IMMEDIATE FINANCE ARRANGEMENTS

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Immediate financing arrangements (IFAs) have become quite popular in recent years and are often leveraged as an advanced planning concept for high net worth clients. But what is an IFA? And, when does it make sense? This report will delve into the basics of IFAs, starting with the insurance need itself.

Why purchase life insurance?

Life insurance is primarily purchased to help protect against risk, including the financial risks associated with unexpected death. For example, you may want to help cover debts like your mortgage, or income replacement needs for your growing family.

Business owners may buy life insurance on the life of a key person so that the insurance proceeds provide liquidity to assist the business in continuing should this person pass away. The proceeds of key person insurance can be used for many purposes, including the provision of capital to buy out the deceased person's share of the business.

Finally, some Canadians have the need for "permanent" life insurance policies, which can help cover things like tax liability at death, equalizing their estate for their loved ones, or as an alternative asset class for the long term.

What is "permanent" life insurance?

A "permanent" life insurance policy provides not only insurance protection, where insurance proceeds are paid tax free to beneficiaries on the death of the insured, but also has a cash value component that can grow on a tax-advantaged basis. A permanent life insurance policy may also be appropriate if you have funds that may not be needed to cover future lifestyle expenses.

Permanent life insurance can be viewed as a separate asset class within your overall financial portfolio. Generally, permanent insurance policies issued in Canada are structured to qualify as "exempt" life insurance policies for tax purposes. For an "exempt" policy, the policyholder is not required to include any growth within the cash value as income for tax purposes. In addition, on the death of the insured, the death benefit is received tax-free by the policy's beneficiary.

How an immediate financing arrangement works

After you've purchased a permanent insurance policy that meets your insurance need, you may be interested in learning alternative ways of leveraging your permanent insurance policy for investment purposes or business expansion, such as an immediate financing arrangement (IFA), and whether that might be appropriate for you. An IFA allows for capital replacement on the premiums paid to the policy. Under an IFA, a permanent insurance policy is assigned as collateral for a loan from a third party financial institution like CIBC Private Banking. The loan proceeds could be used for investment or business purposes. Depending on the use of the funds and the term of the loan, interest charged on the loan, and a portion of the insurance premiums paid, could be deductible for tax purposes.[1]

Subject to lender approval, clients may be able to increase the amount of the loan annually, or as needed. The lender may approve the loan based on future projections of the CSV provided by the insurer's illustration and will lend up to 100% of the CSV. Over time, the CSV of the policy should increase proportionally to the loan, however, if the CSV is insufficient to support the loan increase, the lender may request additional collateral.[2] The policyowner has the ability to pay the loan off during their lifetime, or at the death of the insured. If the loan is paid at the death of the insured, the lending financial institution will be repaid the loan balance from the death benefit as the insurance policy was used as collateral for the loan. The amount of the death benefit in excess of the loan repayment (if any) will then flow to the beneficiary of the insurance policy.

Corporate owned life insurance

An IFA can be an attractive strategy for a corporation. Once a permanent life insurance is in place the IFA can then provide liquidity for business expansion and investment opportunities. Corporations looking to utilize an IFA must own the permanent life insurance policy being used as collateral, and pay the premiums as well as any additional deposits.

When a life insurance policy is owned by a corporation, at the time of death of the person whose life is insured, the death benefit paid would generally be received by the corporation on a tax-free basis. The death benefit also creates a credit to a notional account of the corporation called the Capital Dividend Account (CDA)[3]. An amount equal to the CDA balance at any point in time can be distributed to shareholders as tax-free capital dividends from a private corporation.[4] The amount of the proceeds received as a death benefit, after repaying any loan outstanding, can be used to fund a tax-free capital dividend. If a positive balance remains in the CDA after the capital dividend payment using insurance proceeds, capital dividends can continue to be paid using other funds, until the CDA is reduced to zero.

[1] In order for interest paid to be deductible, generally it must be incurred to earn income from a business or property. If interest is capitalized, only amounts of compound interest that are paid are generally deductible for tax purposes. A tax advisor should be consulted to determine whether a tax deduction is available in respect of any interest on the loan or premiums paid on the life insurance policy.

[2] Generally, if the policy remains in force and no policy withdrawals or surrenders are made, the CSV of a policy should grow over time as insurance premiums are made and/or additional deposits are paid into the policy.

[3] The life insurance death benefit, less the adjusted cost basis (ACB) of the policy, is added to the CDA. The ACB of the policy is the portion of the premiums paid relating to the investment component of the policy (the total premiums paid, less the Net Cost of Pure Insurance (NCPI)). The life insurance provider should be contacted for information regarding the ACB. A tax advisor should be consulted to determine the calculation of the CDA.

[4] Certain events reduce the balance in the CDA, such as capital losses.

Example

Stephan is a high net worth, insurable client and is the sole shareholder of a private corporation (Aco). There is accumulated after-tax income inside Aco. Stephan has estimated the tax cost to wind up Aco on his death. After speaking with his licensed life insurance advisor, he has decided that he would like Aco to purchase a permanent life insurance policy to cover this tax liability. Aco will be named as the owner of the policy, while Stephan will be the insured person, and Aco will pay the annual premiums and any additional deposits.

Stephan later decides that he would also like his corporation to continue to fund venture capital projects and speaks with his wealth advisor about his options. As Stephan has a moderate to high risk tolerance and is comfortable taking on debt, Stephan has Aco enter into an IFA. Under the IFA, Aco takes out a loan from CIBC Private Banking using the permanent life insurance policy as collateral for the loan. The loan proceeds are invested into a new venture capital project. Depending on the circumstances, Aco may be able to claim a tax deduction for the interest paid, as well as for a portion of the life insurance policy premiums. This arrangement continues until Stephan's death. At that time, the death benefit from the insurance policy will first be remitted to the lender to pay off the outstanding amount of the loan. Any remaining death benefit proceeds would be paid to Aco as the named beneficiary, which Aco would use to fund the tax liability arising to wind up Aco. As the death benefit received by Aco results in an addition to its CDA account, a tax-free capital dividend can be paid using the net death benefit proceeds. If there is a positive balance in the CDA after the net insurance proceeds are so used, other funds in Aco can be used to pay a further tax-free capital dividend until the CDA account balance is reduced to zero.

Note: An IFA is not for everyone; there are financial and tax risks associated with insurance leveraging strategies. You must consult with professional tax and legal advisors to assess whether an IFA may be suitable for your specific circumstances.[5]

If you have a need for permanent life insurance it is recommended that you speak with a licensed life insurance advisor who would be able to discuss the concept of permanent life insurance further. The insurance advisor will help you assess your insurance need, the amount of insurance required to meet that need, and the insurance product that would be suitable for your specific circumstances.

[5] Representatives of CIBC Private Wealth may only provide general information on tax, insurance and estate planning matters.

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