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INSURANCE POLICIES OFFER ADVANTAGES

David Wm. Brown / November 1, 2009

For the majority of people life insurance is a product which is used to provide cash and liquidity at death.

The proceeds of the death benefit are traditionally used to pay off outstanding debts, such as mortgages or loans. And the cash serves to replace the lost earnings of the deceased. These proceeds allow the family to continue living in their home, make them debt free and give them an investable sum that can generate an income for living expenses. Insurance can also be used to create funds to pay capital gains tax liabilities.

In partnership or corporate scenarios life insurance may be used to satisfy obligations pursuant to provisions of shareholder agreements, to fund a purchase or sale in the event of a shareholder's death, or to provide capital in the event of a death of a key partner or employee. Life insurance might also be needed to pay off a corporate loan or for charitable bequests on the part of the company.

But there's another side to life insurance. Properly deployed, it also can be used as a tax-efficient and effective accumulation and savings vehicle. Many clients use the tax sheltered features of an exempt life insurance plan to accumulate income for retirement, for loan leveraging purposes, or to transfer wealth from one generation to the next.

Most life insurance policies in Canada are designed to be exempt contracts under the terms of the Income Tax Act. As such, income generated within the contract isn't subject to tax on an accrual basis. The Income Tax Act limits the amount that can be accumulated in the contract.

Based on an exemption test in Regulation 306 but despite this limitation, significant sums can be built up in most policies and situations. This concept of using life insurance as a component of an investment plan is particularly of interest to people who have maximized all their other tax-sheltered capabilities through plans such as RRSPs and TFSAs. It's also attractive to folks who appreciate the guarantees available through the contracts and the life insurance companies.

In an exempt life insurance contract, the policy holder can make deposits into the plan that are over and above the mortality cost and can accumulate in a tax-free account within the contract. (The policy owner can direct the type of investments based on options made available by the insurance company.)

Most of these investments are linked to fixed-income terms or mirror the performance of various mutual and segregated funds. The policy holder chooses the funds based on his or her investment and risk profile. These funds can be used to pay for the future cost of the insurance, buy additional

insurance, or accumulate cash that can be accessed by the owner for retirement, leveraging or wealth-transfer purposes.

One very popular and useful planning opportunity is the intergenerational transfer of a policy, which has accumulated a large amount in the tax-exempt account to a child or grandchild. When doing this, be sure to consider the rollover provisions of the Act in order to ensure the transfer takes place tax-free.

In simple terms, the process works like this: A grandparent decides to insure her adult child. She funds the contract by depositing a stream of payments over a limited number of years, and the excess funds accumulate tax-free in the contract. The grandparent has the option to transfer ownership to the child, or the grandparent could appoint her child as successor owner.

In the event of the grandparent's death, the rollover would apply and the grandchild would be appointed an ultimate beneficiary of the funds.

The insurance contract could also be used for leveraging purposes and allow the child to borrow using the cash value of the contract as collateral security. These funds could be used for various planning purposes such as higher education, buying investments or purchasing a home.

There are many variations on the intergenerational wealth transfer theme, and the use of the tax-free accumulation features of exempt insurance plans. Each should be considered when taking the goals of the individual client into account.

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