

LIFE INSURANCE

Planning for the Next Generation

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Introduction

The worst misfortune that can happen to an ordinary man is to have an extra-ordinary father.

– Austin O'Malley, American Physician and Humorist

In the interest of serving a family, often the needs of the second and following generations are overlooked. This is easy to do when a Matriarch or Patriarch is a first generation wealth holder and the creation of the wealth has preoccupied them and their advisory team. However, we are seeing more and more families where the family wealth will clearly outlive the first generation and it is not a question of if the second generation will become wealth holders, but merely a question of when.

This article will discuss using life insurance in the interests of strategic wealth transfer to the next generation(s), as well as a governance and risk management tool.

The Need for Second Generation Planning

Once a Matriarch and Patriarch are at a point of “financial independence” and they know that their wealth has grown to a point that it is “bigger than them” – a plethora of planning opportunities present themselves. Many of these families are counselled by their advisory teams to do an estate freeze. But how many of these families have looked at the estate planning needs of the next generation?

Many times, the insurance planning ends with ensuring there is enough coverage on the mom or dad to redeem the frozen preferred shares or fund their terminal tax liability. Good planning, but what about the tax liability

they have so thoughtfully deferred through the estate freeze? If the freeze included the creation of a family trust to own the new growth shares, then twenty-one years later, the trust will likely be wound up.¹ At this time, it is very likely that the second generation will suddenly inherit an accrued tax liability on these shares.² Twenty-one years is a short time horizon for families of significant wealth. Does the next generation understand this responsibility and all that it entails? Have their parents, in thinking they were doing a service to their children, done them an injustice? Is there more that should be done?

Insurance planning for this generation should start at the infancy of the estate freeze, while family dynamics are solid and parents can still take a leadership role. In twenty-one years, much can happen, siblings can have a falling out with the parents or amongst themselves, the family business can be sold, children can become uninsurable or become non-resident, mom and dad can divorce, and families will grow through marriage and births. A very dynamic time indeed.

Life insurance can play the role of chameleon and fulfill different needs at different times in the lifecycle of a family. For example, it can help fund the child's estate tax liability, once the shares have been rolled out of a family trust. Knowing that this liability is funded (even if only partially) can help ensure that family assets do not have to be sold or monetized. It can also help avoid a fire-sale of assets or a non-tax efficient withdrawal of capital.

With wealthy families, having life insurance can help address some restrictions imposed by matrimonial contracts. Future spouses can be named as a beneficiary of the life insurance policy, knowing they will not become financially dependent in an estate situation. It can even be one of the factors that helps ensure the share value stays in the family and no one is tempted to transfer shares

¹ This is due to the deemed disposition rule contained in subsection 104(4) 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 To avoid the deemed disposition rule, the assets of the trust will be distributed to the family beneficiaries on a rollover basis under subsection 107(2) of the Act.

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to a spouse simply to defer taxes on share values.³

Many family businesses also rely on insurance contracts to help fund “sibling buy-outs.” If the underlying asset is a family business, having the ability to buy out deceased siblings can alleviate the need to take on heavy debt burdens or worse, try to split the value of business between active and non-active children. If a life insurance contract has significant cash values that have had the benefit of time to grow in a tax-advantaged environment, the values can be accessed to fund a full or partial buyout.⁴ Ensuring that a unanimous shareholder agreement is in place that addresses these issues also goes hand in hand with the insurance planning.

As you can see, life insurance is more than just an income replacement tool, and can grow to take on a meaningful role for wealthy families in their wealth management and succession planning.

Practical Considerations for Insurance on the Second Generation

Underwriting

It is a commonly held view that good or reasonable health is the sole requirement in the purchase of life insurance. Although important, good health is only one of a number of factors reviewed by life insurance companies when considering a life insurance application. Other factors include financial underwriting (see discussion below), occupational

³ This is accomplished by taking advantage of the spousal rollover provisions in subsection 70(6) of the Act.

⁴ The cash accumulations within an “exempt” insurance policy are not subject to the annual income accrual rules by virtue of paragraph 12.2(1)(a) the Act.

duties, vocational pursuits, drug and alcohol consumption, driving record and foreign travel patterns. For this reason, it is possible for a healthy individual to be declined or rated for life insurance coverage, if some of the above are considered to create excessive risk to the life insurance company. When life insurance is purchased at a younger age, most of these factors (with the possible exception of financial underwriting) are non-issues. Therefore, a “standard” contract is often issued and will remain in force regardless of what type of avocations or lifestyle decisions the insured makes later in life.

Locking-in Rates at a Younger Age

By starting insurance coverage at a younger age, the insured is able to “lock-in” a contract at their current age pricing. The premiums for the same initial death benefit for a policy purchased at age 23 are less than a policy issued 10 years later. Also, with a permanent policy, the future cash values and future death benefits will typically be less on the policy purchased by a 33-year old than one purchased by a 23-year old despite the higher premiums at the older age. The examples that follow assume premiums are paid for 20 years:⁵

⁵ The product is a participating plan offered by London Life. The values include non-guaranteed values. The non-guaranteed values are based on the current dividend scale. Dividends are not guaranteed and will increase or decrease depending on future dividend scales. In this example, if the dividend scale was reduced by 25%, the death benefit of the policy purchased by the 33-year old at age 65 and 85 are projected to be \$2,628,000 and \$3,896,000 respectively. For the 23-year old, the death benefits at 65 and 85 respectively are projected to be \$3,532,000 and \$5,099,000.

	Age 23	Age 33	Difference
Initial Death Benefit	\$1,000,000	\$1,000,000	0%
Premium	\$21,445	\$27,414	27.8%
Death Benefit – Age 65	\$4,791,000	\$3,362,000	(29.8%)
Death Benefit – Age 85	\$7,551,000	\$5,463,000	(27.6%)

The benefit of insuring at a younger age is further enhanced in the circumstances where a policy is owned in a Canadian-controlled private corporation and the capital dividend account can be accessed.⁶ By delaying the purchase of this policy until age 33 and investing the related premium of \$21,445 for the first 10 years, then paying the higher premium of \$27,414 for 10 years, the corporation would need to earn over 9% annually before tax to provide the same benefit to the estate at mortality (age 85). This is a significant hurdle rate to overcome and there is no guarantee that the child would qualify for standard insurance rates 10 years later.

Net Amount at Risk Limits

As noted above, life insurance companies require financial justification for the amount of insurance applied for. This is no different for insurance on younger people. The insurance company needs to know details on the family/company structure and financial circumstance including estate/capital gains tax liabilities in order to validate the life insurance amount requested.

They will also take into account other policies that are in-force on the insured and may limit the new policy amount based on this information. They are also interested in the amount of insurance on the lives of the parents and often require one of the parents to own at least two times the amount applied for by the child.

When underwriting the policy, the company considers not only the initial face value but also the potential growth of the policy's net amount at risk ("NAR"). A policy's NAR is the difference between the death benefit of the policy and the cash value and will vary over time as the policy grows. Insurance companies look at the ultimate NAR, which is the maximum NAR that is reached over the life of the policy. In the case of the 23-year old referred to above, at age 83, the illustrated death benefit is \$7,228,000 and the illustrated

⁶The difference between the policy death benefit and its adjusted cost basis (as defined in paragraph 148(9) of the Act) is added to the corporation's capital dividend account (see the definition of capital dividend account in subsection 89(1) of the Act). A capital dividend is tax-free to the recipient by virtue of subsection 83(2) of the Act.

cash value is \$5,541,000. The net amount at risk in this case is \$1,687,000 (\$7,228,000-\$5,541,000).

In some cases, particularly when a policy is issued on a younger person, a policy will be issued with a NAR restriction (maximum allowable net amount at risk). This limits the exposure of the life insurance company and is based on its risk capacity available at the time of the application. Depending on world events (i.e., 9-11, the economic collapse of 2008), the maximum risk the insurance industry will accept can vary significantly. However, depending on the type of policy, once a contract is issued, the terms of the contracts are typically no longer negotiable.⁷

Each insurance company will view the application differently in terms of the amount of coverage that they are willing to offer and the level of premium required. It is often advisable to seek offers from more than one company to obtain the most suitable product and offer for the client.

Ownership Options

When dealing with multi-generational wealth, there are almost as many ownership options as there are family personalities. Ownership and beneficiary options need to be well thought out and flexible in order to deal with dynamic families. The three main options are: owned personally by the parent or grandparent, owned by an *inter vivos* family trust or owned in the family holding company.

There are a number of characteristics of a life insurance contract which differ from other financial assets that will affect the advisory team's decision-making. These include:

- The tax rollover available between parents and child (or grandparent and grandchild) in subsection 148(8). In particular, a life insurance policy on a child (or grandchild), initially owned by the parent of grandparent, can be transferred to the insured child (or grandchild) after the age of 18 for no consideration without triggering a disposition of the policy.

⁷Term insurance rates will increase upon renewal, whereas permanent policies typically provide guarantees that limit the insurance company's ability to modify the cost structure or guaranteed death benefit.

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This is an appealing feature to most parents/grandparents as they appreciate the ability to control the policy and pass it to their child/grandchild at an appropriate time, and at their discretion.

- The tax-deferred growth of cash values in a life insurance contract.⁸ Much like an RRSP, the cash value growth in life insurance contracts is not subject to annual accrual taxation. This means that cash values in a permanent, cash value life insurance contract can grow significantly over time. This is particularly appealing when the alternative is taxable investment assets in a corporation or investing in interest-bearing investments.
- The tax-free death benefit. Either owned personally, corporately or in an *inter vivos* trust, the death benefit, including any growth that is added to the death benefit, is received tax-free.⁹
- The creation of a capital dividend account, if the policy is owned in a private Canadian corporation.¹⁰ A comparable corporately owned traditional investment will be subject to annual accrual taxation and dividend tax of approximately 30% (depending on the province) upon distribution to the estate or future shareholders of the corporation.
- Insurance is not considered a capital asset in an *inter vivos* trust. This means that there is no 21-year deemed disposition imposed with resulting tax owing on the accumulated cash values in the contract.

- The ability to make the preferred beneficiary designation with a personally owned contract. This enables the owner to access additional creditor protection available under the provincial insurance acts, during the lifetime of certain specified family members of the life insured.¹¹
- The flexibility to change the beneficiary on a contract, as family dynamics and the needs of the second generation change over time.
- The next generations are also less likely to consume or cash in a life insurance policy, and this helps to create more longevity to a family's wealth.

Conclusion

As the baby boomers retire and businesses are sold, families are creating more liquid wealth than ever before. This wealth will soon begin to transcend the first generation and become available to children and grandchildren. Many of these families are searching for governance tools and financial structures to help perpetuate this wealth. Life insurance can be a financial cornerstone for the second generation and the generations after them. Families of significant wealth need to think in terms of 100-year investment timelines, and life insurance can be an important component in support of this thinking. It is a unique financial tool that is particularly suited to long-term inter-generational wealth transfer. The benefits of starting policies at a younger age are compelling and the uniqueness of life insurance can provide significant inter-generational financial benefits. This will be a sought after feature as trusts hit their 21st anniversary and the second generation is left to deal with significant capital gains tax liabilities.

⁸ Supra note 4.

⁹ See the definition of disposition in paragraph 148(9) of the Act.

¹⁰ Supra note 6.

¹¹ Refer to Barbara Lawrie, "Creditor Protection of Life Insurance Products Confirmed" (1994) 2 *Insurance Planning* 66.

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