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TAXSTRATEGY

Immediate Financing Arrangement

Leverage and Life Insurance

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We have all been taught nothing in life is free. There is a cost to everything. Sometimes the cost is extremely low. That is the case with leverage and life insurance.

Most people who buy life insurance are unaware of tax-effective leveraging strategies that can allow them to protect and grow their wealth cost-efficiently while enjoying tax deductions.

Many of our clients use the leveraging strategy to acquire their life insurance. Simply put, they pay the premiums and immediately borrow back those funds. This allows them to get life insurance at just a fraction of the true premium cost, without reducing cash available for their use. As a result, they enjoy tax benefits and increase their estate values.

When asked, most people would prefer to tie up as little of their cash as possible on life insurance premiums. They would like to have access to the money allocated to insurance premiums for use in other places, like a business or investment portfolio that will reap profits for them.

The cash surrender value (CSV) that builds in an exempt whole or universal life insurance policy can be used to reduce your net, out-of-pocket costs to buy a policy. This allows you to keep your money, in the form of borrowed premiums, working for you in whatever investment you choose. This doesn't mean the insurance is totally free, but it is a way to keep your money working for you in the investments of your choice.

How it works

It all happens through a premium financing strategy called an Immediate Financing Arrangement (IFA). With the IFA, you use your insurance policy as collateral for a line of credit with a Canadian bank or life insurance company. The money from the loan can go into your business or property to produce income.

Every year, you would pay interest on the line of credit, using the collateral insurance deduction and the interest expense as tax deductions from your current income. Any of the tax savings obtained from the deductions helps to reduce the outstanding balance on the line of credit. When the cash value of the insurance policy grows, the borrowing limit on the line of credit also increases.

During this time, as you pay the ongoing premiums for the life insurance policy you are eligible to borrow back as much as 90% of the CSV and up to 100% with sufficient collateral.

Using the line of credit enables you to inject the capital into cash flow, acquisitions, investments and other business purposes.

Repaying the IFA Loan

The outstanding loan can be repaid in several different ways. Both individuals and business owners can repay the loan as their income grows and cash flow increases. It can also be repaid when the insurance policy death benefit is paid out (when the life insured passes away) and any remaining proceeds get paid out to beneficiaries.

Within prescribed limits, the cash value that builds in the policy is only subject to income tax when withdrawn. As with all insurance policies, the policy remains in force as long as premiums continue to be paid.

If you re-invest the loan pro-

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ceeds back into your business or investment portfolio and get taxed at the highest marginal rate, you can claim some of that interest as a deduction on your tax return.

A corporate IFA can also increase the size of your company's Capital Dividend Account. This account tracks certain tax-free surpluses that are accrued by a private corporation and may be distributed in the form of tax-free capital dividends to the shareholders of the corporation.

90% or 100%

There are two general structures for IFAs, depending on how much of the CSV is leveraged. For example, many business owners opt for a 90% strategy, in which they borrow 90% of the CSV of a policy, creating a rapidly increasing borrowing capacity over time. The disadvantage with using the 90% strategy is that you would have a substantial funding requirement during the first few years of the policy.

If you want to borrow back all of the premiums, you will be asked to provide additional acceptable collateral security. This might be satisfied by a letter of credit from one of Canada's chartered banks, a mortgage on specified residential real estate, collateral assignment of an investment portfolio or other assets. Making this move will increase the rate of return of the IFA.

Bear in mind a potential risk. The value of the additional security could fall or disappear altogether, depending on the quality of the security, the economy, and other factors.

Company owned

Here's a recent client example: A successful entrepreneur knew that he needed a substantial amount of permanent life insurance but was unprepared to take the money out of his business to pay the premiums.

He was earning close to 25 per cent on the funds used in his business, so he was understandably reluctant to reduce his income to buy life insurance.

We arranged sufficient life insurance coverage and structured an IFA that covered 100% of the insurance premiums. He continues to invest his own money in his business, not insurance premiums. The effective net cost of his life insurance is the tax-deductible interest cost only, and amounts to less than 4% of the true premium.

Estate Planning

While IFAs can be an ideal tool for business owners, they can also be integral to increasing estate values as part of your planning strategy.

Dr. R. bought a permanent life insurance policy, owned by her corporation to create an estate for her children. The doctor and her husband plan to use the annual loan proceeds to fund the mortgage payments on a multi-residential investment property, which required an investment of $900,000 – more than the total value of the CSV.

As it happened, the couple owned another permanent life insurance policy with a significant CSV that they were able to assign as additional collateral security and receive 100% IFA funding.

Always remember that future changes to tax rules are always possible. Leveraging arrangements are generally flexible enough to permit clients to react to any changes, but this issue requires a thorough review by a professional. The potential for changes in tax and lending practices could limit the ability to receive tax-free loan advances in the future.

Leveraging isn't for everyone and may not be the best option for you.

If you are considering an IFA, you will have to qualify for this program through an insurance medical and financial underwriting.

The IFA can be an ideal solution if you have been turned off at idea of paying monthly premiums for life insurance and favour using your money for business purposes. Its an efficient mechanism that can improve cash flow, provide access to cash, and carry tax-free benefits for your family and other heirs.

IFA strategies are not new, but they need to be developed ahead of time by experienced professionals who can help you determine which financial institution is best for you. Some lenders have set minimum loan amounts, while others may have stipulations on how the IFA proceeds should be invested. As well, a policy loan will be considered a disposition of assets and could trigger taxes if the loan exceeds the adjusted cost base of the policy. Use an expert to help you navigate the process.

Don't do it yourself. Seek professional help. The best way to get financial peace of mind starts with advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner. ❒

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