ADVISOR.CA

HOW CLIENTS CAN USE LIFE INSURANCE TO MINIMIZE ESTATE TAXES

Lisa MacColl / September 19, 2011

Life insurance can be an effective tool to mitigate estate taxes on your client's portfolio.

Life insurance and business succession

If your client has a business, life insurance should form part of the business succession plan. John Armstrong, vice president of Armstrong & Quaile, states clients need to plan ahead: "You can always restructure your company, [but] you will not always be insurable."

If your client owns shares in a business, the shares will pass to the beneficiary when your client dies. If the beneficiary isn't interested in the business, the partner will have to find adequate capital to buy out the beneficiary's share. Armstrong advises business partners to take out adequate life insurance on each other so that one can buy out a beneficiary and continue the run the company. Rona Birenbaum of Caring for Clients adds partners should have a buy-sell agreement so the business succession plan is clear.

Spousal rollover

When a taxpayer dies, Canada Revenue Agency values all the taxpayer's assets as if they had been sold on the day prior to the date of death, and the assets are subject to tax on the deemed disposition. If the taxpayer has a spouse, the assets can pass to the spouse through the spousal rollover provision. Taxes can be deferred until the spouse dies or otherwise disposes of the assets.

Birenbaum suggests the client and spouse purchase a joint-last-to-die life insurance policy. A client who's not insurable on his own can still qualify for life insurance in joint-last-to-die policies because all insured lives are considered together. The life insurance proceeds are not paid until the last of the insured dies, so it's important to make sure the funds won't be needed until that happens. Birenbaum suggests investing in a Universal Life (UL) policy with an investment component, and overfunding the policy with a very conservative rate of return assumption to ensure its value will cover future taxes owing.

Estate freeze

This strategy requires a financial advisor with in-depth tax knowledge. An estate freeze is an effective strategy for a client with a valuable business asset who plans to transfer it to a family member or trusted business associate. Here's what to do:

- Commission a professional valuation on the business to establish its value as at a specific date.
- Have a transfer of ownership drafted. Client transfers part-ownership in the company by selling growth common shares to the successor owner. Client then purchases non-growth preferred shares for a portion of ownership, effectively freezing his share of the company at a set point in time. For example, if the company is worth $4 million, client would sell growth common shares to the new owner for $2 million, and keep $2 million in non-growth preferred shares. The value of the client's interest in the company is now frozen at $2 million.
- Successor will be taxed on any dividend or capital gain that she earns on the growth common shares.
- Client purchases life insurance policy with a value that will cover the taxes owing on a deemed disposition of $2 million. When the client dies, taxes will be paid on $2 million, rather than the company's current fair market value.

Birenbaum cautions the transfer of ownership must be constructed to allow the current owner to maintain control of the business. Armstrong adds timing is essential, as the estate freeze must be completed while the owner is still insurable.

Charitable donations

Charitable donations valued up to 100% of net taxable income in the year of death can be claimed as a tax credit. Birenbaum suggests clients purchase life insurance coverage roughly equal to their taxable income at death, and designate a charity as the beneficiary of the policy. The charitable donation will provide a tax credit that will mitigate or eliminate the tax liability.

Make the estate the beneficiary

Life insurance policies with a named beneficiary avoid probate and are not subject to probate fees. In some instances, Birenbaum states, it makes sense to name the estate as beneficiary. "Even though the proceeds will then be subject to probate fees, the money to pay the taxes will then be part of the estate. It's easier to pay the taxes from the estate proceeds than to try to get the money back from a family member after they have received it."

Filed by Lisa MacColl, editor@Advisor.ca

Originally published on Advisor.ca