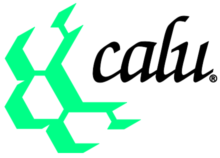

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May 29, 2013

VIA EMAIL

Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Attention: Chantal Pelletier, Chief, Financial Institutions

Dear Ms. Pelletier:

Re: Budget 2013 – Proposals on Leveraged Insured Annuities

I am writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU was formed in 1991 to meet the needs of financial and professional advisors who specialize in advanced applications of life insurance and related financial services, including such areas as employee benefits, wealth accumulation, retirement planning, estate planning and business succession planning.

In matters of advanced tax policy, CALU also represents the members of Advocis. Advocis is the trade name for The Financial Advisors Association of Canada (TFAAC), which is the largest voluntary professional membership association of financial advisors in Canada, representing more than 11,000 advisors across Canada. Advocis members provide comprehensive financial and retirement planning, employee benefits planning, wealth management, estate and tax planning, risk management products and advice to millions of Canadians.

CALU and Advocis members are often engaged in providing insurance planning advice to professionals, executives and small to medium-size business owners. We are writing to provide you with our comments on the budget proposals relating to leveraged insured annuities ("LIAs") that were released by the Minister of Finance on March 21, 2013 as part of the 2013 Budget (referred to collectively as the "Budget Proposals").

Discussion of Proposals on Leveraging Insured Annuities

1. Introduction

Annex 2 of the 2013 Budget Papers ("Annex 2", at page 359) describes an LIA as an investment product that is acquired with borrowed funds and provides a fixed and guaranteed income to an investor until the death of an individual, at which time the capital invested in the annuity is returned in the form of a tax-free death benefit. However, each element of an LIA is treated separately for tax purposes which results in multiple tax benefits that are not available in relation to comparable investment products.

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

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

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

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

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

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

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

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

2. Specific Comments

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

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

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

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

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

b) Application of the LIA Proposals to New Arrangements

(i) Tax Policy Underlying these Rules

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

As a starting point, we believe it is important to note that the annuity and life insurance policy underlying an LIA arrangement are not part of a "structured investment product". The annuity and life insurance policy typically originate from separate and arm's length insurance companies, while the loan is advanced by an arm's length financial institution. The risks associated with the annuity and life insurance is

separately underwritten and the issuance of one product is not dependent on the other. As well, the terms and conditions of the loan are negotiated independently and based on market rates and terms available at that time.

Assuming that it is appropriate that the tax treatment for LIA policies should be similar to that accorded comparable investment products, we are concerned that the rules as currently proposed could in fact put LIA arrangements in a worse position than comparable investment products. This concern is increased where such an arrangement is established within a closely held private corporation because of the application of specific elements of the LIA proposal to those situations.

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

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

The Life Annuity

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

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

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

As an alternative approach, we would propose that this rule be amended to include only the accumulating fund of the annuity in determining the fair market value of the shares. The accumulating fund in effect reflects the remaining amount of the annuity premium after reflecting the "repayment" of capital amounts

to the corporate owner of the annuity. Otherwise, the stated goal of greater tax parity between an LIA arrangement and other corporate owned investments would not be achieved.

Exempt vs. Non-Exempt Policies

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

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

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

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

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

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

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

[2] See Regulation 201(5).

Capital Dividend Account Treatment

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

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

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

Again, the approach taken in relation to disallowing the CDA credit, appears to have as its policy underpinning that the annuity and insurance policy should be treated as one structured investment, and in combination with the loan, should not provide greater tax benefits than a fixed term investment combined with a loan. However, in considering the financial results of the annuity/insurance structure, we must again reinforce the fact that the annuity payments include a return of capital, which over time creates additional value in the corporation even after taking into account the insurance premiums. In other words, at or near the life expectancy of the annuitant/life insured, the annuity combined with the insurance death benefit can increase the financial value of the corporation over that available from a fixed income investment. To achieve the appropriate tax result, the CDA credit should therefore be available to provide a similar tax result to a fixed income investment.

Tax Treatment of the Loan Arrangement

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

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

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

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

Again, our concern is that the proposals relating to LIA proposals go further than stated and actually tilt the playing field in favour of other fixed income investments. We believe there may be other solutions

that would address the Government's concerns relating to LIAs while also mitigating the ones noted in our submission.

Conclusions

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

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

ii) Joint and Multi-Life Policies

It is possible for LIA arrangements to be established using a joint first or last-to -die insurance policy or possibly a multi-life policy, as well as a joint last-to-die annuity. We believe the intent would be to have the proposals apply to these types of arrangements. However, there may be circumstances where the rules may apply too broadly (or may not achieve the goals of the proposals) and we believe further discussions would be helpful. For example, if a multi-life policy is assigned as collateral security under an LIA arrangement, it appears that the entire policy and related coverages will be caught by the proposed rules. We don't believe this is an appropriate result.

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

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

iii) *Ongoing Application of the Rules*

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

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

Yours truly,

Kevin Wark, LLB, CLU, TEP
President, CALU

cc: Don Smith, CFP, CLU
Chair, CALU