Permanent Life Insurance as a Tax Shelter

Robert MacKenzie

Proceeds from a life insurance policy are paid out tax-free and any money in it will grow without ongoing annual taxation. This seems, at first glance, like a better way to pass on money to the next generation than regular investments (assuming one has already maximized a Tax-Free Savings Account). In this article we'll examine that claim as it pertains to permanent life insurance.

Permanent life insurance differs from the more common term insurance in that it runs for the whole of a person's life and not just to age 85 or so. The premium payments, whether made from within the policy or from outside of it, also last for a lifetime, making it much more expensive than term insurance at younger ages.

Permanent life insurance is available in three main forms. The most basic is Term to 100 (T100), where one pays only for a fixed amount of insurance coverage. Whole Life (WL) insurance has a T100 component and an investment component usually termed a participating fund. Universal Life (UL) insurance also can contain T100 and an investment component, but in this case the owner can choose which investments to use. In what follows I will assume that the "level" option of premium payments is selected, which means that cost of the insurance will not rise as the years pass (the safest option).

Ten years ago (*Canadian MoneySaver*, October 2001) I looked at equity- or stock-based UL insurance to compare it with a comparable investment in equity index funds. My conclusion was that after about 25-30 years the index fund's value would surpass that of the insurance payout, tax-free or not. This should not be surprising, given that insurance premiums must be deducted every month from the accumulated value of a policy, that relatively high annual fees are deducted from its investment fund and that there is an initial 2% (or so) tax bite taken out of each insurance deposit. All these costs reduce the compounding effect over time on any assets contained in the policy.

However, the situation is better with fixed-income funding of insurance, since the income of fixed-income investments, such as bonds or GICs held outside of a policy, are taxed every year. Moreover, bonds held outside of a tax shelter are unlikely to benefit from the preferential tax break on capital gains that is available to stock market investments.

Not much has changed since I wrote that article, in my opinion. Life insurance will indeed pay out a lot of money in the first decade after it is purchased, more than would any comparable investment fund. But that higher payout depends on (bad?) luck – someone has to die prematurely to ensure that this happens. (Think of the movie *Double Indemnity*.) Nevertheless, as I said 10 years ago, insurance can still be a simple, guaranteed method of leaving money to others or to charity, even if it is not a miraculous way to save or make lots of money when compared with ordinary investments. Life insurance over the long term has an adequate, if not spectacular return. I own both permanent insurance and investments.

When considering the purchase of permanent life insurance you may be confronted by enticing sales and marketing presentations. Remember that you are buying life insurance and not a tax-sheltered investment. If you want a tax-sheltered or a sure-fire investment, consult an accountant or a stockbroker, not an insurance agent. I suggest that you take your time in making a decision, read the articles in past issues of the *Canadian MoneySaver* and on the Term4Sale.ca website, and be guided by the following maxim: Keep it simple, keep it certain.

Keep It Simple

The simplest permanent insurance is T100 or a UL policy that looks and acts like it. A "limited-pay", premium-paying period of 10 to 15 years for the policy, coupled with a term certain annuity to pay the premiums for a matching length of time makes it really simple. You pay the required amount all at once and never have to do anything else. The cost of insurance is known and the annuity pays that premium automatically once a year or once a month. If you die before the annuity is paid out to the life insurance company, a contingent beneficiary can receive the remaining money from it.

Let's take the example of a 55-year-old male, non-smoker in good health who has inherited money and wants to have about $90-100,000 of it to be passed on to his heirs. A Term to 100 policy for $250,000 from Wawanesa Life would cost $7,7742 for 15 years ($116,145) at which time it would be paid up. A 15-year prescribed term certain annuity for that amount would cost $94,800. It would cover the premium requirement, although there would also be an extra cost each year in income tax to pay on the $1,422 taxable portion of the annuity (at a 33% tax rate, about $500 a year, or $7,500 in tax over 15 years).

Equitable Life has a 10-pay Universal Life product, EquiLife, which can be treated as a T100 policy. In this case, premiums would be paid for 10 years by an annuity that costs $87,332 (with $1,082 of that being taxable annually, resulting in $3,300 in tax over 10 years). Because this is a UL policy, the required amount to cover the annual premiums for 10 years could also be paid by an annuity over only 5 years and a portion invested in a cash account inside the policy during that period until all the payments have been made.

In each of these cases, the process is straightforward. You pay your money and obtain the desired coverage. There is no chance for you to miss an annual payment and have the coverage lapse, nor can the cost rise in the future. The money you wanted to pass on will be passed on (when you pass on), unless for some reason you surrender the policy for its cash value and pay the huge tax bill that would result.

Keep It Certain

In both of the examples above (and other companies have similar products), the premium amount is known in advance, as is the number of years that they must be paid. They are contractual and will not change. The payout is guaranteed, and even if the insurer goes out of business, the industry's Assuris fund will cover most or all of the amount for which you contracted.

You could introduce complexity and risk into the process by choosing to pay the premiums out of non-guaranteed equity or bond investment funds inside the policy. Or you could add extra money and have these funds or a participating fund try to generate more money. But why bother? Stay away from investing inside of a life insurance wrapper. Instead, use insurance segregated funds (which carry guarantees of capital) or regular investments and benefit from their tax advantages.

Summary

If you want to secure your estate's value, simple and certain permanent life insurance can help. In our example, a payment of about $100,000 after taxes bought $250,000 in coverage for a 15-pay policy. Assuming that our 55-year-old lived for another 30 years to age 85, a lifespan not far from that expected for men, the death benefit would be worth about $100,000 in "buying power" at that time, assuming a 3% annual inflation rate.

The rate of return on the money spent on insurance would be 3.1%. (The 10-pay policy costing $90,000 would have a return of 3.5% and by putting money inside a UL policy in cash over just 5 years to help shelter it, it would be even higher.) To obtain the same $100,000 of "after-inflation" money in 30 years, one would have to obtain a pre-tax annual rate of return of 4.6% on fixed-income vehicles such as GICs, assuming a 33% personal tax rate. A higher marginal tax rate would require even a greater GIC yield.

Variations on this theme are possible. If an adult child wanted to shelter fixed-income money they could take out a policy on their parent and get their money back later with interest. Or coverage could be based on a couple's two lives (joint last-to-die). This would reduce the premium required but probably also add to the time waited until the payout upon the death of the second person. No matter the exact form, what remains constant is that a known amount of money put out now returns a known amount of money some time in the future. And the "investment" carries a reasonable after-tax rate of return, given the low risk incurred.

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