CORPORATE PLANNING ASSOCIATES

ADVANCING *Issues*

Winter 2002 • Published quarterly by Corporate Planning Associates • Vol. 8, No. 4

Universal Life – Investment Vehicle?

By David Vicic, ASA, Senior Vice President, Licensed Life Agent, Corporate Planning Associates

On a visit to the web site of a major Canadian insurer, I happened to come across their consumer introduction to universal life insurance. Among other things, the web page stated that universal life insurance provided a "powerful combination of life insurance protection and tax-advantaged investment opportunities". Universal life (UL) is a product that combines a term life insurance element with a tax deferred investment account. The owner of the policy can make premium payments in excess of the minimum required premiums, up to a maximum premium. Any premiums in excess of the required minimum are deposited to the investment account. The investment income earned within an exempt insurance contract is sheltered from tax as long as it remains within that contract. Since premium payments are flexible, they could stop altogether if the investment fund is generating sufficient investment income to pay the premium. The benefit paid on death (could be face amount of the policy or face amount plus the investment fund value) would be payable to the beneficiary listed on the insurance company's books, on a tax-free basis.

It has always been my belief that the primary reason for buying universal life (or any other insurance for that matter) should be to insure one's life against premature death. Any other benefits or perceived benefits of the policy should be simply a "throw in". However, many of our clients receive proposals from their insurance advisors where the primary use of a universal life policy is as an investment vehicle rather than as an insurance contract.

The advisor's position is that aside from Registered Retirement Savings Plans, there are no real tax deferral vehicles available to the average Canadian, except for life insurance (due to the tax deferred nature of life insurance). A proposal is made whereby an individual purchases insurance and then puts the maximum premium into the policy for a specified number of years. These funds would remain in the policy and at some point in the future, the assets in the policy could be used to generate an income for the individual. There may or may not be an insurance need for the client. If there is an insurance need, then the product could/should be exploited so as to generate as much benefit for the individual as possible. However, if there is no need, then the above-noted investment strategy is VERY expensive. Let's look at an example to illustrate the point:

Our client is 50 years old and is a non-smoker. He has been presented with a proposal for $1 million of universal life insurance. Given his current insurance holdings, there is no real need for the additional death benefits. The contract is simply being purchased as an investment vehicle. He has no additional RRSP contribution room and has excess cash flow. The insurance cost is level, i.e. does not increase over time, the maximum annual deposit is $58,940 and the premium is paid over a 10 year period. We have assumed a 6% rate of return and the

continue on page 2

continued from page 1

investment option used is an index that mirrors the net rate of return of an equity mutual fund. The death benefit is equal to the face amount plus the account value. The table summarizes some key information.

Year	Premiums Paid	Account Value*	Rate of Return**
5	$294,700	$221,092	(7.33%)
10	$589,400	$633,696	1.31%
15	$589,400	$841,313	3.40%
20	$589,400	$1,125,114	4.21%

* A surrender charge (payable up to year ten) would reduce the amount received.

** Rate of return is annualised up to the end of the year listed. Since our example is meant to illustrate the cost of using a life insurance contract as an investment vehicle, the rates of return are simply based on the deposits made and the account values at the end of the year.

The promise of using insurance as a tax deferred investment vehicle sounds great in theory. However, the reality does not match theory in our case. If no tax is being paid and investment earnings are reinvested, why are the returns so low in comparison to our 6% assumption? You will recall that the client invested $58,940 per year in the policy. However, a portion of that deposit is used to pay the cost of insurance, premium tax and administrative charges, with the rest being deposited in the investment fund (think of these charges as up-front sales charges). Over the first five years, the total of these charges is $66,000 or roughly 22% of the total deposits. Over ten years, these costs eat up approximately 24% of the money deposited. While it is true that if the client was to die, the estate would receive an additional $1 million, it is a very steep price to pay when you don't need the insurance and if you are looking for a way to maximise your return while minimizing your taxes.

Now let's assume that this same client decides to take his money and invest it in mutual funds. He will contribute $58,940 per year for ten years as in the previous example. His expected pre-tax rate of return will be 8.5% and the funds will be invested in the underlying equity funds that drive the insurance policy's investment fund.

Year	Deposits Made	Account Value	Difference between Insurance and Mutual Fund
5	$294,700	$378,927	$157,835
10	$589,400	$948,703	$315,007
15	$589,400	$1,426,524	$585,211
20	$589,400	$2,145,002	$1,019,888

The first thing that you should notice about this example is that the rate of return is different than that used in the insurance example. This assumption is completely appropriate and the reasoning for this is as follows. If you recall, the investment fund in the insurance policy bases its return on the net return of an equity mutual fund. For the privilege of investing in this index, the insurance company charges a management fee of approximately 2.5%. Remember that this is over and above what is being charged by the mutual fund manager. As a result, for the index to generate 6%, the underlying fund would need to generate a return of 8.5%. If we assume that the management expense ratio (MER) of the underlying fund is 2.5%, our client would be paying a total MER of approximately 5%.

Based on our example, it would appear that by the end of twenty years, our client has created an investment portfolio that is almost double that of the insurance policy, on a before tax basis. In fact, the case could be made that he could now self-insure with a portfolio value that exceeds the total death benefits payable.

One additional point that should be made is that the surrender charges in a universal life policy are a function of the minimum annual premium required. The surrender charges will generally increase to three-, four-, or five times the

minimum premium before they eventually decrease to zero. In some contracts, these charges are in place for up to fifteen years.

It should be noted that there may be other reasons for wanting to use the life insurance policy as an accumulation vehicle. Death benefits are payable to beneficiaries on a tax-free basis (including the account value if that option is chosen). Life insurance contracts provide a measure of creditor protection, provided certain requirements are met. When someone other than your estate is named as the beneficiary, the insurance proceeds are payable directly to that beneficiary, bypassing the fees associated with probate. If these factors are not an issue, using a universal life insurance contract solely as an investment vehicle can be an expensive proposition.

Probate Protection

By; Hilary Laidlaw, Counsel for McCarthy Tetrault, LLP, Toronto

This article is reprinted with permission of the author, and Advisors Edge.

For some, writing a will can be daunting. So the idea of writing more than one is a bit like tempting fate. Given such widespread aversion to the task, when would you ever advise a client to consider multiple wills?

Multiple wills may be necessary if your client holds assets – particularly real estate – in different jurisdictions. Foreign succession laws may differ from place to place, so these assets should be properly dealt with according to local laws. Often, the best way to accomplish this is with a separate will, made in that jurisdiction by a lawyer qualified to practise there.

When planning a foreign will, it is generally more expedient to appoint an executor who resides in the same jurisdiction. This eliminates the need for a foreign bond, saving the estate both time and money. It also simplifies the administrative process.

Clients who have no foreign assets may still benefit from writing more than one will, depending on the nature and value of their assets. For example, multiple wills can be an effective way to reduce probate fees. (In Ontario, probate fees are now called an estate administration tax.)

Estate plans that include multiple wills can save the client probate fees

Probate is not a legal necessity. However, it is often a practical requirement as proof to third parties, like banks and stock transfer agents, of the executor's authority to deal with the estate assets. Certain assets, however, can be administered without such formal proof. The multiple wills technique isolates those assets in a separate will, not intended for probate. As a result, no fees are payable on the value of the assets that pass under that will.

Consider the following example: Your client owns a house in joint tenancy with her husband, insurance on which he is the designated beneficiary, an investment portfolio valued at approximately $550,000, and $3.5 million in shares of a privately held corporation, of which the spouses are sole shareholders.

On her death, title to the house will pass automatically to her husband by right of survivorship. Because it is not subject to the will, no probate fees would be payable on its value. The same is true of the insurance benefits, which would pass directly to her husband outside the terms of the will in accordance with the beneficiary designation.

The investment account, however, will have to be dealt with by her executor, and the broker will typically require a probated copy of the will before following the executor's instructions. Accordingly, fees will be payable on the value of that account. But what about the private company shares?

Because they are closely held, such shares can usually be administered by the executor without the need for probate. In many instances,

continued on back page

Probate Protection

(continued)

the deceased may have been the sole director, and the executor would consequently assume this same function in due course, entitling him or her to deal with the shares as directed in the will. Even in cases where there are other directors, they will not typically require probate to confirm the executor's authority. As a result, your client could create a separate will, not intended for probate, that deals only with the private company shares. By these means, the estate would achieve a significant probate savings. Based on Ontario rates (approximately 1.5%), the probate savings on the shares would amount to $52,500.

Probate Planning

As recently as 1998, the Ontario Superior Court of Justice confirmed the use of multiple wills for probate planning. Since then, multiple wills have become commonplace. But they aren't the answer for everyone. While Ontario recognizes them as valid for this purpose, other provinces may not. You should familiarize yourself with your province's laws in this area before raising the issue with clients.

Remember too, that even where multiple wills are effective in reducing probate fees, your client's assets may not warrant such treatment. Multiple wills are more expensive because they are more complex than a single will and take more work to prepare. You can assist your client with a cost/benefit analysis to ensure that the potential savings outweigh the cost. If your client does not have a lawyer who can draft the wills, be prepared to refer him or her to a trusted contact in the legal profession who can.

Careful drafting is critical to the successful use of this technique. There are many traps for the unwary. For example, one must ensure that the wills do not unintentionally revoke each other. It is also necessary to avoid duplicating benefits, provide flexibility in the payment of debts and expenses, and ensure that the appropriate assets are included in each will. If just one asset in the non-probateable will requires probate, it will taint the entire will. Probate fees would then apply on the very assets your client intended to shelter. Thus, where there in uncertainty, a questionable asset could itself be made the subject of yet another will. Although this may seem excessive, it could be necessary in more complex estates.

As a trusted advisor, it is important for you to recognize when multiple wills may be beneficial to your client. Sound advice is critical. You must ensure that your client receives appropriate legal advice from a professional who is experienced in this area.

Clients want to save money and anything you can do to further this goal can only strengthen your relationships with them. Think of multiple wills as another tool to help you, and them, do just that.

Published by
Corporate Planning Associates
Suite 1700, 320 Bay Street
Toronto, Ontario, M5H 4A6

Tel: (416) 364-7898
Fax: (416) 364-6438

Managing Editor:
Joy Rooney

While we make every effort to ensure the accuracy of information contained in *Advancing Issues*, we cannot guarantee its accuracy or completeness. Readers are advised to seek professional advice to determine the applicability of the information to their own circumstances. Reproduction, in whole or in part, without written permission is forbidden.

Subscription price: $100 per year

Visit our Website at
www.cpafin.com