

INSURANCE
“An alternative to Immigration Trusts”

Prepared for the Law Society of Upper Canada
14th Annual Immigration Law Summit

November 28th and 29th, 2006

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Introduction

Many practitioners find themselves in a dilemma concerning the information they possess regarding their immigrant client's net worth and the conflicting representation that their client is intending to make, or likely to make, to the Canadian Revenue Agency. Lawyers try to assist their clients by providing information concerning immigration trusts, but many clients are simply not interested or don't follow up.

What is the issue? Canada's culture of basic security and social stability based on relatively high tax rates is foreign to many immigrants coming to this country. Most immigrants are more familiar with government confiscation of assets, foreign intervention leading to confiscation, black market economies where financial resources are not disclosed and serious threats from criminal elements due to kidnapping and home invasions.

The Canadian immigration trust is a vehicle providing five years of tax free growth on assets settled into the trust, in exchange for which the government eventually gets full disclosure of the assets contained in the trust, levies tax on annual income and gains on an accrued basis (unless resettled directly in Canada) and then, if the immigrant should ever decide to leave, Canada levies a departure tax.

The wealth attributable to high net worth immigrants is also generally part of a family operation. It can be difficult for the immigrant client to justify to his or her family members that s/he may be subjecting the family's assets to Canadian taxation.

Lastly, there is also the general unfamiliarity with the concept of a trust, where ownership of the assets is given over to a third party trustee. The trust concept is derived from British common law, which is not the basis of the legal system in many immigrant countries.

Solution

One potential solution may be the use of either domestic or international insurance. Immigrant clients coming to Canada can acquire a life insurance policy, either domestically or through an international affiliate, that can qualify as an exempt contract under 12.2(1)(a) of the *Income Tax Act*, (R.S.C. 1985, c. 1 (5th Supp.)) ('Act') and Regulation 306 to the Act. As such, and presuming it continues to meet the exemption test on an annual basis, policy gains generated will grow tax-deferred (potentially tax-free).

On the death of a life insured, policy proceeds are paid to designated beneficiaries free of tax (see paragraph (j) in subsection 148(9) of the Act with respect to payments made on the death of a person whose life is insured under an exempt policy). Payments can also be made under morbidity provisions, such as critical illness or disability on a tax-free basis (see paragraph (h) in subsection 148(9) of the Act with respect to disability payments made under a life insurance policy).

Clients also maintain the option to leave Canada to re-establish residency in their country of origin, with the policy in tact (subject to certain terms of domestic underwriters) and not incur Canadian Departure Tax. Whereas, after the five year exemption period has expired in relation to the trust, the trust assets would be subject to capital gains tax if the client was to exit Canada.

Some clients may raise concerns surrounding investment restrictions inherent in insurance policies. However, most domestic policies have indexing pools that match most conceivable asset allocation models imaginable. In addition, the international policies, due to the use of segregated cell legislation not available domestically, can usually accommodate the appointment of customized investment managers and hold any type of asset within the policy, including shares of private companies (there are issues, however, in relation to such types of assets that raise other concerns for advisers, such as segregated fund issues and valuation issues in respect of exempt policy testing).

Some clients may also raise concerns surrounding access to funds during the lifetime of an insured as compared to a trust. However, policies generally provide for loans or can be used as collateral for loans. Again, with segregated cell legislation, international underwriters can lock in interest rates, eliminating variable rate exposure that a client may face with domestic loans.

The client may in fact, use borrowing in relation to his or her insurance planning to enhance their tax planning. Some borrowing can be effected in such a way as to create active deductions against taxable income for the client in Canada. Immigration trusts are not usually used in this fashion.

Confidentiality of asset holdings can also be maintained through the use of insurance. Policy holders resident in Canada are not generally required to report assets to the Canadian government – policyholders do not report the existence of an exempt policy to the government. Further, most international insurance companies are based in tax-free (or low tax) jurisdictions that have legislated confidentiality provisions and no individual reporting requirements.

The client may perceive the cost of an insurance contract as a barrier. However, when considered in light of the legitimate obligation to pay taxes, insurance can be less expensive. Also, most international carriers are able to cut out intermediate sales costs, as well as regulatory and corporate tax costs that many of the domestic underwriters would face. International exempt policies can be maintained for as low as 1 to 2 % per year, based on the net asset value of a life insurance policy.

Conclusion

Life insurance is an attractive planning tool for many immigrants – it is private and has a degree of confidentiality that provides a good measure of security and comfort to the inbound client. As well, it helps deal with many clients unfamiliarity with trusts – for

many, giving away legal title to assets and, being subject to taxation after five years is not a palatable alternative.

Exempt life insurance policies offer:

- Tax-deferred (and in some cases tax-free) growth of assets
- Tax-free payout on death, critical illness or disability
- Confidentiality of assets
- Options for tax planning in the future should the client ever wish to leave Canada
- Enhanced domestic tax planning strategies

Insurance is not:

- Cost prohibitive
- Restrictive in terms of investment strategies
- Restrictive in terms of cash flow

Notice

This paper is intended for information purposes only and is not intended as a substitute for legal advice. The reader is encouraged to obtain qualified professional assistance on any specific matters in which he or she may be engaged.

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APPENDIX

THREE CASE EXAMPLES

Case 1 Facts

Husband age 40; wife age 38; three children ages 7, 9 and 11. Husband's family have significant wealth out of Hong Kong and he is part of a family business that brokers Chinese manufactures with North American distributors of finished goods. Family wishes to move to Canada at least until the children are finished university. They may or may not choose to move back to Hong Kong in the future, but they want to keep their options open.

Case 1 Issues

1) The husband and wife have significant savings in their personal names, the gains on they hope to shelter from taxation if legally possible. 2) Given that they may wish to reside outside of Canada some day, they would like to keep their options open with respect to Canadian Departure Tax. 3) The husband has some concerns about leaving Hong Kong as it might weaken his claims on some of the family's assets. However, his father will not allow the assets to be placed into a taxing situation, even after a five year exemption.

Case 1 Possible Solutions

The husband and wife take out a domestic universal policy insuring both of their lives on a last to die basis. They could fund this over a five year period with their existing assets. Second, the husband and father could purchase a single premium insurance contract from a foreign underwriter with an agreed amount of family assets, insuring both of their lives, with a first to die clause.

The assets in the domestic policy will grow tax free (assuming it meets the standard criteria noted above) until such time as both the husband and wife die. Should the decide to depart Canada prior to both of their deaths, then the assets and gains can be ported out of Canada tax free.

The assets in the international policy will likewise grow tax free and will either be paid out to the husband on the death of the father into Canada, or will be paid back to the father in the unlikely death of the son and the assets will always remain outside of Canada. Like the domestic policy, should the couple decide at some point to exit Canada, then the assets in the domestic policy will not be subject to Canadian Departure Tax.

Case 2 Facts

Wife age 39; husband age 36; no children. Wife's family has significant wealth from the Czech Republic, of which she has an agreed share. Husband is an entrepreneur investing

in mining operations in the Ukraine, none of which are producing positive cash flow presently. The couple wish to immigrate to Canada because they are worried about the political stability of Eastern Europe. Their real ambition is to move to the United States, but so far they have been unsuccessful. They see Canada as a good compromise for now giving them access into the US and affording them the ability to travel back to Eastern Europe fairly easily.

Case 2 Issues

1) The couple wish to avoid taxation on the growth of their liquid assets if possible. 2) The husband's businesses produce no cash flow, so the couple need some income to live off of. 3) While the husband's business ventures are active businesses and not subject to foreign accrual property income tax, his plan is to broker them for sale as opposed to operating them, which would subject them to capital gains taxation with no deduction for Canadian Taxable Property (i.e. full taxation).

Case 2 Possible Solutions

The wife and husband take out a domestic universal policy insuring both of their lives on a last to die basis. As in Case 1 above, they could fund this over a five year period, either from assets in their name or even from gifts from the wife's family of her share of the family assets. They could then take out a domestic loan on the policy to assist them with their cash flow considerations, until such time as the husband's business ventures bore fruit.

Having the funds in the policy would allow the couple to avoid taxation on income and capital gains. Should they decide to exit Canada for the United States or back to Europe, they would avoid any Departure Tax.

Second, the husband and wife could take out an international life policy insuring both of their lives on a last to die basis, using the shares of the husband's companies as a premium payment in kind. When the husband brokered a sale of companies (on behalf of the insurance company) the cash would go into the policy on a tax free basis. The husband could be paid a salary (which would be taxable in Canada) from the insurance company from the assets in the policy in regard to the sales brokering that he is doing in relation to the businesses. This would alleviate the couple's cash flow issues and allow them to pay back the domestic loan, or the domestic loan could be paid out on death.

Case 3 Facts

Husband age 44; Wife age 42; two children ages 14 and 16 from Venezuela. Both husband and wife are doctors and have considerable savings from family inheritances. They are fleeing Venezuela due to their perceived violence and economic instability in the country. The husband, although not old, suffers from a congenital heart issue.

Case 3 Issues

1) The couple have enough cash flow as doctors, so they wish to avoid taxation on their investment income and gains as much as possible. 2) They are also very concerned about any potential revelation of their net worth, as they still have family back in Venezuela and they intend to travel back there to visit on occasion. Kidnapping and extortion are potential threats to them.

Case 3 Possible Solutions

The couple could first take out an international life policy on a last to die basis with the bulk of their funds. The assets in the policy would grow tax free until the death of both spouses. Although the husband may not be insurable in Canada, given the segregated legislation in offshore jurisdictions, insurance companies can limit their risk with respect to the insured and therefore are more flexible in their underwriting practices. Also, most of the underwriter's are based in jurisdictions with statutory confidentiality laws. Such laws limit the information required to be filed, which will no doubt give the couple some additional confidence surrounding personal security concerns.

The couple can then fund a domestic universal life policy with the balance of their funds over a period of five years (likely only on the wife as the insured) and obtain a loan against that policy to fund an investment account. The interest on the loan could be deductible in relation to the gains made on the investment account and the couple would enhance their net worth via both the policy and the external investment account. The domestic policy could be used primarily as an estate planning tool to pass on family funds to the two children.

Lastly, both policies will act as an excellent asset protection vehicle for the doctors in the event of any malpractice suits.