The TaxLetter®

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ESTATEPLANNING

Preserve Your Wealth

Use Virtual Real Estate

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I have been in the financial services arena for close to 30 years now and am lucky to count successful business owners, entrepreneurs and high-net worth families as my clients, many of whom are asset-rich in the areas of real estate and private equity.

Over the last few decades they have slowly but surely built up valuable portfolios comprised of real estate, businesses, or other investments that have matured. Sometimes they have assembled considerable interests in all three, and soon many of them will be looking for some sort of exit strategy.

Wise businesspeople know that they have to take defensive steps to ensure that the fruits of all their hard work don't get consumed by taxes. Like most people, they want to keep more of their money to give to their families and charities rather than give to the Canada Revenue Agency (CRA).

Many people with healthy portfolios of $50 -$100 million feel quite confident in their financial futures., But they don't realize that once the estate taxes are paid, their $50 million that now looks like a summit in the Rockies might end up looking more like a big ski hill.

If you have a $50 million real estate portfolio that originally cost $10 million, you are 'pregnant' with a $40 million gain that will be subject to a tax of 27% (in Ontario). At death, your estate will have to come up with approximately $10 million dollars to pay those taxes.

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Make It a Strategy Not a Tragedy

There are, thankfully, a few options available to pay those taxes.

Option 1: Use cash. Even the wealthiest people I know don't keep millions sitting around in cash, not invested, unused, and not making anyone any money. In real estate, for example, those who are most successful have an asset, grow the equity of that asset and then refinance it to buy more real estate. The same goes for those owning business/private equity.

Option 2: Borrow. Who would your family borrow from and what will the interest rate be? That interest expense will not be tax deductible. Of course, the debt must eventually be repaid, and no one can accurately predict market conditions.

Option 3: Sell the real estate, sell the business, or liquidate other assets. While I say that's an option, it's more tragedy than strategy if your family must go that far. Even if that drastic measure is a potential way of dealing with the tax issue, what kind of real estate will they sell? Will it be a good time to sell? Will your business be worth 100 cents on the dollar if you are not around? The whole idea of this option is so antithetical to how you have been investing in real estate or your business. Selling your business or real estate to fund a tax liability is like selling the cow that's been producing milk for you for years.

Option 4: This method is likely the least expensive way of handling the issue: using tax-exempt life insurance. Now don't be put off by the fact that it's insurance. You may be like many people who see insurance as a kind of "grudge" purchase, like paying the premiums on car or home insurance, they feel forced to do it and feel they rarely receive anything for it. Those people know what life insurance is, but no one has explained what it can do.

In this case, we are talking about the use of permanent insurance, which can become an asset rather than an expense. Real estate investors can use the embedded cash surrender value of their permanent insurance as collateral to borrow against and use the proceeds to invest in more real estate or their business., When doing so, they can often deduct the interest costs.

As you know, there are few tax-exempt products left in Canada – your personal residence, lottery winnings (good luck), your TFSA – and life insurance.

Please know that the insurance we're talking about here is not term insurance that increases in cost every 10 or 20 years and eventually expires. Term insurance is like renting a home or an apartment: you get the use of it while you pay and live there but once you leave you have no equity to take with you.

There are two major components of permanent life insurance. There is, of course, the death benefit, which in real estate parlance, can be considered the future "market value." There is also the cash surrender value that we can equate with the current "equity" value. Over time, contributing to an insurance policy not only builds up your market value but also the equity value.

It's Virtual Real Estate

If used properly, this life insurance can be used as a tax-effective way to accumulate passive wealth inside a company, enjoy access to that wealth and transfer it tax-effectively to surviving beneficiaries.

Many of our clients use a leveraging strategy to acquire their life insurance. Using what's known as an Immediate Financing Arrangement (IFA), you can use your insurance policy as collateral for a line of credit with a major Canadian bank or life insurance company bank like Manulife Bank. The proceeds from the loan can go back into your business or into investment property to continue to produce income.

This means your money keeps working for you in whatever qualified investment you choose – including real estate. And since you are borrowing to invest, you can generally deduct the interest and the lesser of the annual premiums and net cost of the insurance (NCPI) associated with the policy, which can increase over time.

The IFA can be set up personally or corporately, although doing it on a corporate level has many distinct advantages.

So for example, if you contribute $100,000 per year as a deposit for a $5-million joint last-to-die life insurance policy needed for estate tax purposes, you can use the policy cash value (and likely some other collateral) to borrow back the $100,000 – money that can be invested back into your real estate portfolio or business.

Immediate Financing Agreement

While IFAs are great for business owners, they can also be part of your planning strategy and a key to increasing estate value.

Take for example the case of Dr. R. who bought a permanent life insurance policy owned by her corporation to increase the value of her estate for her children. The doctor and her husband plan to borrow against the policy and use the annual loan proceeds to fund the mortgage payments on a multi-residential investment property. It required an investment of $900,000, more than the cash surrender value.

As it turned out, the two owned another permanent life insurance policy that did have a large cash surrender value. They were able to assign this as additional collateral security and increase the amount that may be borrowed under the IFA.

The IFA can be the perfect solution for you, but it needs the support of experienced professionals who can help determine which financial institution is best for you. Some lenders have set minimum and maximum loan amounts, while others may have rules on how the IFA proceeds should be invested.

Now, leveraging isn't for everyone and it may not be the best option for you. We have found that it is best suited for an individual who:

1. Has embedded capital gains taxes and will need liquidity at death
2. Is comfortable with the use of

leverage/borrowing

3. Has a suitable place to invest their money with anticipated return on investment
4. Has the ability to deduct interest personally and/or corporately
5. Is healthy

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

A properly structured IFA takes time to develop and we suggest you seek professional advice to navigate the process and get the financial peace of mind you deserve.

One size does not fit all, and there's no cookie-cutter solution for every TaxLetter reader. This article, limited by space considerations, does not present many additional strategies available to meet your needs.

Our team of experienced advisors is available to help you across the country. Contact us for a no-obligation consultation. ❑

Please visit our new website WEALTHinsurance.com

Watch "The New Philanthropy", my recent "Ted Talk" at Moses Znaimer's ideacity conference http://bit.ly/MarkHalpern

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Mark Halpern is one of Canada's top life insurance advisors, a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) and CEO of WEALTHinsurance.com®.
He guides successful business owners, who are already challenged for time, through the complex process of ensuring the people and organizations they care about are taken care of.
If you are like his other successful business owner clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Incompletions rob us of energy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His approach is simple. He makes sure what is important to you gets done. He gets you organized, provides a big picture view of your financial affairs, determines your strategy and helps you take action. He will simplify the complicated, so you and your family can rest easy. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com.
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