Special

FINANCIAL PLANNING

For high-net-worth Canadians, liquidity is key to protecting wealth

Life insurance specialist and lawyer Paul Tompkins of Tompkins Insurance Service Ltd. has provided financial and estate planning solutions for high-net-worth families across Canada for over 20 years. He answers questions about the role of life insurance in protecting wealth.

What are some of the ways that life insurance can help high-net-worth individuals protect their businesses and their personal wealth?

If you've built up a business that you wish to transfer to the next generation, you must put in place proper mechanisms to fund the capital gains tax. If your family cannot come up with cash, it may force the sale of the business. An estate plan that simply distributes the shares of the business equally to all of the children is not always the best strategy for the business or the family, so having liquidity to buy out certain family members is a good idea.

Using cash to pay the tax burden may deplete the estate value, and borrowing to pay the tax is an expensive option. The alternative, selling assets, may result in triggering more tax, and it may be an inopportune time to sell, such as during a depressed real estate or stock market.

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How are estate freezes and family trusts typically used to protect wealth for business owners?

An estate freeze allows the shareholder to exchange his or her common shares, which have a significant accumulated capital gain, for preferred shares with a value frozen at the current fair market value. A trust is then created to hold new common shares that will reflect future growth. The beneficiaries of this trust will typically be the shareholder and his or her spouse and children.

The Income Tax Act requires that the trust distribute these common shares to the beneficiaries within the next 21 years. It is therefore advisable not to undertake an estate freeze too early in life.

The preferred shares allow the parent to maintain control of the company, and the tax on these shares will be due on his or her death. However, any capital gains tax on the new common shares is deferred until the death of the beneficiaries.

What role does life insurance play in mitigating tax and preserving family capital for the business owner?

Life insurance death benefit proceeds are tax-free payments. If the policy is owned by a private Canadian-controlled company, the death benefit proceeds, subject to its adjusted cost base, will be credited to the capital dividend account of the company. Capital dividends may be paid out tax-free from the company. The combination of the tax-free capital dividend and a taxable dividend can result in lower estate-related taxes. So not only does whole life or universal life insurance provide the liquidity to fund the tax, it helps reduce the tax.

What role can life insurance play as part of a charitable gift strategy?

There are various life insurance based charitable strategies; for example, transferring an existing life insurance policy to a charity. Alternatively, the taxable benefits resulting from a donation of cash or shares today can be used to fund a life insurance policy, to replace the capital to the estate.

DATA

Relative costs to fund estate tax liability

| Borrow from the Bank | Sell an Asset and/or Use Cash | Prefunded (with Insurance Policy) |