

Creative ways to use life insurance



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**By
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Recently, I was speaking with Richard, a close colleague, and he recounted a personal story involving a company's cash flow situation. I believe the moral contained within the conversation has value for each successful Canadian business owner, executive and tax advisor.

It begins one perfect summer day about 15 years ago. Mark, a very successful automobile dealer, and Richard were about to tee off on the fourth hole. Almost out of nowhere Mark looked up from his tee and said,

"Rich, I have recently bought this life insurance policy. I am paying a lot of premium and I want a second opinion."

"Sure Mark what kind of policy is it?" Richard asked.

"Well if I remember correctly I think it's a universal life policy," said Mark.

"Do you pay premiums for a limited number of years?" asked Richard.

"No, I think I pay for as long as I have the policy," Mark said.

Mark shared that the reason he had purchased the policy in the first place was to provide his wife and his two sons, who were now taking over the family business, with cash-flow when he died because all his assets were tied up in real estate, shares in private businesses and stock market investments.

Mark did not want his wife or children to be forced to sell assets in a fire sale as they probably would not receive their true value, nor did he want them to be forced to sell investments, as it could be at a time when there

was a market meltdown.

Having solid cash flow had always been the factor driving all his most important decisions as an entrepreneur.

Even though Mark had created cash flow upon his death through the purchase of the life insurance policy, what continued to plague him was the loss of his use of his premium dollars while he was still alive.

Richard asked, "Do you have to leave your deposit in the policy or can you take the money out each year and use it?"

Mark responded, "I have to leave the money in and this I have a problem with. If I had access to my own money I would reinvest it in my business and make 10 times more money than any stock broker could do with it."

Richard's next question was the big one: "How much net do you take from your cash flow each year and lock up permanently to pay these premiums?"

Mark's response: "One hundred thousand dollars."

With this information Richard asked, "Mark, did you know that there are solutions that are sanctioned within the *Income Tax Act* that allow you to take your premium deposits out each year? Did you know these solutions can be structured so that you are able to take money out of your company and not pay tax? These solutions result in an increase in both your personal and corporate cash flow."

Mark took a moment to digest this and then spoke. "I know one thing – we need to meet immediately to discuss this in more detail."

When Mark and Richard resumed their discussion at their next meeting, Richard learned that Mark was paying his premiums personally and the policy did not provide for a payout before death if Mark contracted a critical illness or suffered a disability.

After reviewing the policy Richard made the following recommendations to help Mark achieve maximum cash flow during his lifetime and for his family after his death.

First, changes needed to be made to have Mark's company own the policy. The beneficiary would also be the company. Premiums are paid by the company and since the company is the owner and beneficiary of the policy there is no taxable benefit to Mark.

Presently, he personally pays \$100,000 a year out of his own pocket.

To pay \$100,000 after tax Mark has to earn \$186,600 before tax.

When the company pays the premium, the cost before tax is \$156,543.

Second, the solution should include a provision for a payout

if Mark were to suffer a disability or critical illness before death.

Third, the solution should also allow the company to borrow at a guaranteed rate as well as crediting interest at a guaranteed rate to the amount held as collateral in the policy.

This yields the company a guaranteed return on borrowed funds, resulting in building up corporate accessible assets.

For example if the company borrows from the policy it can invest the money in an eligible investment or use the money while the interest is deductible. So if he borrows at 10 per cent his after tax cost is 5.359 per cent.

The money held in the collateral account of the policy is earning eight per cent tax free – this is a 49 per cent cash-on-cash return.

Let's take a closer look at how Mark will achieve a greater actual return on his investment and increase his cash-flow:

- After tax collateral account return: eight per cent
- After tax loan interest: 5.359 per cent
- Guaranteed return on borrowed money: 2.641 per cent
- Before tax return on borrowed money: 4.928 per cent

This is a guaranteed return and he still has the money to invest and earn additional revenue. The majority of the money deposited can be borrowed back within five business days and reinvested.

Fourth, at a desired point in time – such as retirement – the company can repay the loan. Mark can then obtain a loan annually from a bank for which the company signs as guarantor and the company assigns the policy to the bank as collateral, thus creating an additional annual tax effective cash-flow for him.

The insurance company has this arrangement with national banks. The interest each year is added to the amount of the loan.

On death the cash value retires the loan and the death benefit is paid to the beneficiary tax free.

Nearing the end of the meeting, after Richard had shown only a few of the countless improvements that could be made, Mark said, "Rich, will I have to cancel my present policy? Will I lose money?"

Rich replied "Absolutely not."

What we will do is restructure your present policy if circumstances permit while implementing the improved solution.

Our end goal is to enhance your company's cash flow, earn you higher returns in your company than you would if you invested the money in an insurance company's funds, and in addition your company will

receive guaranteed returns on the borrowed money."

"Why didn't my trusted accountant – who does all my personal and corporate tax returns or my insurance agent – recommend this solution to me in the first place since this is what I actually intended?" asked Mark.

"I can only assume that your trusted accountant and your insurance agent were not aware of this solution, or do not have the expertise and resources to properly implement, maintain and wind down this simple yet complicated structure," replied Richard.

Mark was in good health and he did augment his policy with the solution recommended by Richard.

After five years Mark earned substantially more money just from the guaranteed return on the borrowed money, resulting in an increase to his cash-flow.

Also by borrowing the money from the policy the dealership had further increased its cash-flow and return on investment by expanding its pool of accessible funds for its leasing department.

This generated more sales and higher revenue than it would have received by leaving the money invested in an insurance company's funds.

A few years later Mark did contract a critical illness. He received a tax free payment of \$509,000, equivalent to the policy's cash value at the time. He would not have received any payment if he had not implemented the solution.

I am happy to say that Mark recovered from his illness. Since the benefit was payable if he contracted a critical illness there was no obligation for Mark to repay the amount that he received when he became ill.

The moral behind this story is simple. Because of the tax savings, an insurance solution of this nature makes sense even if there is no need for insurance, but a great need for an improved cash-flow statement.

If you have a universal life policy it is definitely in your best interest to have the policy reviewed by an expert.

This will ensure that you have not been paying for a BMW, only to find too late that you have been actually driving a Ford Focus.

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