Markewich Financial Corporation

RESOURCE UPDATE

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Leveraged Life Insurance Plans in light of new proposed legislation.

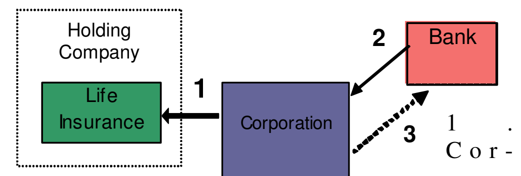
Life insurance provides cash at time of a specific death. If one's affairs are organized so that liquidity is needed on death, to pay tax, buy-out a shareholder, or to provide a charitable gift or income for dependant family, then life insurance should be considered. This article will not attempt to sell anyone on the virtues of this type of planning; but will instead, discuss a very interesting way of maximizing the return on investment when purchasing life insurance.

Of the two basic types of life insurance, term and permanent, we are only dealing with permanent protection. Term insurance is an important tool, but should never be considered a good investment because you must die by a certain time for the death benefit to pay out. Almost all term insurance is cancelled before death, so it is only a win for the insurance company, not the client. Permanent insurance is an investment, even when there is no cash value, because everyone dies. You can bank on the death benefit being paid, and the only variable is time.

In our practice, we most often use Universal Life insurance policies because they are the most flexible type of insurance offered. Flexibility is very important because insurance policies will be owned for several decades, and no one can predict how one's circumstances may change. Universal Life policies come in many forms, but they all have one common trait - they perform best when maximum funded. This means that clients invest the maximum amount that is allowed to grow tax-sheltered within the policy. There is a detailed calculation that each insurance company must perform on each policy to ensure it does not exceed the Maximum Taxable Actuarial Reserve (MTAR).

Clients often do not maximum fund their insurance because of the cost, which is non-deductible. Our solution to this is to use someone else's money, more specifically, from an insurance-linked bank. If the client borrows for business reasons, and not for purchasing life insurance directly, then the loan interest is deductible. Sometimes the company has sufficient cash flow to pay for the insurance, which is used as collateral for the business loan, but in most cases we are borrowing to pay a dividend up to a holding company, then the holding company purchases the life insurance.

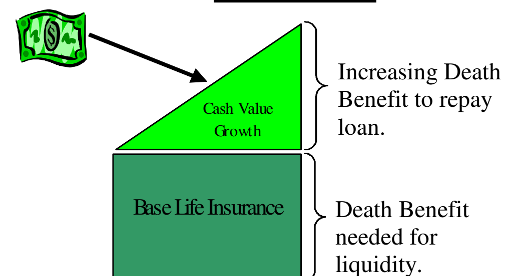
Structure:



1. Corporation pays life insurance premiums.
2. Bank makes annual loan.
3. Corporation pays interest (monthly).

The cost of the insurance becomes the after-tax interest, instead of the pre-tax premium. This looks extremely good in the early years, but eventually the interest will be higher than the regular premium. This is not a problem in a properly structured insurance policy because the face amount of insurance will continue to increase in a maximum funded plan, so that when interest is paid, there is an offsetting increase in the coverage. The long-term benefits of this program are derived from the difference between paying deductible simple interest, and earning sheltered compounded growth.

Policy Design:



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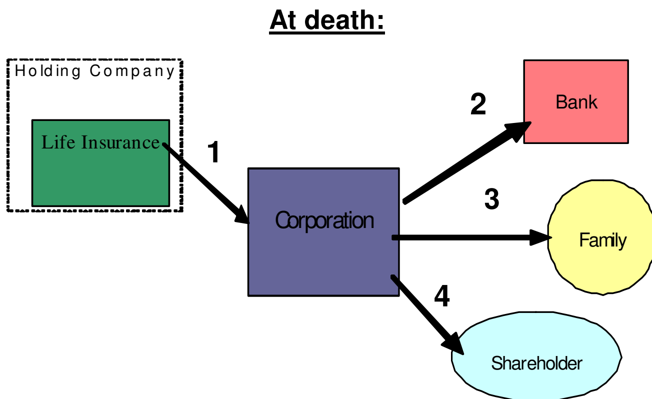
There will be an additional benefit to corporate clients because the full death benefit will create Capital Dividend Account (CDA) in the operating company. After repaying the premium loan, and paying out the original death benefit, there will be leftover CDA equal to the amount of loan. The value of this account is that it can be removed tax-free, and negate the 35% tax that is normally payable on dividends. When this extra tax-savings is figured into the mix (assuming tax-free dividends are of value in your situation), the cost of purchasing life insurance reduces significantly.



1. Death Benefit is paid to the corporation.
2. Corporation repays the bank loan.
3. Corporation redeems shares of non-shareholders tax-free.
4. Surviving Shareholders remove Capital Dividends—tax-free.

Note: The life insurance will first repay the bank loan, and then be used to repurchase shares of the family business.

This is why, for several years, we have been saying that life insurance can be a good investment; especially, when you use someone else's money to buy it.

The proposed changes to interest deductibility

For years now, the Department of Finance and CCRA have been discussing whether loan interest on different transactions should or should not be deductible. The proposed changes to the Income Tax Act together with Interpretation Bulletin 533 will no doubt create a lot of conjecture over the next several years, but there are some specific points that discuss the life insurance products that we market. We have reviewed the proposed changes and see no new barriers to the structures we recommend for purchasing life insurance; in fact, some of our structures have been given written approval where only court rulings governed previously. You will notice in the Act and IT bulletin both, that life insurance and annuities get a special place of mention. To paraphrase, *" you cannot deduct interest on money borrowed to buy tax-sheltered life insurance and annuity products"*. This is not new, and the life insurance ideas that we recommend do not breach or push the boundaries of the intention of The Act. We have always understood this, and whenever leveraging is involved in our work, we never borrow to buy life insurance. In order for a client to buy life insurance in his operating company, the company will pay cash for the insurance, and then borrow a similar amount from a bank using the cash value and death benefit of the policy as security, which creates a deduction for the Net Cost of Pure Insurance (NCPI) portion of the premium. (For the NCPI to be deductible, a true and legally binding assignment must be registered against the policy, and loan and insurance must be owned in the same company.)

In situations when the retained earnings are sufficient to pay for life insurance or a life annuity, then borrowed money can be used to pay-up dividends to a holding company. The holding company will purchase the insurance product. Removing paid up capital has long been considered a legitimate business purpose for a loan, and interest is fully deductible. This principle is re-affirmed in new IT-533. Paragraph 23 refers to "Filling a hole" as allowing a company to remove it's own capital, either through paying a dividend to a shareholder, repaying a shareholder loan, or other such removal of shareholder equity. This principle applies to inter-corporate transactions, so our transaction will qualify for interest deductibility. It is perfectly acceptable to use that dividend to purchase life insurance or an annuity.

Can GAAR apply to this concept? The answer is that GAAR can be applied to any transaction that does not have a true business purpose. The goal of this transaction is to buy life insurance in a holding company for the benefit of the operating company. The practice of purchasing life insurance in a company other than an operating company has long been considered a correct business approach for several reasons:

- The policy will be creditor proof if held in Holdco.
- Cash value is an inactive asset, and should not be held in Opco. It may be possible to structure Holdco so that it's assets will not be part of the '90/10 active asset test' for Opco.
- As a non-capital asset, it is difficult to remove a life insurance policy from Opco in the event of a share sale to a third party.
- In companies with multiple shareholders, each with holding companies, permanent insurance may be better held in Holdco because most people outlive their working years, and the life insurance may ultimately be used for estate planning, instead of funding shareholder agreements. (The beneficiary would change on retirement from company to family.)
- The adjusted cost basis of the insurance will be in the holding company. If the operating company receives the death benefit, there will be no grind of the Capital Dividend Account. All of the death benefit can be paid out as tax-free dividends.

These practical uses for life insurance are well known and understood by CCRA, and at this time show no intention of changing their course.

In conclusion, we find nothing in the new proposed legislation that requires us to amend our corporate insurance concepts. If anything, the IT-Bulletin reaffirms our practices of borrowing for a direct business purpose. Legislation is only in draft form at present, and changes are likely. We will continue to follow the discussion, safe in the knowledge that our own work is accepted by CCRA.

- By Douglas C. Markewich, CLU, CH.F.C., TEP
Advanced Markets Specialist

WHAT'S NEW?

The U.S. Alternative

Clients who have been declined or highly rated by Canadian Life Insurance companies, may be rated much lower, or even considered a standard risk by U.S. Life Insurance companies.

We have recently formed an alliance with a U.S. Life Insurance distributor. This organization specializes in re-shopping health risks to ten major U.S. Life Insurance companies. Premiums and benefits are all paid in U.S. dollars, and the rules state that the policy must be owned by a U.S. entity at time of purchase. The owner of the insurance contract must be either a U.S. relative, a related U.S. corporation or failing both of these, a U.S. Life Insurance Trust would be set up.

Setup costs are approximately $2,000 U.S., but the Trust can transfer the policy to a Canadian company or individual immediately after issue, with no U.S. tax concerns. Once owned in Canada, the policy will follow all of the tax rules as though it were from a Canadian insurer, attracting Capital Dividends in corporations to preserve the tax-free status of the death benefit.

The better risk treatment is due to the size of the U.S. market, and their larger experience pools of seniors to draw from. The U.S. market also has several more re-insurance companies to share the risks. In other words, they have more age 70+ clients insured than we do in Canada, so they can be more liberal when assessing risk.