

# CA

MAGAZINE

AUGUST 1995  
FOR CANADA'S  
CHARTERED ACCOUNTANTS

## MATTERS OF LIFE AND DEATH

Within "exempt" limits, life insurance still offers a cost-effective means for meeting future obligations

By George F. Lengvari  
and Ronald S. Joshua

*Reprints permission of CAmagazine,  
published by the Canadian Institute  
of Chartered Accountants, from the  
August 1995 issue*





# Matters of life and death

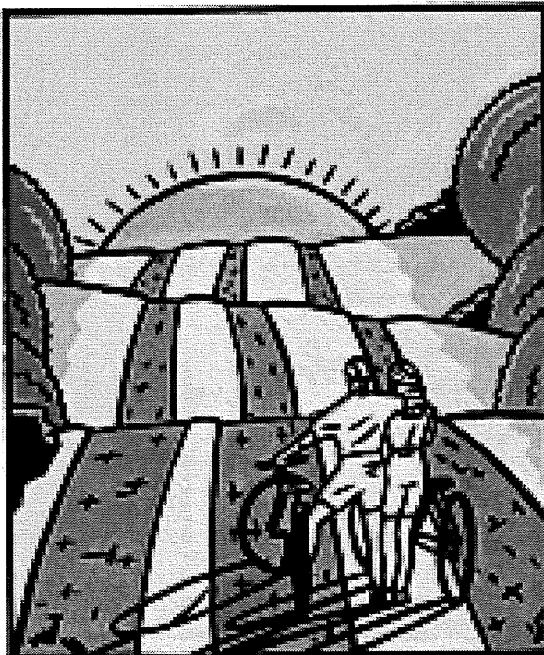
*Within "exempt" limits, life insurance still offers a cost-effective means for meeting future obligations*

BY GEORGE F. LENGVARI AND RONALD S. JOSHUA

TAX ADVISERS KNOW THAT IN 1982 THE Income Tax Act restricted the use of life insurance as a tax-sheltered vehicle for funding future obligations and benefits. The reason was simple: we overdid it, so we lost it — but not all of it. Life insurance is still an excellent investment tool. In fact, some policies are constructed not only to look after cash needs that arise on the death of the policyholder, but also to help fund retirement.

Before the 1982 limitations were brought in, astute agents and tax advisers promoted single premium life insurance. With this type of insurance, a single payment was made up front for all the costs and benefits of the policy, because it meant a tax-sheltered accumulation and tax-free maturity of the policy reserve. As a result of the aggressive use of this favourable tax treatment, single premium life insurance was stopped and new "exempt" rules were introduced. The new rules were not applied retroactively to policy contracts acquired before 1982. Therefore, we distinguish between policies issued before December 2, 1982 and policies issued after that date. The tax treatment differs in the way the adjusted cost base (ACB) is calculated in the application of the exemption rules. The ACB of the pre-1982 policies is the cumulative premium payments, while for post-1982 policies cumulative premiums are reduced by the annual mortality charge on the net amount at risk.

Within the "exempt" limits, life insurance still offers a tax-sheltered accumulation and tax-free maturity of the



type of investment chosen by the policyholder. To determine the exempt status of any given policy (the "real policy"), the concept of the exemption test policy (ETP) has been introduced into the Income Tax Act. The ETP is a hypothetical policy that provides for an endowment at age 85, and a death benefit at age 85 equal to the projected death benefit at age 85 of the real policy. To qualify for the exempt status, the reserve of the real policy has to be less than that of the ETP.

The taxpayer is required by the tax act to have his or her life insurance policy tested on each policy anniversary. Canadian life insurers test the policies they issue as a matter of service, and most of them contractually guarantee to maintain these policies within the exempt rules.

For policies that pass the exemption test, taxation is deferred until disposition occurs. At the time of disposition, the taxable income corresponds to the

excess of the proceeds of the disposition over the adjusted cost base. Surrender, full or partial, of a policy and a policy loan gives rise to disposition under the tax act. However, neither the termination of a policy because of death nor the collateral assignment of a policy to secure a loan gives rise to a disposition. These two exemptions make life insurance as flexible as any other non-tax-sheltered investment.

The holder of a non-exempt policy must pay taxes annually on an accrual basis — which is probably why there is little demand for such policies.

In fact, few insurers issue them.

In addition to ensuring that a policy is exempt, tax advisers must also decide what type of life insurance would be best for the client — whole life, term to 100, universal life or endowment.

Whole life insurance is permanent insurance that matures on death. It has an accumulating policy reserve that equals the death benefit at the assumed extreme end of the human life span.

In order to maximize the investment element of a whole life policy, policyholders pay the premiums up front within the exempt limits. By escalating the death benefit, it's possible to increase the investment element over the years.

Term to 100 is a level whole life policy that is paid up at age 100. It has a reserve, but this reserve has no cash value.

Universal life (UL) is the most popular whole life policy. Its creators originally called it the "unbundled policy" because it unbundled the three elements

Department Editor:  
Dianne McMullen, CA  
BDO Dunwoody  
Toronto

Jason Schneider

of whole life insurance: expenses, mortality charges and investment. The expenses and mortality charges in a UL policy are clearly spelled out and represent the basic insurance element of the policy — which is likely obtained at a lower cost than “cheap” term insurance. The latter is simply temporary insurance and has little or no investment element.

Endowment life insurance matures at a given time (10 or 20 years, for example) or age (say at age 65) or on earlier death. At the end of the endowment term (except for death), the maturity value over the adjusted cost base is fully taxable. As a result, this type of insurance is not widely used.

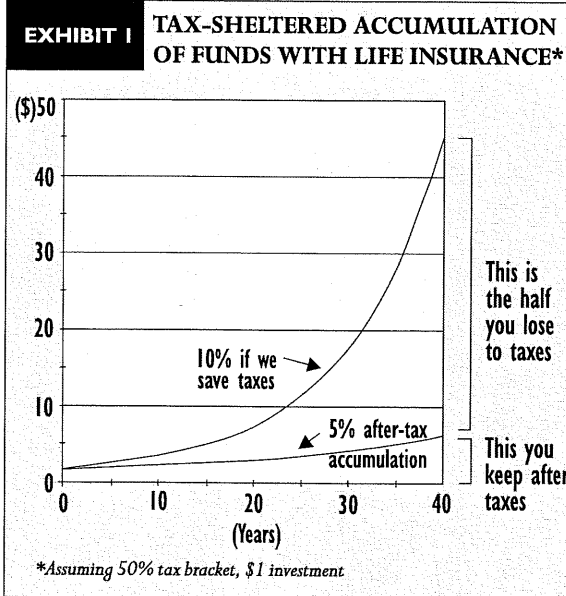
Let’s now look at the investment element of a whole life policy: the policy reserve that accumulates on a tax-sheltered basis and that remains tax free on maturity.

There are numerous investment vehicles for this reserve. The two major types are those that guarantee the interest credited to the policy reserve for a period of years (GIC type) and those that credit to the reserve a return generated by a fund invested by the insurer (fund type).

The fund type of reserve is divided into two categories: segregated funds (that is, segregated from the insurer’s general portfolio assets), and non-segregated.

The popularity of mutual funds in the past 10 years has made investing the policy reserve in segregated funds common, though this type of reserve does not benefit from the tax-sheltered accumulation enjoyed by non-segregated funding. In effect, the policyholder trades the benefits of tax deferral for the promise of higher returns.

The tax-sheltered accumulation of a life insurance policy is best understood from Exhibit 1, which is based on the assumption that \$1 is invested at a 10% annual gross yield and that the taxpayer is in the 50% bracket. The curve showing the accumulation at 10% compound interest demonstrates the increase attributable to the saving in taxes when compared to the return of 5% after 50% tax paid annually. Time is a great factor in compounding at pre-tax rates. Unlike other tax-sheltered vehicles, life insurance also compensates for the loss of



tax-shelter time caused by premature death — in other words, if the policyholder dies early, the death benefit greatly exceeds the cash value of the policy.

Policyholders can use the accumulating fund during their lifetime by borrowing against it from a lending institution. This allows them to avoid the tax that would be triggered on partial surrender or withdrawal, or by taking a policy loan. In effect, the policyholder is banking against the tax-favoured maturity of the policy.

Exhibit 2 shows how a policyholder can leverage the funding capacity of a \$100 deposit in a life insurance policy — a permanent tax shelter accumulating at 10% and maturing tax free in 25 years. In year 10, the accumulated fund would have risen to \$260. Instead of cashing in the policy and paying \$80 tax on \$160 of gain, it would be wiser to borrow against this equity and to allow the insurance to mature tax free on the assumed death at the end of 25 years. The exhibit shows that if this option were taken, the \$260 would grow to \$1,083 in 15 years. This tax-free maturity value of \$1,083 would theoretically allow the individual to borrow up to \$452 in year 10 at a net after-tax cost of 6% (12% pretax) and pay back the cumulative loan of \$1,083 at the assumed maturity on death at that time. To fund \$452 in 10 years with an initial investment of \$100, a taxpayer would require an after-tax return of 16.3% — an equivalent of 32.6% before tax.

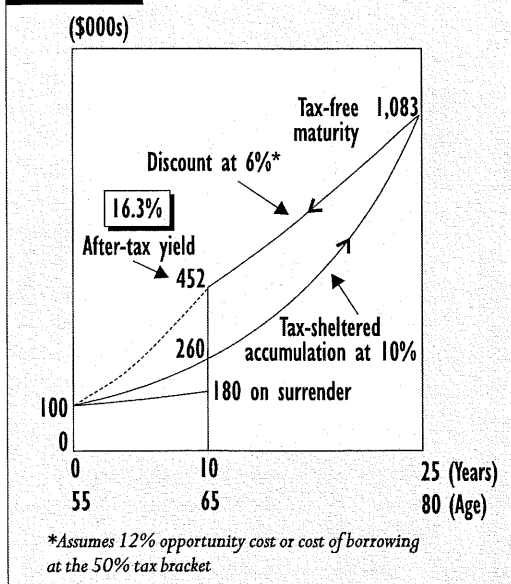
Another “living” benefit — retirement funding — is too important to ignore. Life insurance is an effective tool for funding executive supplementary retirement benefits and for the retirement of partners in a legal, accounting or other type of professional partnership. The policyowner can borrow against the cash value to pay for retirement obligations, while the loan can be repaid with the tax-free maturity value of the policy. Funding for those obligations without

the help of tax-free accumulation would be considerably more expensive.

Many partnerships recognize the payout for a retirement income based on a combination of capital, undrawn income, work in progress, accounts receivable, goodwill, etc. If not properly funded, these payments could cause a serious monetary drain on the remaining partners and present a disincentive to new partners. Sinking funds administered by outside trustees would not be as tax effective as life insurance.

In addition to retirement funding, there are death taxes to consider. Many estates are faced with acute cash shortages because of capital gains taxes on the deemed disposition of capital assets on death. Life insurance offers the advantage of not only providing cash to pay the tax liability, but providing it tax free. With assets such as private company shares or real estate, there is always a risk of poor liquidity. The heirs may be forced either to sell their assets at a loss or to borrow money at a non-deductible interest cost to meet their tax obligations. For that reason, taxpayers facing tax liabilities on their death would be well advised to consider life insurance as a funding vehicle before the beneficiaries are shocked at the reduction in their inheritance or its total evaporation owing to liquidation under adverse market conditions.

To provide for cases where there may be few liquid assets available to fund death taxes, a special type of policy —

**EXHIBIT 2**
**LEVERAGED TAX-SHELTERED FUNDING AT RETIREMENT**


cost recovery life insurance — has been constructed by several insurance companies. The death benefit of a policy is the desired amount plus the premium payments compounded by the agreed after-tax cost-of-money factor. With every extra dollar invested into an exempt policy, the insurance cost can be reduced by the profits generated by the tax-sheltered accumulation of that dollar at a rate higher than the depositor's after-tax opportunity cost.

There is also a way for corporations, shareholders and beneficiaries to use exempt life insurance for tax advantages. The capital dividend account available to Canadian-controlled private corporations allows the proceeds of a life insurance policy received on death in excess of the adjusted cost base of the policy to flow out tax free to its share-

holders. This has been an important planning tool for funding buy-sell agreements and key-man insurance, and, in some cases, for converting otherwise taxable surplus into a tax-free dividend.

In cases where there has been a capital gain on the deemed disposition of the shares of a deceased taxpayer and the shares have been subsequently redeemed, the capital gain on the deemed disposition may usually be eliminated (by use of subsection 164(6) of the Income Tax Act). But the share redemption gives rise to a deemed dividend, which is taxable. The capital dividend account produced by life insurance pro-

ceeds can effectively convert this taxable dividend into a tax-free dividend. However, if proposed changes to Section 112 (as set out in the April 26, 1995 technical amendments) become law, the capital loss on the redemption of the shares may be reduced by the amount of the capital dividend.

The value of the shares of a company that owns a life insurance policy on the life of the deceased shareholder does not reflect the death benefit but only the cash value of the policy. This fact, along with the capital dividend account, has allowed planners to effectively use private corporations to own life insurance.

Although the advantages of whole life insurance are obvious, there are still some people who would rather opt for term insurance. Tax advisers can try to

persuade these clients to buy "cheap" term insurance and invest the difference between the premiums for whole life and those for term insurance into a universal life policy where the accumulation is tax sheltered and paid out tax free on death. Clients who follow this advice will enjoy tax-free access to the accumulating fund during their lifetime by borrowing from the bank against the accumulating fund; or by living on capital or other assets as long as possible. This allows tax-sheltered compounding of the exempt policy.

Whatever type of policy is chosen, it's important to remember that an investment into life insurance and a life annuity can be protected from creditors through the appointment of a preferred beneficiary (parents, spouse or children).

Clearly, then, life insurance is one of the few investments that allows for a tax-sheltered accumulation of funds and at the same time covers the risk of death. The pre-tax compounding effect and the tax-free access to this accumulating fund are two of the attractions of life insurance. The tax-free maturity on death is the ultimate plus.



George F. Lengvari, Sr.,  
PhD, LLB, CLU,  
is the head of Lengvari  
Financial Inc., an estate  
and benefit consulting and  
life insurance brokerage firm.



Ronald S. Joshua,  
MA, CA, is currently on  
the executive of the  
Estate Planning Council  
of Toronto.