

EXPLANATORY NOTES – LIFE INSURANCE POLICY EXEMPTION TEST

INCOME TAX ACT

The *Income Tax Act* (the “Act”) contains rules regarding the taxation of the income earned on the savings in a life insurance policy. In the case of a policy other than an annuity contract, the tax treatment differs depending on whether a policy is classified as an “exempt policy”. A test (the exemption test) is applied each year to determine whether a policy is an exempt policy. The exemption test measures the extent to which a life insurance policy is protection-oriented (i.e., an exempt policy) or savings-oriented (i.e., a non-exempt policy).

Income earned in a non-exempt policy is taxed as interest income and on an accrual basis at the policyholder level. In contrast, income earned in an exempt policy is not taxed on an accrual basis at the policyholder level. Instead, it is subject to a 15% minimum tax (the Investment Income Tax) that is levied on the insurer.

These rules, including the exemption test, were introduced in the early 1980s. These proposals would amend a number of aspects of the rules relating to the tax treatment of life insurance policies other than annuity contracts, including:

- (1) the determination of whether a policy is an exempt policy;
- (2) the determination of what types of transactions give rise to a disposition of an interest in a policy;
- (3) the determination of the tax treatment of a disposition of an interest in a policy (having regard to both the adjusted cost basis of the interest and its proceeds of the disposition); and
- (4) amendments to the Investment Income Tax consequential on some of the other amendments.

The proposals would also amend the rules applying to the determination of the capital element of annuity payments for certain annuity contracts.

Amendments to the rules regarding the tax treatment of life insurance policies have typically been accompanied by grandfathering for existing policies. As a result, the manner in which the rules apply also depends upon the date on which an interest in the policy was last acquired and, in some cases, the date of issuance of the policy. Grandfathering is also proposed in respect of the principal legislative amendments described in this commentary. The following table summarizes grandfathering in respect of the accrual taxation rules and exempt testing for life insurance policies other than annuity contracts:

Policy Acquisition/Issuance Date	Income Tax Treatment
Policies issued before 2016 an interest in which was last acquired before December 2, 1982.	<p>Exempt from accrual taxation unless prescribed premium is paid and certain other conditions met. If grandfathering is lost, annual or triennial accrual applies depending upon taxpayer and whether policy is an exempt policy. See subsections 12.2(1), (3) and (9) of the <i>Income Tax Act</i>, c.148 RSC, 1952.</p> <p>Exempt policy status determined after 2015 as if policy were issued after 2015. See paragraph 306(10)(a) of the <i>Income Tax Regulations</i>.</p>

<p>Policies issued before 2016 an interest in which was last acquired after December 1, 1982 and before 1990.</p>	<p>Annual or triennial accrual taxation depending upon taxpayer, unless policy is an exempt policy, as determined under rules applicable to a policy interest last acquired after December 1, 1982 and before 1990. See subsections 12.2(1) and (3) of the <i>Income Tax Act</i>, c.148 RSC, 1952.</p> <p>If grandfathered status is lost after 2015, exempt policy status determined as though policy were issued after 2015. See paragraph 306(10)(b) of the <i>Income Tax Regulations</i>.</p>
<p>Policies issued before 2016 an interest in which was last acquired after 1989.</p>	<p>Annual accrual taxation, unless policy is an exempt policy, as determined under rules applicable to policies an interest in which was last acquired after 1989. See subsection 12.2(1) of the Act.</p> <p>If grandfathered status is lost after 2015, exempt policy status determined as though policy were issued after 2015. See paragraph 306(10)(b) of the <i>Income Tax Regulations</i>.</p>

Clause 1

Life insurance policies

ITA
148

Section 148 of the Act sets out rules for determining the income tax consequences of the disposition of an interest in a life insurance policy. Subsection 148(1) generally requires that an amount be included in a policyholder’s income for a taxation year in respect of a disposition of an interest in a life insurance policy. The amount to be included is the amount by which the proceeds of the disposition of the interest that the policyholder (or a beneficiary or assignee) is entitled to receive in the year exceeds the adjusted cost basis to the policyholder of the interest immediately before the disposition.

Although “adjusted cost basis”, “disposition” and “proceeds of the disposition” are defined in subsection 148(9) for purposes of section 148, subsections 148(1.1) to (7) apply in certain circumstances to deem there to be a disposition of an interest, or to deem an interest’s adjusted cost basis or proceeds of a disposition to be a certain amount. In addition, subsections 148(8) to (8.2) provide exceptions from the income inclusion on the disposition of an interest in a life insurance policy, allowing a disposition of an interest to be made on a tax-deferred (i.e., rollover) basis if the transfer is made to a child, or to a current or former spouse or common-law partner, and certain other conditions are met.

Subsections 148(9) and (9.1) define certain terms for purposes of sections 12.2 and 148. Section 148(10) contains a number of deeming rules that apply to life insurance policies, including annuity contracts.

Deemed proceeds of disposition

ITA
148(2)

Subsection 148(2) of the Act deems there to have been, in certain circumstances, a disposition of an interest in a life insurance policy for the purposes of subsections 148(1) and 20(20) and the definition “adjusted cost basis” in subsection 148(9).

New paragraph 148(2)(e) applies to a policy issued after 2015 that is an exempt policy if after its issuance:

- a benefit on death (as defined in subsection 1401(3) of the *Income Tax Regulations*) under a coverage (as defined in subsection 1401(3) of the *Income Tax Regulations*) under the policy is paid at a particular time;
- the payment results in the termination of the coverage; and
- the amount of the fund value benefit (as defined in subsection 1401(3) of the *Income Tax Regulations*) paid at that time exceeds the fund value benefit allocated to the coverage (as determined under clause (A) of variable B of the formula in subparagraph 306(4)(a)(iii) of the *Income Tax Regulations*) on the last policy anniversary before that time.

In this case, the policyholder whose interest gives rise to an entitlement (on the part of the policyholder, beneficiary or assignee) to receive all or a portion of that excess is deemed to have disposed of a part of the interest at that time and is deemed to be entitled to receive at that time proceeds of the disposition equal to that excess or part, as the case may be. As a result, subsection 148(1) will apply in respect of the disposition to require an amount to be included in the taxpayer’s income for the year that includes that time and that amount is under that subsection the amount by which the proceeds of the disposition of the interest exceeds the adjusted cost basis to the taxpayer of the part of the interest immediately before the disposition.

For information on related amendments, see the commentary on subsection 148(4) and the description of O of the formula in the definition “adjusted cost basis” in subsection 148(9).

This amendment comes into force on Royal Assent.

Income from disposition

ITA
148(4)

Subsection 148(4) of the Act applies on the partial disposition (other than one involving a policy dividend or a policy loan) of a taxpayer’s interest in a life insurance policy. In these circumstances, the adjusted cost basis (ACB) of the interest is prorated: only the portion of the ACB attributable to the part of the interest disposed of is taken into account in determining the amount to be included in the taxpayer’s income in respect of the disposition. The ACB to be used is the proportion of the interest’s ACB immediately determined before the disposition that the proceeds of the disposition of the part are of the interest’s accumulating fund determined immediately before the disposition.

For further information on an interest’s accumulating fund, see the commentary on sections 307 and 1401 of the *Income Tax Regulations*. For further information on an interest’s ACB, see the commentary on the definition “adjusted cost basis” in subsection 148(9).

Subsection 148(4) is amended to modify the ratio used in determining the portion of a taxpayer’s interest’s ACB to be taken into account on the partial disposition of the taxpayer’s interest in a life

insurance policy. The interest's accumulating fund will no longer be used in the case of life insurance policy (other than an annuity contract) issued after 2015. Instead, the ratio will be the proceeds of the disposition of the part to the interest's proportionate share of the policy's cash surrender value determined net of policy loans in respect of the policy that are outstanding and any interest under the loans accrued in favour of the insurer.

This amendment comes into force on Royal Assent.

Definitions

ITA
148(9)

Subsection 148(9) of the Act contains a number of definitions that apply for the purposes of sections 12.2 and 148.

“adjusted cost basis”

The adjusted cost basis (ACB) of a taxpayer's interest in a life insurance policy is relevant to determining the amount of any income inclusion in respect of the interest under the accrual taxation rules in section 12.2 of the Act and the amount of any income inclusion that may, under subsection 148(1) or (1.1), result from a disposition of the interest or a part of the interest. If the policyholder is a private corporation, the interest's ACB is also relevant to determining the proceeds of the life insurance policy received by the corporation in consequence of the death of an insured under the policy that may be added to the corporation's capital dividend account. In general terms, the ACB of a taxpayer's interest in a policy (other than an annuity contract) is the total of the premiums paid by the taxpayer under the policy less the net costs of pure insurance in respect of the interest (i.e., the costs of the protection element of the interest) and certain other adjustments to reflect previous dispositions of the interest. For further information on “net cost of pure insurance”, see the commentary on section 308 of the *Income Tax Regulations*.

The definition “adjusted cost basis” is amended to clarify its application in the case of certain policy transactions involving the repayment of a policy loan, premiums or cost of insurance charges for ancillary benefits (i.e., benefits other than the benefit on death), capital disability or death benefits (i.e., savings paid as death or disability benefits that do not result in the termination of a coverage) and benefits on death resulting in the termination of a coverage under the policy (but not of the policy itself).

Variable E of the formula in the definition increases the ACB of an interest by reference to the repayment of a policy loan in respect of the policy. The ACB increase, however, is limited to the total of certain amounts also described in variable E, including the proceeds of the disposition (as defined in subsection 148(9)), if any, of the policy loan. The proceeds of the disposition in respect of a policy loan is, in turn, computed by reference to the amount of the loan, but ignoring the portion of the loan used immediately after the loan to pay a premium under the policy. Accordingly, the repayment of the portion of a policy loan used to pay a premium that does not form part of the proceeds of the policy loan does not currently result in an increase in the ACB of an interest in the policy.

Variable E of the formula is amended to provide for an ACB increase on the repayment of the portion of a policy loan used immediately after the loan to pay a premium under the policy to the extent that the portion has not reduced the proceeds of disposition on surrender or maturity of an interest in the policy. This amendment applies to policies issued after 2015.

Variable G.1 of the formula increases the ACB of an interest, that has been the subject of a tax-deferred transfer under subsection 149(8.2) on the death of a policyholder, by the mortality gain, if any, resulting

from the death. The description of variable G.1 of the formula is amended to correct a grammatical error, and to modernize its language.

The formula in the definition is also amended to add variables M, N and O, each of which decreases the ACB of an interest in a policy (other than an annuity contract) issued after 2015. A number of terms used in the descriptions of these variables carry the meanings assigned by subsection 1401(3) of the *Income Tax Regulations*. For further information, see the commentary on the definitions “benefit on death”, “coverage”, “fund value benefit”, “fund value of a life insurance policy” and “net premium reserve” in subsection 1401(3) of the *Income Tax Regulations*.

Variable M of the formula reduces the ACB of taxpayer’s interest in a policy by the amount of premiums paid by or on behalf of the taxpayer, or cost of insurance charges incurred by the taxpayer, in respect of ancillary benefits under the policy (i.e., benefits other than a benefit on death). For information on a related amendment, see the commentary on the definition “premium” in subsection 148(9).

Variable N of the formula reduces the ACB of a taxpayer’s interest in a policy by reference to the taxpayer’s interest in a capital disability or death benefit payment made under the policy. The payments of these types of benefits are considered a return of savings before the termination of a coverage under the policy on the death of the life or lives jointly insured. The ACB reduction under variable N is limited to the taxpayer’s interest in the amount of the benefit paid up to the greater of the policy’s cash surrender value, if any, and the fund value (as defined in subsection 1401(3) of the *Income Tax Regulations*), if any, of the policy at the time the amount is paid.

Variable O of the formula reduces the ACB of a taxpayer’s interest in a policy under which more than one coverage is provided, if a benefit on death under a coverage under the policy is paid and the payment terminates the coverage (but not the policy). The reduction in the ACB is intended to represent the portion of the ACB of the interest that corresponds to the share of the savings in the policy associated with the payment and any fund value benefit paid on termination. Savings for this purpose is determined by reference to a number of amounts determined under subsection 1401(3) of the *Income Tax Regulations* and having regard to savings as measured for purposes of Part XII.3 of the Act.

The ACB reduction itself is reduced under variable U of the formula in variable O to account for the portion of the interest’s ACB that was determined under subsection 148(4) in respect of the deemed disposition under paragraph 148(2)(e) that arises in respect of the payment of a fund value benefit, if any, on termination.

For information on a related amendment, see the commentary on paragraph 148(2)(e).

The amendments to the definition “adjusted cost basis” come into force on Royal Assent.

“premium”

Paragraph (c) of the definition “premium” excludes amounts paid in respect of accidental death benefits and disability benefits provided under a policy or in respect of certain risks under the policy (e.g., risks as a result of insuring a substandard life). The definition is amended so that paragraph (c) does not apply to policies (other than annuity contracts) issued after 2015. For information on a related amendment, see the commentary on variable M of the definition “adjusted cost basis” in subsection 148(9).

This amendment comes into force on Royal Assent.

“proceeds of the disposition”

The definition “proceeds of the disposition” of an interest in a life insurance policy applies in determining the amount, if any, that the interest holder is required to include in income on a disposition of the interest. Under the definition, the proceeds of the disposition of an interest are the amount of proceeds that the interest holder is entitled to receive on the disposition of the interest. The definition also provides more

detailed rules for determining the proceeds of the disposition of an interest, under paragraph (a) of the definition in respect of a surrender or maturity of a policy, under paragraph (b) of the definition in respect of a policy loan, under paragraph (c) in respect of certain dispositions involving payments under certain life annuity contracts, and under paragraph (d) in respect of a disposition on the death of a life insured under paragraph 148(2)(b).

Paragraph (a) of the definition provides that the proceeds of the disposition of an interest on the surrender or maturity of a policy is the cash surrender value of the interest less certain specified amounts, including an amount payable at the time of surrender or maturity by the policyholder in respect of a policy loan in respect of the policy. Paragraph (a) is amended as it applies to life insurance policies issued after 2015. For these policies, in determining the proceeds of the disposition of an interest, the specified amount by which the cash surrender value is reduced in respect of a policy loan is only the part of the loan applied, immediately after the loan, to pay a premium under the policy, as provided for under the terms and conditions of the policy. Other parts of a policy loan in respect of such a policy will not apply to reduce the proceeds of the disposition.

This amendment comes into force on Royal Assent.

Loss of grandfathering

ITA
148(11)

New subsection 148(11) of the Act suspends the grandfathered status, otherwise available under a number of the related amendments to the income tax rules for life insurance policies, of life insurance policies (other than annuity contracts) issued before 2016. The subsection is similar, and related, to new subsection 306(10) and paragraph 1401(5)(b) of the *Income Tax Regulations*, which apply similar rules in determining whether a policy is an exempt policy and in applying Part XII.3 of the Act. For further information, see the commentary on those provisions.

Subsection 148(11) in effect provides that for the purposes of a determination (other than to the extent that subsection 306(10) and paragraph 1401(5)(b) of the *Income Tax Regulations* apply) of whether a policy is issued before 2016 or after 2015, a policy will be considered to have been issued after 2016 if, after 2015,

- in the case of a policy the interests in which were last acquired before December 2, 1982, a prescribed premium is paid under the policy and the policy is not an exempt policy (determined having regard to subsection 306(10) of the *Income Tax Regulations*) or there is a prescribed increase in any benefit on death under the policy (i.e., in effect, subsection 12.2(9) applies in respect of any interest in the policy in a manner that triggers application of the accrual rules in respect of the interest); or
- in any other case of a policy issued before 2016, life insurance is underwritten in respect of which a particular schedule of premium or cost of insurance rates applies (i.e., paragraph 306(10)(b) of the *Income Tax Regulations* applies in respect of the policy).

This amendment comes into force on Royal Assent.

INCOME TAX REGULATIONS

Clause 2

Annuities and life insurance policies

Part III

Part III of the *Income Tax Regulations* (the “Regulations”) contains prescribed rules for annuities and other life insurance policies.

Capital element of annuity payments

ITR

300(2)

The income tax rules require, with some exceptions, that the non-capital portion of annuity payments received by a taxpayer in a taxation year be included in the taxpayer’s income for the year. Section 300 of the Regulations contains rules that apply for determining the part of a payment made under an annuity contract that is to be treated as a return of capital. The determination is made under subsection 300(1) by reference to

- if the annuity contract is for a term certain, the amount of payments to be made under the contract, or
- if the contract is one under which payments continue to be made having regard to the survival of an individual, the amount of payments expected to be made under the contract.

In the second case – where the annuity payments continue for a period that depends upon the survival of an individual – subsection 300(2) contains rules for determining the payments expected to be made under the contract.

Paragraph 300(2)(a) is amended to update the mortality tables used in determining the payments expected to be made under an annuity contract. The new table is the *Annuity 2000 Basic Mortality Table* of the Society of Actuaries as posted on the Internet website of the Society of Actuaries on Announcement Date. The use of this table applies to annuities issued after 2015. The table also applies to an annuity issued before 2016 if on December 31, 2015 the annuity is neither a prescribed annuity contract under section 304 nor an annuity that would be a prescribed annuity contract but for the fact that annuity payments have not commenced before the end of the taxation year that includes December 31, 2015 (and the annuity rates under the contract were fixed and determined before 2016 and the contract cannot be terminated except on the death of an individual whose life is a measuring life under the contract).

Subsection 300(2) is also amended by moving the definition “adjusted purchase price” from its current location in paragraph 300(2)(b) to section 310, which contains a number of definitions relevant to Part III of the Regulations. Consequential on this change, existing paragraphs 300(2)(c) and (d) are renumbered as paragraphs 300(2)(b) and (c), respectively. Renumbered paragraphs 300(2)(b) and (c) are also amended to conform to current drafting standards.

Finally, renumbered paragraph 300(2)(b) is amended to add a rule for determining the age of an individual to be used on any date (i.e., the date as of which a calculation is being made) if the insurer that issued the relevant annuity contract determined the individual’s life to be a substandard life at the time the contract was issued. In this case, subparagraph 300(2)(b)(i) provides that the age to be used is the age in years obtained by adding two amounts. The first amount is the age used at the time the contract was issued for the purposes of determining the annuity rate under the policy. The second is the number

obtained by subtracting the calendar year in which the contract was issued from the calendar year of the date on which the calculation under the subparagraph is being made.

This change applies to annuities issued after 2015. The change also applies to an annuity issued before 2016 if on December 31, 2015 the annuity is neither a prescribed annuity contract under section 304 nor an annuity that would be a prescribed annuity contract but for the fact that annuity payments have not commenced before the end of the taxation year that includes December 31, 2015 (and the annuity rates under the contract were fixed and determined before 2016 and the contract cannot be terminated except on the death of an individual whose life is a measuring life under the contract).

Subparagraph 300(2)(b)(ii) contains the rule found in existing paragraph 300(2)(c). This rule continues to apply in all cases other than a case where subparagraph 300(2)(b)(i) applies.

These amendments come into force on Royal Assent.

Clause 3

Exempt policies

ITR

306

Section 12.2 of the Act provides for the accrual taxation of income earned in life insurance policies. Certain policies, including policies referred to as “exempt policies”, are excluded from this accrual requirement. Section 306 of the Regulations contains rules for determining if a policy is an exempt policy.

ITR

306(1)

Subsection 306(1) of Regulations provides that a life insurance policy (other than an annuity contract or a deposit administration fund policy) is an exempt policy if the savings accumulating in the policy do not exceed the savings in its associated benchmark policies (the exemption test policies or ETPs). This determination is generally made on each policy anniversary of the policy, having regard both to current savings (paragraph 306(1)(a)) and future anticipated savings in the policy and its ETPs (the pre-testing rule in paragraph 306(1)(b)). A policy that is not an exempt policy on a policy anniversary cannot subsequently become an exempt policy. Section 307 contains rules for determining the savings (the accumulating fund) in a policy and its ETPs. The rules in section 307 in turn rely upon a number of determinations made under section 1401. For information on related amendments, see the commentary on sections 307 and 1401.

A number of amendments are made to section 306. These amendments generally apply to policies issued after 2015.

The opening words of subsection 306(1) are amended to provide that a tax avoidance policy cannot qualify as an exempt policy. If a policy that was previously an exempt policy becomes at any time a tax avoidance policy, the policy is subject to a deemed disposition under paragraph 148(2)(d) of the Act. For further information, see the commentary on the definition “tax avoidance policy” in section 310.

Paragraph 306(1)(b) contains a pre-testing rule that applies in determining whether a policy is an exempt policy on a given policy anniversary of the policy. The rule requires that on the policy anniversary it must be reasonable to expect, having regard to a number of assumptions, that the policy and ETP savings requirement set out in paragraph 306(1)(a) will be met on future policy anniversaries. Paragraph 306(1)(b) is amended for policies issued after 2015 to shorten the pre-testing period to the policy’s first subsequent policy anniversary. Under the new pre-testing rule, it must be reasonable to expect that the requirement in paragraph 306(1)(a) will be met on the policy’s next policy anniversary.

This determination is to be made using the most recent information available to the insurer and without regard to any automatic adjustments under the policy that may be made after the policy anniversary to ensure that the policy is an exempt policy.

These amendments come into force on Royal Assent.

ITR

306(3) to (9)

ETP: date of issuance, benefit on death and time of payment of the benefit on death

Under existing paragraph 306(3)(a) of the Regulations, the first ETP of a policy is deemed to be issued on the date of issuance of the policy. An additional ETP is deemed to be issued, under existing paragraph 306(3)(b), in respect of the policy if the benefit on death under the policy increases by more than 8% from the time of the immediately preceding policy anniversary (or the policy's date of issuance if the rule is being applied on the policy's first policy anniversary). Existing paragraph 306(3)(c) defines the ETP's benefit on death on a policy anniversary. The ETP's benefit on death is presumed to be the same as that of the policy on the policy anniversary, with special rules for allocating the death benefit across ETPs in circumstances where a policy has more than one ETP issued in respect of it. Existing paragraph 306(3)(d) determines the time at which the benefit on death is presumed to be payable under an ETP (i.e., the earlier of the death of the life insured under the policy and the endowment date of the ETP). Under existing subparagraph 306(3)(d)(ii), the ETPs in respect of a policy are generally presumed to endow at age 85 of the individual whose life is insured under the policy. For policies under which the individual whose life is insured is older than 75 years on their date of issuance, the ETP endowment date is instead presumed to be ten years after the date of issuance of the policy.

Paragraphs 306(3)(a) to (d) are renumbered and paragraph 306(3)(e) is repealed. Paragraphs 306(3)(a) and (b) become subparagraphs 306(3)(a)(i) and (ii), paragraph 306(3)(c) becomes subparagraphs 306(4)(a)(i) and (ii), and paragraph 306(3)(d) becomes paragraph 306(4)(b). The renumbered provisions continue to apply to policies issued before 2016.

Rules for ETPs for life insurance policies issued after 2015 are found in new paragraph 306(3)(b), subparagraphs 306(4)(a)(iii) and (iv) and paragraph 306(4)(b). In defining ETPs, these rules account for the possibility of more than one life being insured under a policy and life insurance being underwritten at different times in respect of a life insured (i.e., there being separate coverages under a policy), as well as accounting for policies that provide joint insurance coverage in respect of two or more lives. For further information on the meaning of coverage, see the commentary on the definition "coverage" in section 310.

An ETP issued in respect of coverages under a policy issued after 2015 will have the following characteristics:

- Under subparagraph 306(3)(b)(i), the first ETP in respect of each coverage under the policy is deemed to be issued on the date of issue of the coverage. That ETP's benefit on death, which is determined under the formula in subparagraph 306(4)(a)(iii), is equal to the coverage's benefit on death (variable A of the formula) grossed up by the portion of the policy's fund value benefit, if any, that is allocated to the coverage (variable B of the formula) less the total benefits on death allocated as of that date to other ETPs issued in respect of the coverage (variable C of the formula).

A fund value benefit corresponds to the portion of the fund value of a life insurance policy that increases the benefit on death but does not reduce the net amount at risk under any coverage. The fund value benefit is not associated with any specific coverage. Therefore, if the coverage is in respect of a policy with a fund value benefit, the coverage's share is calculated (i.e., under variable B of the formula in subparagraph 306(4)(a)(iii)) based on the maximum amount of fund

value benefit that would be payable under the policy if no other coverage were offered. For further information on the meaning of “benefit on death”, “fund value of a life insurance policy” and “fund value benefit”, see the commentary on section 310 and subsection 1401(3).

- An additional ETP is deemed to be issued, under new subparagraph 306(3)(b)(ii), in respect of the coverage if the total of the benefit on death under the coverage and the fund value benefit allocated to the coverage (as determined under variables A and B of the formula in subparagraph 306(4)(a)(iii) if that formula applied) increases by more than 8% from the time of the policy’s immediately preceding policy anniversary or the coverage’s date of issuance, whichever is later. The benefit on death of the additional ETPs issued under this rule is the amount of the excess under subparagraph 306(3)(b)(ii) (i.e., the amount by which the increase in the benefit on death of the coverage and the fund value benefit allocated to it exceeded the 8% annual growth permitted by the subparagraph).
- Under paragraph 306(4)(b), the ETP’s benefit on death is presumed to be paid at the earlier of the ETP’s endowment date (generally, age 90) and the date of death of the individual whose life is insured under the coverage; an exception applies in the case of a coverage under which two or more lives are jointly insured – in that case, the ETP’s benefit on death is presumed to be paid at the earlier of its endowment date and the date at which the benefit on death under the coverage would be payable as a result of, in the case of joint first-to-die coverage, the death of the first of the lives jointly insured, and, in the case of a joint-last-to-die coverage, the death of the last of the lives jointly insured. For further information on an ETP’s endowment date, see the commentary on section 310.

Existing subsection 306(4) of the Regulations provides a number of exceptions to the general rules that apply in determining whether a policy is an exempt policy. The rules in existing subsection 306(4) are moved to subsections 306(5) to (9) and new rules are added to those subsections for policies issued after 2015.

Reduction in ETP death benefit

Under existing paragraph 306(4)(a), where the benefit on death under a life insurance policy is reduced, the benefit on death of ETPs that have been issued in respect of the policy under existing paragraph 306(3)(b) (i.e., ETPs issued after the date of issuance of the policy because the 8% growth limit test was failed) is reduced. The reduction is allocated to those ETPs under existing subparagraphs 306(4)(a)(i) and (ii) based on the proximity of their date of issuance to the time at which the benefit on death is reduced (i.e., the reduction is allocated first to the most recent ETPs). Paragraph 306(4)(a) is renumbered as subsection 306(5). Paragraph 306(5)(a) preserves existing 306(4)(a) for purposes of policies issued before 2016. Paragraph 306(5)(b) contains a new rule for policies issued after 2015. For post-2015 policies, if the benefit on death under a coverage under the policy, or the coverage’s share of a fund value benefit, is reduced, the benefit on death of an ETP issued in respect of the coverage because of having failed the 8% growth limit test in new subparagraph 306(3)(b)(ii) is reduced by the least of three amounts: (i) the actual reduction in the benefit on death; (ii) the relevant ETP’s benefit on death as otherwise determined ignoring the actual reduction in the benefit on death; and (iii) the portion if any of the actual reduction not applied to other ETPs issued, after the date of issue of the ETP, in respect of the coverage. This reduction is generally consistent with the approach taken to policies issued before 2016, except that for post-2015 policies the rule applies on a coverage basis.

ETP re-dating rule

Existing paragraph 306(4)(b) is an anti-avoidance rule that limits the ability to increase the savings in a policy several years after its issuance in circumstances in which savings were not contributed in earlier years of the policy. The rule applies if the accumulating fund of (i.e., the savings in) a life insurance

policy on its 10th or any subsequent policy anniversary exceed 250% of its savings on its 3rd preceding policy anniversary. Where the rule applies, the policy is in effect treated as being re-issued, by having the issuance dates of each ETP associated with the policy re-dated to the later of that 3rd preceding policy anniversary and the date on which the relevant ETPs were issued.

Paragraph 306(4)(b) is renumbered as subsections 306(6) and (7). The substance of the existing rule is generally maintained for policies issued before 2016, except for two new rules that relax the test for all policies. Specifically, the anti-avoidance rule will no longer apply, even if the policy savings increase exceeds the 150% savings growth limit in the measurement period, unless that increase exceeds the increase over the same period in the total of the accumulating funds of the ETPs issued in respect of the policy.

The rule is also relaxed by suspending its application for a period of time after it last applies. Specifically, for policies issued before 2016 the rule is suspended for seven policy anniversaries after its last application, and for policies issued after 2015, for five policy anniversaries. In addition to the above changes, for policies issued after 2015, the rule will apply on the policy's 8th (as opposed to its 10th as is the case for policies issued before 2016) or any subsequent policy anniversary to the extent the tests under paragraphs 306(6)(b) and (c) are met.

New subsection 306(7) generally preserves the existing ETP issuance re-dating rule and clarifies that ETP issuance re-dating under the subsection does not apply for purposes of paragraph 306(4)(a) and subsection 306(5).

Saving provisions

Existing paragraph 306(4)(c) applies in respect of certain older policies issued before December 2, 1982. If, because of a transaction undertaken after December 1, 1982, the policy is required to be tested for exempt policy status, paragraph 306(4)(c) deems the policy to have been an exempt policy at all times prior to the first of those transactions undertaken after December 1, 1982. The rule ensures that the conditions in subsection 306(1) are satisfied in respect of that period. Paragraph 306(4)(c) is renumbered as subsection 306(9). For further information on a related amendment, see the commentary on subsection 306(10).

Existing paragraph 306(4)(d) provides for a 60-day grace period under which a policy, that fails the exemption test requirements under subsection 306(1) on a policy anniversary of the policy, can be "untainted" so as to restore its exempt policy status. Typically, during the grace period, cash would be withdrawn from the policy or the policy's death benefit increased. Paragraph 306(4)(d) is renumbered as subsection 306(8).

Note that a policy that does not satisfy the exemption test requirements at the end of the grace period would be subject to a deemed disposition, under paragraph 148(2)(d) of the Act, at the time the policy ceased to be an exempt policy. Note also that a transaction undertaken, during this grace period, to bring a policy back inside the exemption test is not intended on its own to result in the policy being a tax avoidance policy. For further information, see the commentary on the definition "tax avoidance policy" in section 310.

These amendments come into force on Royal Assent.

ITR 306(10)

New subsection 306(10) of the Regulations applies to deem certain policies, issued before 2016 and not otherwise subject to the new rules for policies issued after 2015, to be issued after 2015 for purposes of determining whether the policy is an exempt policy. The rule applies in two cases. The first case,

described in paragraph 306(10)(a), involves an interest, in a policy, last acquired before December 2, 1982. These interests are ordinarily not subject to accrual taxation. However, the policy's status as an exempt policy is relevant to determining if subsection 12.2(9) of the *Income Tax Act*, c.148 RSC, 1952 applies in respect of the interest. That subsection applies if a prescribed premium (as determined under subsection 309(1)) is paid after December 1, 1982 by or on behalf of a taxpayer in respect of the interest, and either the policy is not an exempt policy or there has been a prescribed increase (as determined under subsection 309(2)) in any benefit on death under the policy after December 1, 1982. In these circumstances, the interest may become subject to accrual taxation as set out in subsections 12.2(1) and (3) and paragraphs 12.2(9)(c) to (i) of that Act. In determining after 2015 whether a policy is an exempt policy for these purposes, the rules that apply to policies issued after 2015 are to be used.

Paragraph 306(10)(b) describes the second case in which new subsection 306(10) applies. This case involves a policy issued before 2016 under which life insurance is underwritten after 2015 and in respect of which life insurance a particular schedule of premium or cost of insurance rates applies. For example, the paragraph will apply if insurance is underwritten after 2015 in respect of a life that was on December 31, 2015 not insured under the policy. Similarly, the paragraph will apply if a life was insured under the policy on December 31, 2015, but an increase in a benefit on death is underwritten in respect of the life after 2015 and the underwriting results in an increase in premiums, or charges for the cost of insurance, under the policy.

For information on two related amendments, see the commentary on subsection 148(11) of the Act and paragraph 1401(5)(b).

These amendments come into force on Royal Assent.

Clause 4

Accumulating funds

ITR
307

Section 307 of the Regulations prescribes the meaning of “accumulating fund” for the purposes of Part III of the Regulations and sections 12.2 and 148 of the Act.

ITR
307(1)

Paragraph 307(1)(a) of the Regulations defines the accumulating fund of a taxpayer's interest in an annuity contract not issued by a life insurer. Paragraph 307(1)(a) is amended to modernize its language.

Paragraph 307(1)(b) defines the accumulating fund of a taxpayer's interest in a life insurance policy, including an annuity contract issued by a life insurer. The computation of an accumulating fund under paragraph 307(1)(b) is made having regard to amounts determined under subsection 1401(1). The post-amble to paragraph 307(1)(b) is repealed because the assumptions contained in the post-amble are no longer required to compute the necessary amounts under section 1401 – those assumptions, which related to the application of section 1401 in an earlier context, are no longer applicable under the current law relating to the deductibility by life insurers of certain reserves under subsection 138(3) of the Act.

Paragraph 307(1)(c) defines the accumulating fund of an exemption test policy (ETP) issued in respect of a life insurance policy. The computation of an accumulating fund under paragraph 307(1)(c) is made having regard to amounts determined under paragraph 1401(1)(c) of the Regulations. Paragraph 307(1)(c) is amended to account for the new definitions “endowment date” and “pay period” in section 310 and to add a new rule for computing the accumulating fund of an ETP issued in respect of a coverage under a

life insurance policy issued after 2015. For further information on the definitions “endowment date” and “pay period”, see the commentary on section 310 of the Regulations.

For ETPs issued in respect of life insurance policies issued before 2016, subparagraph 307(1)(c)(i) and (ii), together with paragraph (a) of the definition “pay period”, preserve the existing components of paragraph 307(1)(c) and subsection 307(4). These amendments render subsection 307(4) redundant and the subsection is repealed.

For life insurance policies issued after 2015, subparagraphs 307(1)(c)(i) and (ii), together with paragraph (b) of the definition “pay period”, apply in determining the relevant ETP’s accumulating fund. In addition, new subparagraph 307(1)(c)(iii) applies to assign to the relevant ETP at a particular time that is after the ETP’s endowment date an accumulating fund equal to its benefit on death at the particular time.

In more general terms, the accumulating fund of an ETP at a particular time depends on whether the particular time at which the determination is made is during or after the ETP’s pay period (i.e., the period, as defined in section 310, over which premiums are assumed to be paid under the ETP). Existing subparagraph 307(1)(c)(i) provides that, if the particular time is after the ETP’s pay period, its accumulating fund is equal to the present value of the future benefits provided by the ETP. New subparagraph 307(1)(c)(i) provides that, if the particular time is during the ETP’s pay period, its accumulating fund will be equal to the product of the present value, calculated at the end of the pay period, of the future benefit on death of the ETP and the ratio of the number of years since its issuance and the number of years in its pay period.

Existing subparagraph 307(1)(c)(ii) provides that, if the particular time is during the ETP’s pay period, its accumulating fund is equal to the product of the present value, calculated at the end of the pay period, of the future benefits provided by the ETP multiplied by the ratio of the number of years since its issuance to the number of years in its pay period. An ETP’s pay period is calculated based on the age of the individual whose life is insured under the exemption test policy at its date of issue. New subparagraph 307(1)(c)(ii) provides that, if the particular time is after the ETP’s pay period, its accumulating fund is to equal the present value at the particular time of the future benefit on death under the ETP.

These amendments come into force on Royal Assent.

ITR 307(2)

Paragraphs 307(2)(b) and (c) of the Regulations contain rules that apply in computing an accumulating fund under paragraphs 307(1)(b) and (c), respectively. Paragraphs 307(2)(b) and (c) are amended to limit their application to amounts being determined in respect of life insurance policies issued before 2016. Paragraph 307(2)(c) is also amended to account for amendments to subsection 1401(1) and the introduction of the definition “endowment date” in section 310. Finally, the rules in subsection 307(3) are moved to new subparagraph 307(2)(c)(iii) and the subsection is repealed.

New paragraph 307(2)(d) is added to provide rules of application for the purpose of calculating the accumulating fund of an ETP issued in respect of a coverage under a life insurance policy issued after 2015. The paragraph provides that the present value of the future benefit of death under an ETP issued in respect of a coverage is to be calculated using the mortality rates for the life (based on the age of the life at the issuance of the coverage) or lives jointly insured under the coverage and the interest rate determined under new subsection 1401(4) (i.e., the mortality and interest rates used in respect of a coverage for the purpose of calculating the net premium reserve in respect of the relevant life insurance policy).

These amendments come into force on Royal Assent.

ITR
307(5)

Subsection 307(5) of the Regulations modifies certain provisions under section 1401 as they apply in determining an amount under section 307. Paragraph 307(5)(c) is amended to account for amendments to subsection 1401(1).

This amendment comes into force on Royal Assent.

Clause 5

Net cost of pure insurance

ITR
308

Section 308 of the Regulations contains rules for computing the net cost of pure insurance (NCPI) for a year in respect of a taxpayer's interest in a life insurance policy. NCPI for a year generally measures the annual cost associated with the insurance component under a policy or the net premium that would be payable for a one-year insurance with a benefit on death equal to the net amount at risk under the policy (i.e., the difference between the benefit on death and the savings of the policy).

ITR
308(1)

Subsection 308(1) of the Regulations provides that the NCPI for a year in respect of a taxpayer's interest in a policy is calculated as the product of the probability of death in the year of a life insured under the policy multiplied by the net amount at risk in respect of the taxpayer's interest in the policy at the end of the year. The probability of death in a year is calculated based on the 1969-75 mortality tables of the Canadian Institute of Actuaries published in Volume XVI of the Proceedings of the Canadian Institute of Actuaries and the relevant characteristics of the life insured under the policy. The net amount at risk in respect of a taxpayer's interest in a policy at the end of a year is calculated as the difference between the benefit on death in respect of the interest at the end of the year and the accumulating fund (as defined in section 307 and calculated ignoring policy loans) or the cash surrender value in respect of the interest at the end of the year depending on the method regularly followed by the life insurer in computing the net cost of insurance.

Subsection 308(1.1) provides that for a particular class of life insurance policy where pricing does not depend on smoking or sex status, the probability of death in a year may be determined using mortality rates other than the rates in subsection 308(1) to the extent these rates would result in a net cost of pure insurance that is equal to the expected value of the net cost of pure insurance using the aggregated mortality tables described in subsection 308(1).

Subsection 308(1) is amended to clarify that NCPI is calculated at the policy level and allocated to the policyholders who have an interest in the policy according to their proportionate interest in the policy. The subsection is further amended to introduce new rules for policies issued after 2015. For policies issued before 2016, the current rules are preserved in paragraph 308(1)(a) and subsection 308(1.1).

For policies issued after 2015, paragraph 308(1)(b) provides that the NCPI of a policy is equal to the sum of the net cost of pure insurance in respect of each coverage under the policy allocated to the policyholders who have an interest in the policy according to their proportionate interest in the policy. A coverage's NCPI for a year is equal to the product of the probability of death of the life or lives jointly insured in a year under the coverage multiplied by the coverage's net amount at risk at the end of the year. The probability of death is calculated based on the mortality rates used for the purpose of calculating

present values in respect of the coverage for calculating the net premium reserve in respect of the life insurance policy for the purposes of paragraph 1401(1)(c).

The net amount at risk of a coverage at the end of a year is calculated as the difference between the benefit on death of the coverage at the end of the year and the coverage's net premium reserve calculated at the end of the insurer's taxation year that ends in the year. The coverage's net premium reserve is equal to the total of variables A and C of the definition "net premium reserve" calculated at the end of the insurer's taxation year that ends in the year for the purpose of Part XII.3 tax – for variable C, those variables are in turn J and K of the formula for variable C in paragraph (b) of the definition "net premium reserve" in subsection 1401(3).

These amendments come into force on Royal Assent.

ITR

308(1.2)

Subsection 308(1.2) of the Regulations provides that for a life insurance policy issued after 2015 where pricing does not depend on smoking or sex status, the probability of death in a year may be determined using mortality rates other than the rates in paragraph 308(1)(b) to the extent these rates would result in a net cost of pure insurance that is equal to the expected value of the net cost of pure insurance using the aggregated mortality tables described in subsection 1401(4).

This amendment comes into force on Royal Assent.

Clause 6

Interpretation

ITR

310

Section 310 of the Regulations defines a number of terms for the purposes of sections 300, 301 and 304 to 310. Section 310 is amended to add a number of new definitions, and to amend the definition "benefit on death". These amendments come into force on Royal Assent.

"adjusted purchase price"

The definition "adjusted purchase price" replaces the same definition found in current paragraph 300(2)(b). That paragraph is repealed and its contents moved to this definition in section 310.

"benefit on death"

The definition "benefit on death" excludes both policy dividends (including related interest) held on deposit by an insurer and amounts payable as a result of accidental death. The definition is amended to instead incorporate by reference the new definition "benefit on death" in subsection 1401(3). For further information, see the commentary on subsection 1401(3).

"coverage"

The new definition "coverage" is relevant in applying sections 306, 307 and 308 to life insurance policies issued after 2015. In respect of these policies, certain determinations under those sections are made in respect of the coverages under a policy, and not in respect of the policy as a whole. Coverage under a life insurance policy means each life insurance underwritten under the policy at a specific time in respect of a life, or two or more lives jointly insured. Each such insurance is treated as a separate coverage.

“endowment date”

Each exemption test policy (ETP) issued in respect of a life insurance policy has an endowment date. The ETP’s endowment date represents a presumption of the latest time at which the ETP’s benefit on death will become payable. This time is factored into the calculation of the ETP’s accumulating fund, as determined under paragraph 307(1)(c).

Paragraph (a) of the new definition “endowment date” incorporates, for life insurance policies issued before 2016, the rules found in existing subparagraph 306(3)(d)(ii). Under that paragraph, the endowment date of an ETP issued in respect of an actual policy issued before 2016 is the later of two dates: (i) the date that is ten years after date of issue of the actual policy; and (ii) the day on which the individual whose life is insured under the policy would, if the individual survived, attain the age of 85 years.

Paragraph (b) of the definition sets out the endowment date of an ETP in respect of a coverage under a life insurance policy issued after 2015. For these policies, the endowment date of ETPs issued in respect of the coverage is generally the later of two dates: (i) the date that is 15 years after date of issue of the ETP; and (ii) the day on which the individual whose life is insured under the coverage would, if the individual survived, attain the age of 90 years. A special rule is in place for an insured life of an individual who is over 90 years of age at the time the ETP is issued – in this case, the relevant ETP’s endowment date is the day on which the individual would, if the individual survived, attain the age of 105 years. Another special rule applies if the coverage under the policy is for two or more lives jointly insured – in this case, the relevant ETP’s endowment date is the day that would be determined under the general rule described above, but using the equivalent single age that reasonably approximates under actuarial principles the mortality rates of the lives jointly insured.

For further information on related amendments, see the commentary on paragraphs 306(1)(b) and 307(1)(c) and subsection 307(2).

“fund value benefit”

The new definition “fund value benefit” incorporates by reference the new definition “fund value benefit” in subsection 1401(3). For further information, see the commentary on subsection 1401(3).

“pay period”

Each exemption test policy (ETP) issued in respect of a life insurance policy has a pay period. The pay period is relevant to determining the ETP’s accumulating fund (i.e., savings). For further information on a policy’s “accumulating fund”, see the commentary on section 307.

Paragraph (a) of the new definition “pay period” incorporates, for life insurance policies issued before 2016, the rules found in existing paragraph 307(1)(c) and subsection 307(4). For these policies, the pay period of the relevant ETPs is, subject to two exceptions, the 20-year period that begins on the ETP’s date of issue (as determined under new paragraph 306(3)(a)). The first exception applies if on that date the individual whose life is insured has attained the age of 75 years – in this case, the pay period is instead the 10-year period that starts on that date. The second exception applies if on that date the individual whose life is insured has attained the age of 66 years but not 75 years – in this case, the pay period is the period that starts on that date and lasts for the numbers of years obtained when the numbers of years by which the individual’s age on that date exceeds 65 is subtracted from 20.

Paragraph (b) of the definition sets out the pay period of an ETP issued in respect of a coverage under a life insurance policy issued after 2015. The general rule for these policies is that the pay period is the eight-year period that starts on the date of issue of the relevant ETP. Two exceptions apply. The first applies if the coverage is for a single insured life and the individual whose life is insured under the coverage would, if the individual survived, attain the age of 105 years within the eight-year period that

starts on the date of issue of the relevant ETP – in this case, the ETP’s pay period is the period that starts on that date and that ends on the day on which the individual would, if the individual survived, attain the age of 105 years. The second exception applies if two or more lives are jointly insured under the coverage in respect of which the relevant ETP is issued and an individual of an age equal to the equivalent single age on the date of the issue of the coverage would, if the individual survived, attain the age of 105 years within the eight-year period that starts on the date of issue of the ETP – in this case, the ETP’s pay period is the period that starts on that date and that ends on the day on which the individual of an equivalent single age would, if the individual survived, attain the age of 105 years.

“tax avoidance policy”

The new definition “tax avoidance policy” applies in determining whether a life insurance policy issued after 2015 is an exempt policy. Accordingly, the definition is not relevant to annuity contracts. A policy is no longer an exempt policy from the first time at which it is a tax avoidance policy. Under paragraph 148(2)(d) of the Act, a loss of exempt policy status generally results in a disposition of the policy for proceeds of the disposition equal to the policy’s accumulating fund (as determined under section 307), which disposition may result in an income inclusion under subsection 148(1) of the Act. In addition, a policy that is not an exempt policy is subject to accrual taxation under section 12.2 of the Act.

A policy is a tax avoidance policy if a transaction, arrangement or event (the “transaction”) in respect of the policy decreases the accumulating fund of the policy or increases the accumulating fund of an exemption test policy issued in respect of a coverage under the life insurance policy and the transaction is an avoidance transaction determined under subsection 245(3) of the Act as though the policy’s status as an exempt policy were a tax benefit. In effect, the transaction will be an avoidance transaction unless it may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit of the policy being an exempt policy. For example, an avoidance transaction would include a transaction that increases the accumulating fund of an exemption test policy without increasing the accumulating fund of the policy or a transaction that decreases the accumulating fund of policy without decreasing the accumulating fund of any exemption test policy issued in respect of the coverages under the policy unless it may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit of the policy being an exempt policy. In these circumstances, if the Canada Revenue Agency sends a notice to the policyholder and insurer identifying the transaction, the policy will be a tax avoidance policy following the expiry of the 60-day period that starts on the day the notice is sent if on the last day of the period the policy would fail the test in subsection 306(1) if that test applied on that date and without regard to the transaction.

The following examples illustrate the intended scope of this anti-avoidance rule.

- A policyholder acquires a permanent life insurance policy with yearly renewable cost of insurance charges in order to protect against the mortality risk. The life insurance amount under the coverage is overinflated in the early years of the policy in order to increase the accumulating fund of the associated exemption test policies and to shorten the period over which premiums would be otherwise payable to ensure that the policy is an exempt policy. The transactions involving the excess amount of life insurance that was temporarily acquired during the early years to effectively reduce the pay period of the policy would be considered avoidance transactions.
- If a policy, or a coverage under a policy, is designed or structured to convert what is effectively a fund value of a life insurance policy that is not a fund value of a coverage into a fund value of a coverage in order to reduce the accumulating fund of the policy, the transactions involving the conversion would be considered avoidance transactions. The converted amount of fund value would be treated as a fund value of a life insurance policy that is not a fund value of a coverage for the purpose of applying the exemption test.

Transactions (e.g., an increase in the benefit on death of, or a withdrawal from, a life insurance policy) that are undertaken in respect of the policy to restore exempt status would not be considered avoidance transactions. Such transactions are explicitly contemplated by subsection 306(8) and paragraph (b) of the definition “tax avoidance policy”.

Clause 7

Insurance business policy reserves

Part XIV

Part XIV of the Regulations provides rules in respect of insurance business policy reserves.

Policy reserves

ITR

1401(1)

Section 1401 of the Regulations applies in determining certain amounts for the purpose of calculating a life insurer’s Canadian life investment income for Part XII.3 purposes. Section 1401 also applies for the purpose of calculating a life insurance policy’s accumulating fund in section 307. For further information, see the commentary on section 307 and subsections 1401(3), (4) and (5) of the Regulations and the definition “adjusted cost basis” in subsection 148(9) of the Act.

Paragraphs 1401(1)(a), (b), (c.1) and (d) are amended to clarify the time of the making of determinations under those paragraphs and to update those provisions. Paragraph 1401(1)(c) and subsection 1403(1) are amended, and subsections 1401(3), (4) and (5) are added, to provide new rules for policies issued after 2015.

For life insurance policies issued before 2016 and annuity contracts, the amount determined under paragraph 1401(1)(c) in respect of a life insurance policy remains, in general terms, the greater of the policy’s cash surrender value (as defined in subsection 1408(1)) and the reserve component in respect of the policy. The cash surrender value component measures the savings accessible upon the surrender of the policy. The reserve component measures the savings accumulating in respect of future benefits under the policy. The reserve component is equal to the difference between the present value of future benefits and the present value of future modified net premiums (the modified net premium reserve). Modified net premiums, as defined in subsection 1408(1), generally refers to the portion of premiums corresponding to the benefits (i.e., premiums net of expenses and loading or net premiums) adjusted to take into account policy acquisition costs in the early policy years.

For life insurance policies (other than annuity contracts) issued after 2015, paragraph 1401(1)(c) is amended to provide that the cash surrender value component will be calculated without taking into account charges (i.e., surrender charges) that are applicable on the surrender of a policy. In addition, the reserve component of the paragraph as it applies to these policies is computed by reference to the net premium reserve in respect of the policy. The net premium reserve component is, in general terms, equal to the difference between the present value of future benefits and the present value of future net premiums with relevant adjustments to account for policies where premiums are not fixed and determined. The net premium reserve component is to be calculated using the assumptions and other rules found in subsection 1401(4). Subsection 1401(5) provides specific rules and assumptions for the calculation of both the cash surrender value and net premium reserve components for the purposes of Part XII.3 of the Act. In addition, subsection 1401(5) provides transitional rules for Part XII.3 purposes in respect of policies issued before 2016. The commentary on those subsections and subsection 1401(3) contains more information on the net premium reserve component of paragraph 1401(1)(c).

These amendments come into force on Royal Assent.

ITR
1401(3)

New subsection 1401(3) of the Regulations contains definitions that apply for the purpose of calculating the amount determined under paragraph 1401(1)(c) for a life insurance policy (other than an annuity contract) issued after 2015. Some of these definitions also apply for the purposes of the exemption test in section 306 of the Regulations, the calculation of the net cost of pure insurance under section 308 of the Regulations and the determination under section 148 of the Act of the tax treatment of a disposition of an interest in a life insurance policy.

New subsection 1401(3) comes into force on Royal Assent.

“benefit on death”

A benefit on death ordinarily includes an amount payable on the death of a life insured. The definition “benefit on death” excludes from this meaning any additional amount payable as a result of an accidental death. The definition also extends the meaning to include an endowment benefit (i.e., a benefit payable upon the survival of the life insured at a specified age). A benefit on death does not include an amount held on deposit by an insurer and associated interest income (including policy dividends left on deposit with an insurer) if the interest income is included in the income of a policyholder under Part 1 of the Act.

For the purposes of paragraph 1401(1)(c), the definition “benefit on death” is relevant to defining the vector of benefits on death in respect of a coverage under a life insurance policy (see the definition “future benefits to be provided”, and a number of other definitions, in subsection 1401(3)). The definition “benefit on death” also applies, because of section 310, for a number of purposes in Part III of the Regulations.

“coverage”

For a life insurance policy (other than an annuity contract) issued after 2015, the reserve component of the amount determined under paragraph 1401(1)(c) (i.e., the net premium reserve) includes three separate elements, two of which are calculated based on amounts determined for each coverage under the policy. A coverage means life insurance that is issued on a life, or two or more lives jointly insured under a policy, and that was underwritten at a specific time and that is subject to a particular schedule of premium or cost of insurance rates (including the period over which the premiums are payable or cost of insurance are chargeable, as the case may be).

When an amount of life insurance is underwritten at a specific time on a life, or two or more lives jointly, insured and a portion of the amount is subject to a particular schedule of premium or cost of insurance rates while another portion is subject to another schedule of premium or cost of insurance rates, each portion will be treated as a separate coverage. A coverage includes the benefits on death that are payable under the coverage, the premium or cost of insurance rates payable or chargeable under the coverage, the fund value that is used to determine the net amount at risk under the coverage and the net amount at risk, if any, during the period over which the coverage will be in effect.

“fund value benefit”

The fund value benefit under a life insurance policy at any time is the difference, if any, between the policy’s fund value (as defined in subsection 1401(3)) and the total of all amounts each of which is the fund value of a coverage (as defined in subsection 1401(3)) under the policy. The fund value benefit corresponds to the portion of the fund value of a life insurance policy that increases the benefit on death and does not reduce the net amount at risk in respect of any coverage under the policy.

Fund value benefit is relevant for life insurance policies (other than an annuity contract) issued after 2015. For the purposes of paragraph 1401(1)(c), the fund value benefit is relevant to computing the net premium

reserve in respect of a policy. The net premium reserve in respect of policy includes three elements, one of which (the amount for variable B of the formula in the definition “net premium reserve”) is calculated by reference to the fund value benefit. The definition “fund value benefit” also applies, because of section 310 of the Regulations, for the purposes of subsections 306(4) and (5) of the Regulations and for the purposes of paragraph 148(2)(e) and the definition “adjusted cost basis” in subsection 148(9) of the Act. For further information, see the commentary on those provisions.

“fund value of a coverage”

The fund value of a coverage is relevant for a life insurance policy (other than an annuity contract) issued after 2015. The fund value of a coverage under a life insurance policy is calculated by adding the portion of each investment account, in respect of the policy, that reduces the net amount at risk under the coverage for the purpose of calculating the cost of insurance charges of the coverage that will be deducted from one or more investment accounts under the policy during the period over which those costs are chargeable or would be chargeable if cost of insurance charges were to apply until the termination of the coverage. The fund value of a coverage corresponds to the portion of the fund value of a life insurance policy that does not increase the benefit on death but instead reduces the net amount at risk under any coverage (i.e., the difference between a coverage’s benefit on death and the coverage’s fund value) under the policy. Fund value of a coverage under a life insurance policy is relevant to applying the definitions “fund value benefit”, “future benefits to be provided”, “future premiums or cost of insurance charges” and “net premium reserve” in subsection 1401(3).

“fund value of a life insurance policy”

The fund value of a life insurance policy is relevant for a life insurance policy (other than an annuity contract) issued after 2015. The fund value of a life insurance policy at any time is the total at that time of all investment accounts in respect of the policy. The fund value of a life insurance policy is calculated by adding the amount of each investment account in respect of the policy. For greater certainty, the fund value of a life insurance policy includes an amount held on deposit by an insurer and associated interest income if the interest income is not included in the income of a policyholder under Part 1 of the Act and excludes an amount held on deposit by an insurer and associated interest income if the interest income is included in the income of a policyholder under Part 1 of the Act. The definition “fund value of a life insurance policy” applies for the purposes of the definition “fund value benefit”.

“future benefits to be provided”

Future benefits to be provided in respect of a coverage is relevant for a life insurance policy (other than an annuity contract) issued after 2015. Future benefits to be provided in respect of a coverage at any time means the vector comprised of each of the benefit on death that would become payable at a particular time that is after that time under the coverage depending on the time of death of the life or lives jointly insured under the coverage.

If a coverage has a fund value at the time at which the future benefits to be provided are determined, the benefit on death payable at a particular time that is after that time is equal to the net amount at risk in respect of a coverage at that time (i.e., the difference between the coverage’s benefit on death at that time and the coverage’s fund value at that time). If a coverage does not have a fund value at the time at which the future benefits to be provided are determined, the benefit on death payable at a particular time after that time is determined based on the terms of the policy at that time.

“future net premiums or cost of insurance charges”

Future net premiums or cost of insurance charges in respect of a coverage is relevant for a life insurance policy (other than an annuity contract) issued after 2015. The definition “future net premiums or cost of insurance charges” in respect of a coverage applies in determining the amount for variable C of the

formula in the definition “net premium reserve” in subsection 1401(3). A coverage’s future net premiums or cost of insurance charges at any time corresponds to the vector comprised of each future net premium or cost of insurance that would become payable or chargeable at a particular time after that time if the life or lives jointly insured under the coverage survived until the particular time. Specifically, under paragraph (a) of the definition, for the purpose of determining an amount under paragraph 1401(1)(c) in calculating the accumulating fund of a life insurance policy, a coverage’s vector of future net premiums or cost of insurance charges at any time is calculated by prorating its vector of future premiums or cost of insurance at that time (i.e., each future net premium or cost of insurance payable or chargeable at a particular time after that time). Prorating applies based on the ratio of the present value of the coverage’s future benefits to be provided on its date of issue to the present value of the coverage’s future premiums or cost of insurance charges on the coverage’s date of issue.

Under paragraph (b) of the definition, for the purpose of determining an amount under paragraph 1401(1)(c) in calculating Canadian life investment income under Part XII.3 of the Act, a coverage’s vector of future net premiums or cost of insurance charges is calculated by prorating its vector of future premiums or cost of insurance charges based on the prorating used for determining the “modified net premium” relevant to policies issued before 2016. For Part XII.3 purposes, for policies other than annuities issued after 2015, the modified net premium approach will continue to be used in determining the reserve component under paragraph 1401(1)(c).

“future premiums or cost of insurance charges”

Future net premiums or cost of insurance charges in respect of a coverage is relevant for a life insurance policy (other than an annuity contract) issued after 2015. The definition “future premiums or cost of insurance charges” in respect of a coverage applies for the purposes of the definition “future net premiums or cost of insurance charges” in respect of a coverage.

Future premiums or cost of insurance charges in respect of a coverage at any time means the vector comprised of each future premium or cost of insurance in respect of the coverage that would be payable or chargeable against an investment account under the policy, as the case may be, at a particular time after that time if the life or lives jointly insured under the coverage survive until the particular time. The vector of future premiums or cost of insurance charges includes the amount of each future premium or cost of insurance charge and the time at which the premium or cost of insurance would become payable or chargeable, as the case may be.

If a coverage has a fund value at the time future premiums or cost of insurance charges are determined, its vector of future premiums or cost of insurance charges at that time is determined assuming that the net amount at risk at a particular time after that time is equal to the coverage’s net amount at risk at that time (i.e., the difference between its benefit on death at that time and its fund value at that time). If a coverage does not have a fund value at the time future premiums or cost of insurance charges are determined, its vector of future premiums or cost of insurance charges will be determined based on the terms of the policy at that time.

“interpolation time”

The interpolation time of a coverage is relevant for a life insurance policy (other than an annuity contract) issued after 2015. The interpolation time of a coverage is the earlier of the time that is eight years after the date of issue of the coverage, and the first time after which no premiums are payable or costs of insurance chargeable in respect of the coverage. The interpolation time of a coverage applies in determining at any time the amount for variable C of the formula in the definition “net premium reserve” in subsection 1401(3) as it applies for the purpose of calculating the accumulating fund of a life insurance policy. The determination at any time of variable C of that formula depends upon whether that time is before the interpolation time of the coverage or not.

“net premium reserve”

The net premium reserve of a policy is the reserve component determined under paragraph 1401(1)(c) in respect of the policy if the policy is issued after 2015 and is not an annuity contract. Policies issued before 2016 and annuity contracts continue to use the modified net premium reserve, as determined in existing paragraph 1401(1)(c), in determining the reserve component determined under that paragraph.

The net premium reserve in respect of a life insurance policy at any time equals the total of three elements calculated at that time, being variables A, B and C of the formula in the definition.

For a life insurance policy with a fund value, at the time the net premium reserve is calculated, variables A and B capture the reserve associated with the fund value of the policy at that time. Variable A represents the reserve associated with the fund value of all coverages under the policy. The present value of the fund value of a coverage is calculated as if the fund value were a benefit on death issued on the life, or lives jointly, insured under the coverage. Variable B represents the reserve associated with the portion of the fund value of a policy that is not a fund value of a coverage (i.e., the reserve associated with the fund value benefit). Variable B equals the fund value benefit at that time.

Variable C calculates the reserve associated with the portion of a policy's benefit on death that is not paid from the fund value of the policy. It is equal to the total of the reserve in respect of the portion of a coverage's benefit on death that is not paid from the fund value of the coverage. The reserve in respect of the portion of a coverage's benefit on death that is not paid from the fund value of the coverage is calculated using two set of rules that apply depending on whether the amount is calculated for the purposes of calculating the accumulating fund in respect of a policy or Canadian life investment income under Part XII.3 of the Act.

For the purpose of calculating the accumulating fund in respect of a policy, if the time at which variable C is calculated is at or after the interpolation time, variable C is equal to the difference between the present value of the coverage's future benefits to be provided at that time and the present value of the coverage's future net premiums or cost of insurance charges at that time. If the time at which variable C is calculated is before the interpolation time, variable C is calculated by prorating the amount that would be determined at the interpolation time for variable C. In addition, if the coverage has a fund value at the time variable C is calculated, the amount for variable C that would be determined at the interpolation time is calculated as if the benefit on death at the interpolation time were equal to the net amount at risk at the time variable C is calculated. Prorating is applied based on the ratio of the number of years that the coverage has been in effect at the time variable C is calculated and the number of years that the coverage would have been in effect at the interpolation time.

For the purpose of calculating Canadian life investment income under Part XII.3 of the Act, variable C at any time equals the difference between the present value of the coverage's future benefits to be provided at that time and the present value of the coverage's future net premiums or cost of insurance charges at that time. The coverage's future net premiums or cost of insurance charges are generally calculated based on the existing definition “modified net premium” in subsection 1408(1) and existing mortality, lapse and interest rates in section 1403.

“policy anniversary”

The definition “policy anniversary” incorporates by reference the existing definition “policy anniversary” in subsection 310(1). Under that definition, the ordinary meaning of policy anniversary is extended to assign, to certain policies that do not otherwise have a policy anniversary in the relevant calendar year, a policy anniversary that is the end of that calendar year. The expression policy anniversary is used in new paragraph 1401(4)(c). For further information, see the commentary on subsection 1401(4).

ITR
1401(4)

New subsection 1401(4) of the Regulations provides rules for the purpose of determining an amount under paragraph 1401(1)(c) in respect of the calculation of the accumulating fund, as determined under section 307, in respect of a life insurance policy (other than an annuity contract) issued after 2015.

Paragraph 1401(4)(a) provides that present values are to be calculated using an annual interest rate of 3.5% and mortality rates in respect of the life or lives jointly insured under a coverage are to be factored into the calculation of the present value. Paragraph 1401(4)(b) sets out a number of rules for determining mortality rates in respect of a life or lives jointly insured under a coverage. Under subparagraph 1401(4)(b)(i), for a life that is not jointly insured with other lives and is not a substandard life, the mortality rates in respect of the life are calculated based on the age of the life that is nearest or last to the date of issue of the coverage, depending on the pricing methodology used by the issuer of the policy, and on the 1986-1992 Canadian Institute of Actuaries mortality tables posted on the Internet website of the Society of Actuaries as of Announcement Date.

The mortality tables used for a particular life insured should be those corresponding to the characteristics of the life insured. For example, if the life is insured is a female and smoker, the mortality table corresponding to a smoking female is to be used. If a life is not jointly insured with other lives and is a substandard life, the mortality rates that would be otherwise determined if the life were a standard life are multiplied by the rating attributed to the life insured but can never exceed 1. When the coverage is underwritten, select and ultimate mortality rates associated with the age of the life insured at issuance from the relevant mortality table are to be used. Under subparagraph 1401(4)(b)(ii), for lives that are jointly insured under a coverage, the joint mortality rates are calculated based on the 1986-1992 Canadian Institute of Actuaries mortality tables as posted on the Internet website of the Society of Actuaries as of Announcement Date and using the pricing methodology of the issuer of the policy.

Paragraph 1401(4)(c) provides a rule for calculating the present value of future net premiums or cost of insurance charges. Future net premiums or cost of insurance charges means the vector of future net premiums or cost of insurance charges, including the time of payment or charge, as the case may be, of each future net premium or cost of insurance charge, which (ignoring the paragraph) corresponds to the time of payment or charge of each future premium or cost of insurance charge. If the time of payment or charge of a future premium or cost of insurance charge is a policy anniversary, paragraph 1401(4)(c) deems the time to be one day after the policy anniversary.

New subsection 1401(4) comes into force on Royal Assent.

ITR
1401(5)

New subsection 1401(5) of the Regulations provides rules for determining an amount under paragraph 1401(1)(c) for the purpose of calculating an insurer's Canadian life investment income under Part XII.3 of the Act in respect of a life insurance policy other than an annuity contract.

Paragraph 1401(5)(a) applies to policies issued after 2015. Subparagraph 1401(5)(a)(i) requires that present value calculations required for determining an amount under paragraph 1401(1)(c) in respect of a coverage under a life insurance policy are to be made using the rates of interest, mortality and lapse defined under section 1403. For this purpose, section 1403 is to be read without regard to the adjustments provided under subsections 1403(2) to (8); in addition, the rates referred to under paragraph 1403(1)(e) are to be the rates used by the insurer in determining the premiums or cost of insurance charges in respect of the coverage. Specifically, if there are no fixed and determined premiums in respect of a coverage, the rates to be used are those used for determining the cost of insurance rates of the coverage. If the coverage

is one where premiums are fixed and determined, the rates to be used are those used for determining the premium rates of the coverage.

Subparagraph 1401(5)(a)(iii) provides a rule for calculating the present value of future net premiums or cost of insurance charges. Future net premiums or cost of insurance charges means the vector of future net premiums or cost of insurance charges, including the time of payment or charge, as the case may be, of each future net premium or cost of insurance charge which (ignoring the subparagraph) will correspond to the time of payment or charge of each future premium or cost of insurance charge. If the time of payment or charge of a future premium or cost of insurance charge is a policy anniversary, subparagraph 1401(5)(a)(iii) deems the time to be one day after the policy anniversary.

Paragraph 1401(5)(b) applies to deem certain life insurance underwritten after 2015 in respect of a policy issued before 2016, and not otherwise subject to the new rules for policies issued after 2015, to be a separate life insurance policy issued at the time of the underwriting. The rule applies if the coverage is one in respect of which a particular schedule of premium or cost of insurance rates applies. However, the rule does not apply if the coverage is part of a rider that is deemed by subsection 211(2) of the Act to be a separate life insurance policy.

For further information, see the commentary on subsections 148(11) of the Act and 306(10) of the Regulations.

New subsection 1401(5) comes into force on Royal Assent.

Clause 8

Assumptions in applying paragraph 1401(1)(c)

ITR
1403(1)

Subsection 1403(1) of the Regulations contains rules that apply for purposes of paragraph 1401(1)(c) in determining the amount of a modified net premium or an amount determined by an insurer under that paragraph.

Subsection 1403(1) is amended so that it generally does not apply to life insurance policies issued after 2015, unless the policy is an annuity contract. Under a special rule contained in subsection 1401(5), the rules in subsection 1403(1) remain relevant in applying paragraph 1401(1)(c) for the purposes of subsection 211.1(3) of the Act in respect of policies issued after 2015. For further information, see the commentary on subsection 1401(5).

This amendment comes into force on Royal Assent.