Leveraging life insurance

Flexible alternatives for accessing the cash value of life insurance

Insurance & Investments
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Empire Life®

Permanent life insurance with values

Permanent Life Insurance with values offer more than lifetime protection and tax free payouts at death.

There are benefits available to the policyholder while the life insured is still living.

Life insurance is accorded special treatment under the Income Tax Act.

A policyholder may be able to deposit money into a policy in excess of the contracted premium required to keep the policy in force depending on the contract type and provisions.

Such excess deposits if permitted under the terms of the contract, being advance premium payments, may be invested within the policy and accumulate exempt from annual taxation.

The upper limits of such excess deposits are dictated by many factors, the key considerations being:

- Age of the life-insured
- Deposit stream
- Current & anticipated expenses, and
- Internal policy assumptions
- Type of policy

Certain policy dealings may constitute partial or full policy dispositions, resulting in tax being payable at such times. The most common such events are:

- Direct account withdrawals
- Policy loans from the insurer
- Actual and deemed policy transfers

The death of a life-insured does not constitute a policy disposition, and therefore all the accumulated value may pay out tax-free at death.

Accessibility of account values

The three common ways to access value in an exempt policy are:

Direct account withdrawal

- Policyholder exercises available contract rights to withdraw funds
- Costs may include transaction fees and/or early surrender charges
- The taxable amount of the withdrawal is the ratio of the policy's adjusted cost basis to cash surrender value, multiplied by the actual withdrawal.

Policy loan from insurer

- Policyholder exercises available contract rights to borrow from insurer
- The contract will state the amount of interest, or how it is to be calculated
- There is no tax on policy loans up to the adjusted cost basis of the policy, but everything above that is taxable.

Loan leveraging

- Policyholder offers the policy as loan collateral to a lending institution
- The main cost is the annual interest rate as negotiated between the policyholder and the institution, and may also include one-time set-up charges and annual maintenance fees
- Under the current administrative practice of the Income Tax Act, when a policy is offered as collateral for a loan, that is not considered a policy disposition, and therefore there is no tax due.[1]

Loan leveraging: A closer look

A policyholder will usually structure the policy so as to maximize the exempt envelope, which structure may in fact be different than would be put in place for traditional needs.

A pro-rata portion of the lesser of the net cost of pure insurance or the premiums paid or payable during the tax year may also be deductible. If the loaned funds are devoted to a business or other income earning purpose, the annual interest may be a tax-deductible expense.[2]

In qualified circumstances a lender may agree to capitalize some or all of the annual interest due, with the result that the out-of-pocket payback may be deferred until the insurance proceeds arise upon the death of the life-insured. However, if the interest is capitalized, it is arguable whether that capitalized interest is tax-deductible from year-to-year.

It may be possible to quick-pay a policy. Usually the policy will be in force for 10-20 years or more before it is leveraged to generate a cash flow stream to supplement retirement (Insured Retirement Strategy). Sometimes the policy will be leveraged after the first year using either the growing cash value and no other collateral, or leveraging the premium by providing additional collateral. Either of these two approaches is called the Immediate Financing Arrangement. The borrowed monies are used to invest in income generating investment.

The lending institution will review the value of the collateral at the time of the loan application. For example, a lender might loan:

- Up to 80-90% of the guaranteed portion of the investment account
- Up to 40-60% of the variable fund-based portion of the investment account

The loan may be lump sum, in a series or be used as a line of credit.

The risk-reward proposition

This strategy uses a policy's tax-sheltering to build wealth, and non-taxable loans and tax-free insurance proceeds to access that wealth. As with any financial strategy, there are risks to consider, including:

- The law may change to make life insurance proceeds taxable.
- Regulations may change to deem one or more aspects of policy collateralization as taxable policy dispositions. While one could challenge CRA in court, the cost of doing so may be prohibitive.
- If pre-collateralization stage growth does not meet expectations, the available loans will be similarly reduced.

NOTE: An insurance illustration is dependent upon the inputs made by the advisor in consultation with client, and except where explicitly stated otherwise, the illustrated values are not guaranteed.

- The availability of a willing lender is not assured. While an insurer and/or the broker may assist in finding a lender, it is the lender's prerogative whether to accept a risk, require further collateral, or reduce the available credit.
- In the post-collateralization stage, if loan costs exceed investment growth and/or the life-insured lives beyond life expectancy, the arrangement may be imperiled. At the extreme, the lender might call the loan, resulting in a taxable policy disposition and potential loss of the insurance coverage.

Tax Retirement & Estate Planning Team

Providing you with the insurance, wealth and planning strategies that matter most, the Tax, Retirement & Estate Planning team is comprised of practicing professionals whose primary objective is to support you as you help your clients reach their financial goals.

For more information reach out to Empire Life's sales teams who can access the team and its resources for large and complex cases.

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[1] definition of "disposition" para. f, ,ss.148(9) Income Tax Act
[2] para.20(1)(e.2) Income Tax Act

Using life insurance as collateral in personal or business lending may be appropriate only for clients with higher risk tolerance. Clients should review the appropriateness of this strategy with their own legal and tax advisors before proceeding. The cash surrender value of a client's insurance policy will vary if not guaranteed, or if policy changes or withdrawals are made however they must meet their loan obligations and repay their loan in full in accordance with the arrangements made with their lender. The Empire Life Insurance Company acts solely in the capacity of issuing and administering life insurance policies and does not provide advice of any nature concerning CSV lending to individuals or advisors. The advisor is responsible for determining the appropriateness of CSV lending for their clients and informing them of the risks associated with borrowing to invest.

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