Protecting your Estate with Tax-Exempt Life Insurance

CIBC Wood Gundy

Sniderman – Agopian
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Most people are aware that assets left behind at their time of death will be transferred to their heirs in accordance with their wishes as long as they have a Will. However, many people do not consider the effect of taxes on the value of these assets and are surprised to find out that their estate will be hit with a tax bill that could significantly reduce what they planned to pass on to their heirs. In Canada, when a person passes away, the government deems all their property (unless jointly held) such as stocks, bonds, RRSPs, real estate, etc to have been sold at their fair market value on the date of their death. Therefore, an Ontario resident in the highest marginal tax bracket would pay tax at the following rates on the day of their death:

Principal Residence	Registered Assets	Non-Registered Assets	TFSA	Other Real Estate	Holding Company
No Tax	53.53%	26.77% of Net Gains	No Tax	26.77% of Gain	26.77% of Gain

Tax-exempt life insurance, such as whole life and universal life, can be an effective tax-planning tool in preserving your estate for your heirs. It combines permanent insurance protection, the death benefit, with a savings component, the cash surrender value. These features provide an attractive opportunity to defer taxes during your lifetime, as capital grows tax-free within the policy. The death benefit is also paid out tax-free to your heirs. Furthermore, the cash surrender value can be used to provide non-taxable retirement cash flow via a leveraging strategy. The death benefit makes life insurance ideal for paying taxes on accrued capital gains and registered investments triggered at death, as well as to enhance the estate for heirs or fund a charitable donation.

If the policy is owned and funded by a corporation, the advantages of tax-sheltered growth are augmented by the ability to flow the death benefit out of the corporation as a tax-free capital dividend. There are also potential tax savings related to the capital gains liability on the shares of the corporation payable on the death of the shareholder.

Who should consider tax-exempt life insurance?

Typically permanent life insurance policies work best for those who:

- Are in good health;
- Currently maximize their RRSP and TFSA contributions or are able to do so;
- Have substantial non-registered savings subject to annual taxation;
- Have, or will likely accumulate, more capital in their lifetime than they will likely consume (redundant capital);
- Are concerned about and would like to proactively address the effect of taxation on their estate.

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What type and amount of insurance is appropriate?

A permanent insurance policy is a long-term planning strategy, whose early cancellation can be quite punitive. Accordingly, it is important to first carefully consider your personal and financial circumstances and goals. Our process typically involves:

1. Creating a full financial plan: identifying assets and liabilities, expected spending and saving, major future outlays and all other considerations relevant to your financial affairs in order to project your future net worth.
2. Identifying the existence of, if any, capital that is likely destined for the estate
3. Recommending the type and amount of coverage to meet your objectives within the context of the financial plan, such as: funding your projected estate tax liabilities, enhancing your estate or your retirement income.

What are the benefits of permanent life insurance?

Permanent life insurance policies are attractive for the following reasons:

- The death benefit can be used to:
    - provide cash for heirs quickly by bypassing the estate;
    - provide increased cash flow in retirement;
    - magnify the value of the estate;
    - avoid the forced sale of valuable or illiquid assets, such as a cottage, to pay tax liabilities;
    - reduce probate fees if direct beneficiaries are named;
- Growth in the cash surrender value of the policy is not subject to annual taxation;
- The rate of return on premium dollars can be quite substantial;
- If a preferred beneficiary is named, the policy is creditor-protected;

Case Study

Janice, 55, is an executive and her husband, Joe, 55, is a property manager. Over the years, they have accumulated significant wealth, keeping their tax bill low by maximizing RRSPs and TFSAs. They currently own several stock positions with low cost bases and several investment properties. They have led a comfortable lifestyle and would like to conserve their assets so their children and grandchildren can enjoy a similar lifestyle.

After speaking with their investment advisor, they are shocked to discover that their death will trigger a tax bill of over $1,000,000. In particular, taxes will reduce their RRSPs by 53.53%, the growth in the value of their stocks, family cottage and rental properties will attract a capital gains tax of 26.77%. They decide to purchase a permanent insurance policy with a death benefit matching this $1,000,000 liability for annual premiums of $25,714* for 10 years. This ensures that their estate receives the necessary cash to settle the tax liability and their assets are passed onto their children according to their wishes.

* Life insurance premiums quoted are based on standard non-smoker rates in effect as of January 17, 2013.

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