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They get a bum rap, but life policies can ease tax bite

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Of all the financial products available to help Canadians protect their life's assets, perhaps the most overlooked is life insurance. Blame it on its natural association with death, the necessity of monthly premiums or even the memory of aggressive direct marketers.

Whatever the reason, life insurance has received a bum rap, experts say.

When built into a larger financial strategy, life insurance can reduce taxes and enhance wealth. You still can't beat death, but you may be able to beat the taxman with life insurance payouts.

The primary role of life insurance is to cover known liabilities, says George Denier, a Toronto-based retired partner at KPMG working on contract with the firm's high-net-wealth services unit.

Life insurance policies can be used to cover capital-gains taxes on real estate, RRSPs or the value of a business in the event of the owner's death, so that heirs need not sell assets to pay taxes. The advantage of using a whole life or term life policy to cover these costs is that the policy is paid out almost immediately and is tax free.

A life insurance policy can also serve as a tax-free source of retirement income, Mr. Denier notes. He gives the example of an individual with a policy that over the years has built up \$500,000 worth of cash surrender value and/or a \$1.5-million mortality benefit.

"I go to a financial institution and say, 'What will you lend me against this?' and I pledge the proceeds of that policy to them as security for a loan. What I have done is accessed money to fund retirement without incurring any taxation."

The sudden need to come up with a pile of cash to pay off accumulated - but not necessarily unexpected - liabilities upon the death of a private business owner is a big reason only 10 per cent of family businesses in Canada make it past the second generation, said Hugh MacDonald, president of Canadian Succession Protection Co., a firm that specializes in using life insurance in succession planning. A corporate-owned policy will provide a spouse with tax-free cash when the business is weakest, after the death of an owner.

Life insurance can also provide an effective way to avoid probate fees and other entanglements that can come with the windup of an estate, adds Mr. MacDonald. "If you name your wife, kids or grandchildren as a beneficiary of a life insurance policy, it is outside your will, and you save probate," he says. "It is one of the few vehicles other than a trust which has creditor protection."

Insurance policies can also be used to cover the value of RRSPs, income property or vacation property. Mr. MacDonald gives the example of a cottage originally bought for \$100,000. Now it's worth \$400,000, and a widow wants her children to inherit it. "That \$300,000 [difference] is a capital gain triggered on death, almost half of which is taxable in Ontario, triggering a \$70,000 liquidity problem for the children. You can buy a permanent policy [on the mother] to cover that liability."

Taking out a policy on mom to pay for a middle-aged couple's retirement may sound ghoulish, but it is proving to be increasingly popular, said Frank Wiginton, a Toronto-based certified financial planner with TriDelta Financial Partners. The "mom as retirement vehicle" scheme does not work in all cases, he noted: The parent must be in good enough health to be insurable and not too young, he said.

In an ideal scenario, a mother is in her late 60s or early 70s while the son, the policy holder, is in his 40s. The yearly premium is \$16,500, or \$247,500 over 15 years.

"About the time you are likely to go into retirement, that is when mom is likely to die," he said. In a case where the mother lives 20 more years, the result is a tax-free payout of \$500,000, which Mr. Wiginton says results in an annual after-tax return in excess of 5 per cent. "It is a very attractive strategy," he says.