RBC Wealth Management

The three uses of life insurance

There are three opportunities to utilize insurance in the process of generating a financial or estate plan. Insurance can be used to bridge gaps in your current financial plan during your working and retirement years, and to help create an estate plan for the efficient distribution of your assets. Insurance also plays a key role in risk management. It resolves issues around the risk of a premature death and the effect this has on wealth creation. Insurance also addresses the risk of estate shrinkage on death due to capital gains and income tax liabilities. Lastly, insurance eliminates current taxation on pools of capital exposed to taxes on fixed-income investments.

Life insurance can satisfy a number of wealth management objectives.

Wealth creation

Life insurance, in this context, is used to create wealth that would have otherwise been created if not for the premature death of a financially contributing spouse. Typically, you would use insurance for this purpose if you're younger with financial obligations that would include, but not be limited to, a mortgage, education savings plans and childcare expenses. The surviving spouse would be financially compromised if there were no money in place to retire debt and fund education and other childcare expenses. Because discretionary cash flow is at a minimum, the insurance solution is typically renewable and convertible term insurance. Renewable means that at the end of each term the policy can be renewed without evidence of insurability. Convertible means the policy can be converted to any permanent plan the issuer has available at the time of conversion. Again, this can be done without evidence of insurability.

Estate preservation

This type of strategy is the most cost-effective method of funding the tax liability associated with the disposition of assets at death. The cost effectiveness is determined by a projected growth rate of asset-to-life expectancy and calculating what taxes will be attributed to the specific assets held at the time of death. This is always a moving target and all calculations are approximations. Should you sell or give away the asset while you are alive, then taxes will be paid at the time of disposition. In this case, the type of insurance you would apply for is permanent, either with a fixed death benefit or one that grows with the outstanding liability.

Please contact us for more information about the three uses of life insurance.

Tax-exempt investing

This is by far the most exciting opportunity for affluent Canadians with disproportionate amounts of their portfolio in fixed-income instruments. Most of these individuals have been either GIC refugees from the past or business owners or senior executives that have taken sufficient risk in their primary occupation or business and want to protect their funds from potential future loss or market volatility. However, these individuals have to pay tax on the income that their fixed-income capital generates regardless of whether they have spent it. Coupled with inflation, they find their purchasing power eroded annually.

The insurance industry recognizes that tax-exempt investing is appealing to these individuals, however the need for life insurance is not. To that end, the industry has created strategies and products that enable you to use insurance as a tax-exempt investment that complements your existing portfolio. You can reallocate a portion of your fixed-income investments into a tax-exempt policy, therefore effectively eliminating future taxation on that portion. The net amount, less the insurance costs, will accumulate tax-sheltered therefore generating no tax slips. Products have become sophisticated to the extent that the actual ongoing cost of managing the tax-exempt portfolio is now comparable to that of a plan that is tax-exposed.

Funds can be either left on account and paid out as part of the death benefit for the next generation or accessed for tax-free income via a loan strategy. However, in either case, a tax-free death benefit flows to the estate or directly to a named beneficiary or beneficiaries. The estate can then utilize the proceeds to fund for capital gains and/or income tax liabilities, create a personal legacy for children or other dependants or provide a social legacy for charities, trusts or foundations.

Conclusion

To summarize, life insurance can satisfy a number of wealth management objectives. Insurance products, not unlike the marketplace, have become more sophisticated and complex over the years and these types of plans are increasingly gaining acceptance among affluent Canadians and the tax and legal advisors that serve them.

Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and legal advisors before taking any action based upon the information contained in this article.