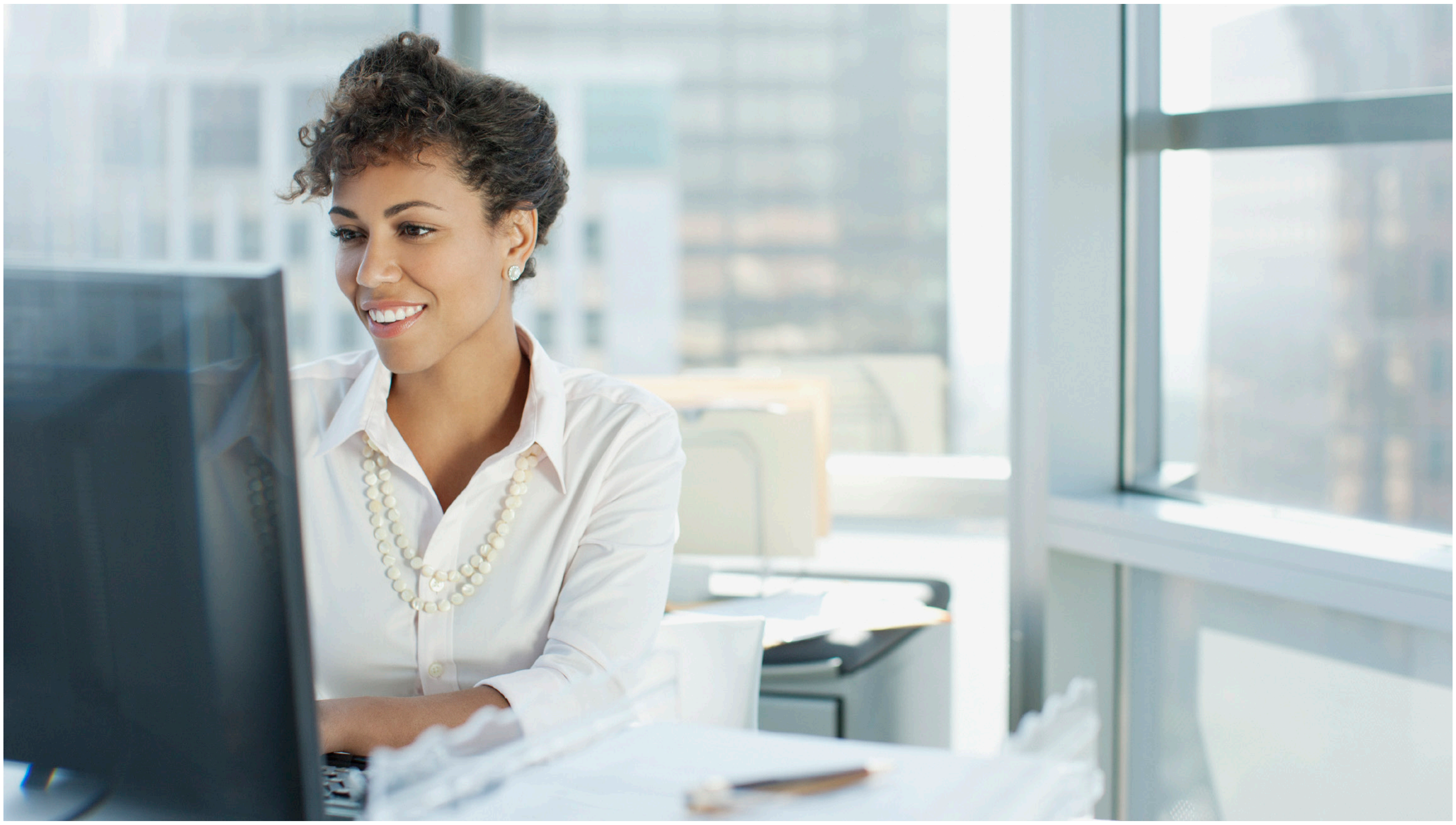
Immediate Financing Arrangements

Building wealth and reducing the overall cost of life insurance



When asked, most clients and their advisors would prefer to invest in their portfolio or business, rather than allocate their cashflow to life insurance premiums. For the right individual or corporation, an immediate financing arrangement (IFA), provides the benefits of permanent insurance at a fraction of the cost, without reducing cash available. This article will detail how an IFA works, including the risks involved and appropriate client profiles.

How an IFA works

Simply put, the client pays a premium, and immediately borrows back against those funds. This allows the client to keep their money working for them the way they'd like, while still taking advantage of the benefits insurance offers.

The steps below outline how to arrange an IFA.

1. A client takes out a permanent life insurance policy that builds cash value, such as whole life or universal life. Choosing a product that best suits an IFA, an advisor may design it to have the highest amount of cash surrender value (CSV) as possible during the early years of the policy, with the premium deposit being significantly higher than what's needed to pay the cost of insurance.
2. The policy and its associated CSV are assigned as collateral to a lender to secure a line of credit.
3. The client pays the premium out of pocket at the beginning of the policy year.
4. The client immediately borrows back CSV[1] from the lender and uses it for investment purposes.
5. The client pays interest on the loan and may be able to use it as a tax deduction, if the funds borrowed are used to invest in a business or property that produces income.
6. Steps 3 – 5 are repeated for all future years where premiums are required, with the client always paying the premium out of pocket, in advance of borrowing.[2]
7. The loan is paid off at claim, by the tax-free death benefit, with the surplus going to policy beneficiaries. Alternatively, if there is an increase in the client's cash position during lifetime, the loan can be repaid early.

The alternative borrowing method is to post additional collateral, such as real estate or investments, so the client can borrow 100% of the premium paid. Due to the modest net cash outflow (net annual interest costs) required, the rate of return when compared to the death benefit increases. Adversely, the client is increasing their overall risk.

Risks of an IFA

Due to low borrowing rates, current economic conditions may make an IFA appear favourable, but that may not always be the case. IFAs are a long-term arrangement (i.e. 20, 30, or 40 years) and are reviewed by the lender on an annual basis. As such, it is important that advisors and their clients consider scenarios where the interest/dividend rate impacting the CSV in the policy decreases, but the floating interest rate increases. Should that happen, the borrower faces capital deficiency in the arrangement and must either post additional collateral, partially repay the line of credit, or surrender the policy. Surrendering the policy will result in a disposition, any excess of the cash surrender value over the adjusted cost base of the policy will be included in the policyholder's income and may be subject to tax.

To avoid unexpected results, it is important to obtain insurance illustrations before putting an IFA in place, using a variety of interest or dividend rates. Regardless, the rule of thumb is that a client should not consider an IFA unless they have the necessary assets required to support the annual premium, without borrowing, or repay the loan without any punitive impact to their lifestyle.

Why an IFA

An IFA is a solution intended for the high net worth, insurable client who is comfortable with the concept of using borrowed funds to their advantage. They should have the appropriate risk tolerance and a long investment horizon.

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An IFA may be an ideal solution for the following reasons:

- To increase the rate of return on an estate planning strategy that integrates life insurance;
- To facilitate the purchase of life insurance for a client who prefers to invest in their business or portfolio;
- For a corporate client, the IFA may increase the balance of the Capital Dividend Account, created upon the death of the life insured;
- To make a charitable gift without a negative impact on a client's lifestyle.

A properly structured IFA may reduce the after-tax cash flow costs of funding a life insurance policy. It can be a superior planning tool if properly executed, but leveraging is not for everyone and tax rules often change. The best way to learn more about whether this solution is right for you is to include legal, tax, insurance and trusts and estate professionals in the conversation.

Considerations

For questions about Immediate Financing Arrangements, please reach out to your TD Advisor. TD's credit specialists have experience in structuring the funding of IFAs for clients and can help you explore whether this strategy would be appropriate for you.

[1]The percentage of CSV varies depending on the lender and the type of policy. A universal life policy linked to a fixed income investment or whole life policies are typically extended between 90-100% of their CSV. Lenders may prefer to lend up to 50% on a universal life policy linked to equities.

[2]The annual growth in CSV creates increased borrowing capacity; however, in the initial years the CSV will be lower than the total premium paid so there is a significant net funding requirement from the client.