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*FINANCIAL*PLANNING

New rules are coming. Benefit now from an insurance policy that's …

Tax-free

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Life insurance has long enjoyed special tax-exempt treatment under Canada's tax laws, enabling wealthy people to buy it as a strategic investment. With infrequent changes in legislation, life insurance earned its reputation as a financial safe haven. Not a single policy holder has ever lost a contractual benefit under a life insurance policy issued by a Canadian insurance company.

Everyone knows what life insurance is, but few people really know what it can do. As you'll see in this article, life insurance can do a lot, including saving you a substantial amount in taxes.

The tax laws related to life insurance are updated from time to time. New regulations coming into effect January 1, 2017, will change the tax-exempt status of permanent life insurance policies. Policies in place before that date will be grandfathered and not adversely affected.

This is a good time to review your estate planning and insurance needs with an experienced professional—before the new regulations take effect—to learn how you can take advantage of this tax-exempt benefit.

You may be able to multiply the amount of the original tax-exempt funds and provide further asset diversification in your estate plan.

New rules for permanent life insurance policies

The upcoming changes result from a 2012 decision in Ottawa to change the "exempt test" of life insurance policies to reflect the fact that, as people now live longer, their insurance policies will pay out later. It's a very simple way for the government to collect more taxes.

The new rules will sharply reduce the maximum cash value accumulations allowed inside exempt insurance policies.

Tax considerations under the current rules …

At present, when you buy a permanent life insurance policy, all the income earned within the policy is non-taxable. Many fixed-income products purchased for personal investment reasons (like bonds or guaranteed investment certificates ("GICs")) get taxed by as much as 50 per cent.

… versus standard investments via a corporation

Making investments in a corporation often carries a tax break of some sort, but there's no real advantage when you buy fixed income investments like GICs through your corporation, where the income can be taxed at a rate of 46.17 per cent.

Participating permanent life insurance (often called "PAR") enjoys favourable, tax-free treatment. With this kind of policy, the base insurance protection is guaranteed as long as the premiums are paid when they become due.

Current advantages of permanent life insurance

PAR policies provide the opportunity for tax-free cash value growth in addition to the

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peace of mind knowing your family is properly looked after financially. This tax-exempt growth appeals to high-net-worth individuals and their corporations.

'Participating insurance' funds

A handful of Canadian insurance companies have introduced participating insurance funds, basically a type of fixed-income asset. Instead of paying tax on the growth, you can put money into these policies and eliminate your tax on growth going forward.

Participating insurance meets different needs than life insurance

Many of the people who look at this type of insurance have already bought life insurance in sufficient amounts to provide for their families when they pass away. They are using these policies as alternatives to fixed-income investing, strategic diversification of assets, or transfer of wealth to future generations on a tax-exempt basis.

Case study: Focused on growth for estate planning

A recent case: A couple in their early fifties, own a successful business and have accumulated substantial wealth in their company, more than they need or will be able to spend in their lifetimes. They are in fact, the stewards, or custodians, of that extra wealth for future generations.

Most of the "never-spend" money is invested in a variety of safe places: GICs, government bonds and first mortgages. They earn substantial income from that portfolio every year, but they also have to pay tax on that income each year. It makes more sense for them to move a portion of those assets into exempt status and thus increase their estate.

If they put $2.5 million into a taxable GIC, growing at four per cent annually, they could cash out the GIC at age 90 and give the money to their beneficiaries—with an accumulated value of $4,077,729.

Two very different levels of returns: Insurance policy versus GICs

Instead, by transferring the same $2.5 million into an insurance policy, at the rate of $250,000 annually over the next 10 years, their beneficiaries would receive $14,393,907 net when the couple turned 90. The difference is more than $10 million. The equivalent rate of return you would require in the taxable fixed-income environment is 10.13 per cent. This strategy delivers positive equity returns with fixed-income risk.

What insurance can do that GICs can't

The exponential growth is easily explained: the benefits are tax-exempt. In addition, the participating plan has a cash value that grows over the years and can be easily accessed at any time, before or after retirement.

This long term strategy is ideal for younger people too because the cost of insurance is much lower for young people, they are healthy and qualify more easily, and will hopefully have several decades to build up substantial tax-exempt funds. This is an easy way to safely diversify an estate plan for parents and grandparents.

Making use of an 'immediate financing arrangement'

This strategy is of special interest to business owners who use what's known as an "immediate financing arrangement" (or "IFA"), a method of building wealth and protecting it against creditors, while reducing the carrying cost of life insurance.

Business owners with a portion of their wealth in cash get a higher return on their money by putting it back into their own businesses, real estate or equity markets compared to the rate of return on a policy.

How an IFA works

Using an IFA, a business owner can buy a participating life insurance policy, either personally or through his or her corporation. The minimum IFA premium is usually around $100,000 per year. In this scenario, the corporation borrows money from a financial institution using the cash value in the policy as collateral. The policyholder with a policy in force makes a deposit into it and then leverages it to the bank for the cash value. By pouring the "borrowed" money back into the company, the business owner gets ready cash and important interest deductibility.

The IFA provides life insurance protection and preserves cash flow for investment. The loan interest as well as the insurance premiums may be deductible and loan repayment can be deferred until death.

At that time, the death benefit proceeds retire the outstanding loan balance and the remaining proceeds are paid to beneficiaries. The net result can be a return to the business owner of more than 20 per cent annually in contrast

to about 10 per cent described earlier without financing.

IFAs aren't for everyone

This insurance tactic is not for everyone. High-net-worth business owners should have a comfort level with leverage to make this work. Real estate investors, especially those who are asset rich, are often more comfortable with this leverage financing idea than others.

Not all policies will be grandfathered under the new rules

Historically, these kinds of changes to life insurance policies are grandfathered, so anyone who owns a current policy, or buys a policy before 2017, should have no problem retaining the policy's tax-exempt status.

The new legislation contains certain triggers that can remove the grandfathering status even if you bought the policy years ago. For example, life insurance coverage added to the policy with underwriting that occurs after 2016 will not qualify for the grandfathering benefit.

Beyond your principal residence, there will soon be only two remaining places to keep and grow your money on a tax-exempt basis: Registered Retirement Savings Plans (or "RRSPs") and Tax-Free Savings Plans ("TFSAs"). It's worth noting that RRSPs should be more accurately described as "tax-deferred": you certainly do pay tax, but not until you take your money out, at which point you lose almost half to taxes.

There's limited time left to access these tax-exempt policies

Until 2017, a participating permanent policy offers compelling benefits and tax advantages. With the help of an experienced insurance and estate planning professional, you too may be able to capture those advantages before they are gone for good. ❐

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