Insuring the Future

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Supplementing Retirement Income

"Leveraged Life"… Using universal life insurance for supplementary retirement income

A supplemental retirement income strategy that has been in the market place for the past few years but may not be well recognized, is a concept known as "leveraged life". Also marketed as "Retirement Enhancer", "Insured Retirement Plan", and "Personal Retirement Account", to name a few, is simply, using a portion of the account value of a life insurance policy as collateral for a series of tax-free bank loans.

This strategy gives a person the ability to take advantage of the tax-sheltering ability of a life insurance policy.

Outside of an RRSP/RRIF, life insurance (and we will deal more specifically with universal life) is the only other vehicle in Canada where we can accumulate growth on investments on a tax-sheltered basis. A major difference between the RRSP/RRIF and insurance is that the insurance plus the value of its investment account will be paid out totally tax-free at death where the RRSP/RRIF will be fully taxable.

Taking money directly from a policy in the form of a withdrawal has always been an option for the policyowner, but the down side with doing so, is that a portion or all of the withdrawal from the plan will be taxable at the policyowner's marginal tax rate. The same tax implications may arise if the policyowner exercises a policy loan.

Using the policy as collateral for a series of bank loans can provide the insured with a larger stream of funds and also allows for the loans to flow tax free to the policyowner. The policyowner has not put the plan in a taxable disposition by using it as collateral and therefore there is currently no tax paid on the loans.

***** This newsletter is not suggesting not to invest in non-registered investments, but rather to supplement your existing portfolio and point out certain strategies and pitfalls.*** **

Who should be looking at this strategy?

The market for this concept is a consumer typically in the age range 35-55. This gives them enough time to build up some significant cash value in their policy to later use as the collateral.

Generally speaking the consumer will be a high-income earner and have typically maximized their RRSPs, but will still need additional supplemental income upon retirement, and will look for ways to provide this supplemental income.

Consumers do not have a great deal of knowledge of this concept other than some articles that have appeared in newspapers and magazines. The articles are fairly general in nature although they will also include warnings regarding the risks inherent with this concept.

Alternatives to accumulating non-registered savings plans include mutual funds, segregated funds and to a lesser extent, GICs. Leveraged life insurance is an alternative, but the client requires a realistic view of the risks involved to make an informed decision.

"How many people would be excited about or be satisfied with a 66% reduction in income?"

The Registered Savings Problem

Because RRSP limits are frozen at $13,500 (as well as defined contribution or "money-purchase" pension plans) until 2003, this effectively means that individuals with incomes in excess of $75,000 can't save the full 18% of their pre-tax earnings in these tax shelters.

Consider the Defined Benefit Pension Plan limit of $1,722.22 per year of service or the overall limit of $86,111. For someone with a $125,000 income, this is a 68% replacement of pre-retirement income. But this drops off dramatically as income increases. At $250,000 annual salary, the maximum defined benefit pension pay out will only replace about 34% of pre-retirement income. How many people would be excited about or be satisfied with a 66% reduction in income?

Possible Supplemental Retirement Income Solutions

Financial vehicles available to help supplement pension plans and RRSPs are:

- Non-registered GICs
- Equity investments
- Leveraged Life

Let's look at each of these vehicles:

Non-registered GICs

On the safety side of the investment spectrum, you can invest in secure, guaranteed investment certificates outside of your RRSP.

Of course, the interest is fully taxable each year whether you spend the interest or not, so it will be a slow growth unless we return to the extremely high interest rates of the '80s. Most of us, however, don't want the high inflation and high unemployment that goes with high interest rates.

Today's interest rates in the 5%-6% range make it unlikely that this strategy will allow you to meet your goals when 1/2 of the earnings are taxed each year and are reduced again by the effects of inflation.

Non-registered equity investments

Many investors use equities, either in the form of direct stock ownership or in the form of mutual funds or segregated funds.

The good news here is that only 50% of capital gains are taxable (assuming the October 2000 Budget passes into legislation) and they aren't taxed until you sell your stocks or mutual fund units or until the fund manager decides to sell holdings of the mutual fund or segregated fund. Any dividends from Canadian stocks also give you a preferential tax treatment.

This strategy works well when the markets are going up. The trouble may come when markets go down. If you decide to move out of equities when the market starts to fall, you'll trigger all those deferred taxes. This may be well before your retirement and undo all the good tax deferral you have accomplished up to then. Most mutual funds and most individual investors create a certain amount of portfolio 'turnover', which brings a portion of deferred gains into income each year – limiting the amount of tax deferral available.

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Leveraged Life Insurance

An alternative that many high-income earners are considering is the purchase of a Universal Life Insurance plan and implementing the "Leveraged Life" concept.

Many enhancements and improvements have been made to universal life plans over the past few years. A full range of investment accounts including guaranteed investments, links to indexes such as the S&P 500, Eurotop 100 Index and the S&P/TSE 60, as well as links to mutual funds and mutual fund portfolios are available.

As long as the funds stay within the plan, these accounts will not be diminished by income tax or capital gains tax even upon a switch from equities to guaranteed accounts. Also to note, is that there are no foreign content limits.

How does leveraged life work?

"Because the investments are tax-sheltered, they will grow faster than similar investments that are outside of the insurance plan."

"These loans are not considered to be income so they will not affect clawback of the Old Age Security program or integrate with any other pensions..."

First and foremost, the reason for purchasing insurance is that there is a need for it. In looking at both your present situation and any future estate and business needs, an insurance professional along with your financial advisor and accountant can determine what this amount may be.

Deposits to an exempt life insurance policy will first be used to pay the cost of insurance and any other costs associated with the life insurance plan. All deposits in excess of this will accumulate on a tax-deferred basis in the investments you have chosen. Because the investments are tax-sheltered, they will grow faster than similar investments that are outside of the insurance plan.

In situations where the insured is also an owner/manager of a corporation, the split dollar concept may also be used to reduce the before tax cost of the insurance plan (see my March 2001 Newsletter). The corporation will be the owner of the insurance portion and the owner/manager will be the owner of the investment portion of the plan.

At retirement, the corporation will relinquish its ownership to the owner/manager in exchange for $1. There are no tax consequences in this exchange. The owner/manager may then collaterally assign the plan for the supplemental retirement income. Another great advantage for the owner/manager is the creditor-proofing of an insurance plan within the limitations.

When it comes time to use your policy as collateral, typically the financial institution will hold up to 90% of the account value if you hold long term interest accounts, and up to 50% if you hold equities in your plan. Typically, if you pledge up to 90% of your plan as security, it will provide you with more income and a lesser estate value at death. If you pledge up to 50% of your plan as security, the opposite is true.

Annual tax-free loans will be taken using the account value in the plan as security much the same as a reverse mortgage. These loans are not considered to be income so they will not affect clawback of the Old Age Security program or integrate with any other pensions and more importantly, no income tax is payable. You may service the interest alone or let the loan compound. At death, the amount owing on the loan will be paid to the institution, and the balance then paid to the beneficiaries – all tax-free!

Let's look at an example…

Art Van-Delay is an architect and owns a successful company. He's married, is 40 years old, maximizes his RRSPs, is in the highest marginal tax bracket of 46%, has very little debt and needs to explore other investment and retirement strategies. He currently has some term life insurance in place but has heard about using universal life insurance as a tax shelter and for supplementing retirement income. Art needs to review his life insurance needs for the protection of his family as well as looking at the succession of his business, as he has a daughter that is in university and plans to come and work at his firm.
After meeting with his accountant, financial advisor, and insurance professional, it was determined that Art would purchase a Universal Life plan with a face amount of $1,500,000. He is going to set the plan up in a

it. The plan has a guaranteed level cost of insurance and a death benefit that pays out the face amount of insurance plus the investment account.

If Art dies while the company still owns the insurance portion, the $1,500,000 will pay into the company's Capital Dividend Account and the investment account will be paid to Art's beneficiaries – tax-free!

Along with Art's accountant, it was calculated that Art's company would need to pay out substantial dividends and bonus to Art over the next few years so that his company would retain its reduced corporate tax rate. The company will pay for the minimum cost of the plan – $8,775.00 per year – and Art will deposit $26,225.00 for a total of $35,000 annually for 15 years. Art will leave the plan to accumulate further and plans to start taking income at age 65 for 20 years.

For our illustration purposes, we will assume the following:

- Assumed rate of return on investments for all years – 6.50%
- 50% of the account value will be used as security for increased estate value
- The loan rate for the collateral assignment – 8.00%
- For comparison purposes, a blended tax rate of 34.25% will be used for a diversified and balanced non-registered portfolio

The following table will illustrate the comparison between the "leveraged life" concept and using a non-registered investment portfolio:

	Annual Deposit	Estate Value at age 41	Estate Value at age 64	Annual After-Tax Income from age 65 - 84	Total After-Tax Income	Estate Value at age 85
Leveraged Life	$35,000	$1,527,955	$2,851,057	$68,384	$1,367,680	$4,879,785
Non-Registered Portfolio	$35,000	$36,500	$1,138,381	$68,384	$1,367,680	$795,465
Difference	***$0***	***$1,491,455***	***$1,712,676***	***$0***	***$0***	***$4,084,320***

The critical elements here are the Cash Surrender Value, the Accumulated Bank Loan, and the percentage of the accumulated bank loan with respect to the cash surrender value (loan capitalization rate). The bank will lend money to the policyholder and continue to do so until the accumulated bank loan reaches a certain percentage of the cash surrender value. The financial institution and the individual taking the loans will agree upon this percentage.

The insurance policy and the non-registered portfolio provide the same income but the insurance also provides insurance coverage during the same period. Moreover, the insurance will leave a projected benefit of over $4.8 million at age 85 – more than $4 million over a non-registered portfolio using the same deposit amounts!

Clearly, the leveraged life concept is a powerful strategy in this case.

Borrowing Risks

Like any strategy involving borrowing or “leveraging” as its sometimes called, there are risks – and borrowing usually increases risk at the same time it increases the rewards. In this case the reward is tax-free income.

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Revenue Canada could change tax laws between now and the time you decide to execute the borrowing strategy. This is always a risk. But they also have the General Anti-Avoidance Rules (GAAR) to deem this to be a policy loan. In this case the loans would be taxable income.

If your loan exceeds the loan capitalization rate, the lender will want more collateral or payments on the loan. If neither of these are available, then the lender has the right to go to the insurance company and request policy fund value to repay or pay down the loan. Tax on these withdrawals will be your responsibility even though the lender got the funds.

The difference in interest rates for the loans and the policy will affect this strategy. The higher the difference, the lower amount you will be able to borrow or the sooner you’ll come up against the limits of the lender.

It is most likely that the loan interest will be a floating rate while the values in your policy may be invested in a series of guaranteed interest accounts with longer-term rates. This creates the opportunity for a much bigger spread, as interest rates can and do change dramatically even over short periods of time.

The higher-than-expected spread may cause the loan balance to exceed the agreed loan capitalization rate of the fund value much sooner than expected. This could trigger the taxable withdrawal of funds.

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On a final note…

Leveraged life insurance is one strategy that can help in both supplementing retirement income and protecting your estate. However, because of the risks inherent, this concept may not be for everyone. Also, because it involves life insurance, you have to qualify for the insurance through medical and lifestyle information. Not everyone may qualify for the insurance. In the case of a couple, if one spouse doesn't qualify, the other may. This then, may still make sense to proceed. Before you enter into this strategy, be sure to familiarize yourself with all of the risks and rewards.

Remember to involve the professionals!

The Leveraged Life concept can be a very involved and complex concept. When coupled with other concepts such as the split dollar concept, the complexity can strengthen. When planning is initiated for this concept, some or all of the professionals including the accountant, lawyer, insurance professional, and financial advisor will need to be involved and consulted before proceeding with the implementation process.

For more information…

If you need to have any specific information in relation to these articles or any other insurance related matters, call or email me and I'll provide you with the information needed to help solve these and other estate and business planning needs.

Regards,

John Jordan, CFP