Accessing the Cash Value of an Insurance Policy

Borrowing Against an Insurance Policy – While one of the main reasons for having insurance is to protect your family or business, consider that there may be other benefits derived from holding a life insurance policy. One opportunity involves borrowing against the insurance policy. A permanent life insurance policy with a cash value component, such as universal life or whole life, can act as a flexible financial planning tool that can help to support tax planning, fund the liquidity needs of an individual or business without disrupting cash flow or facilitate business succession planning.

A COLLATERAL LOAN: THE IMMEDIATE FINANCING ARRANGEMENT

As the cash value component of permanent life insurance grows within the policy, it may be accessed to help support other objectives throughout your lifetime, while the policy continues to achieve the original goal of providing protection. In general, there are three ways in which you can access the cash value:

1. Withdraw the cash value from the policy.
2. Borrow from the insurance company based on the life insurance policy's terms.
3. Use the cash value as collateral for a third-party loan.

In this article, we focus specifically on the opportunity of using the cash value of a permanent life insurance policy to act as a collateral loan under an immediate financial arrangement (IFA). Under this arrangement, the policy is assigned to a lender, such as a bank, as security for a loan. The size of the loan is typically between 50 and 100 percent of the policy's cash value but may potentially increase if other assets are temporarily assigned to the lender as collateral for the loan (and when the cash value of the policy becomes large enough, this collateral may no longer be required). The individual or business pays the loan interest to the lender going forward. While the loan may be repaid at any time, the intent is often for the loan to be repaid using a portion of the insurance proceeds upon the death of the insured. Any excess proceeds can be used to meet the needs for which the insurance was originally intended.

THE BENEFITS OF AN IFA

There are a variety of benefits that can be achieved through the IFA arrangement, including:

Tax optimization – One of the main advantages of the IFA is that it is generally the most effective way to reduce the amount of cash flow required to secure permanent insurance. Income tax is not payable by the policyholder when the policy is assigned to a lender and the loan proceeds received are not considered as income for tax purposes. As well, with an IFA, where the loan is used for business or investment purposes, there may be an opportunity to deduct taxes through interest and collateral insurance deductions, which can reduce annual net after-tax costs to secure coverage.

Funding the liquidity needs of an individual or business – All or a portion of the proceeds from the loan can be used for investment purposes or reinvested into the business and reduce net after-tax cash flow by allowing the individual or business to claim valuable tax deductions and keep more funds working for other purposes beyond only insurance.

Business owners: Tax-free distributions through the CDA – Generally, when a life insurance policy is held within a corporation, the amount of the death benefit received less the policy's adjusted cost-basis (ACB) may be credited to the corporation's capital dividend account (CDA), potentially enabling the corporation to pay a non-taxable dividend to Canadian resident shareholders. Under an IFA, the corporation receives a credit to the CDA on the same basis, regardless of the loan amount, and even when the death benefit is paid directly to the creditor. This may help to facilitate business succession planning by providing significant tax savings when distributing assets to the business' shareholders.

THE RISKS OF AN IFA

While there are a variety of benefits, collateral loans also involve certain risks. Depending on how the lending arrangement is structured, there may be tax consequences when this arrangement is held within a corporate structure. Typically the proceeds from the loan are received by the policymaker. However, if the loan is made directly to the shareholder, instead of the corporation, there may be additional tax risks. For example, using a corporate asset for personal purposes may result in a taxable benefit to the shareholder. If, at death, the shareholder's personal loan is repaid directly from the death benefit proceeds of the corporately-owned policy, taxes may also arise.

Other risks may include potential future changes to the following: debt servicing requirements, tax rules, loan requirements due to mortality risk, the lending institution's practices and the spread between the loan interest rate and policy interest rate. Due to current low borrowing rates, the IFA may appear favourable, but keep in mind that IFAs are intended to be structured as long-term arrangements and future increases in interest rates can impact the IFA arrangement. If the spread between the loan interest rate and policy interest rate widens and the accumulated loan balance increases faster than projected, the borrower may need to provide additional collateral, partially repay the loan or surrender the policy.

BACK-END LEVERAGING

As an alternative to immediate financing, borrowing against the policy's cash values using a third-party loan may make sense down the road. If a policyholder were to instead withdraw the cash value from the policy (option 1, above) or borrow from the insurance company through a policy loan (option 2, above), depending upon the ACB of the policy, there may be taxes payable.

SEEK ASSISTANCE

For high-net-worth individuals and business owners who are comfortable with using leverage, a well-structured IFA has the potential to be a flexible financial planning tool. As always, please seek the advice of legal, tax and accounting professionals if you are considering this strategy to assess the potential risks and the implications relating to your particular situation.

Note: *The terms and conditions noted in this article may not apply within the province of Quebec. In Quebec, the use of a life insurance policy as collateral involves the use of a movable hypothec.*