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TAXPLANNING

Life insurance can be a wonderful investment. Using Leverage can…

Maximize your returns

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Most successful business owners, entrepreneurs and wealthy Canadians will claim to know what life insurance is. But very few of them have actually been exposed to what it really can do.

People buy life insurance for many reasons: to protect their family, insure bank loans, cover taxes payable at death, to leave a special gift to a favourite charity or to provide the funding required for a buy/sell agreement.

Despite the long list of good reasons to buy life insurance, few people consider expensive life insurance premiums as a wise investment – it is often a "grudge" purchase.

Given the choice, most people would prefer to use the money they would otherwise spend on insurance premiums for other useful purposes: investing back into their business, expanding a real estate or stock investment portfolio or simply enjoying it.

After all, they worked hard to accumulate that wealth through smart investments. They understand the value of their investment dollar.

How to be insured and get your money back at the same time

There is a tax-effective strategy generally known as a "10-8" (today it's called a "9/7" or "Leveraged Insurance Arrangements") that provides life insurance, loan financing or investment leverage to wealthy Canadians. Owning a business is not a requirement. For the right person in the right situation, it can be a wonderful opportunity.

This is a strategy that incorporates life insurance policy loans – either loans made directly on exempt life insurance policies, or commercial loans with banks using insurance policies as collateral.

The "10-8" name refers to the specific interest rate differential that providers of the strategy will guarantee clients.

Today the rate offered by one large insurer is a nine per cent annual loan interest charge and a seven per cent annual guaranteed return on money deposited into the tax-exempt life insurance policy. In fact, "10-8" is a misnomer because the same principle applies no matter what the differential. It could be 6-4 or 12-10.

At first glance, that differential may seem like a bad deal – until you factor in the potential for interest deductibility on the loan or the relatively low-risk leverage you can achieve with the proceeds of the loan.

The 10-8 strategy involves making use of the tax rules that allow a taxpayer to write off the interest on a loan as long as it is being used to generate income for business or investment purposes.

The loan proceeds – which can range from as low as $100,000 into the millions – can be used for cash flow, acquisitions, investment and other business purposes.

A new or existing company might like to make different

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kinds of investment opportunities right in their own business, and it makes perfect sense that most business owners making great returns (but in need of insurance) don't want to tie up that cash in an insurance policy. Wealthy people who don't own a business feel the same way.

The loan is made using the insurance policy itself as collateral for the loan. This allows a business or individual to acquire the insurance that they need while enjoying the tax and economic benefits of leverage.

Get your insurance needs addressed first

This is also the perfect time for "crash testing" your current plans. This should include a comprehensive review of available estate-planning tools such as wills, powers of attorney, probate tax exposure, taxes due on death, titles, corporate structure, life insurance, illness insurance, health benefits, charitable giving strategies and more.

Best candidates

The best candidate for this strategy is a wealthy non-business owner or business owner (and possibly their spouse to reduce insurance costs further) with significant cash holdings in an Operating Company (Opco) or a Holding Company (Holdco) where cash is regularly generated from the business. This is a person who requires permanent life insurance for estate planning or business succession purposes.

This arrangement can also work for a wealthy individual generating a sizable income from employment or investments (e.g. real estate holdings), paying taxes at the highest marginal rates and having significant capital gains due on death.

Those capital gains taxes could be upwards of 25 per cent at death. Ideally, the individual should be otherwise debt-free, comfortable with leverage and determined to minimize their tax.

Under the terms of most tax-exempt life policies, it is possible to simply take out a loan from the policy. Most life insurance providers already allow policyholders to do this. Less common and a bit more complex is a commercial policy loan.

Using a life insurance policy for a commercial loan

Here's how a commercial loan using an insurance policy as collateral works.

The strategy requires ownership of a universal or whole-life insurance policy, although any tax-exempt life insurance product with a cash value separate from the death benefit will work. Accordingly, term life policies do not apply.

Assume that you invest $100,000 in a life insurance policy. Subject to financial underwriting, the insurance company will advance a loan of $100,000 against the policy, although in some cases there is a two per cent reduction in the advance to account for provincial premium tax.

Guaranteed returns with positive cash flow

The strategy is structured to guarantee a seven per cent return on the $100,000 deposited to the policy's investment account. At the end of the first year, therefore, there is $107,000 in the policy's cash value. Of course, the strategy "cost" is nine per cent in loan interest, or $8,820 annually.

The key is the interest deductibility

If you re-invest the loan proceeds back into your business or investment portfolio and get taxed at the highest marginal rate (for illustration purposes I'll use 50 per cent), you can claim half that interest back, or $4,410, as a deduction on your tax return. In the end, you are still netting a positive cash flow of 2.5 per cent.

How is the loan paid off?

Individuals and business owners can repay the loan as their income grows and their cash flow increases. The arrangements may also be structured so that part of the death benefit on the policy pays off the loan.

In any event, the loan is matched, dollar for dollar, with the cash value of the policy. In most cases leveraging arrangements can be easily wound up. The insurance policy can remain in force as long as premiums continue to be paid.

Proceed with caution

Investors must exercise caution to use the strategy effectively. This strategy is not widely known or frequently used, but when it is, it is usually a large life insurance policy.

Having an insurance need is the key, because a leveraged arrangement is not a product unto itself, but is simply an additional feature that can be made available for clients with a life insurance requirement.

Tax considerations

Every situation is different. Most people employ this strategy for tax efficiency, and it is imperative that your insurance advisor fully understands your unique situation to be sure the concept fits and will work as illustrated.

There are many tax issues to be addressed with your accountant and a tax lawyer. Their intimate understanding of your business situation is very important.

A policy loan will be considered a disposition and could trigger taxes if the loan exceeds the adjusted cost base of the policy.

Generally, the Leveraged Insurance Arrangements strategy is used only in the early years of the contract, before the Adjusted Cost Base of the policy is whittled down. After that, the policy loan is a disposition.

All the insurance companies provide advice from tax accountants to certify the viability of this strategy, but they do not provide a guarantee.

Timing is everything

From a financial and investment perspective there has never been a better time to purchase permanent insurance.

The low interest rate environment continues to put upward pressure on the rates for permanent insurance. The cost of insurance has been steadily increasing over the past few years as a result of reduced interest rates. Premiums will likely continue to rise.

Guaranteed level cost of insurance will soon be unavailable in Canada. The former CEO of a top insurer recently predicted the end of permanent types of life insurance within the next five years.

Other considerations

Despite the fact that many of the tier-one insurance companies have been marketing leveraged strategies in various forms for years, changes in the tax rules are always possible. Leveraging arrangements are generally flexible enough to permit clients to react to tax changes, but this issue requires a thorough review by the tax advisor.

Remember that your premiums pay for the program, but it's your good health that buys it. As a result you will have to qualify for this program through an insurance medical and financial underwriting.

There are many issues to consider when evaluating insurance leveraging: the required life insurance coverage, the insurance contract, your income objectives, the financial reserves and strength of the insurance company, the underlying mortality costs and administrative expenses and the investment management fees, just to name a few.

Professional advice of a Certified Financial Planner or Trust & Estate Practitioner dealing with insurance and estate planning issues is a must when assessing the merits of this strategy. ❒