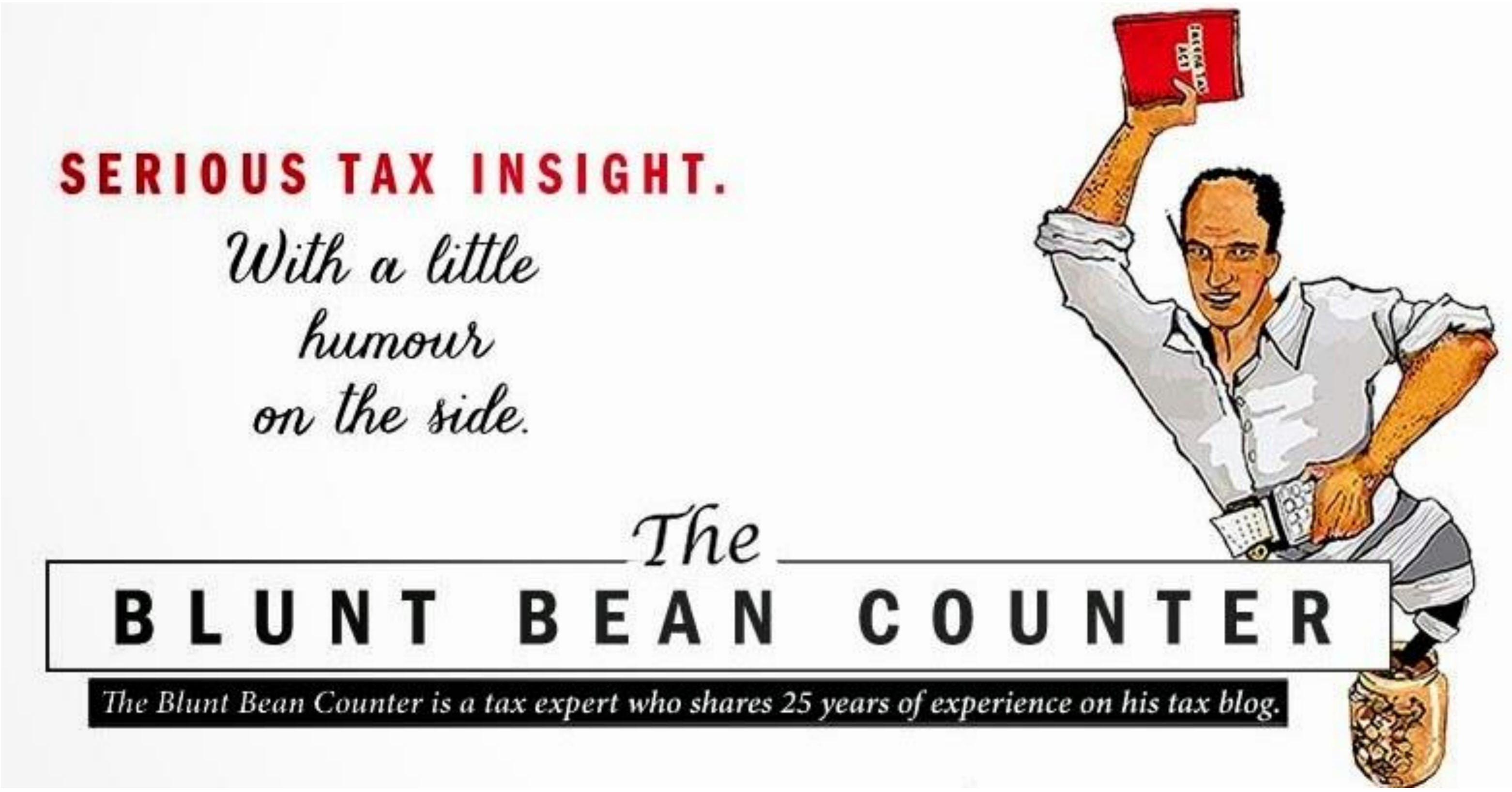

My name is Mark Goodfield. Welcome to The Blunt Bean Counter ™, a blog that shares my thoughts on income taxes, finance and the psychology of money. I am a Chartered Professional Accountant and a partner with a National Accounting Firm in Toronto. This blog is meant for everyone, but in particular for high net worth individuals and owners of private corporations. The views and opinions expressed in this blog are written solely in my personal capacity and cannot be attributed to the accounting firm with which I am affiliated. My posts are blunt, opinionated and even have a twist of humor/sarcasm. You've been warned.

Monday, February 22, 2016

What Small Business Owners Need to Know - Insurance as a Corporate or Estate Planning Investment Class

Last summer, I attended a BDO SuccessCare Program that dealt with helping small business owners plan for succession (in a couple weeks I have a post on "One Day You Will Sell Your Business" that discusses how less than 40% of corporate business owners actually have a succession plan).

At the course, Brodie Mulholland, a lawyer who provides insurance and tax based estate planning strategies spoke about how small business owners can use insurance for estate planning and investing purposes even where there is no specific need for life insurance in the traditional sense. I was very impressed with his talk and afterwards started speaking to him about some of the points he made. Brodie volunteered to write a blog post on using insurance as a corporate or estate planning investment class and today I am posting his blog.

Note: over the years I have had several clients purchase insurance in their corporation for estate planning and/or investment purposes. While for certain small business owners, such insurance clearly provides a substantial increase in value to their estate at death, please be aware, that neither Mark Goodfield, The Blunt Bean Counter blog nor the firm I work for is endorsing Brodie or the purchase of insurance for the purposes discussed below. You must obtain independent insurance advice and speak to your accountant on whether purchasing an insurance policy makes economic, estate and income tax sense in your own circumstances.

All the examples, numbers and discussion below are Brodie's solely and I make no representation as to their accuracy. Finally, Brodie's examples below reflect a whole life policy. Before considering any corporate funded insurance policy, you should discuss the advantages and disadvantages of Universal Life ("UL") vs Whole Life or any other alternative insurance product. Many estate and insurance advisors feel UL is a better product, while others feel a whole life policy is the way to go. You need to understand which product best suits your needs.

With all these caveats out of the way, I will leave it to Brodie to discuss the use of insurance as an investment class.

Insurance as a Corporate or Estate Planning Investment Class

By Brodie Mulholland

Today I will review how life insurance may be used, either personally or in a corporation, as vehicle for investments to grow and pay out tax free. It is important to understand that insurance facilitates the investment and in many cases, the person purchasing the policy may feel they already have sufficient life insurance in the traditional sense. As reflected in the examples below, compared to a GIC earning 3% per year after tax, the effective after tax rate of return with an insurance policy is substantially higher, if the policy is owned personally, the returns are even more compelling if owned by a private corporation.

In general, you would typically only consider funding a life insurance policy as an investment where you anticipate having more funds than you will need to live and you want to leave this money to your estate.

An Example

Let's take a couple, Thom and Sophie who are, respectively, 66 and 64, who have $100,000 to invest each year (while I am using an investment of $100,000 a year for this example, until the year in which the survivor of Thom and Sophie die, for many small business owners, the investment is often $25,000-$50,000 for say ten years). One option would be for Thom and Sophie to invest in a GIC. In Ontario, if you are paying tax at the highest marginal rate; 53.53% of the income earned each year on the GIC goes to pay income tax. How do you shelter that income from tax?

One option is to use life insurance. Under the current life expectancy tables used for income tax purposes, the statistical life expectancy of the last of Thom and Sophie to die is 25 years (for example, suppose Thom died in 20 years and Sophie in 25 years). If Thom and Sophie paid $100,000 per year into a GIC that earned 3% after tax (that's like earning 6% before tax at a 50% marginal tax rate), after 25 years the GIC would be worth almost $3,800,000. However, the amount paid out on a tax free basis to their estate could be more than $6,300,000 if instead they acquired a "participating with paid up additions" whole life insurance contract that paid out on the last of them to die assuming current policy premiums and insurance company dividend payment rates (different types of insurance are explained below). That's over $2,500,000 (or over 65%) more to their estate after tax.

Does this sound too good? Even if I lower the insurance company's dividend payment rates by 1% (many experts believe they will be lower in the future given the historically low interest rates the last decade) the amount that would be paid out after tax would still be almost of $5,700,000. Still some risk you say? If they used a T-100 insurance policy that pays out on the last of them to die and where the annual premiums and payout amount are guaranteed for life, the tax free payout could be almost $6,000,000 – that is almost $2,200,000 (or 58%) more than the GIC after tax.

Which Investment or Type of Insurance to Choose?

Year	GIC 3% After Tax Rate of Return	Whole Life Insurance - Current Dividend Scale	Whole Life Insurance - Current Dividend Minus 1%	T-100 Life Insurance
10	$1,180,780	$2,922,055	$2,840,120	$5,940,856
20	$2,767,649	$4,980,042	$4,541,546	$5,940,856
25	$3,755,304	$6,315,893	$5,588,146	$5,940,856
30	$4,900,268	$7,787,482	$6,682,200	$5,940,856

Based on information obtained on or before November 26, 2015, assuming:
- Thom and Sophie are non-smokers in standard health
- $100,000 payments are made annually at the start of each year until the year in which the survivor of Thom and Sophie die

There are pros and cons to each option. The biggest "con" to using life insurance versus a GIC, is that life insurance does not pay out until death and so the insurance benefits your estate or the beneficiaries you designate, not you directly. When choosing between life insurance products, the advantage of a T-100 life insurance policy is that the amount that you pay and that will be paid out on death are guaranteed. With universal and whole life policies, generally there will be certain guaranteed minimum payout amounts, but the actual tax free payout amount will vary depending upon, in the case of universal life, investment performance and for whole life, dividend rates.

There are ways to borrow against, or in some cases, withdraw, amounts you have paid into certain permanent insurance policies, although I do not recommend planning to use life insurance in this way as an investment unless you are quite certain that you will never need to use it during your lifetime. With T-100 policies, generally borrowing or withdrawing from the policy is not possible.

Funds in a Corporation

What if the funds to be invested are inside your corporation? Using corporate dollars to pay the insurance premiums is often better because, generally, corporate dollars have not been taxed as much. More importantly, because life insurance proceeds are credited to a special account called the Capital Dividend Account ("CDA"), depending upon the type of life insurance and how long the policy has been in effect, most, if not all, of the insurance proceeds may be paid out of your corporation to you/your estate tax free. See Mark's post on Capital Dividends - A Tax-Free Withdrawal from your Company for more information on the CDA account.

Thom and Sophie's Corporation

So to carry on with our example, let's suppose that Thom and Sophie had a corporation with $100,000 per year to invest and that their estate will need these funds and the accrued growth from the corporation to pay taxes on the death of the survivor of Thom and Sophie.

Again, let's compare what would happen if Thom and Sophie used that $100,000 per year to have the corporation fund a GIC versus funding a life insurance policy with premiums of that amount. Let's further suppose that the survivor of Thom and Sophie dies 25 years from now so their estate would need funds to pay its tax liability then. If the corporation earned 3% per year after tax on the GIC, as above, in 25 years that would amount to almost $3,800,000. Now how does the estate get the funds out of the corporation? Usually the corporation would pay a dividend on the shares formerly held by Thom and Sophie's to their estate, assuming that their estate now holds their shares in the corporation. However, at current tax rates, if these funds were paid to the estate by dividend, the estate would have to pay tax of about 1/3 (or much higher after the Liberal tax changes - the accountants may use various tax planning techniques to lower the tax rate on removing the funds) of the dividend amount, leaving the estate with about $2,500,000 after tax.

If the corporation instead acquired the same “participating with paid up additions” whole life insurance as stated above and assuming current dividend payment rates, the payout amount would be over $6,300,000, much of which could be paid out to the corporation to Thom and Sophie’s estate tax free.

If Thom and Sophie were to take the most conservative approach, and had the corporation acquire the same T-100 insurance policy referred to above, the proceeds would be almost $6,000,000 and these should be able to be paid out of the corporation tax free, so the difference to Thom and Sophie’s estate compared to the GIC would be almost $3,500,000 – over double. (again, there may be additional tax savings from further tax planning involving Thom and Sophie’s shares.)

Term vs. Permanent Life Insurance

There are two basic types of life insurance: term and permanent. Term insurance is the type with which most of us are familiar – it is in effect for a specified term, for example, 20 years. Its purpose is primarily to manage the risk to the family in the event of death (i.e. income replacement) – that is, if an income earning spouse were to die prematurely, what amount of capital would produce enough income to make up for the loss to the family of the deceased’s income. If the person whose life is insured lives longer than the term (e.g. 20 years) the policy’s term will have expired. Another type of life insurance is permanent insurance: insurance that is intended to payout on the death of the life insured, and has no specified term – it is intended to be in effect permanently until the insured dies.

Participating Life Insurance and Statistical Life Expectancy

Permanent life insurance policies can be “participating” or “non-participating”. Most participating policies are ones where the insurance company pays dividends to the policy holder. Depending upon how these dividends are paid or used, they may not be taxable to the policy owner/recipient. One of the most common ways that non-taxable dividends are paid or used is by way of “paid up additions” – the dividends are used to buy extra amounts of life insurance so the insurance contract payout amount increases every year. Again, in very general terms, there are three types of permanent life insurance: universal, whole life and T-100 policies. Generally, with Universal Life, the investments inside the policy are managed by you and those in a whole life policy are managed by the insurance company. Universal and whole life policies may be participating or non-participating and T-100 policies are non-participating. A permanent life insurance policy “matures” (that is, pays out) when the life insured dies, so for the purpose of comparing life insurance to other types of investments, we use statistical life expectancy as the date to which returns are calculated.

Tax Free Investment Growth Inside an Insurance Policy

Under the Income Tax Act when you may make extra contributions to a life insurance policy they can grow tax free within certain limits (known as the MTAR rules). Generally, the larger the face amount of the insurance policy (that is, the death benefit or amount paid on death) and the older the person whose life is insured, the greater the extra contribution allowed. As mentioned, those extra contributions grow inside the policy on a tax free basis. You might be saying “yes, but I can do that in my RRSP”. True, but on death, your RRSP is fully taxable – often to the tune of almost 50%. That is not the case with the extra contributions and growth inside the insurance policy: on your death, they payout to your beneficiary’s tax free, in addition to the death benefit.

So you don’t Have a $100,000 a Year to Invest?

This type of insurance planning works for amounts less than $100,000 per year, but for various reasons, including of fixed policy fees, as amounts get smaller, the effective returns will not be as high and may not make sense for amounts less than $25,000 per year, for say at a minimum of ten years.

The Rules are Changing in 2017

The tax rules are changing for insurance policies issued after 2016, in some cases, substantially reducing the amount that may grow tax free inside an insurance policy. Thus, you may wish to consider this type of planning before 2017, especially since the process of putting such a life insurance policy in place can take several months; in other words, right now is a great time to look into it.

Brodie Mulholland is a consultant to tax and estate planning lawyers, tax accountants and investment advisors to assist their clients with insurance based tax and estate planning strategies. Brodie is a lawyer who has practised for over 30 years in the areas of trusts, wills, tax and estate planning, corporate and commercial law and corporate restructuring. He is a member of STEP (Society of Trust and Estate Practitioners) and received an Advanced Certificate in Family Business Advising (with distinction) from STEP. Please feel free to contact Brodie directly at 416-917-0058 or by email at brodie.mulholland@gmail.com.

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