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FINANCIALPLANNING

Your insurance policy may be worth more than you think

Tapping value

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Canada's life insurance industry heaved a collective sigh of relief on April 21, 2015, when the new federal budget was announced. It kept alive the opportunity for high net-worth taxpayers to use a unique and time-tested insurance tax strategy with the potential to save significant tax dollars.

With many complex and technical considerations, this strategy requires the knowledge of experienced professionals to ensure all the details are worked out to the satisfaction of the Canada Revenue Agency and, most importantly, to you.

The strategy uses a life insurance policy, term or whole life, owned by you directly or held by a trust, to generate significant tax benefits by transferring ownership of that policy to your holding company. Many business owners and professionals (such as accountants, lawyers, doctors, dentists, etc.) now use a holding company for tax and other purposes.

Under the regulations, an actuary is retained to review the insurance policy and provide an opinion of current fair market value. The valuation process considers several factors including your current health and insurability, how the policy is set up, the death benefit, cash value and premiums required to maintain coverage.

If the actuary determines a fair market value that exceeds the policy cash value, you can transfer that policy to your holding company at the new fair market value, and receive payment of that amount from your company tax-free. At that point, your holding company owns the policy and pays the premiums. In addition to getting large sums out your holding company tax-free, the effective cost of insurance is sharply reduced—because premiums are now paid by a corporation with a tax rate of only 15.5 per cent, and no longer paid personally at a hefty tax rate of 46.5 per cent.

Tap the gain of your insurance policy value

Broadly speaking, the strategy noted above is just one example of insurance policy valuation, how that valuation can change over time, and how policy holders can tap into that value. Let's look at some other examples.

Review old policies

People who own life insurance policies sometimes decide they no longer want to keep them. There are many possible reasons to explain why people decide to give up insurance policies: the policy was taken out to secure a loan that's been paid off; the policy was purchased to finance a buy-sell agreement that's no longer in force; the policy was intended to protect a spouse and the relationship has ended, etc.

Insurance companies carefully evaluate health and lifestyle when underwriting a new policy. People with medical conditions have trouble getting covered and are often rejected. If your health declined after an insurance poli-

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cy was issued, the value of that policy rises sharply. At one time, your beneficiaries would be the only people to benefit under those changed circumstances. Today, if you become ill, even your term insurance policy can enjoy a high valuation, allowing you to sell your policy to your holding company or donate it to a charity and save on taxes.

Types of policies that benefit most

Term-to-100 policies, universal life policies with level insurance costs and whole life policies will also have a value that will be higher with older policies. Rates on these types of policies have increased by up to 60 per cent in the past five years due to low interest rates.

In addition, term life insurance rates have dropped in the last few years so it's a good idea to get in touch with an insurance professional to see where rates stand and determine whether it is to your advantage to convert some or all of existing term to permanent insurance without medical evidence.

Not all life insurance policies are candidates for this strategy; every situation is different and requires investigation.

Tapping the value of insurance policies: client case studies

Here are some recent cases using the strategy.

Case #1
An entrepreneur and his wife

An overweight businessman was referred to me by his banker after he was declined for coverage through the bank in trying to secure a new business loan. We applied for new coverage for him and his spouse/business partner. The insurance company underwriters rated him highly (i.e., it charged him more than standard rates for being heavy) and deemed her uninsurable.

We retained an actuary to review the couple's portfolio of old insurance policies. The fair market value of his old policy was determined to be over $500,000. There will be a taxable disposition of about $3,500 because there was a current cash surrender value which exceeded the adjusted cost basis.

The fair market value of her old policy was pegged at $450,000. There is no taxable disposition on this policy (the cash value is nominal) and the new adjusted cost basis will be (virtually) nil.

Combined, the fair market value of their two policies exceeded $1 million and the sale to their holding company saved about $400,000 in taxes.

Case #2
An architect with big plans

We completed a preliminary ballpark valuation for the life insurance policy on the life of a 52-year-old male non-smoker. In his situation, the fair market value of the policy was approximately $154,000. When it moves over to his holding company, a tax savings of more than $50,000 will be crystallized if we assume a dividend tax rate of 35 per cent.

The cost for his valuation and transfer amounted to $2,500 plus HST and some nominal accounting and legal fees. After accounting for all the fees and costs the client reaped a windfall of savings.

Case #3
The accidental philanthropist

This tax strategy is especially good for people who are interested in giving to charity. This client in his forties had a $2-million life insurance policy he no longer needed. He was about to cancel it until I suggested he get a valuation on the policy, which he did and received the news it was worth $250,000. He donated that policy to a charity and received a charitable tax donation receipt for $250,000, which will save him more than $100,000 in taxes today. A decision to continue funding that policy would deem all new premiums paid as a charitable donation and will actually only cost him half the official amount. And more importantly, he is recognized by the charity as giving a big donation versus being remembered for leaving a large tax to the Canada Revenue Agency.

Creditor protection and litigation issues

There are some potential issues dealing with creditor protection and litigation that you need to consider. That's why I always encourage people to get professional help. An experienced trust and estate practitioner and a trust lawyer are essential to implementing this strategy. Professional fees paid to the actuary, lawyer, and accountant to execute an effective plan are deductible and usually amount to just a tiny fraction of the taxes saved. The potential downside of not getting professional help can also lead to paying much more in taxes.

Get professional assistance

I was contacted a few years ago by a taxpayer who had read a previous article I wrote on this subject and thought he followed everything that was recommended. He was more than a little miffed when he subsequently received a T3 tax slip from the Canada Revenue Agency for $45,000. He didn't realize the cash value in his life insurance policy was taxable and ended up paying full tax on all of it as income.

His mistake? He neglected to heed my standard advice to use an advisor and actuary familiar with these transactions.

We have done dozens of policy transfers and the first thing we always discuss is how to deal with the cash value that's always taxable on a transfer. There are ways to offset the gains, but they need to be considered beforehand. Always get proper legal, accounting and tax advice before you do something, not after.

Financial professionals often find great opportunities to save taxes. Those opportunities, presented by the tax department and federal government, are often called "loopholes." Governments come and governments go, and when they change, new sets of eyes examine ways to grow revenues by closing loopholes. No one can predict the future or how long this strategy will remain available. If you have worked hard for your money I suggest you consider taking advantage of this opportunity now.

Please be in touch if you need any help evaluating your options. ❒

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