LIFE INSURANCE

Not All Assets Are Created Equal*

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Introduction

There are very few decisions that can have such a profound effect on family legacies, business succession and financial wellness for generations to come, as deciding to buy life insurance. Life insurance – of the kind where there are associated cash values – is a most unique financial instrument. It is both a risk management and wealth accumulation tool.

For many private business owners and high net worth families, life insurance can be an ideal estate planning tool to fund tax liabilities arising on death, to assist with succession plans, for estate equalization between children and second families, and for charitable gifting. As a risk management tool, it may allow a business to continue in the event of the death of the owner. For these same individuals, life insurance can also form part of their investment portfolio with the cash surrender value of a policy becoming an integral part of their net worth or corporate balance sheet.

Although life insurance provides funding for many estate and succession planning issues and opportunities, these are not in the scope of this article and will not be discussed. The purpose of this article is to explore the decision-making process used to determine the desired level of cash value in a life insurance contract and to consider how the accumulation of significant cash values may complement a more traditional investment portfolio.

* The information provided is based on current tax legislation and interpretations for Canadian residents and is accurate to the best of our knowledge as of the date of publication. Future changes to tax legislation and interpretations may affect this information. This information is general in nature, and is not intended to be legal or tax advice. For specific situations, you should consult the appropriate legal, accounting or tax expert.

Initial Considerations

When determining whether to purchase an insurance policy and maximize its cash values, clients should ask questions such as:

- What types of investments do I currently have in my portfolio?
- Do I want to diversify my risks?
- What are my rates of return expectations – in the long and short term?
- What is my opportunity cost of buying insurance versus another financial vehicle?
- How much market risk or volatility can I handle?
- Do I want to include market risk in my insurance products?
- What guarantees are offered by the contract?
- Is liquidity important? Will I need to access the cash values, and if so, how soon?
- How long do I want to be paying for my contract?
- How much flexibility do I require?
- What is the tax treatment of the various investment options under the contract?
- Are there specific ways that I can maximize the tax benefits of the contract?
- Who will manage the investment decisions? Do I want to be actively involved?
- Who should own and pay for the contract? Myself, a corporation or a trust?
- Is creditor protection important to me?
- What are the costs associated with accumulating a larger cash value?
- Whose life should be insured? When do I require a death benefit?
- Do I require or want a growing death benefit?
- Am I or my other family members insurable?
- What is the financial rating of the insurance company?

The answers to some of these questions may be less clear for high net worth individuals and families as they often may not need

life insurance in the traditional sense, but rather want it as a complement to their estate planning.

In addition, their family situations can often be dynamic and continuously changing, so it may be difficult to forecast what their financial goals will be in 10, 20, or 30 years. There are also many competing uses for their cash, particularly when dealing with family businesses and private business owners. In addition, the choice to "buy term and invest the difference" is ever-present.

The choice of investments within life insurance contracts has expanded substantially over the past decade. Universal life contracts include both guaranteed interest accounts and accounts that credit interest that is linked to most major market indices and in many cases to a number of mutual funds. On the other hand, in the case of participating life insurance policies, the assets of the participating fund backing those policies – typically, fixed-income type investments predominate – are professionally managed by or on behalf of the issuing insurance companies themselves. Clients cannot purchase specific securities, or invest in private investments within either type of contract. However, many high net worth clients may ultimately use the cash value accumulated in their contract as collateral to purchase other investments.

Regardless of the type of insurance contract and investment accounts selected by the client, the decision of high net worth individuals to deploy a portion of their wealth into a life insurance contract may often be influenced by one or more of the following:

- the tax-deferred growth of the cash surrender values;[1]
- the ability to create a capital dividend account (if the beneficiary of the policy is to be a private corporation);[2]
- the ability to access the cash surrender values in a tax-efficient manner, if required; and
- the possibility of obtaining protection for the policy, and its values, against creditors.[3]

Each of these considerations is discussed in more detail below.

Advantage #1 – Tax-deferred Growth of the Cash Surrender Values

The growth in the cash value of an insurance contract may be exempt from annual accrual taxation under Canadian income tax legislation, if all the requirements for exemption are met. Generally, the cash value of an exempt life insurance policy will only be taxed if part or all of it is withdrawn from the policy.[4] Over an extended period of time, the values in the contract may grow considerably without attracting income tax.

For high net worth individuals who are taxed at the highest marginal rates, this can result in a significant tax saving compared to other investments, especially when the alternate investment is a fixed income investment that is subject to annual taxation. For example, when comparing the accumulated after-tax returns of a fixed income investment over a long period of time to a participating insurance policy (the assets backing the policy are predominately in fixed income investments), the effective returns under the life policy can be surprisingly higher – both from an estate planning perspective and also from a living net worth point of view.

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[1] An "exempt" insurance policy as defined in Regulation 306 is not subject to accrual taxation by virtue of paragraph 12.2(1)(*a*) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] Capital dividend account is defined in subsection 89(1) of the Act.

[3] For the statutory basis of such protection, see the provincial Insurance Acts.

[4] Subsection 148(1). See, also, the definition of disposition in subsection 148(9).

	Insurance *	Traditional Investment	Percentage Enhancement
Cash Values at age 85	$3,450,000	$2,400,000	44%
Estate Values at age 85	$4,900,000	$2,400,000	104%

* Based on a joint and survivor life insurance policy on a male age 60 and a female age 60 both non-smokers and standard risks. The basic death benefit is $2,255,000 and the current policyholder dividend scale is assumed. The annual premiums are $100,000, payable for 15 years and the policy dividend option is paid-up additions. The traditional investment is an interest earning investment yielding 5% pre-tax annually. The personal tax rate on the investment income is 45%. Policy values are dependent on future investment returns and other factors that affect policyholder dividends and are not guaranteed. This example is not complete without the life insurance company illustration including the cover page, reduced example and product features pages having the same date. Insurance cash values shown represent pre-tax values accumulated within the policy.

For this reason, many high net worth clients choose to substitute an exempt insurance contract for their fixed income investments or cash holdings. The accumulated values may be accessed in a variety of ways and their tax treatment is discussed below. If the policy values are retained until death and are paid out as part of the policy's death benefit, those cash values can be paid out and received on a tax-free basis.

The favourable tax treatment of insurance contracts is magnified in a corporate ownership setting where the corporate tax rate applicable to passive investment income is quite punitive. For this reason, many private business owners who have accumulated substantial capital in their private corporations choose to transfer part of the corporate investment portfolio into life insurance, where the deposits not only benefit from the tax-deferred growth of the cash values, but also from the capital dividend account mechanism (see below).

Advantage #2: the Capital Dividend Account

The creation of a credit to the capital dividend account is a significant income tax advantage to private corporations receiving life insurance proceeds. The capital dividend account mechanism is one of the few ways, under current tax legislation, to "unlock" funds from a private corporation and let the funds flow tax-free to the shareholders. Briefly, the death benefit is received tax-free by the private corporation and at the same time the capital dividend account of the corporation is increased. The capital dividend account credit is equal to the death benefit less the adjusted cost basis of the policy.[5] The directors of the private company may declare a tax-free dividend to the shareholders for an amount up to the capital dividend account.[6] The capital dividend mechanism can amount to an income tax savings of up to 30%,[7] depending on the province of residence of the shareholders.

For comparative purposes, a traditional interest-earning investment owned in a private corporation must earn approximately 13% before tax to provide the same amount to a shareholder's estate after personal dividend taxes have been paid. For this reason alone, it

[5] Supra note 2.

[6] Subsection 83(2).

[7] Based on a joint and survivor life insurance policy on a male age 60 and a female age 60, both non-smokers and standard risk. The basic death benefit is $2,255,000. The annual premiums/deposits are $100,000 payable for 15 years and the dividend option is paid-up additions. The corporate income tax rate on the interest income is assumed to be 48% annually and the refundable dividend tax on hand rate is 26.67%. Refundable dividend taxes are refunded at a rate of $1 for every $3 of dividends paid. The personal tax rate on dividends received from the private corporation is 30%. Values in the insurance contract are dependent on future investment returns and are not guaranteed.

is difficult for other corporate investment vehicles to compete within the same investment risk profile.

It is anticipated that corporately-owned life insurance will become more commonplace, especially if the small business deduction continues to increase, and as more business owners accumulate capital within their private corporations and look for ways to maximize the growth of that capital.

Advantage #3: Accessing the Cash Surrender Values

The third advantage of insurance is the ability to access the cash surrender values during an individual's lifetime. For many high net worth families, it is unlikely that they will need to access the funds, but it is important to understand both how they can be accessed and the liquidity of such cash values relative to other portfolio holdings. Life insurance should not be considered a short-term investment vehicle (indeed, there should be an ongoing insurance need) given the costs of setting up the contract and the surrender charges that exist in many contracts. To maximize the overall returns in a contract, it is worthwhile emphasizing that life insurance is best left untouched and used as an estate planning tool. Having said that, clients can also supplement their retirement income with the cash values within their policy, and/or access those values to provide cash for other purposes (e.g., to redeem preferred shares or to help purchase another asset or business).

There are three ways to access the values accumulated within a contract: (1) surrender the contract all at once or over time; (2) take out a policy loan from the insurance company; or (3) leverage the contract by using it as collateral for a loan with a third party institution. The first two options are considered a disposition of all or part of the contract and can create a tax liability.[8] To avoid this potential tax liability, many high net worth clients look to the third option of borrowing to access the values even though it has the usual risks associated with any leveraging arrangement.[9]

[8] Supra note 4.

[9] Paragraph (*f*) of the definition of "disposition" in subsection 148(9) specifically excludes the assignment of an interest in the policy to secure a debt or loan (other than a policy loan).

Advantage #4: Creditor Protection

The last advantage – which should not be underestimated – is the ability to make a "preferred" beneficiary designation, which involves naming a beneficiary in a prescribed "family class" relationship to the life insured (or in the case of Quebec, to the policyowner). If the beneficiary of the policy is in such a family class relationship (or if the beneficiary is named irrevocably), then under provincial and federal law, the ability of a creditor of the policyowner to seize or realize against the policy or its benefits may be restricted, or even precluded altogether (subject to conditions, e.g., the designation is not done to evade present creditors). This can be an important feature, especially in the case of personally owned policies, in a time when many corporate directors are increasingly subject to personal exposure, and private business owners are seeking means to protect some or all of their investment savings, given their personal guarantees and the uncertainty of their succession strategies. The preferred beneficiary election can be a simple asset protection feature and does not come at any additional cost, as do other asset protection tools, such as trusts or offshore structures.

In the case, however, of corporate-owned life insurance, designating a beneficiary other than the corporation may not be practicable or advisable, for other reasons.[10] However, in these circumstances, it may be possible to establish a holding company to own the insurance and obtain creditor-proofing advantages.[11]

In the case of personally owned life insurance, having a beneficiary other than the estate of the policyowner may, as discussed above, protect the life insurance death proceeds from creditors of the estate and (outside Quebec) reduce probate fees. Since probate fees are calculated based on the value of the estate assets, if life insurance proceeds are paid to a named beneficiary other than the estate, the value of these proceeds will not be included in the estate assets. The savings in

[10] For example, this may result in the assessment of an employment benefit under section 6 or a shareholder benefit under section 15 of the Act.

[11] For Quebec, the beneficiary would have to be an irrevocable beneficiary, since there can be no "family class" relationship between the corporate owner and the beneficiary.

fees could be as high as 1.5% of the asset value at death in some provinces. Other estate fees based on the aggregate value of the estate will also be reduced if there is a beneficiary other than the estate of the deceased.

Conclusions

Life insurance is often overlooked as a financial tool by traditional investment professionals. For many high net worth families who have exhausted their onshore tax-planning opportunities and do not want the complexity or costs of pursuing offshore structures, life insurance can provide access to both asset protection features and tax-deferred growth. When deciding between various assets to deploy their wealth, clients should evaluate life insurance like other investment opportunities, and its pros and cons weighed relative to other uses of cash. Not all assets are created equal – some are liquid, others are invested for the long term, some have risk, some have guarantees, some have preferential tax treatment, others are highly taxed, some have built-in asset protections, some provide annual cash-flows, and others are designed to payout in the long term. Life insurance is specifically designed for its estate planning benefits, but the investment aspects should not be ignored or underestimated.

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