been put in place under current LIA arrangements are Term to 100 or Universal Life Level Cost of Insurance (UL LCOI) policies funded on a minimum level basis. As a result, these policies typically do not have values that are available to the policyholder as either a cash surrender value or increased death benefit and would otherwise be subject to the Investment Income Tax.[1]

Another concern with the deeming of the LIA policy to be non-exempt relates to compliance with the policyholder´s reporting obligations. Due to the complexity of the accrual rules as they apply in the case of a non-exempt life insurance policy, the Regulations require an insurer to make an information return in prescribed form in respect of an amount required to be included in computing a taxpayer´s income under subsection 12.2(1) of the Act.[2] It is virtually impossible for a policyholder to determine what income, if any, needs to be reported on an annual basis as the amount is computed with reference to the accumulating fund and the adjusted cost basis of the policy and the policyholder must therefore rely on the insurance company for this information. It is our understanding that insurance companies currently don´t have non-exempt accrual reporting systems in place for Term to 100 products or minimum funded UL LCOI products, as these are policies that are sold as exempt products. Therefore, the insurance companies may not be able to supply the appropriate information to policyholders on a timely basis to fulfill their reporting obligations. We have also been advised that they are not likely to have the resources to automate the tax reporting for these policies given the upcoming changes to the exempt test rules.

Moreover, the insurance company may not know in advance whether such reporting will be required by the policyholder, as the treatment of the policy as non-exempt arises because of the existence of the annuity and the assignment of the annuity and life insurance policy to a lender, of which the insurer may be quite unaware, and not because of anything specific to the policy. The proposed amendment to the regulations in resolution 41 contemplates notice by the end of the calendar year, which could mean the insurer has as little as eight weeks´ notice to produce the appropriate T5 information return.

For these reasons it is our position that deeming the policy to be non-exempt is both unfair and impractical.

Capital Dividend Account Treatment

The taxation of private corporations is based on the fundamental principle of tax integration. That is, income earned by a private corporation and distributed to its shareholders should be subject to approximately the same amount of tax as if the income had been earned by the shareholders directly.

As part of the theory of tax integration, if an amount would be received tax-free if paid directly to the shareholder, then it should not be subject to tax if first paid to the private corporation and then distributed to the shareholder. The capital dividend account mechanism is the means by which certain tax-free amounts received by a private corporation are tracked, which in turn allows the private corporation to pay out tax-free capital dividends to its shareholders. In keeping with this theory, where a private corporation is the beneficiary of a life insurance policy, the excess of the insurance death benefit over the adjusted cost basis of the policy to the recipient corporation is credited to the capital dividend account.

As discussed in the Introduction section, where an LIA policy is owned by a private corporation, the budget proposals will eliminate the capital dividend account (CDA) balance arising from the receipt of the insurance proceeds. CALU also has concerns with this proposal and whether it is needed to address the issues that the Government has expressed with these programs.

Again, the approach taken in relation to disallowing the CDA credit, appears to have as its policy underpinning that the annuity and insurance policy should be treated as one structured investment, and in combination with the loan, should not provide greater tax benefits than a fixed term investment combined with a loan. However, in considering the financial results of the annuity/insurance structure, we must again reinforce the fact that the annuity payments include a return of capital, which over time creates

additional value in the corporation even after taking into account the insurance premiums. In other words, at or near the life expectancy of the annuitant/life insured, the annuity combined with the insurance death benefit can increase the financial value of the corporation over that available from a fixed income investment. To achieve the appropriate tax result, the CDA credit should therefore be available to provide a similar tax result to a fixed income investment.

Tax Treatment of the Loan Arrangement

Under a “typical” leveraged insured annuity arrangement, the borrowing has two tax consequences for the policyholder. First, the loan interest will be deductible subject to the requirements of paragraph 20(1)(c) of the Act. As well, a portion of the annual premium (up to the net cost of pure insurance for the policy) is deductible under paragraph 20(1)(e.2) of the Act to the extent that, inter alia, the lender requires that the insurance be assigned as collateral for the borrowing.

The budget proposals relating to LIA policies would continue to permit the deduction of interest, but would disallow any deduction that might otherwise arise under paragraph 20(1)(e.2) of the Act.

Again, the tax theory for this change appears to be that the annuity and insurance arrangement is the equivalent to a fixed income investment, and therefore any tax benefits normally associated with the life insurance policy should be disallowed.

However, as discussed above, as the annuity payments restore the capital to the private corporation, this theory breaks down and the insurance clearly plays a role very similar to any corporate owned insurance policy.

Again, our concern is that the proposals relating to LIA proposals go further than stated and actually tilt the playing field in favour of other fixed income investments. We believe there may be other solutions that would address the Government´s concerns relating to LIAs while also mitigating the ones noted in our submission.

Conclusions

Based on the forgoing discussion, we would recommend the following changes to the proposals governing LIA policies:

1. Resolution 36(1) – for simplicity this proposal be retained. However, as noted above, we believe there are good tax policy reasons to allow some deduction under paragraph 20(1)(e.2).
2. Resolution 37 – amend to the effect that the accumulating fund of the annuity contract be included in determining the fair market value of any property deemed to be disposed of on death.
3. Resolutions 38 – for simplicity amend this proposal to delete the reference to LIA policies in the determination of a private corporation´s CDA. Alternatively, this provision should be amended to provide that the credit to the CDA reflect the insurance component provided by the life insurance.
4. Resolution 42 – not proceed with this proposal, with the effect that an LIA policy would continue to be treated as an exempt policy.

ii) Joint and Multi-Life Policies

It is possible for LIA arrangements to be established using a joint first- or last-to-die insurance policy or possibly a multi-life policy, as well as a joint last-to-die annuity. We believe the intent would be to have the proposals apply to these types of arrangements. However, there may be circumstances where the rules may apply too broadly (or may not achieve the goals of the proposals) and we believe further discussions would be helpful. For example, if a multi-life policy is assigned as collateral security under an LIA

arrangement, it appears that the entire policy and related coverages will be caught by the proposed rules. We don´t believe this is an appropriate result.

There is a somewhat similar concern where a life insurance policy with a death benefit that exceeds the amount of the loan is assigned as part of an arrangement that is later determined to be an LIA. In this situation it appears that the full amount of the capital dividend account credit will be denied, even though this would not be the case if the insurance coverage was split between two separate policies. Again, this does not appear to be the correct result from a tax perspective

Therefore, should Resolution 38 proceed, we would ask that its application be restricted in the two situations described above.

iii) Ongoing Application of the Rules

We would appreciate confirmation that if one of the conditions that makes an insurance policy an LIA policy ceases to be in effect (for example, the loan is repaid, or the annuity and/or insurance policy ceases to be used as security for the loan) that the LIA rules no longer apply to that policy. This seems to be the proper result, but the definition of an LIA policy in Resolution 40 is somewhat unclear as to whether the conditions must be met at all times, or only at any point in time. This is obviously a critical issue if an existing LIA policy arrangement could possibly lose its grandfathered status, or a new LIA policy arrangement arises after the Budget Day through inadvertence, and the affected policyholder, annuitant or borrower, as the case may be, wishes to take steps to ensure that the arrangement is brought onside.

Endnotes

[1] The embedded reserves of Term to 100 contracts are subject to Investment Income Tax (IIT). It is also assumed that once the new exempt test rules are enacted, the embedded reserves of UL LCOI policies will also be subject to IIT. Therefore, in the future all LIA policies will have an implicit tax in the form of lower credited values or higher expense charges.

[2] See Regulation 201(5).

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Thank You

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