Wealth Management

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Create wealth and maximize your estate with tax-exempt life insurance

Life insurance has always provided a solid foundation in any financial plan. It provides protection for you and your family in the event of a disastrous situation, and has come to be regarded as a necessary expense in hedging the risk of future financial loss. Have you also considered that life insurance can be another asset within your overall portfolio?

What is tax-exempt insurance?

We all have the same pools of capital within which to invest our wealth – pension, Registered Retirement Savings Plan (RRSP), Tax Free Savings Account (TFSA), and non-registered accounts (equities, fixed income, mutual funds) and real estate. Income derived from each of these pools of capital is taxable, as is often the annual growth and any residual value upon your death.

There is, however, another pool of capital that allows for:

- Tax-deferred growth, just like within your registered pool of capital
- Potential for tax-free income during retirement
- Tax-free distribution upon your death

Also, you can use some of the proceeds from this pool to fund the tax liabilities incurred within your other pools, with the remainder immediately distributed to your heirs, free of cost or hassle. This pool of capital is known as tax-exempt life insurance.

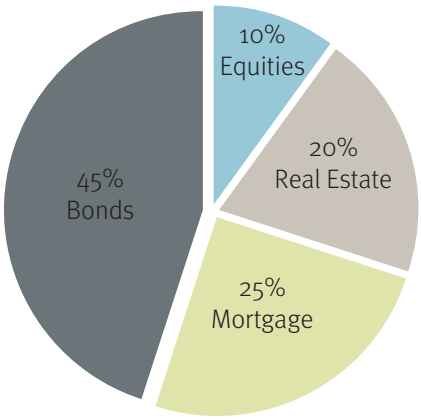
Under the federal Income Tax Act, assets accumulate within a tax-exempt life insurance contract free of annual accrual taxation. When you pass away, any proceeds of the policy are distributed to your beneficiaries on a tax-free basis outside the scope of your estate, bypassing its associated costs.

With traditional insurance products, you pay an annual expense – the cost of protecting yourself. However, with tax-exempt life insurance, that expense is merely the price of admission. You can actually deposit amounts well in excess of those costs and invest the difference within the contract. How that investment is managed differs between two product options – Participating Whole Life (PAR) insurance and Universal Life (UL) insurance.

Participating Whole Life

With this type of coverage, your insurance company invests those additional deposits within a large pool comprised of similar deposits from other policyholders. This pool, called the PAR fund, is separate from the rest of the firm's general assets and helps to drive its profits. A typical breakdown for the investments within this pool is as follows:

Asset breakdown of PAR fund (sample)



Based largely on the performance of this pool, your insurer returns a portion of your deposits in the form of dividends. In essence, you are participating in the profits of your insurer.

Dividends

You have several options for receiving these dividends. You can take them in cash, allow them to accumulate at a fixed interest rate, or possibly use them to offset your future premiums. However, the most popular option – and the one that can generate the most tax-deferred growth – is called Paid-Up Additions (PUA). These are additional amounts of permanent insurance that create their own dividends, creating a compounding effect that can lead to a substantially higher estate benefit. The additional "growth" in this estate benefit is, of course, exempt from tax. Dividends aren't guaranteed and will fluctuate.

Guarantees

One of the attractive features of PAR is its level of guarantees. You are guaranteed an annually increasing cash value – the net amount you would receive if you choose to end the contract. The cash value is an asset that can be used as part of a number of strategies down the road. And when dividends are credited to the policy, you benefit from increases in both the cash value and the estate benefit. Of course the greatest thing about dividends is that once they are credited they cannot be taken away. This provides a great amount of comfort for risk-averse clients. And though dividends cannot be guaranteed, they do have a long history of stable performance. Investments within the PAR fund are regulated by the Office of the Superintendent of Financial Institutions of Canada (OSFI).

Bundled product

As a bundled product, all of a PAR product's elements are inextricably linked. Policyholders cannot identify the various components at work within the contract, such as how much of premium is used to pay costs and how much is allocated to the PAR fund. Every year they receive a statement that indicates how much premium they must deposit, what their cash value is, and what their current insurance coverage is. The only other information they know is the publicly stated dividend rate at which the insurer will credit the policy.

Other considerations

One of the concerns with PAR is its lack of flexibility. The premium requirements are quite rigid and are not easily manipulated once the policy is issued. And if your needs change, it is difficult to alter the details of the initial coverage. Furthermore, the changes that are permissible often have unfortunate tax consequences. In the past, individuals who were interested in

managing and controlling all aspects of their own finances grew uncomfortable with this bundling effect.

Universal Life

In response to consumer demand for an "unbundling" of PAR, Universal Life was born. All of its components can be controlled and tracked, but the investment risk is passed into the hands of the client.

Minimums and maximums

Based on the amount of insurance coverage, you must pay a minimum premium that covers the cost of the insurance, administrative fees, and premium taxes. If you are interested in only maintaining your coverage, this is all you would pay. However, you would not enjoy any tax-deferred growth.

Though policyholders must deposit at least the minimum, they are also allowed to put in as much as the maximum premium. The maximum is several times more than the minimum premium, and dependent on your age, gender, health, and the face amount of insurance coverage. The difference between the minimum and what you actually deposit is invested in a variety of options, and any growth is tax-deferred.

Investment options

What individuals really like about UL is that it puts control back into their own hands. They no longer have to rely on the insurer investing prudently within the PAR fund; they can now choose to invest their money as they best see fit.

Choices are limited to the options within the individual plan, but most policies allow you to invest in an array of vehicles, such as guaranteed interest, leading equity and bond indices, and even some brand name mutual funds. You can build a diversified portfolio within your UL plan, whereby interest equal to the growth in your options is credited to your plan.

A fee, similar to a management fee on a mutual fund, will be deducted before interest is credited. Fees will vary based on the underlying investment and by company.

Risks

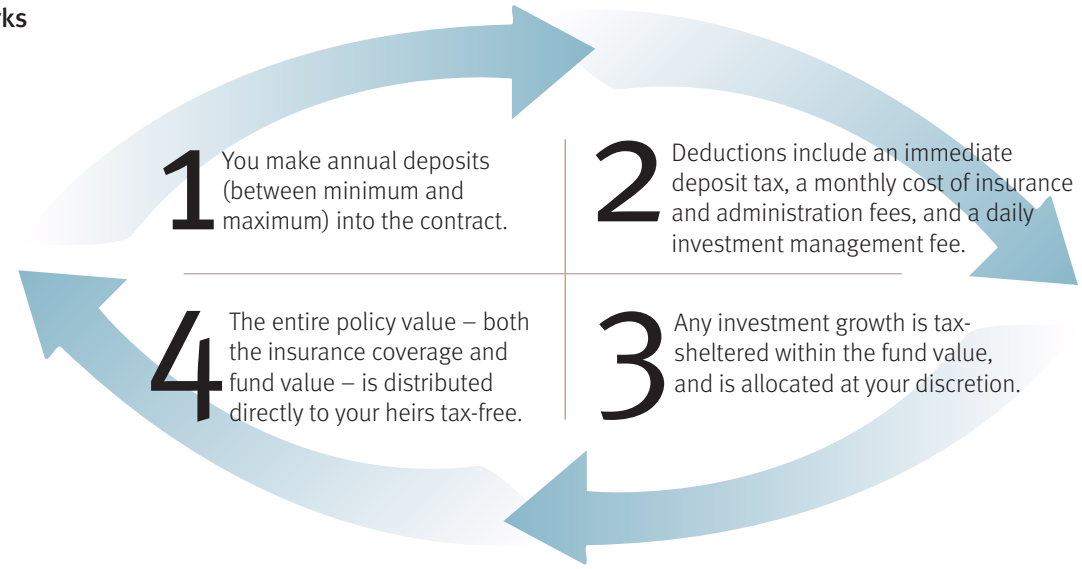
Unlike PAR, where exposure is limited to a dividend not being credited, the risk of investing within UL is similar to other financial vehicles. Returns on options linked to equity indices, such as the S&P/TSX or Nasdaq, can just as easily be negative as positive. Individuals must be willing to subject themselves to this possible volatility. Certainly you can choose to invest in guaranteed options, but as in your regular portfolio, the opportunity for long-term growth is linked to investment risk.

You should also consider the actual insurance coverage within the contract. It must be supported by either new deposits or the value of the investment fund. The performance within that portfolio may affect the sustainability of the coverage and significantly impact your original plans.

PAR vs. UL

Life insurance coverage – whether it is term, UL or PAR – continues to be, first and foremost, an estate planning tool. The benefits are primarily for our loved ones and other individuals. However, one cannot ignore the growth opportunities within tax-exempt insurance.Once you've determined that your financial plan can be enhanced by tax-exempt insurance, the big question is, PAR or UL? At the end of the day, they are both geared towards accumulating wealth and enhancing your estate.The basis of your decision will most likely come down to your personal attitudes towards risk and investment style.

Here is an illustration of how UL works



The following chart outlines considerations for PAR or UL. As you can see, PAR provides a more stable, long-term investment approach for the conservative individual, but at the expense of visibility, control, and flexibility. UL offers the ultimate investment arrangement within a life insurance policy, but by placing the responsibility of investing in your hands, you also incur a market risk. Keep in mind, there is a wealth of options within UL from which to choose including guaranteed interest investments.

"The life insurance industry has developed attractive and highly sophisticated products that can help you meet two planning objectives at once: having insurance coverage and providing retirement income from tax-sheltered growth … if you have maximized your TFSA and RRSP contributions, this type of life insurance policy may provide another opportunity for you to shelter your savings from tax … professional advice is a must when assessing the merits of this type of 'investment.' Insurance policies are, however, a potential opportunity for those who cannot otherwise find alternative deferral arrangements."

— KPMG Tax Planning For You and Your Family, 2012

	Universal Life (UL)	Whole Life (PAR)
Risk	You are comfortable with normal investment risk.	You are more risk averse, preferring slow but stable returns.
Control	You need to have control of the investment part of the policy.	You are comfortable allowing the insurer to control the investments.
Flexibility	You value the ability to change your policy if you need to.	You are comfortable that little to no change will be required.
Visibility	You feel the need to regularly monitor your performance.	You are comfortable with the long-term investment approach.

Reallocate from one pool of capital to another

There are two basic truths with regards to planning:

1. The purpose of all capital is to generate income for you and to help you provide for your heirs.
2. Tax is the single largest factor eroding the performance and ultimately the size of your estate.

So, if sufficient capital has been allocated for income and the surplus is intended for the next generation, why should we continue to expose all of it to the punishing effects of taxation? You may want to consider shifting a portion of your assets from a taxable account to a tax-exempt environment.

For passive pools of capital that are earmarked for the estate and future generations, there is virtually no other investment vehicle that can provide an immediate estate benefit, reduce taxes payable on existing pools of capital, accumulate funds in a tax-exempt manner, and generate a better after-tax return for your estate.

With tax-exempt life insurance, there is no right or wrong decision. The biggest consideration is your level of comfort. Talk to us about your goals and values, and we will help you decide what solution is the best for you.

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