BMO Nesbitt Burns

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Financial Insights

from Quinn+Cardy Wealth Management
of BMO Nesbitt Burns

Insurance to Complement Fixed Income

With higher rates, there has been increased attention to low-risk Guaranteed Investment Certificates (GICs). Are there alternatives after factoring in the potential tax implications?

Consider a GIC returning four percent in a non-registered account: after tax, this would yield two percent for an investor with a marginal tax rate of 50 percent. While a GIC may provide comfort during volatile markets, there may be alternatives. For high-net-worth (HNW) investors, there may be an opportunity to use permanent life insurance as part of an investment strategy.

Many permanent life insurance products have fixed premiums and a guaranteed payout at death. As such, it is possible to calculate a rate of return (IRR) on the premiums. Since proceeds upon death are paid tax free, the only variable is the age of death. Take, for example, a whole life policy for a non-smoking, healthy 50-year-old male who pays an annual premium of $14,000 for a $1 million policy (see chart, right).

Illustrative: IRR for $1M Whole Life Policy with $14,000 Annual Premiums

Age at Death	IRR	Equivalent Pre-Tax Fixed Income Return*
75	7.35%	10.5%
80	5.13%	7.33%
85	3.67%	5.24%
90	2.64%	3.78%

*Based on a marginal tax rate of 30%.

Permanent life insurance may be a way to achieve fixed income exposure. A participating whole life insurance policy ("par policy") allows you to share in the potential surplus earnings of the insurer. Your premiums go into a broader participating account that is managed by the insurance company and used to pay insurance claims, expenses, taxes and other costs. The majority of assets in the participating account are typically invested in longer-term debt instruments, such as public and private fixed income investments, bonds and mortgages, and may also include real estate and equity holdings. This provides the policy owner exposure to a low-cost, diversified portfolio.

In addition to the traditional benefit of holding life insurance — to support loved ones in the untimely event of the death of an income earner — there may be other benefits. The participating investment account is tax sheltered for the policy owner, compared to a fixed income portfolio of investments that would be taxable. Based on the account's performance, annual "policy dividends" are often issued to policyholders. These can be

used to purchase additional paid-up insurance that would increase the policy's death benefit coverage, which the beneficiary will receive tax free upon the death of the insured. This provides the policy with the potential to outperform the after-tax fixed income component of a traditional balanced portfolio.

In the event of a premature death, the par policy would have a high probability of outperforming the fixed income component of a traditional investment portfolio (see chart, showing an increasing IRR at a lower age). The estate value may also be higher, as income and any growth would be earned on a tax-free basis inside the policy. Death benefits paid from the policy may not be subject to probate where the policy is owned outside of a corporation and certain specific beneficiaries have been named, such as a spouse or children (where applicable). For business owners, there may be additional tax benefits through the use of the company's capital dividend account. Corporations with active business income may also be able to offset the tax that can result from the passive income rules.

Be aware that funds must be committed to this strategy, so sufficient assets must be available after premiums are paid to cover lifestyle needs. If premium payments stop, the policy could lapse (if the policy is surrendered, the owner would be entitled to a surrender value). Annual policy dividends are not guaranteed, though many of the large life insurance companies have continued to pay these on a regular basis. Policy premium rates will vary by age and health. If you are interested in learning more, please get in touch.

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