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TAX MATTERS

When the insurance agent calls, here are eight reasons to listen

I realize that insurance agents get a bad rap. There are few people on the face of the Earth who can be more persistent than an insurance adviser.

I often tell the story of the time I met with my own adviser who was trying to sell me a policy. I told him I would sleep on it. He then said: "Tim, that sounds good. You sleep on it, and if you happen to wake up in the morning, give me a call and let me know your decision." We had a good laugh.

If the truth be known, life insurance can be used in many effective ways, and so shouldn't be dismissed quickly. Today, I want to share with you some of the ways in which many affluent Canadians have used life insurance in the past. Some of these ideas might just make sense for you.

1. Tax-sheltered accumulation

Assets inside an insurance policy can accumulate free of annual income tax, and this sheltering can allow for greater accumulation over time than when using comparable vehicles. If you're accumulating part of your investment portfolio inside an insurance policy, holding all or some of your fixed-income investments in the policy will allow you to shelter what might otherwise be highly taxed interest income.

2. Reliable returns on investment

A number of Canada's life insurance companies offer whole life policies with a very high consistency of returns in the form of dividends paid on the accumulating balances inside these policies. The low volatility of returns, along with the tax-free payout of these amounts upon the death of the insured, can create attractive internal rates of return.

3. Insured bequest of shares

It is possible to donate private company shares to charity upon the death of a shareholder. Using life insurance, it is possible to then redeem the shares bequeathed to the charity to provide cash to the charity. The strategy results in an elimination of tax on the private company shares on death, greater value left to the heirs of the deceased's estate, and cash in the hands of the charity.

4. Extracting funds from a holding company

Many people accumulate significant assets inside holding companies, often the result of profitable businesses. Accessing these assets on a tax-efficient basis can be a challenge because of the level of tax imposed on distributions from holding companies. Life insurance can be used to create a tax-free "pipeline" from the holding company to the shareholders as the result of the "capital dividend account" that can be created when a holding company is the beneficiary of a life policy.

5. Cascading assets to future generations

Some families have more assets than they will consume in the lifetime of the current generation. When assets change hands and move from one generation to the next, the tax liability can be significant in the absence of effective planning. Life insurance can create an opportunity to move assets from one generation to the next free of tax when the lives of the next generation are insured by the current generation.

6. Creating a source of cash

Some families have used life insurance policies as a means to accumulate assets and achieve attractive after-tax rates of return. These families recognize that they have access to the accumulating assets inside the policy if they desire to use it as a source of cash flow. While assets can be withdrawn directly from these policies, it is common to find these families borrowing against the policies to access cash instead (because it is more tax-efficient).

7. Covering taxes on death

Given that life insurance pays out tax-free upon the death of the insured it can be an effective tool to provide cash at the time of death to satisfy a tax liability. In addition, where there is exposure to U.S. or other foreign estate taxes, it can be more cost-effective in some cases to use life insurance to pay those taxes rather than implement more complex and expensive structures.

8. Reducing the value of a corporation

The higher the value of a family's holding company(ies) at the time of death, the higher the potential tax liability that might arise. It is possible to use a "back-to-back" structure where life insurance is purchased back-to-back with an annuity by such a holding company with the effect that the value of the holding company is reduced, thereby reducing the potential tax on those company shares on death.

I will provide more detail on some of these strategies soon.

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