Insurance exemption deadline looms

While tax exemptions that apply to some permanent life insurance policies will be tightened up next year, advisors insist insurance will remain a valuable tax-planning tool: "It's just going to be a new reality"

By Megan Harman | Mid-October 2016

Insurance advisors are running out of time to help their clients secure permanent life insurance policies that fall under the existing tax rules. New, tighter rules will apply to all policies issued on and after Jan. 1, 2017.

Although the changes will result in less tax-exempt investment room in permanent life insurance policies, insurance advisors such as Mark Halpern, CEO of **WEALTHinsurance.com** in Markham, Ont., say there still will be many advantages to using permanent life insurance for tax-planning purposes.

"I don't think conversations with clients are going to change," Halpern says. "[Having life insurance] still will be a very important part of somebody's estate plan. [Planning parameters] just are going to be a new reality."

The long-awaited changes to the so-called "exempt test" - which governs how much of the investment earnings associated with the cash value in a life insurance policy are exempt from taxes - will affect various insurance-planning strategies. The changes will reduce the amount of tax-exempt savings room in personally owned permanent life insurance policies, and will create new barriers to withdrawing funds tax-free from a corporation-owned life insurance policy.

"There are some profound planning effects," says Trevor Parry, president of ***TRP Strategic Consulting*** and a partner with ***Parry McCone Ltd.***, a planning and strategy firm in Toronto.

Policies issued prior to Jan. 1, 2017, will be "grandfathered" and remain under the current tax rules. However, loss of grandfathering could occur if certain changes are made to in-force policies after Dec. 31, such as converting a term policy to permanent coverage or increasing the face value that requires medical underwriting.

For clients who still hope to secure coverage or make changes to their existing policy under the current rules, the clock is ticking. Insurance companies have set various deadlines in September, October and November for the submission of applications to allow time for underwriting so that policies can be issued by the end of this year.

After those deadlines, insurers such as Toronto-based Manulife Financial Corp. have stated they will process applications and policy change requests on a "best-efforts basis."

The insurers have beefed up their underwriting teams in anticipation of receiving high volumes of applications leading up to the implementation of the new rules. Nonetheless, there are bound to be some clients whose policies won't be issued before the end of the year. Because applications for permanent life insurance policies often involve wealthier clients who require more complex underwriting, Halpern says, there's a risk that even applications submitted prior to the insurers' deadlines could be processed too late to fall under the current tax rules.

"For more sophisticated situations for people with wealth, the underwriting could be more lengthy," Halpern says. "There's no guarantee that a policy will go through underwriting [and] be issued and settled before Dec. 31."

To avoid any nasty surprises, Parry says, you should warn your client, if you submit an application for a policy or make changes to a policy in the final three months of 2016, that the new rules may apply to the new or revised policy.

"Be forthright with your clients, and make sure that you have good notes," Parry says, "because if you don't get a grandfathered policy, your client had better be aware of it."

Once the new rules kick in, permanent life insurance still will offer benefits from a tax-planning perspective. For personally owned life insurance, the biggest impact of the changes will be a lower amount of cash that can be sheltered within the policy on a tax-exempt basis, particularly after the first 10 to 15 years of the policy.

"In the first few years of the policy, there's not that much difference in how much [tax-exempt money] you can get in," Parry says. "The effect on funding is in the later years."

In order to achieve the same amount of tax-exempt savings room that is available under the current rules, your clients will need larger policies under the new rules, which "is going to make things more expensive," Parry says.

Many insurance companies are in the process of tweaking their product lineups and rolling out new products designed to fit the new rules.

"The insurance companies are going to adjust products to still be as beneficial as possible," Halpern says.

In addition, as you adapt to the new rules, new planning strategies are likely to emerge to help your clients maximize the tax benefits of life insurance.

"There may be some innovative planning to deal with some of the tax ramifications," Parry says.

Overall, he says, life insurance will continue to be a valuable tax-planning tool for many clients.

"It still makes overwhelming sense," he says. "If your alternative is to pay taxes, insurance will win in almost every situation."