TAB 4

Life Insurance Strategies for Trusts and Estate Planning

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LIFE INSURANCE STRATEGIES

FOR TRUSTS AND ESTATE PLANNING

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HISTORICAL BACKGROUND

In order to understand, appreciate and have confidence in using life insurance as a tool for tax, retirement and estate planning, it helps to look at the history of this financial product. It is also important to respect the history, financial strength and global scope of Canada's large life insurance companies.

Life insurance in Canada, and most countries around the world, has significant tax advantages. The tax treatment of life insurance is embodied in Section 148 of the Income Tax Act and the rules governing insurance today go back to the Federal Budget of 1981. In summary, the Minister of Finance Allan MacEachen delivered a budget in November 1981 that proposed to tax the investment income earned within a life insurance contract – both during the life of the policyholder and upon death. This legislation was met with considerable opposition from the life insurance industry and, after a year of consultations, new regulations were introduced and passed that are the basis of today's tax treatment of life insurance.

Life insurance is "tax exempt", meaning that the investment income earned within a contract is not taxed during the life of the insured and the death benefit, including the accumulated investment income, is not taxed upon death. In addition, life insurance contracts have no tax reporting requirements on the part of the policyholder and contracts are creditor-proof under provincial insurance legislation.

Canadian life insurance contracts are 1) tax-exempt, 2) non-reported to CRA, 3) creditor-proof, and 4) backed by AA financial institutions that are highly regulated. Finding another financial instrument with these attributes is difficult indeed. The problem for most lawyers, accountants and financial planners is this product profile sounds “too good to be true”. As a result, life insurance is still misunderstood and is not used as effectively as it could be in developing comprehensive wealth management strategies.

ESTATE PLANNING

The traditional use of life insurance is to provide a hedge against mortality risk. Insurance supports widows and orphans and allows small businesses to carry on if the owner passes away before his time. Life insurance replaces income, repays debt and provides financial security to both families and companies.

“Advanced” life insurance concepts and strategies, however, go far beyond basic protection and can provide a powerful tool for tax, retirement and estate planning.

Life insurance can be viewed in three basic ways when in comes to estate planning:

1) Life insurance provides a hedge for those who will not plan
2) For those who plan, life insurance provides a hedge if the plan does not work

3) For many people, life insurance *is* the estate plan and the goal is to spend everything before passing away.

Life Insurance as an Asset Class:

In the high-net-worth market, life insurance is often viewed as a pure investment, or distinct asset class. To illustrate this concept, it helps to think of having "three boxes" of assets at the time of retirement:

1	**2**	**3**
Tax Deferred Assets • RSP • RIF • Pension Plan	***Taxable Assets*** • Stocks • Bonds • Real Estate	***Tax Exempt "Insured" Assets*** • **Life Insurance**

We are all familiar with Box #1 and #2. Indeed, these two asset groupings are the basis of the financial services industry. Most Canadians, however, are unaware of Box #3. One of the key factors in successful retirement planning is the order in which an individual "blows up", or liquidates his or her investment assets. Having the "third box" affords tremendous flexibility in developing and managing this program.

For those practitioners who are good with a calculator, it often comes as a great surprise to find out that life insurance has a very attractive expected rate of return. For example, a man and women both aged 60 can purchase a $1,000,000 "Joint & Last" contract for an annual premium of $9,802. Premiums must be paid until both individuals have passed away.

Let's consider this policy as an "investment". Assuming one of the couple lives to age 85, the total premiums for 25 years would equal $245,500. The death benefit is $1,000,000 and this payment is made to the beneficiary tax-free. The after-tax IRR on this investment is 9.6%. If we gross up this number to a pre-tax equivalent, the return is almost 18.0%. If the last survivor lives to age 96, the after-tax rate of return is still 5.1% (see Exhibit 1).

For the past 25 years, the Scotia Capital Bond Universe index has also earned 9.3%, but most of this return was taxed as income at the highest marginal rate (46% today). Investing $9,802 in this bond index every year for the past 25 years would have resulted in an estate of approximately $500,000. Putting the same $9,802 into an insurance policy creates a $1,000,000 estate, or 50% more money for heirs.

The difference of $500,000 is significant – but how should we characterize this gain? Is it sophisticated tax planning? A clever asset allocation strategy? Or just plain old life insurance? Note that the policy has no cash value – we are simply purchasing death benefit.

The purchase of a "whole life" or "universal life" insurance contract offers a second advantage. The annual premiums can exceed the cost of the pure death benefit and provide a "cash surrender value". The investment strategy for the excess deposits can be handed over to the insurance company (whole life) or can be self-directed by the policyholder (universal life). A typical universal life policy from a large insurance company today offers 40-50 different investment choices, including bonds, bond indexes, equity indexes (S&P 500) and mutual funds (see Exhibit 2).

The table below shows the rate of return and standard deviation on various investment assets over the past 25 years to December 31, 2009:

	Participating Whole Life (1)	**S&P/TSX Index**	**Scotia Capital Universe Bond**	**5-Year GIC**
Average Annual Rate of Return	9.8%	7.9%	9.3%	6.1%
Standard Deviation	1.9%	16.4%	6.4%	3.0%

1. Manulife Financial "Performax" product.

As shown, life insurance not only has the highest rate of return, but also has the lowest standard deviation. Furthermore, over this 25 year period the lowest return for life insurance in any year was 7.0%. The highest annual return was 12.8%.

If a goal of the estate plan is to maximize value using conservative tax planning and a conservative investment strategy, then life insurance should be considered as one component of the plan.

Joint & Last Policies:

The policy example above was as "Joint & Last" contract. Much of the planning and strategy used in estate planning revolves around deferring income and capital gains taxes until the second death of a married couple. The ability under tax rules to roll over shares, create Spousal Trusts and do estate freezes are examples of this type of planning.

So, if the tax bill is due on the second death, couples need a hedge that provides cash liquidity at the same time – joint & last life insurance. What is interesting about these contracts is that they seem to be "mispriced". For example, our 60-year old couple gets priced for their $1,000,000 policy as the equivalent of a male non-smoker age 49. Intuitively, this sounds like a good deal and the calculator verifies that it is. Owning an investment that has an expected return of 18%, is AA-rated and creditor-proof is a good strategy for funding capital gains taxes triggered upon death.

INSURANCE AND HOLDING COMPANIES

Most high-net-worth individuals and families own one or more investment holding companies. This structure is based on the history of tax rates for holding companies, the manner in which intercorporate dividends are taxed and the traditional notion of creditor protection of assets.

While it is not possible in this paper to address the entire subject of corporate-owned life insurance, financial advisors should be aware of one important fact: Life insurance proceeds paid to a small business corporation is credited to the Capital Dividend Account ("CDA"). This tax treatment creates a variety of planning opportunities for:

- Estate freezes
- Share redemption strategies
- Minimizing capital gains taxes at death
- Buy/sell arrangements in Shareholders' Agreements
- Charitable gifting strategies
- Leveraging life insurance

The CDA is a rather nebulous "accounting thing" and, like life insurance, is not well understood by wealth management advisors or the owners of investment holding companies. When combined with life insurance, however, the CDA becomes a powerful planning tool.

As always, the simplest strategy is often the most effective. Consider a couple who owns an investment holdco with substantial investment assets. Based on their wealth held outside the company, this couple does not require income from the holdco and will leave the shares to their children. The problem: investment income continues to build inside the company, the value of the shares continue to rise and the capital gains tax owing on death grows to a big number. An estate freeze can certainly defer some of this tax, but let's consider the use of life insurance.

The purchase of a "Joint & Last" policy described above will tax-shelter investment income during the couples' lifetime and upon death the entire death benefit (including the accumulated investment income) can be paid out of the CDA as a tax-free dividend. The "trick" is that life insurance death benefit is not included in the valuation of corporate shares for the purpose of calculating capital gains taxes (the policy cash value does).

One strategy that has been promoted over the past ten years is known as a "Triple back-to-back". This structure is used to reduce the value of corporate shares upon the death of a shareholder and thus reduce capital gains taxes. The strategy involves a life insurance contract, a bank loan and a lifetime annuity. The sequence of transactions, assuming a $1,000,000 plan, is as follows:

- The investment holding company uses $1,000,000 of investment assets to buy a $1,000,000 lifetime annuity on the owner of the company.
- The company buys a $1,000,000 insurance policy on the same shareholder
- The company assigns both the policy and the annuity to a bank and borrows $1,000,000 to replace the original capital used to buy the annuity.
- Monthly proceeds from the annuity pay for the insurance premiums and interest on the bank loan.
- Upon the death of the shareholder, the annuity terminates and the life insurance is used to repay the bank loan.

The value of the shares has been reduced by $1,000,000 and taxes of approximately $230,000 (23%) have been saved in the estate. By putting together three simple products – an annuity, an insurance policy and a bank loan – the shareholder has saved a significant amount of tax and has created a larger estate for heirs.

LEVERAGING LIFE INSURANCE

Insured Retirement Plan:

Nobody wants life insurance – but everyone wants an "insured retirement plan". This plan is simple. An individual (or couple) buys a permanent life insurance policy and funds the maximum premium for 10-15 years. Upon reaching retirement, the policy is assigned to a bank and a line of credit is set up to fund retirement expenses. Upon death, the accumulated loan and interest is repaid from the life insurance proceeds with any balance going to named beneficiaries. If the policy is owned inside a company, the plan is known as a "corporate insured retirement plan". Most Canadian insurance companies have established lending relationships with banks to facilitate this type of arrangement. The strategy is very similar to a "reverse mortgage". In this case, the life insurance policy is the house.

Immediate Financing:

The last leveraging strategy of note is "immediate financing". In this approach, the policyholder borrows from a bank to fund the annual premiums on the policy. Additional collateral is posted until the policy cash values exceed the bank loan. At a future point, perhaps 20 years out, the premiums stop and the bank loan is used by the policyholder as income or for investment purposes. For those sophisticated, high-net-worth people who have a solid grasp of leverage and have the financial capacity to unwind the structure if needed, this leveraging structure provides an attractive tax, retirement and estate planning opportunity.

Cost of Life Insurance:

The pure cost of life insurance has dropped dramatically over the past 20 years. The annual premiums for Term 10 and Term 20 life insurance policies are approximately 50% lower than they were in 1990. This change is largely the result of reinsurance, whereby Canadian life insurance companies use very large multi-national reinsurance companies to underwrite a substantial portion of the risk assumed under the policy.

This trend, however, may be coming to an end. The prospect for continued low interest rates and growing concern over health issues such as obesity and diabetes have forced life companies to begin thinking about rate increases on permanent products such as universal life. Term rates are likely to follow.

The other issues facing life insurance companies are increased regulation and possible changes to tax and accounting rules. The Department of Finance and the life insurance industry have been working on updating the tax rules surrounding life insurance and the exempt test and these discussions are likely to result in new legislation being tabled sometime in 2011. Proposed changes to accounting rules under the International Financial Reporting Standards ("IFRS") may also result in greater capital requirements for Canadian life companies, which are likely to translate into higher insurance costs on many products.

It is quite possible that today is the best time in history to purchase a life insurance contract.