Canada Life™

Benefits of a personally-owned life insurance policy

Individuals, corporations and other taxpayers can own a life insurance policy, and there are different advantages to each taxpayer. This article discusses some of the benefits of owning a life insurance policy personally.

Immediate estate enhancement

Many individuals are challenged to accumulate the desired amount of property or wealth to leave for their beneficiaries. Owning a life insurance policy can provide an immediate estate, or enhancement, to an individual's estate, because from the time of purchase of the policy, the life insurer promises the payment of the death benefit should the life insured die while the policy is in force. For example, if an individual buys a life insurance policy on his life for $1 million of death benefit and designates his estate as beneficiary, his estate would be immediately enhanced by $1 million since the life insurer is obligated to pay $1 million to his estate should he die while the policy is in force.

For individuals who have already accumulated significant assets for their heirs, life insurance can help preserve the value of the estate from tax erosion and may also enhance the value of the estate. The tax liability resulting from the deemed disposition of assets immediately before death (at fair market value), can be covered in whole or in part by the death benefit. In this case, life insurance helps to reduce or eliminate the need to sell other assets of the estate to pay the taxes.

Tax-advantaged growth

Investment income earned by individuals from their non-registered accounts is subject to annual taxation. Annual taxation inhibits the compounding growth of the investment's value. However, funds can accumulate and grow on a tax-advantaged basis inside an exempt life insurance policy, up to prescribed limits. In other words, the value inside a life insurance policy can grow without being subject to annual taxation while the life insured is alive, and the beneficiary would receive this value tax-free when it is later paid as a part of the death benefit.

Tax-advantaged growth is also possible in a registered account such as a registered retirement savings plan (RRSP). However, there is an age limit (71) after which time the entire value of the RRSP becomes taxable unless it is converted to either a registered retirement income fund (RRIF) or an annuity. There are also limits on the amount of money that may be contributed annually to an RRSP. In addition, in the case of a RRIF, there is a prescribed minimum amount that must be withdrawn in every year following the set up of the RRIF, even if the funds are not required. This withdrawal is taxable every year. On the other hand, while the tax-free savings account (TFSA) does not have an age limit for withdrawals and there is no minimum withdrawal requirement, the annual amount that can be contributed is restricted. So, any registered accounts have their own government imposed limitations. Assuming there is sufficient cash value in the policy, the value accumulated within a life insurance policy is not subject to any minimum withdrawal rules. The premiums that can be paid into the policy can be much larger than the TFSA limits, provided the insurance need is met and the amount of life insurance under the policy will support these premium payments. This provides an ideal opportunity for individuals to use a life insurance policy to obtain tax-advantaged growth with the cash value inside the policy.

Liquidity/accessing funds

A life insurance policy with accumulated cash value can be a source of funds for the policy owner – offering immediate liquidity. A policyowner can access the cash value inside the policy by either partially or fully surrendering the permanent insurance under the policy or taking a policy loan from the life insurer. Partial or full surrenders of the policy or taking a policy loan decreases the death benefit and cash value of the policy, and may result in some tax consequences, which are also dependent upon the adjusted cost basis of the policy. A policyowner can also pledge the policy as collateral and obtain a loan from a third-party lender after satisfying the lenders financial underwriting and other terms.

No probate or other estate taxes/fees

Where a named beneficiary other than the estate is designated, the death benefit of a life insurance policy is directly paid to the named beneficiary. Since the named beneficiary is not the estate of the life insured, the death benefit does not form part of the estate. This can help reduce probate and other estate administration taxes and fees, if any.

Potential creditor protection and confidentiality

Generally speaking, life insurance policies enjoy special protection against the claims of creditors under provincial and territorial insurance laws. These laws (in the provinces and territories, except Quebec) provide that if specified family members related to the life insured are designated as beneficiaries, the interest or the rights of the policyowner in the contract (insurance policy) cannot be seized. In addition, these laws also provide that where a beneficiary designation has been made, the death benefit does not form part of the policyowner's estate. In Quebec, this creditor protection is available where the designated beneficiaries are related to the policyowner rather than the life insured. The rights under the contract are also exempt from seizure in Quebec.

Creditor protection for life insurance policies depends on court decisions and applicable legislation which can be subject to change and may vary in the provinces and territories. Accordingly, creditor protection can never be guaranteed. Clients should consult their lawyer to learn more about the potential for creditor protection in their specific situation.

In many Canadian provinces and territories, where a named beneficiary other than the estate is designated under a life insurance policy, the death benefit is directly payable to that beneficiary (i.e., beneficiary designations are not contained in the will), and does not need to be included in the probated documents (e.g., deceased's will) of an estate. This provides an opportunity for clients to maintain confidentiality.

Intergenerational wealth transfer (cascading strategy)

A life insurance policy provides an attractive opportunity for intergenerational wealth transfer. A grandparent or parent may purchase a life insurance policy on the life of a child and fund the policy premiums. When the child turns 18, or at anytime thereafter, the ownership of the policy may be transferred to that adult child. Canada's tax rules provide that the policy's transfer of ownership will take place on a rollover basis, so there would be no tax triggered on the transfer of ownership. When the child requires funds, he/she may access the cash surrender value in the insurance policy as outlined above. Any tax consequences from accessing the cash value in the insurance policy will be to the adult child, and not the original policyowner. After the transfer, the parent or grandparent could also ask the child or grandchild to appoint him/her as an irrevocable beneficiary to maintain some control over the policy (e.g., whether and when the child or grandchild may access the cash value in the policy).

Funding buy/sell agreements

Where there are a small number of partners or shareholders (e.g., two or three) a personally-owned life insurance policy on the other party(ies) life can be used to fund the personal buy/sell obligation under their the buy/sell agreement.

Enhanced charitable giving

Many individuals want to contribute more to their favorite charities. A life insurance policy can help these individuals maximize the amount donated to a charity. For example, instead of annually gifting cash to a charity, individuals should consider using the same amount (that otherwise would have been donated to charity) to pay the premiums on a life insurance policy on his/her life and designating the charity as beneficiary. This can result in much larger gift (death benefit) available to the charity in the future, and a tax receipt to the deceased's estate. If the individual makes the charity the owner of the policy but pays the premiums personally, he/she could get an annual charitable tax receipt for the premiums paid in lieu of the larger donation receipt upon death.

Diversification

A permanent life insurance policy with accumulating funds can provide an opportunity for diversification, in addition to providing the individual with an opportunity for tax-advantaged growth in the policy's cash value.