Innovative life insurance strategies for estate planning

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Increasing tax rates for individuals and investment holding companies:

Is there an alternative strategy?

Welcome to 2016.

Welcome to a world of higher personal and corporate taxes on investment income.

Tax rates are increasing for personal income, capital gains and dividends on income over $200,000. In addition, the Part IV tax rate on Canadian-source dividend income and surtaxes on investment income are increasing by 5% and 4% respectively, for Canadian Controlled Private Corporations, which is for many business owners their investment holding company.

The higher tax rates will result in reduced personal after-tax income and after tax investment returns in the investment holding companies.

Given this new high tax regime, are there tax efficient investment alternatives? The short answer is yes – and it comes from an unlikely source; namely tax-exempt life insurance.

KEY POINTS TO CONSIDER:

- **A whole life insurance policy provides unique tax-exempt growth capability** that you can structure as an alternative investment tool, as well as benefiting your estate plan. These policies have a 100-year track record of returns with low volatility. A policy owned in your investment holding company allows you to transfer funds into a tax-exempt managed portfolio that ultimately provides a death benefit that will be received by your company tax-free. In addition, the insurance proceeds will be credited (subject to the adjusted cost of the policy at time of death) to the Capital Dividend Account (CDA). Capital dividends flow, tax-free, to your estate. This CDA credit also acts as a tax-planning tool to help reduce the inevitable capital gains tax in your estate.
- **Rules on tax-exempt life insurance are changing in 2017.** As of January 1, 2017, the life insurance tax-exempt rules are to be slightly modified. All permanent life insurance policies issued prior to the end of 2016 will be grandfathered under the current rules – which allow for (a) a higher credit to the CDA, at or near life expectancy, (b) a greater build-up in cash value and death benefit, in particular for lives insured under age 50. In other words, an effect of the new rules is that the amount of death benefit proceeds credited to the corporation's CDA from a policy issued in 2017 (and onwards) will be slightly less than a policy issued in 2016, all things being equal.
- **Corporate-owned life insurance offers a viable alternative.** The combination of increased tax rates and impending changes to the life insurance tax-exempt rules makes 2016 an ideal time to consider corporate-owned life insurance as an alternative investment tool – for a number of reasons:
  - The cash value of the policy remains an asset of the company.
  - The after-tax internal rate of return on the policy is very attractive.
  - The death benefit creates CDA (with the CDA credit being higher for a 2016 policy).

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Life Insurance Strategies for Estate Plans

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- **Do not wait until distributions are made from family trusts to insure the tax.** If a family trust is within a few years of having to distribute assets that have significant accrued capital gains to beneficiaries as a result of the 21 year rule, it might be wise to consider taking advantage of the grandfathered life insurance rules and purchase the life insurance on the lives of the beneficiaries in 2016, as opposed to waiting until the actual trust rollout.

- **The impact to investment holding companies is real.** Many business owners utilize an investment holding company as a way to invest funds earned in their operating company, and take advantage of the tax-deferral opportunity it provides because of the lower corporate tax rates. Generally, corporate taxes paid in Ontario (rates vary by province) on income earned in the operating company are at 15% on income under $500,000 and 26.5% on income over $500,000. In addition, when selling their companies, many owners retain a significant portion of the sale proceeds in their investment holding company in order to minimize the capital gains associated with the sale.

  The corporate tax rate increases on investment income will make it more expensive to earn investment income in a corporation. In addition, with the personal tax rate increasing on eligible and non-eligible dividends in Ontario (rates vary by province) to 39.34% and 45.3% respectively, there is an even greater disincentive to withdraw funds from the investment holding company as dividends (dividends received from the holding company from after-tax investment income are generally subject to the higher non-eligible dividend tax rate).

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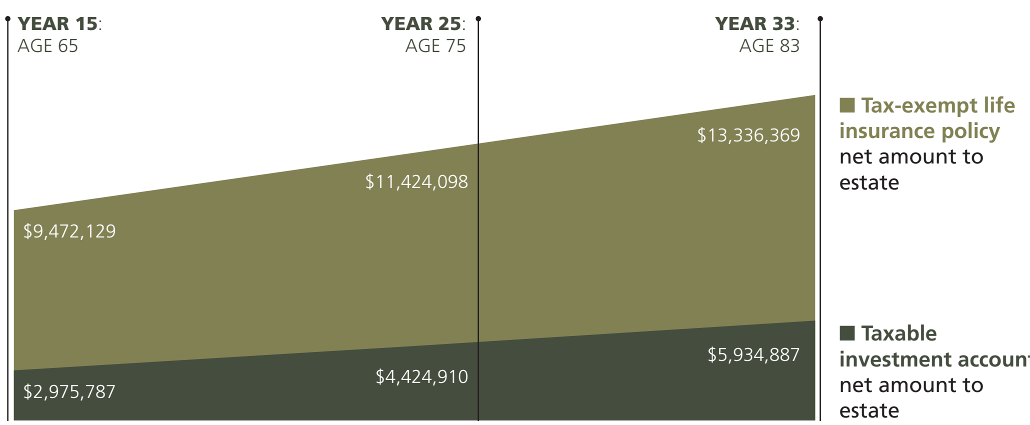
President of Tompkins Insurance Services Ltd., along with his staff and strategic partners, specializes in advising and implementing life insurance based solutions for high net worth individuals and families as part of their overall estate planning process.

LIFE INSURANCE IS OFTEN OVERLOOKED AS A TAX-EFFECTIVE STRATEGY.

For decades, life insurance has provided business owners with unique tax-exempt investment capabilities, as well as a CDA credit. Now, with increasing investment and dividend tax rates, the case for using a whole life insurance policy is more persuasive than ever.

The table below compares investing $250,000 annually for 13 years in a taxable investment account as compared to a life insurance policy. This table illustrates the "net estate value" – the amount available after paying corporate taxes and then distributing the funds and the recovery of the refundable dividend tax on hand ("RDTOH") to your estate as an eligible dividend. As discussed above, it is possible that the higher non-eligible rate would apply, thus increasing the differential in the two net estate values, in favour of using life insurance.)

$250,000 invested annually for 13 years in a taxable investment account vs. a life insurance policy



ASSUMPTIONS: Corporate tax rate: 50.17%, Shareholder tax rate: 39.34%, RDTOH rate: 30.67%.
Returns based on low-risk investment portfolio: 50% in equities at 6% (taxed at captial gains) and 50% in fixed income at 3%.
Assumed annual deposit of $250,000 for 13 years. Values based on Sun Life whole life, using their current dividend scale.

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Tompkins Insurance Services is a specialized firm that designs and implements life insurance strategies for large and complex estate planning needs. We work exclusively with affluent business families and their advisory teams across Canada.

We would be pleased to discuss the merits of this timely life insurance strategy with any business family (or their tax advisor) who has an investment portfolio in their investment holding company, is dealing with family trust distribution issues, is seeking to maximize the long-term intergenerational value of those assets, or is trying to minimize the effects of the estate tax liabilities.