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TAX MATTERS

How insurance can create tax-free income in retirement

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I've got some good friends who are insurance advisers. If there's one thing they have in common, it's that they're persistent. Maybe you've heard the story about the executive who met with an insurance adviser. "You ought to feel privileged that I've agreed to meet you today," the executive said. "So far today, I've had my assistant turn away eight insurance salespeople," he continued. "Yes, I know," the adviser replied, "I'm all of them."

Insurance advisers often get a bad rap because they tend to be so persistent. But I've always believed that insurance can be an effective tool – so be kind to your insurance adviser. Today, I want to share an idea involving insurance that can provide a tax-free source of cash flow in retirement.

The concept

Many people are lamenting the performance of their investment portfolios this year. The concept I'm going to share can provide cash flow in retirement without subjecting your retirement savings to the volatility of the markets. I'm not suggesting that traditional investments should be abandoned, but you might want to supplement your current retirement savings with this insurance-based strategy.

Let me share an example that comes courtesy of Nigel Kettle at Farber Wealth Management in Toronto. Consider Warren and Wendy. This couple, both 50 and with children, have purchased a whole life insurance policy on a joint, last-to-die basis. This means that the insurance won't pay out until the second of them dies, which is a cheaper way to buy insurance than on either of their lives alone. A policy like this not only pays out on the death of the insured, but part of the premiums go into a growing pool of investments.

Now, this couple is investing $100,000 annually in the strategy, for 10 years. That's the amount of their insurance premiums. While that's a pretty big figure for most, we'll use it for the sake of simplicity – you can adjust for your own situation. (If you can afford to invest $10,000 a year, for example, then take the figures in this example and divide them all by 10.)

Back to Warren and Wendy. After paying $100,000 premiums for 10 years, when they reach 60 they will have paid a total of $1-million. At age 65, they'll use the cash value that has accumulated inside the policy to provide income in retirement. But they won't do this by withdrawing the funds from the policy – which they could do (this would be taxable). Rather, they'll visit their bank and borrow funds each month to provide the cash they'll need in retirement. The insurance policy will be pledged as collateral for the loan. The couple will capitalize their loan interest, which means they don't actually make interest payments during their lifetimes. The interest will be added to the total amount of the loan each year.

In this example, it's expected that Warren and Wendy will be able to borrow $100,000 annually (about $8,300 a month) for a total of 30 years (if they live to the age of 95) based on the cash value in the policy at age 65. The policy can allow for this amount of loan because of the growth of the cash value, not only over the first 10 years while deposits are made in the policy, but over the entire life of the policy. And since loan proceeds aren't taxable, this retirement cash flow will be tax-free.

Now, $8,300 after taxes each month is equivalent to $12,770 before taxes at a 35-per-cent marginal tax rate (the average marginal tax rate in Canada for someone earning $100,000 annually). That is, the insurance strategy will provide the same cash flow after taxes as an interest-bearing portfolio generating $12,770 monthly, or $153,240 annually.

How much would you need in an interest-bearing portfolio to produce this much income annually? Well, at a 4.5-per-cent annual yield (the current average rate on a five-year GIC), you'd need $3,405,300 ($3,405,300 at 4.5 per cent a year is $153,240). With the insurance strategy, Warren and Wendy have only invested $1-million of total capital over 10 years, which makes the insurance strategy more efficient than generating income from a traditional portfolio.

The nuances

The story isn't over yet. Warren and Wendy are accumulating debt during their lifetimes as they borrow each month to meet their cash needs. How will that debt be paid off? When the second of them dies, the insurance proceeds to be paid out tax-free will amount to approximately $5.5-million. Most of that – a total of $4-million – will be used to pay off the accumulated debt. This will leave about $1.5-million for their kids.

In the case of Warren and Wendy, an interest-bearing portfolio would leave their kids with $3,405,300 of capital upon the second of Warren and Wendy to die, but the insurance idea, leaving the kids with about $1.5-million, is nothing to sneeze at.

It may also be possible to make the interest cost on the debt tax-deductible by drawing down on non-registered investments in retirement, then using the funds borrowed under the insurance strategy to replace those portfolio investments.

Speak to your insurance adviser to have the numbers crunched in your specific situation.

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