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Leave more to your family and less to the government with an Estate Bond, and…

Multiply your savings

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Like many savvy Canadian investors, your financial plan probably includes an element of savings that you never plan to spend.

Your intention is to pass on some of your non-registered investments to those you care about most. That's the money you have invested to grow, earmarked for the benefit of your family or favourite charities. This money can be personally held, or sitting in a holding company.

The success of this approach is largely based on the investment's rate of return. Unfortunately, the higher the return, the more tax you pay. And taxes, when combined with historically-low interest rates, may have the effect of not allowing the money you earmarked as inheritance to grow to its full potential.

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What is the Estate Bond?

The Estate Bond is an old life-insurance concept that uses the tax benefits of life insurance to maximize your estate.

Properly used, the estate bond can multiply your savings and provide a larger tax-free legacy for those you care about most. Unlike offshore tax dodges and sketchy tax-driven investment schemes, this strategy has already been blessed by the government for well over 100 years.

Few people know that Life Insurance is uniquely recognized in Canada's Income Tax Act, and that information about it can be found in most of Canada's leading accounting firm tax guides (surprisingly, under the chapter "Dealing with Investments").

Aside from its merits as a tremendous wealth creator, you can always access your money in case of emergency or opportunity. The returns are fully guaranteed and not tied to the uncertainties of equity markets or fluctuating interest rates. Another positive outcome is that you can avoid money managers altogether.

Who should consider the Estate Bond?

The estate bond concept is geared towards people age 50-75 that enjoy excess income or have excess assets necessary to sustain their retirement lifestyle.

How does it work?

An Estate Bond moves a small amount of savings from a tax-exposed investment (that is, your non-registered retirement savings plan) to an exempt universal or a permanent whole life insurance policy.

A universal life insurance policy gives you immediate life insurance protection and an investment within the policy that accumulates on a tax-free basis. When you die, your heirs receive the proceeds tax-free. The net result is that you increase the size of your estate, often by well over 200 per cent versus a traditional non-registered investment, and you reduce your taxes.

This strategy works best for people with money socked away in long-term investments that they never plan to spend.

Imagine your non-registered retirement savings in three buckets: short-medium and long-term investments. For long-term investments, which will eventually be passed on to your heirs, charities or used to pay taxes, you are paying taxes on the interest and/or capital gains.

If this money is in a holding company, there are also very prohibitive taxes on getting the money out to your beneficiaries – likely upwards of 32 per cent tax if you live in Ontario.

But with an Estate Bond, there's a way of doubling, tripling or even quadrupling the size of your estate while reducing the amount of tax you pay.

An Example

Elizabeth and Eric Smith are successful professionals, both 54 years old, paying a lot of income tax. The Smiths invest $45,000 annually in a conservative and well-managed portfolio. They get an annual return of six per cent, which is really just 3.4 per cent after tax.

If they invest every year, until life expectancy of 85, they will have accumulated approximately $2.7 million after tax in their portfolio.

Using the same $45,000, they could have purchased a $10 million joint last-to-die life insurance policy. When they both die at life expectancy or at anytime, their estate would receive the $10 million life insurance benefit, tax-free.

If the Smith's had purchased this insurance and kept it in their holding company, the $10 million of insurance proceeds would come out tax-free to their heirs through the use of the company's capital dividend account.

Life insurance proceeds are not taxable from the corporation. Had the Smith's had $10 million of traditional investments in their holding company, the heirs would pay over $3 million in taxes.

Using the exact same investment dollars, their estate value grew from $2.7 million to $10 million on a guaranteed basis without any equity market or interest rate risk. So, what would you choose? Wouldn't it be wise to consider setting aside some of your taxable investments for this investment strategy?

Consider these Estate Bond advantages (compared to traditional taxable investments)

- Large, immediate and guaranteed estate value
- Tax-free maturity value at death
- Reduced estate settlement costs – no probate, legal and executor fees if you have a named beneficiary
- Potential for creditor protection, if you make an appropriate beneficiary designation
- Liquidity for your estate when you need it to pay estate taxes, leave large inheritances or for charitable planning purpose.

Insured Annuity

Do you need income during your lifetime? For those who require income during retirement, there is another strategy called a "Back-to-Back" or Insured Annuity. This strategy typically uses a life annuity to increase cash flow and minimize taxation.

Annuities purchased with non-registered money benefit from lower tax levels, as it is considered more of a return of capital. With the increased after-tax cash flow, you can purchase an exempt life insurance policy to match the amount used for the annuity; if income is not needed, purchase as much death benefit as possible.

When you die, your heirs receive the proceeds back tax-free; avoiding estate taxes, probate, and legal and executor fees if there has been a named beneficiary. No financial institution except an insurance company can offer these sorts of guarantees in Canada today.

The bad news is that this opportunity will not be around for very long. With interest rates at historically low levels, and insurance companies now required to put even more money into reserves, it's only a matter of time until the net benefits of these strategies will be reduced.

In the past two years, the major insurance companies in Canada have increased the cost of permanent insurance from 10 per cent to 40 per cent for some ages.

There are many issues to look at when considering whether to acquire such a contract, such as the underlying mortality costs and administrative expenses, a guaranteed minimum rate of return compared to a similar return in a non-tax sheltered environment, your required life insurance coverage, your income objectives, investment management fees, the financial reserves and strength of the insurance company and so on.

Professional advice of a Certified Financial Planner dealing with insurance and estate planning issues are a must when assessing the merits of this type of strategy. ❑