TAXPLANNING

The unique benefits that make life insurance...

An asset, not an expense

Mark Halpern CFP, TEP

With interest rates low and equity markets unsettled, it's not surprising that many investors are struggling to find the right place to put their money.

But they may have overlooked a relatively unknown asset class with an established history and a well-known name – life insurance.

Modern portfolio theory holds that a sensible investment balances risk and return with an emphasis on diversification.

This is where life insurance comes in. It satisfies the sensible-investing definition by balancing risk in your investments while offering peace of mind through knowing that your heirs and other beneficiaries will be looked after.

I've always considered life insurance to be central to any estate-planning scenario. A participating account (called "par") in a whole life insurance policy is also an excellent way to reduce risks in the fixed-income portion of your portfolio. It provides liquidity and dividends with excellent returns and can be used as part of a corporate investment portfolio.

Fixed income is an essential asset class within a diversified portfolio, often increasing as people grow older and desire less risk in their lives.

At the same time, this portion of your portfolio should be as tax-efficient as possible to give the best after-inflation returns.

A guarantee plus higher income

Most traditional asset classes are, of course, geared towards accumulating wealth.

The icing on the par life cake, however, is its added protections and guarantees for the level of premiums you pay, the death benefit and the growing cash values within the policy.

These safety measures are critical in today's markets and low interest rate environment; they can have a major impact on the amount of wealth that is ultimately transferred to your heirs and beneficiaries.

Par policies are also important during your lifetime. Over the past 25 years, the dividend interest rate for par whole life insurance from a leading Canadian insurer has remained relatively stable, ranging from 11.5 per cent to the current 7.15 per cent.

This compares favourably with Government of Canada 10-year bonds, which have ranged from 11.0 per cent to the current 3.9 per cent.

To be clear, don't do away with the fixed-income investments you already hold. But do consider a portfolio shift into a par life policy for 5 to10 per cent of your portfolio, depending on your age.

The advantages of par

There are basically two kinds of permanent life insurance – universal life and participating whole life.

While both have their strong points, a recent study by industry leaders indicates par beats out universal life in terms of greater cash surrender values and liquidity (despite the fact that par has a higher initial premium commitment than universal life).

In addition, the death benefit is greater for par insurance than for the alternative, non-registered fixed income investment.

The funds in a par insurance policy are professionally managed, just as they are in an average balanced portfolio.

However, the returns from par insurance funds often outperform those of balanced funds. That's because life insurance companies are large and diversified in their holdings, investing in a conservative mix of assets that include government and corpo-

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rate bonds, real estate and equities.

How much each par account is invested in these separate asset classes varies depending on the market conditions at the time and the investment guidelines of the respective company.

On top of that, insurers set aside some of the premiums for the insurance into a special par account and then guarantee the cash value of the policy. Canadian par accounts have existed for decades and some now exceed $10 billion.

The large size of this pool allows management costs to be spread out over a greater number of people, keeping costs low. A unique feature to whole life is that their returns are "smoothed" over time, removing up to 80 per cent of market volatility on par life insurance policyholder dividends.

Added dividends

The extra punch that comes from par accounts are the added dividends derived from earnings that accumulate in the policies.

Premiums are based on conservative calculated assumptions of future expenses, death claims and interest or other investment earnings.

When reality turns out to be better than these assumptions, there's a surplus (you can call it a profit) which the company then pays out to par policyholders via dividends.

You can do whatever you like with the dividends. If your insurance is paid up, you can (for example) use the dividends to buy additional coverage. For those who pay premiums every year, the dividends can help pay the premiums. You can also take the dividends in cash or leave the dividends in what amounts to a special savings account, from which interest may be earned.

The par policy has a cash value. Even if the markets take a tumble, that cash value remains constant and you can access it at any point during your lifetime.

This essentially means that even though the money is invested in a pool of assets that change over time, there is no investment risk on your capital.

Ask yourself: How often does that happen? If that same money had been put into a balanced fund in the latest market downturn, an investor could have lost a substantial amount of capital – in some cases, as much as 20 per cent.

And, as long as the funds remain in the life insurance account, they are sheltered from tax – a meaningful bonus at any time.

Many insurers have enjoyed a long history of providing dividends. It's important to remember, though, that because these dividends are based on future experience (e.g., costs and earnings) they are not guaranteed.

While performance in par accounts is relatively stable and predictable, it is difficult to determine how any asset class will perform in the future. If interest rates rise in the future, this could have an effect on how you would compare the current returns from par life accounts.

The corporate side

Let's not forget that at the end of the day, the policy provides a tax-free death benefit to the insured beneficiaries without the hassle of going through probate.

On the corporate side, life insurance proceeds make the most sense.

Besides using lower-taxed 15.5 per cent after-tax corporate dollars to pay for the policy (versus 46 per cent personal after-tax in Ontario), insurance proceeds at death create a credit to the capital dividend account of a private corporation and then are paid to the deceased's estate or shareholders with little or no tax.

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A BETTER RISK-RETURN SCENARIO

Leading analysts say it's the par whole life that will provide many younger and affluent investors with diversification and a better risk-return scenario.

Take the example of a high-net-worth, 50 year-old healthcare professional earning $450,000 a year. He has a non-registered investment portfolio, currently valued at $1 million, with 60 per cent in equities and the remainder in real estate. He is concerned that his investments are in two major asset classes only and wants to reduce risk as he gets older.

Every year, he will add $50,000 to his non-registered portfolio until at least age 65. Going forward, he has decided to direct all future contributions to lower-risk fixed investments.

Under this scenario, participating whole life insurance was an attractive, alternative class to fixed-income investments. It has three key advantages:

- ✓ **The benefits to his estate were greatly enhanced**
- ✓ **Investment liquidity was comparable**
- ✓ **The concept of setting an optimal portfolio return, given risk and level of returns, was increased by adding par life insurance.**

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This can mean a considerable tax saving since tax rates vary from 22 per cent to 33 per cent (depending on the province, the recipient's marginal tax rate and whether the dividend is considered an eligible dividend).

A number of other strategies are available to cut the tax bite to your corporation during lifetime; these should be explored with an insurance and estate planning professional.

For those 65 and over, a life insurance policy can be added to a life annuity to create what is known as an insured annuity – a topic which I've discussed previously in *The TaxLetter*.

These annuities can also provide a high-yield investment for one's retirement income. In addition, this strategy can be set up favourably using a corporation.

I am a huge fan of using life insurance to preserve and pass on wealth to your heirs tax-free.

A par account in a whole life policy presents unique benefits that you can enjoy during your lifetime, and should be considered as part of your comprehensive tax, retirement and estate planning. ❐

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TAX-WISE INVESTOR

Take full advantage of your RRSP

Tax break

Marc Johnson, CFA

Some investment advisors think that you should never again contribute to an RRSP (or Registered Retirement Savings Plan).

In fact, some go further and suggest that you consider a meltdown of your RRSP. These advisors correctly note that RRSPs expose you to more income taxes than capital gains do. But I feel they fail to fully appreciate other advantages that RRSPs give you.

My advice, keep contributing to your RRSP. Also maximize your TFSA (or Tax-Free Savings Account).

These days, of course, you pay tax on only half of any capital gains you make. By contrast, you pay tax on every dollar you withdraw from a RRSP or a RRIF (or Registered Retirement Income Fund). So some advisors will tell you to stop contributing to an RRSP.

They think you should instead buy high-quality stocks or stock mutual funds. These investments will produce capital gains by the time you retire and cut down on your tax bills.

I see several flaws with this viewpoint. First, you get a tax break within months of contributing to your RRSP.

Those who buy stocks or stock mutual funds, by contrast, get no tax break. Remember, too, that RRSPs give you these tax breaks when they count the most – in your working years when you normally face a high marginal tax rate.

Second, RRSPs let your money compound tax free. Money held outside tax-deferred plans, by contrast, can produce taxable capital gains in your high-tax working years. Mergers and acquisitions might force you take these capital gains.

Or you might take capital gains if you expect the performances of some of your stocks or stock mutual funds to deteriorate.

Besides, you'll certainly face taxes on the dividends or distributions these stocks or stock mutual funds pay out.

Sure, you might buy only stocks that pay no dividends. But most of these are unlikely to give you high investment quality. Besides, forgo dividends and you'll forgo all of the many benefits that dividends give you.

Also, you'll likely only withdraw from your RRSP or RRIF

Marc Johnson, CFA, is the editor of *The Investment Reporter*, an advisory publication that has been providing investors with independent financial advice since 1941.

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