Manulife

Accumulating and Transferring Wealth Through the Use of Life Insurance

The Personal Perspective
Life insurance is well known for its ability to provide liquidity to fulfill financial obligations arising on death. What is less well known is that life insurance is a versatile financial instrument that can also be used to accumulate wealth, preserve assets and increase estate values to heirs. With careful planning, an exempt life insurance policy and strategies designed to maximize the use of tax-deferred accumulation within an insurance policy can also provide substantial tax benefits. At Manulife we call this strategy the "Estate Bond Concept".

Protection and Savings Elements of Life Insurance
Life insurance is, by its nature, a hedge against the risk of death. It is a cost effective method of providing a tax-free lump sum at death to meet liabilities, or to compensate for the financial loss arising as a result of a person's death. This protection element is generally the main reason why life insurance is purchased.

The premium payable in respect of the protection element of a life insurance policy will generally take into account the insurer's estimate of expected mortality rates, investment earnings, policy lapses and terminations, as well as administrative expenses and profit margins.

However, life insurance can also be used as a tax-effective savings vehicle.

Conventional savings investments are exposed to tax, whether under the accrual rules on an annual basis or as income received by way of interest, dividends or as capital gains realized on dispositions of capital property. Exposure to tax reduces investment returns and ultimately, what is received at death by heirs.

As an alternative, a policy owner can deposit funds into an exempt life insurance policy in excess of what is needed to fund the current policy premiums. These extra funds can grow tax-deferred within the policy and be used to fund future policy costs, buy additional insurance coverage and/or accumulate as cash values that can be accessed during life or paid out as a death benefit. As a result, life insurance can be structured to provide pure protection, with no element of savings, or it can be structured to provide protection as well as a savings element or cash value.

The "Estate Bond Concept" compares the net estate value arising from a life insurance policy to an alternative investment assuming the same amount of funding. Note that the tax-sheltered investment component should not be the only motivation for purchase of a life insurance policy. The need for the

pure protection element and the costs thereof should be factored into the comparison to a taxable investment alternative.
When compared to taxable investment alternatives, an exempt life insurance policy is an effective wealth accumulation and transfer tool. The combination of both the protection and investment elements of life insurance can deliver higher estate values.

Income Tax Considerations

Treatment of Accumulating Income
Almost all individual life insurance policies issued in Canada qualify as "exempt policies" under the terms of the Income Tax Act (the "Act"). The income that is generated from the investment of the accumulating fund held for the benefit of the owner under an exempt policy is not subject to tax in the owner's hands on an accrual basis. This ability to defer tax will be attractive to individuals who have exhausted their available contribution limits under tax-preferred plans such as RRSP's, RPP's, TFSA's etc.

A death benefit received under an exempt policy is not considered to be a disposition of an interest in the policy and therefore is not taxable in the hands of the recipient. Consequently, the accumulating investment income within an exempt policy is not taxed on an accrual basis, nor is it taxed when received by a beneficiary as part of the death benefit provided by the policy.

Policy Dispositions
Generally, when an owner disposes (or is deemed to dispose) of an interest in a life insurance policy, the excess of the proceeds of disposition over the owner's adjusted cost basis (ACB) is taxed as ordinary income. For this purpose, a disposition generally includes a sale or other transfer of the interest to another party, a surrender of the policy, a withdrawal from the policy and a policy loan received from the insurer. Where an exempt policy ceases to qualify as such, the owner is deemed to dispose of his or her interest for proceeds equal to the accumulating fund at that time. (This would be rare since most insurance contracts specify that the insurer will take steps to attempt to preserve the exempt status of a policy.)

If a partial withdrawal is in respect of a policy, the owner is considered to have disposed of a part interest in the policy. To determine the gain from a partial disposition, the ACB of the part interest is generally calculated as the proportion of the owner's total ACB that the amount withdrawn bears to the total accumulating fund in respect of the owner's interest immediately before the withdrawal. A policy loan on the other hand, is included in the owner's income only to the extent that the amount of the loan exceeds the total ACB of the owner's interest in the policy.

In general terms, the ACB of an owner's interest in an exempt policy is the aggregate of the premiums previously paid less a measure of the net cost of pure insurance, as prescribed by the Regulations (the "mortality cost"), incurred in respect of the owner's interest in the policy. The ACB is intended to measure the cost for tax purposes of the owner's interest in the accumulating fund. Consequently, to the extent the premiums have effectively been used to cover the pure cost of insurance, they are excluded from the ACB calculation.

In summary, where funds are cashed out of an exempt policy upon surrender of the policy, as a partial withdrawal from the policy or by way of a policy loan, the income which has accumulated within the policy until that time is taxed as ordinary income upon receipt. Similarly, where an owner sells (or is deemed to dispose of) an interest in the policy, the amount of any gain is also taxed as ordinary income. Dispositions are discussed in depth in the Tax Topic entitled "Dispositions of Life Insurance Policies*."*

Exempt Policy
The purpose of the exempt policy test is to establish a standard or a benchmark, to distinguish between policies that are designed mainly to provide insurance protection from those that are designed primarily as an investment or savings instrument, providing only ancillary insurance protection. Tax exempt status is accorded to protection oriented policies. As noted earlier, income accumulated in an exempt policy is not subject to tax on an accrual basis. Income accumulated in a **non**-exempt policy is subject to tax on an accrual basis in a similar manner as interest earnings on debt instruments are taxed.

The test to determine whether a policy qualifies for exemption is applied by comparing the accumulating fund of the actual policy at each anniversary date with the accumulating fund for a hypothetical "exemption test policy" which is deemed to be issued at the time the real policy was issued. A policy remains exempt provided that its accumulating fund does not exceed the accumulating fund of the exemption test policy. The mechanics of the exempt test and the maximum allowable growth within an exempt policy is discussed in depth in the Tax Topic entitled "The Exempt Test."

Even though the savings that can be sheltered in an exempt policy is limited, often significant amounts can be (and are) accumulated in these policies.

Issues to Consider in Comparing the Alternatives

Internal Rate of Return

In comparing life insurance to an alternative investment, it is helpful to consider the internal rate of return (IRR) of the policy as compared to the alternative investment. This is the rate of return that would have to be earned on the deposits to the policy in order to provide the same lump-sum death benefit (after tax) as is provided by the policy. Because life insurance typically provides a large death benefit immediately, the IRR is typically very high in early years. Over time, the death benefit may remain constant (for a term policy or a level death benefit policy), or it may increase with the growth of the cash values. In either case, the IRR for a life insurance policy typically declines over time; that is, the IRR if the life insured dies at say age 65 will be much higher than the IRR if the insured dies at age 90.

The analysis of internal rate of return of an alternative investment should be considered in the type of tax-exposed investment involved to accurately reflect the comparison. If for example, the alternative investment is a capital property which is held until death (as opposed to one which is disposed of regularly and therefore subject to regular taxation of gains), the internal rate of return calculation should reflect this. This can be done by simply ensuring that all cash flows used in the calculation are after tax.

Note that as rates of tax go down in the external tax environment, tax has less impact on the taxable investment alternative. As a result, if tax rates decrease, it will become more difficult for the life insurance policy to compare favorably over the long term. However, one should still realize that it is the combination of the protection element and the tax-sheltered investment component which together deliver the estate values, so while tax rates will have an impact, this may just serve to narrow the gap as opposed to switching their positions.

It is surprising to some investors that life insurance can have a very competitive IRR as compared to alternative investments.

Liquidity

The need for liquidity should be considered in comparing life insurance to an alternative investment. Very often life insurance will provide a very high IRR relative to an alternative investment. This makes it a very attractive vehicle for accumulating, tax-sheltering and eventually transferring wealth that the owner/insured will not need during his/her lifetime. However, if the owner/insured needs to access some of this wealth during his/her lifetime, consideration should be given to how this might be done (withdrawals, policy loans, collateral loans etc.) and the tax consequences of doing so, and how this compares to an alternative investment.

Creditor Protection

One of the advantages of life insurance is that if an appropriate beneficiary designation is made, the cash value of the policy is generally protected from creditors of the policy owner during life. At death the death benefit flows directly to the named beneficiary (circumventing the estate), thus avoiding estate creditors, probate[1] and other administrative expenses, if applicable. As a result the death benefit is usually protected from creditors as long as a beneficiary is named. This is in contrast to personally held conventional investments that are typically fully exposed to personal creditors.

[1] In Quebec, probate does not apply.

Financial Underwriting

Generally speaking, underwriters not only look at the medical health of an individual in relation to an application for life insurance but also his or her financial health. Underwriters are hesitant to approve life insurance coverage (i.e. the protection component) where the person is "worth more dead than alive". To determine a person's financial health underwriters look at the person's net worth and income. In relation to using life insurance to increase estate values, the amount of coverage that is applied for should represent only a portion of the person's net worth.

Investment Flexibility and Mix

Universal life insurance products offer a wide range of investment options ranging from daily interest accounts, to guaranteed investment accounts, to accounts that reflect the performance of various stock market or bond indices or funds (both Canadian and foreign), to accounts that reflect the performance of specific mutual funds. Policy owners can custom design a portfolio of investments within their insurance contract mirroring their investment choices in the external tax-exposed environment, fitting their individual investment preferences and risk tolerance. Adjustments to the portfolio investment mix can be made at any time, for the most part without the transaction costs and realization of tax (which may have been deferred in the form of unrealized capital gains) associated with such adjustments in the external, tax-exposed environment. With universal life insurance products, the responsibility to make investment choices and the management of those decisions is with the policyholder.

Where the preference is to not take on this responsibility, whole life insurance products may provide a suitable alternative. In whole life insurance products the investment choices and asset mix decisions reside totally with the insurer. Funds underlying all of the whole life policies issued by an insurer are invested in one investment account managed by the insurer's investment professionals. Generally, the funds in the investment account for a whole life product would contain various asset classes including: bonds and private debt; commercial mortgages and non-fixed income assets such as real estate, public equities and alternative assets such as private equity and mezzanine[2], power and infrastructure or resource assets). Within each class there is a well diversified pool of assets. It is important to understand that while the insurance company makes the investment decisions within this single diversified investment account, the risks associated with the resulting investment performance rest solely with the whole life insurance policy. The ultimate performance of whole life insurance policies is heavily reliant upon the investment returns achieved in the underlying, consolidated fund. The insurance company manages the investments on behalf of all of the policies that are aggregated in this fund but generally provides no guarantees on the performance of these investments.

It should be understood that the funds invested in a life insurance policy, whether managed by the policyholder (as is the case for universal life products) or by the insurer (as is the case for whole life products) become part of the insurer's general assets. The policy owners themselves are not investing in the underlying index or fund, rather the insurer is promising a rate of return based on the underlying index or fund. The insurer will typically, within its general funds, match appropriate assets and liabilities in order to be able to deliver the promised rate of return to the policy. It is for this reason that the financial strength and stability of the insurer is an important consideration in making a decision to purchase life insurance and maximize the investment component of it.

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[2] Mezzanine is a type of financing that combines the features of a loan with that of equity financing.

Summary
For many people, life insurance can act as an effective savings and investment device aimed at estate creation or estate preservation. Many high net-worth individuals have maximized the benefits of all of the other tax-preferred vehicles available such as RPP's, RRSP's, and TFSA's. By "investing" funds, into an exempt policy rather than a typical taxable investment, more funds may be provided to heirs than would have otherwise have been the case. An exempt life insurance policy can provide an attractive alternative to taxable investments by providing:

- A large, immediate estate value,
- Tax sheltered growth of cash values,
- A tax-free death benefit
- Reduced estate settlement costs (where a beneficiary is named) where applicable
- Increased creditor protection (where an appropriate beneficiary designation is made), and
- Liquidity, if required

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