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TAX MATTERS

Life insurance can be an effective way to pay for an education

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED SEPTEMBER 5, 2024

This week was a memorable postsecondary week for our daughter, who attended her first astronomy class of her master's program in university. Apparently, the professor asked the students to explain what causes a half-moon. One clever student shouted out: "When you can't pull your jeans all the way up."

What was memorable for us was the fact that the cost of our daughter's program is being covered by the investments accumulated in a life insurance policy we placed on her life when she was young. Let me explain.

How life insurance can make for more tax-efficient intergenerational wealth transfers

The concept

There are many uses of life insurance in tax and estate planning. Most folks, however, don't think about insurance as a savings vehicle. Yet, life insurance has some important attributes which can make it effective for accumulating investments. One attribute, for example, is that funds accumulating inside a permanent life insurance policy can grow on a tax-sheltered basis.

With this type of policy, a portion of each dollar paid in premiums is used to cover the cost of insuring the person's life, while another portion goes into a growing pool of investments – called the cash surrender value. The insurance we placed on our kids was inexpensive, and we had many years for the investments in the policy to accumulate and grow. How much can you accumulate in a policy over time? Consider some numbers.

The math

When we bought insurance on our daughter's life, we budgeted to invest about $2,600 per year. Today, if you were to contribute $216 each month ($2,592 annually) to a participating whole life insurance policy on the life of a child, starting in their first year of life, you'll accumulate about $70,023 in 20 years inside the policy. This assumes an annual dividend of 6.35 per cent.

Rather than using those funds for our daughter's education, we could continue to accumulate investments in the policy and would have an estimated $135,994 at her age 30 – perhaps to help buy a home. If instead we continue to grow the fund, it could reach $249,979 at age 40. By her age 65, there would be about $990,023. These funds could be used for starting a business or meeting her costs of living in retirement.

Since we're planning to use the funds for her education, it's worth comparing this savings approach to using a registered education savings plan (RESP). If you invested the same $216 each month in an RESP for 20 years and collected the Canada Education Savings Grants (CESGs) available along the way (which amount to 20 per cent of the RESP contributions to a lifetime maximum of $7,200 for each student), you could expect to have about $95,150 in the RESP over that 20 years. This assumes that you invest with the same risk profile as the whole life insurance policy (fixed income-like risk) and earn an average of 4 per cent over the years.

So, why not choose the RESP over the insurance policy given this math? To be clear, we did save in an RESP for our kids as well. RESPs are a good idea. Keep in mind that the assets in an RESP can be used for just one purpose: funding education. When we invested in an insurance policy, we didn't have any specific plans for the use of the accumulating funds, but we knew there were no restrictions on how the funds could be used.

The considerations

There are various things to consider that could make life insurance an attractive savings vehicle:

· The accumulating funds in an insurance policy can be used for any purpose – whether paying for education, saving for a home, starting a business, providing income in retirement, or for any other reason.

· You can structure the insurance so that you no longer have to pay premiums after a few years (usually 10 or 20), but the cash value can continue to grow.

· You can access the funds in an insurance policy in a few ways. You can receive the annual dividends from the policy as cash payments, borrow from the cash value, withdraw the investments in the accumulating fund, cancel the policy and withdraw the cash value, or borrow up to 90 per cent of the cash value from a bank (perhaps paying the bank back using proceeds from the policy paid out after the insured's death). Each of these methods has its own tax implications.

· You can transfer ownership of the insurance policy to your child or grandchild on a tax-free basis once they've reached the age of 18. This effectively transfers the assets in the policy tax-free to the next generation.

· If the child dies prematurely, a death benefit will be paid to the policy owner. In our case, we'd collect $300,000 from our daughter's policy.

Speak to an insurance adviser for more information.

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