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TAX LETTER

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PRESERVE YOUR WEALTH AND CREATE A CHARITABLE LEGACY PLANNING IN THE AGE OF COVID – LIFE INSURANCE CAN HELP

PRESERVE YOUR WEALTH AND CREATE A CHARITABLE LEGACY

Many wealthy families think of Life Insurance as a grudge purchase, much as they think of their car or house insurance. They don't realize that Life Insurance is about much more than replacing income to support families left behind after a death – a financial challenge seldom faced by families with significant money. With proper planning, it's a tremendous opportunity to support wealth-building and manage risks that include over-taxation and future taxation increases.

There are two basic types of Life Insurance: term and permanent. Term insurance covers you for a specific number of years. At the end of the term, the policy has no value. Permanent insurance (which includes universal Life Insurance and participating whole Life Insurance) provides a lifetime of protection *plus* an investment component. It's an asset with enduring value.

The federal budget and capital gains

Some of the best news contained in the April 2022 federal budget and November 2022 Economic Statement was what they did *not* mention. There was no increase in the capital gains exclusion rate of 50%, which keeps 50% capital gains tax-free. There was no introduction of a wealth tax, an inheritance tax or a principal residence tax (other than ensuring that sales within 1 year cannot normally claim principal-residence, which

was already the case in more reported Court cases). Looking ahead, there's no guarantee that any of those opportunities to build and pass along wealth in a tax-favoured way will remain in place.

One federal budget change removes a tax-planning opportunity for substantive Canadian-controlled private corporations (CCPCs). People were doing some planning involving entities established in other countries that allowed investment income to be taxed in their corporations at about 26% instead of about 50% (the exact rate varies by province). Basically, they got the general rate of tax rather than the investment income tax rate in a corporation. That was creating some deferral advantages. With the budget, this type of planning was shut down.

This change has the effect of making Life Insurance much more attractive compared to other investments within these CCPCs. Life Insurance now easily outperforms many of the alternatives, because it provides tax-exempt growth and creates the opportunity to recharacterize retained earnings into tax-free capital dividends.

Here are 5 ways that affluent families can use tax-exempt permanent Life Insurance to preserve wealth, grow assets tax-exempt and create enduring legacies, often by converting taxes into charitable giving.

#1: Fund taxes due on death

Without advance planning, assets may be taxed on a deceased person's terminal return at a rate anywhere from 27% to 70%. The estate must pay that bill from cash on hand (which many successful people don't have because their cash is effectively deployed), borrowed funds (not attractive because the interest rate adds insult to injury and is not deductible) or by selling assets (a sale should never happen under pressure, and it eliminates future growth potential from those assets).

The better option? Life Insurance. For pennies on the dollar, you can create a tax-free lump sum that is paid promptly and can cover the terminal tax bill. And for those comfortable with borrowing to invest, using an Immediate Financing Arrangement (IFA) can create a cash flow neutral structure, allowing continued investment in private equity, real estate and securities, rather than tying up funds in insurance premiums.

#2: Avoid double or triple taxation

What we call "post-mortem planning" focuses on eliminating double or triple taxation that can be triggered when a shareholder in a private corporation dies. On death, there could be capital gains tax resulting from the deemed disposition of shares. There can be also corporate tax on the capital gains from selling the corporation's assets, and a dividend tax when the money is extracted from the corporation and into the hands of heirs.

Those three layers of tax can significantly erode the value of an estate, but two strategies, used individually or together, can help:

1. Redemption-loss carry-back – eliminates the capital gains tax and must be completed within one taxation year of the shareholder's death

2. Pipeline – eliminates the dividend tax and can be completed within three to five years of the shareholder's death

Usually, you will do the redemption-loss carry-back when you have favourable tax attributes such as refundable dividend tax on hand or capital dividend account balances.

And often you do a pipeline when you're in a more favourable capital gains environment, like today. We'll discuss both strategies in more detail in a future Lax Letter.

Both strategies can use Life Insurance strategically to create a lower effective tax rate.

#3: Make fair bequests

"Equal" isn't necessarily "fair." Suppose Mom and Dad start a business, and they have three children. The daughter works in the business and will one day take over the corporation. The two sons work in other professions. It would be "equal" to divide the shares of the corporation among the children with one-third going to each – but that wouldn't be "fair" to the daughter, who would suddenly become a minority shareholder with two-thirds of her success in running that business flowing out as dividends to her brothers. It would be much fairer to leave the company to the daughter and provide other assets of equivalent value to the sons.

Estate equalization looks at the estate *as a whole*, rather than each piece, to ensure bequests are fair to all heirs. It's an essential consideration when there's a family business and can also be very useful for blended families. Life Insurance is a straightforward and cost-effective way to achieve estate equalization.

#4: Diversify fixed-income investments

Permanent Life Insurance provides a unique tax-exempt investment opportunity that can contribute to the diversification of a portfolio of other assets. Specifically, high net worth families often reallocate some fixed-income investments into permanent Life Insurance to improve returns with the same or lower volatility.

Permanent Life Insurance policies are very predictable and boring, but they can provide long-term returns equivalent to a pre-tax yield of 9% more. In addition, in a corporate setting, you can pay for these policies with after-tax, corporate dollars, with the death benefit credited to the capital dividend account and then withdrawn from the company virtually tax-free. This is an extremely tax-efficient way to get money out of a corporation to benefit the next generation.

Here is the easiest way to see how this strategy could fit your planning. TFSA balances have now surpassed RRSPs in Canada. Imagine if you could have a NO Limit TFSA for yourself personally or for your corporation. Your money would grow tax-exempt, could be accessed tax-free and could be passed along virtually tax-free. Such a strategy exists. And this is how permanent Life Insurance is used by affluent families in Canada.

#5: Accomplish Strategic Philanthropy

A primary goal for many affluent families is to create a substantial charitable legacy. It's possible to create a significantly bigger legacy by converting taxes into philanthropy with permanent Life Insurance. There are many ways to do this, but here's one of the simplest.

Charitable donations can offset up to 75% of net annual taxes payable in any year, and any additional amounts can carry forward for up to five years. But the rules are even more generous when it's time to file a deceased person's terminal tax return. At that point, charitable donations can offset up to 100%

of the taxes due for the year of death *and* for the preceding year.

So, if you're anticipating an income tax hit of $1 million in each of those two years on your death, you could create a tax-efficient $2 million Life Insurance gift. Instead of paying a lot of money to the CRA, you can provide a large donation to support the causes you believe in.

And consider using an IFA to achieve your philanthropic goals. For those who qualify, it's akin to having your cake and eating it too, which means you can do better for the charities and causes that you are passionate about. But all of this needs to be viewed as part of your overall estate planning.

PLANNING IN THE AGE OF COVID – LIFE INSURANCE CAN HELP

The latest COVID news is not reassuring. Despite our best efforts, outbreaks continue in many places and new variants are reported. Mandatory masking is now under discussion and may be making a comeback, even for the multi-vaccinated. Many experts say that living with a pandemic is likely going to be a part of our lives for decades to come.

Aside from lurking COVID dangers, who would have predicted unforeseen events like the deadly collapse of a condo building in Florida, or unpredictable flooding in Western Europe that killed hundreds and destroyed communities that have been around for centuries? We must adjust to living in a world with more risk and unknowns than we've grown accustomed to.

Although we can't predict the future, we all wonder what we can do now to protect our families if something bad happens.

We predict that income tax rates will rise significantly, that taxes will be payable on principal residence gains, and that there will be an inheritance tax and a wealth tax. And estate taxes which currently are at 25% to 70% without proper planning, will continue to rise, leaving even less for your family.

Life Insurance will become more costly

Insurance rates are going to rise, as insurance companies need to produce profits for their shareholders. Claims due to pandemics impact profits. And with investment returns reduced, coupled with less disposable income for average taxpayers, the insurance companies will have to increase premium rates. We may even get to a time where premiums are "not guaranteed" and could become variable. As a result, now might be the best time to lock in those rates.

Underwriting for Life Insurance may become more difficult due to the pandemic – More people won't qualify, and Life Insurance will become something that is only available to the youngest and healthiest Canadians. If you put off applying for Life Insurance, you have no guarantee that you will still be insurable when you want it most.

A successful business person can suddenly become uninsurable. We can never take good health for granted. The time to start thinking about how you will mitigate your tax liabilities is now, while the sun is shining, while you are alive and healthy, and options are available to do the necessary planning.

Why Life Insurance?

In a world of growing uncertainty, aside from getting basic planning together like up-to-date wills, two powers of attorney and

having an updated Estate Directory, there's never been a better time to review your Life Insurance. The cost will likely rise in the future.

The primary purpose of Life Insurance is to provide your family with the financial certainty they need to carry on when you are no longer around. When doing estate planning around estate taxes, one should consider joint and last-to-die insurance, which covers both spouses and is paid out after the second death. It is much less costly than single-life coverage (by up to 40%) and can provide relief from capital gains taxes and other expenses related to the estate for pennies on the dollar.

In fact, Life Insurance is one of only four remaining tax-free investments that Canadians can still access. The other three are TFSAs, your principal residence and – if you are lucky – lottery winnings.

The COVID plague made it easier than ever to buy Life Insurance. It wasn't so long ago (pre-COVID) that people who wanted Life Insurance had to meet with an insurance advisor to complete an application, have a nurse come to their home to obtain blood and urine samples, and patiently await completion of the insurance underwriting process.

Out of necessity, Canada's Life Insurance companies responded quickly to COVID by reducing underwriting requirements and streamlining the entire process. In many cases, clients can get up to $5 million of Life Insurance with no medical underwriting, no blood or urine samples and no in-person meetings. All it takes now is a 15-minute phone call.

Many taxpayers are taking advantage of the opportunity by topping up their own coverage or getting new term and permanent policies for spouses, children, and grandchildren. The policy beneficiaries can include a spouse and other family members, as well as a charity − which is a lot better than leaving half or more of your savings to the government in the form of taxes.

Canadian taxpayers who are single, widowed or divorced may not realize that the government discriminates against them. When they die − without a spouse − they leave the government up to 50% or more (dependent on the province) of their RRSPs and RRIFs, and another 25% on the growth of non-registered holdings.

There are several ways to use Life Insurance. The primary one is for the executor of the estate to use the death benefit of the deceased's policy to pay off taxes owed before distributing the remainder to family or charity.

As a tax-exempt investment you can overfund a policy (pay more than the premium required) and build up cash surrender value (CSV). For business owners, high income professionals, real estate investors and people with substantial investment portfolios, one can consider the Immediate Financing Arrangement (IFA) strategy. It allows them to buy Life Insurance without tying up their money paying premiums, while securing their Tax and Estate Planning needs.
Example: a 65-year-old real estate investor had built a $50 million property portfolio he wanted to pass on to his children. Because he had done no estate, tax, or insurance planning, he would face a $10-million tax bill on his death.

In this example the taxpayer could use Life Insurance to cover those taxes so his family wouldn't be forced to sell assets to pay the tax bill. He was reluctant to use his own money to buy Life Insurance but loved the idea of getting it while still having access to his premiums for other investments.

The insurance policy's CSV serves as collateral to secure a loan with a Canadian chartered bank. The taxpayer paid the initial premium with his own money, then used the policy CSV to secure the loan to reinvest in his real estate business. He would then continue to pay only the loan interest, which would be tax-deductible. The loan will be paid off on his death with the Life Insurance proceeds. The balance goes to family and charity, virtually tax-free.

Business owners enjoy the advantage of using corporate dollars to pay the premiums on their Life Insurance. Corporations get taxed at a lower rate than an individual shareholder's personal tax rate. For example, in Ontario, the corporate tax rate applicable to active business income is about 13.5%, and 50% on investment income (though about half of that is refundable once enough dividends are paid out). The top individual marginal tax rate in Ontario is about 53.5%. Corporate-owned Life Insurance is used by wealthy business owners to accumulate passive wealth inside a company in a tax-effective way. They can also access that wealth and transfer it tax-free to surviving beneficiaries.

For business owners particularly, Life Insurance can protect a family or business against the sudden loss of a key person in the business. It can also be used to fund a shareholder buy/sell agreement so that heirs have a guaranteed buyer for their shares and a guaranteed market value with Life Insurance proceeds, for pennies on the dollar.

Along with proper estate planning, Life Insurance can give you the peace of mind that comes from knowing you have looked after your family and supported a charity of your choice – all crucial during the pandemic. In every generation there seems to be one or two milestone events like war, famine, depressions, and recessions. If you plan now while you and your family are well, and your business is steady, your planning ideas will work as intended.

Don't do this alone. There are many ways to help reduce taxes now and in the future, but they require comprehensive estate planning and working with experienced, knowledgeable people.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.