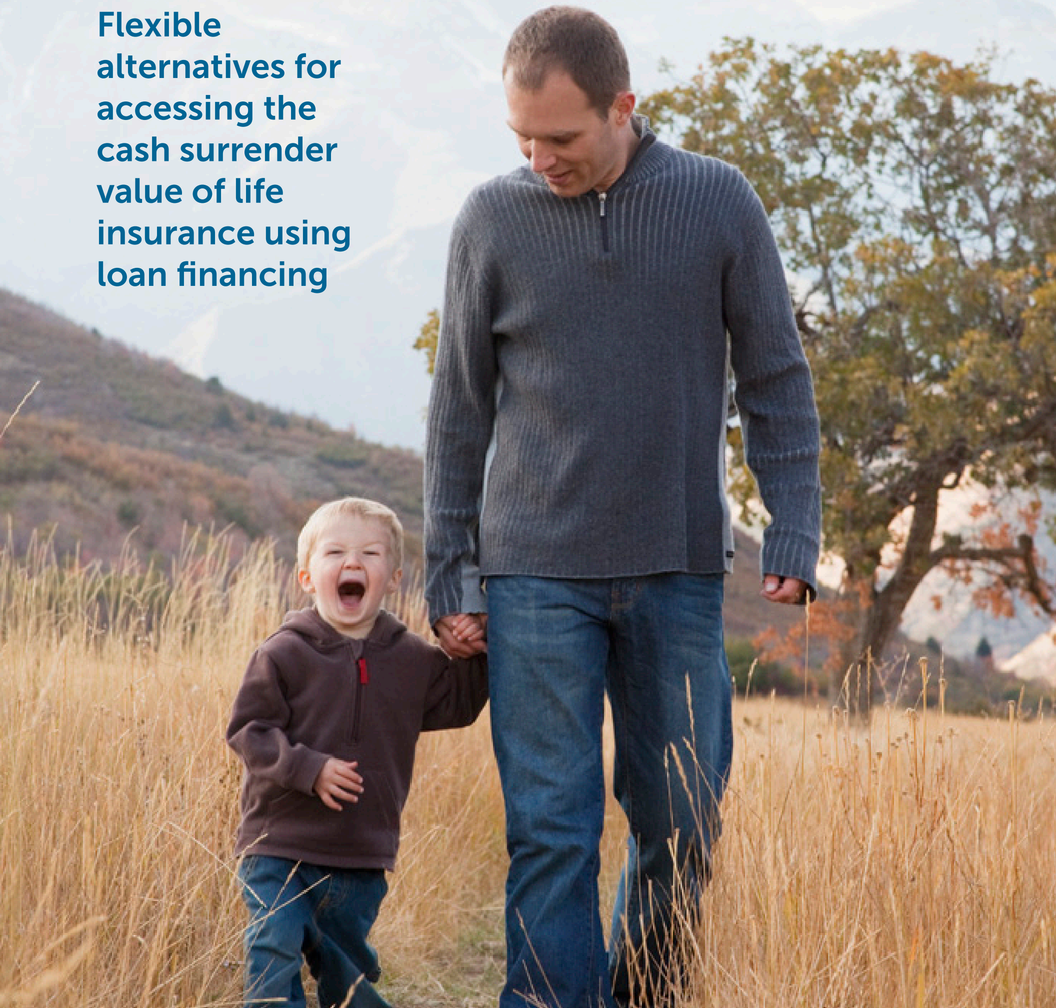
LEVERAGING LIFE INSURANCE



Flexible alternatives for accessing the cash surrender value of life insurance using loan financing

Empire Life™

Exempt life insurance

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

A policyholder may deposit money into a policy in excess of the contracted premium required to keep the policy in force.

Such excess deposits, 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

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 Canada Revenue Agency (CRA), when a policy is offered as collateral for a loan, that is not considered a policy disposition, and therefore there is no tax due

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.

If the loaned funds are devoted to a business or other income earning purpose, the annual interest may be a tax-deductible expense.

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 in as few as 1-5 years, but usually it will be in force for 10-20 years or more before it is leveraged.

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.
- CRA may change its administrative practice 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 broker, and except where explicitly stated otherwise, the illustrated values are not guaranteed.

- The availability of a willing lender is not assured. While an insurer &/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 &/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.

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