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ESTATEPLANNING

The Hidden Benefits of Life Insurance

Get Life Insurance and pay less tax

Mark Halpern, CFP, TEP, MFA-P

In my 31 years of professional practice, I've had the good fortune of helping many successful business owners, entrepreneurs, incorporated professionals, and affluent families. A lot of my work has included collaborating with their allied professionals specializing in accounting, tax, insurance, investments and law. What has been my single biggest takeaway? Everyone knows what Life Insurance is, but very few people know what Life Insurance really does.

They mistakenly believe that Life Insurance is only there to replace income, pay off a mortgage, keep food on the table for their families, and protect their kids' ability to get a good education. At the start of their careers, it was a necessity, much like car insurance or property insurance – but now that they've made it, they say it isn't important.

What most people don't know is that Life Insurance is an extremely flexible tool that complements all the other financial planning strategies they have in place. It has myriad applications, especially for people who have wealth to protect and are interested in creating a legacy for their families and the charitable causes they support.

This article illustrates just a few of the many ways that Life Insurance can be leveraged to support two key goals shared by many high-net-worth individuals – to pay less tax and leave a bigger legacy. I'll use a typical client example, but keep in mind that each of these strategies can be customized and targeted to achieve very specific objectives.

Mark Halpern is a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP), Master Financial Advisor - Philanthropy (MFA-P) and one of Canada's top life insurance advisors. He is CEO of WEALTHinsurance.com® and illnessPROTECTION.com®, with special expertise for business owners, entrepreneurs, medical professionals and high-net worth individuals and their families. He can be reached at 416-364-2929, toll-free at 866-566-2001 or mark@WEALTHinsurance.com.

From success to significance

Bob and Cindy built a thriving business from the ground up. They are 63 and 60, with four children and eight grandchildren. They are pillars of their community and support their local hospital and various other charitable causes.

Their net worth of more than $120 million consists of real estate investments and corporate assets. Their current planning includes a very generous (and unintentional) tax liability of $25 million, due after the second spouse dies. That bill can be funded in several ways. Three of the most common are:

☛ Using cash on hand – though this would require $41.2 million in pre-tax cash from the corporation, assuming the eligible dividend tax rate of 39.34 percent.

☛ Borrowing - but an estate may struggle to access that much credit, and high interest rates may take a big bite out of inheritances. As well, the interest is not deductible and the loan must be paid back.

☛ Selling assets - most people don't want to risk a "fire sale" that doesn't provide fair market value, as well as the fact that there are many additional tax consequences when assets are sold.

Fortunately, there is a fourth and better option. Dedicating a Life Insurance policy to the task of paying estate taxes, which is usually much less expensive and more tax effective. Life Insurance, when corporately owned, can be paid for with cheaper after-tax corporate dollars. It also provides a mechanism for getting money out of your corporation tax-free through the capital dividend account (CDA).

Four ways Bob and Cindy can use Life Insurance to pay estate taxes – and more

1. Cover the tax bill.

Purchasing a $25 million Life Insurance policy will take care of the taxes for a lot less than doing nothing. Funding options include an annual premium of $334,592 payable for life, an annual premium of $372,935 payable to age 85, or an annual premium of $675,000 payable for 10 years only. The highest amount this couple could pay after 10 years is $6.75 million – vastly less expensive than $41.2 million.

2. Cover the tax bill with financing.

It's also possible to acquire a $25 million Life Insurance policy in a manner that's cash flow neutral, using the Immediate Financing Arrangement (IFA) strategy. A policy's cash surrender value (CSV) is welcomed as security by all Canadian chartered banks. If Bob and Cindy are comfortable with financing, they can pay the premiums and immediately borrow back up to 100 per cent of the premiums paid, and invest the loan proceeds.

Because the money gets invested, they can deduct the interest expense. This arrangement can be structured in a cash flow neutral manner, and their estate still receives the full $25 million to take care of the estate taxes. If the insurance policy is corporately owned, their corporation receives an additional Capital Dividend Account (CDA) credit of $24.8 million, allowing a future tax-free withdrawal of $24.8 million for the next generation.

3. Cover the tax bill and maximize charitable giving.

We are dealing with a very community-minded couple who want to leave a significant charitable legacy. They can leave a big gift, at the same time eliminating estate taxes. By buying a $50 million Life Insurance policy at a cost of $1.3 million annually, the total cost will only be $13 million, payable over 10 years. At death, the estate will receive the money and donate it to the couple's charitable foundation – generating a $50 million tax credit that mitigates the estate taxes and turns it into charity instead.

4. Cover the tax bill and maximize charitable, with financing.

This strategy can also be made cash flow neutral. Just as in strategy number 2 above, Bob and Cindy can pay the premiums and immediately borrow back the policy's CSV, invest that money, and deduct the interest expense. In this case, the charity receives the full $50 million, entirely offsetting the estate taxes. Again, assuming this is a corporately owned policy, the corporation gets an additional CDA credit of $49.7 million.

5. Generate cash flow for a charity with the GiftMAXIMIZER™ strategy.

People think that Life Insurance only provides a benefit when the insured dies. But there are actually two ways to benefit from Life Insurance for charity while the insured is alive! We call this the GiftMAXIMIZER™ strategy.

Our generous couple can donate, for example, $500,000 annually to their foundation, Donor Advised Fund or directly to a charity for 10 years. Their total net cost after the annual charitable donation tax credits amounts to $2.5 million. The foundation can use the funds to pay premiums on a joint last-to-die Life Insurance policy. Dividends paid out from permanent Life Insurance are usually used to buy Paid up Additions, which increase the death benefit and CSV. But the dividends can be taken out as cash dividends and given to charity every year tax-free.

Starting as early as the first year of the policy, the charity can begin to receive annual tax-free cash dividends. But waiting until year 10 means that those dividends won't reduce the legacy gift on death. At that point, the charity can begin to receive annual tax-free cash dividends that start at $162,000 and increase annually until the second spouse dies.

In the end, in exchange for a net investment of $2.5 million over 10 years, the charity could receive $5 million of annual dividends and a substantial legacy gift on death of $7.7 million in insurance proceeds. That's $12.5 millions of charity at a cost of $2.5 million.

Much more than income replacement

We meet many people with great advisors working to build customized financial, tax and estate plans for them. But it's a rare client who has a coordinated team working to implement the most effective strategies across every discipline.

We love to collaborate with other specialists, including accountants, lawyers, investment advisors, family offices and insurance advisors. Doing so allows us to share our expertise in personal and business insurance, estate planning and philanthropic planning, and help clients achieve their unique goals.

Get Professional Help

Don't go it alone. Get the benefit of experience and knowledge from a team of seasoned insurance professionals who can assess your needs and suggest appropriate strategies. Simply getting insurance in place isn't enough. Get the right types of insurance in the right amounts, with the help of professionals who will be there to advocate for you in the event a claim is made. ❑

Mark Halpern is one of Canada's top life insurance advisors, a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP), Master Financial Advisor-Philanthropy (MFA-P) and CEO of WEALTHinsurance.com

He guides successful business owners, professionals, and affluent families through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy.

Mark collaborates with your professional advisory team to achieve your desired outcomes. His simple approach makes sure what is important to you gets done. He will suggest appropriate strategies to get your financial affairs meticulously organized, help you take action, and simplify the complicated so you and your family can rest easy. Mark can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com

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-Executor Duties Checklist

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