

HELPING OUR READERS MINIMIZE TAXES AND INCREASE THEIR NET WORTH
Quarter 3 Fall 2006

PROVIDING FOR YOUR BENEFICIARIES

Trying to find a tax-effective method of transferring wealth to your beneficiaries without giving up control while you are still living can at times be challenging. A common method of transferring wealth is to set up a trust with your children and grandchildren as beneficiaries. Depending on the nature of the trust and the type of investment, it may be taxed in the hands of the child or grandchild. Unfortunately, setting up and maintaining a trust can be costly and time consuming. Typically, once a trust is established you no longer have control of the assets held by the trust.

While the use of trusts is a common approach for transferring wealth between generations, there are different approaches that provide similar benefits while allowing you to keep control of your assets until you are ready to give up that control.

The use of a cash value permanent life insurance plan provides unique alternatives to the trust method of intergenerational transfer of wealth. The following are two examples of how life insurance can be used to provide a tax-efficient wealth transfer, all while maintaining complete control.

Example One: The Smiths

The Smiths have \$5,000 per year in additional retirement income that they would like to invest for their grandchild's future. According to their calculations, they should have this income for the

next 15 years. They have done well over the years and their combined retirement income keeps them in the top marginal tax bracket. While they want to invest in their grandchild's future, they are uncertain about his future goals and would prefer to maintain control of the assets until the picture becomes clearer.

The Solution:

A permanent cash value life insurance policy purchased by the Smiths on the life of their grandchild provides a tax-effective solution to their situation. Here is how it works:

The Smiths are the owners of the life insurance policy and remain in control of the policy until they



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transfer ownership. Their grandchild is the life insured. The Smiths name their son and his wife (the grandchild's parents) as beneficiaries of the life insurance policy.

When the Smith's grandchild turns 18 and needs the funds to go to university, the Smiths will transfer ownership of the policy to their grandchild. Under Section 148(8) of the Income Tax Act (Canada), when the ownership of a life insurance policy is transferred to a child of the taxpayer, the interest is deemed to have been disposed of for proceeds equal to the adjusted cost basis of the policy. Transfers should occur after the grandchild turns 18 to avoid any potential attribution rules. A child is defined as including a child, grandchild, great-grandchild or spouse. Therefore, there are no tax consequences on the transfer of ownership in this case. When funds are withdrawn from the policy, they will be taxed in the hands of the grandchild, who will typically be in a minimum tax bracket, maximizing the net withdrawal.

Although the Smiths will need to give up control of the policy to maximize the tax efficient transfer of wealth to their grandchild, they will only need to do so if and when they want to.

This method of intergenerational wealth transfer gives the Smiths the opportunity to see the funds they want to invest in their grandchild's future grow on a tax deferred basis...without giving up control today. In addition, they are providing their grandchild with a gift for life...the gift of life insurance.

Example Two: The Jones

The Jones would like to use \$5,000 of additional annual after-tax income to protect their daughter's family in case of premature death and to invest in their grandchild's future by building a fund for him to draw on for his education.

The Solution:

A cash value life insurance policy purchased by the grandparents on the life of their daughter is an effective solution in this situation. Not only are both of the above needs met, but they are doing so on a tax-effective basis. Here is how it works:

The grandparents own the life insurance policy on their daughter and pay the premiums until their grandchild is ready to go to university. At this point, premium payments stop and the ownership of the policy is transferred to the grandchild. Like the Smiths, the Jones will be taking advantage of Section 148(8) of the Income Tax Act (Canada).

The grandchild withdraws funds from the accumulated cash value of the life insurance policy for five years to fund his education, leaving no cash value in the plan (withdrawals from the plan will be taxed at the grandson's marginal tax rate which is likely to be low while he is attending school).

After the grandson has completed school, he transfers ownership of his policy to the life insured (his mother). Since all of the cash value has been removed from the policy, there is no taxation when transferring the ownership to the mother because there is no policy gain to tax. At this point, the mother owns a policy on her life with plenty of room to deposit funds on a tax-sheltered basis to enhance her retirement income, if she chooses to do so.

The Jones have not only provided the gift of an education to their grandchild, they have also given their daughter the protection her family needs as well as an opportunity to place funds into a tax-sheltered environment to enhance her retirement income.

KEY EMPLOYEE PROTECTION

Offsetting the impact of losing a Key Employee...

While virtually every small to medium sized business is protected against the risk of fire, flood damage, and theft, many have not considered the impact that the loss a key employee would have on the future direction of the business. After all, many successful small companies consist of individuals with highly specialized skills, knowledge and industry contacts. Without these key employees the business may suffer serious setbacks or even worse, not succeed.

Consider the ramifications on a small business if it lost its top salesperson or a primary decision maker. Creditors may become nervous and demand payment, existing and potential customers may lose confidence and lending institutions may become wary about extending or maintaining existing credit facilities. Even worse, competitors may get wind of the situation and take advantage, resulting in a downward spiral for the business that may be difficult, if not impossible, to reverse.

In an ideal world, the business would go out and replace the key employee with someone who possessed the same set of skills, contacts and expertise. Of course this is easier said than done. Recruitment can be expensive and time consuming as the knowledge and experience you are looking for doesn't come easily or inexpensively. While it is likely that the key employee can be replaced at some point, the goal is to minimize the disruption to the business without having to throw fists of cash out the door looking for a suitable candidate.

So how can this be accomplished without breaking the bank? There are several options including setting up a savings account today, borrowing funds on the death of the key employee and the "wait and see" approach, although none of these provide an ideal outcome with any degree of certainty.

Protection against the loss of a key employee and, ultimately, the business can most effectively be achieved through the purchase of an insurance policy on the lives of those who are considered vital to the interests of the business. The benefits of this strategy are two-fold:

- Should the key employee die, tax-free proceeds from the life insurance policy can be used to assist with the costs of recruiting, hiring and training the replacement employee.
- A permanent life insurance plan allows the business to accumulate cash on a tax-preferred basis. This cash can be used by the business in the future as a source of liquidity and to meet other needs such as expansion or to secure a loan from a financial institution.



The business will be the owner, payor and beneficiary of the policy. Premiums paid for the life insurance protection are not tax deductible to the business although the proceeds received on death are tax-free under current laws.

If the business is a private corporation, the excess of the proceeds over the Adjusted Cost Basis of the policy are credited to the capital dividend account of the corporation upon death of the insured. This gives the company some flexibility, as proceeds can be used however the corporation sees fit. The corporation may elect to pay some or all of the cash as a tax-free dividend to the shareholders of the company from the capital dividend account.

For the sole proprietor, things would likely be structured a little differently as they are likely the one who is considered the "key

employee." Unless they have a close family member in mind to continue the affairs of the business, options are limited. The business can be closed or sold to an outsider, although this may prove difficult as valuing a small business can be a tricky issue. You want to ensure the deceased's estate receives full value. Alternatively, you could set up a buy-sell agreement with a trusted employee whereby the employee takes out life insurance on the owner. Upon death, proceeds of the insurance policy would be used to buy the business from the owner's estate. This helps ensure that the interests of the business and key employee have been addressed.

Tax Tip

Tax Tip: Tax Reduction on Donated Securities

Currently the Income Tax Act (Canada) deems that gifts of cultural property to qualified institutions be exempt from capital gains tax. As of May 2nd, 2006 this tax treatment is being extended to gifts of Publicly-Listed Securities and Ecologically Sensitive Land to a qualified charity.

Many Canadians make annual contributions to their favourite charitable organization. While most of us do not have Ecologically Sensitive land available for donation, a large number do have publicly listed securities within their portfolios, some at an appreciable gain. Rather than making your donation with after-tax dollars, consider donating a portion of those securities that are sitting in a gain position. This will eliminate the need for your estate to pay capital gains taxes on these assets, potentially leaving more for distribution to your heirs.

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