Insurance planning for the sophisticated investor

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It is a common notion that insurance strategies at their most fundamental level are about managing risk and protecting against financial loss. In the event of death, life insurance can serve many purposes, such as repaying debts, providing an on-going source of income for loved ones, or funding a child's education.

However, high net worth investors often overlook the place that insurance has in their investment strategy, particularly as it relates to estate planning. Regardless of market performance and accumulated wealth, most people would rather leave more of their hard-earned wealth as a legacy to their family or charity, or both. Insurance can play an integral role in wealth accumulation during an individual's lifetime, preserve their wealth at the time of death, and help to transfer that wealth as efficiently and effectively as possible.

Tax efficiency

Most tax planning that is undertaken by individuals with professional advisors would include strategies for tax minimization and tax-deferral, both of which can be achieved using life insurance, making it an important consideration in any tax planning. Additionally, without proper planning, a large tax liability could be levied on an estate at death. Not only can insurance solutions provide tax-sheltered wealth accumulation during an individual's lifetime, they can also provide the necessary liquidity to fund taxes and other needs at the time of death, such as tax liabilities resulting from accrued capital gains on investments or a family cottage. This can allow families to preserve estate values and not be forced to sell assets they would otherwise keep. Proceeds from life insurance paid as a consequence of death are tax-free and may also avoid probate fees, if structured properly. In all, there are many tax efficiencies that can be created through the effective use of life insurance solutions. Individuals should consult with their professional tax advisors about whether life insurance should be considered as part of their overall tax plan.

Business planning

For professionals or business owners, life insurance can provide a source of tax-free capital for their family or business in the event of premature death. If structured properly, the proceeds can bypass the estate, avoiding probate fees and long delays in the settlement of the estate, as well as benefit from creditor protection. There are additional tax benefits if the policy is owned and funded by a corporation. While life insurance premiums are generally not deductible for tax purposes, most of the tax-free proceeds received by the corporation as a consequence of death can be distributed by the corporation to Canadian-resident shareholders as tax-free capital dividends. This can increase estate values and provide liquidity to meet estate planning needs or simply be held for the benefit of the family.

Retirement planning

Most investors want to ensure they can live the retirement they have worked hard to reach, and also preserve their wealth in order to pass it on to the next generation. Reallocating funds within a portfolio that are invested in fixed income vehicles to purchase a life annuity and a life insurance policy can provide a guaranteed lifetime cash flow in retirement while continuing to maintain the wealth in the estate. Alternatively, life insurance can also create a source of income or cash flow to meet liquidity needs during retirement, either by accessing cash values directly through withdrawals, which may have tax consequences, or indirectly by assigning the policy to a financial institution for a series of bank loans, which would be tax-free.

Charitable giving

Charitable giving with life insurance offers a number of benefits to both the investor and to the charity itself. A gift of life insurance can be an effective and practical way to make sizeable charitable gifts to charities or foundations at a low cost. Not only will life insurance help increase the size of the gift, in most cases it can provide significant tax benefits. For personally owned policies, this is in the form of non-refundable tax credits that can be used to reduce taxes otherwise payable. At the time of death, the proceeds from the life insurance policy flow to the charity tax-free, avoiding any probate and estate settling challenges and delays. The timing of the tax benefits can be designed in one of two ways: if the insurance policy is gifted to the charity at the time the policy is issued, the tax credits are based on the premiums paid each year (with no credit issued for the death benefit); alternatively, if the individual continues to own the policy but the proceeds received on death are paid by the estate to the charity in accordance with the will or are paid directly to the charity through a beneficiary designation, the tax credit is based on the proceeds (with no credit issued for the premiums paid into the life insurance policy).

Planning for the next generation

With life insurance, wealth can transfer to the next generation on a tax-advantaged basis. Reallocating a portion of an existing investment portfolio from a fully taxable position into a tax-exempt life insurance policy can result in an enhanced estate plan. The growth on policy cash values is tax-sheltered during the individual's lifetime. Eventually, the proceeds received on death are paid tax-free to the named beneficiaries, eliminating probate fees and potential delays in the settlement of the estate. When comparing the two options—keeping investments in fully taxable, fixed income vehicles or reallocating a portion of those investments into a life insurance solution—the net, after-tax estate values from insurance option can often result in a significantly higher return. Life insurance can also provide a source of capital to fund estate equalization amongst children. For example, if an individual owns a vacation property but not all of the children are interested in receiving a joint ownership interest in the property with siblings, life insurance can be used to equalize the estate. In this case, an individual may wish to name the children who are interested in keeping the vacation property as beneficiaries of the property in the will. A permanent life insurance policy could then be purchased for the benefit of the remaining child or children, the proceeds of which would be equal to the difference between what their inheritance is and what it would have been if they had received their share of the vacation property.

Life insurance has many uses, many of which are not well known but very valuable, particularly to individuals with significant wealth who are interested in reducing taxes and/or have liquidity issues related to their holdings. Working with an advisor to develop a financial plan should identify where and how such solutions could play a role and add value, enhancing wealth and the legacy that an individual leaves behind.

Please note that it is extremely important that individuals obtain advice from a professional advisor when developing an insurance strategy. Benefits from different strategies can vary greatly depending on a number of factors, such as age and health. Individuals interested in this type of planning should contact their professional advisors.