Individual investment shelter and corporate investment shelter

ADVISOR GUIDE
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Clients who have saved diligently, inherited a large sum of money or sold their business may accumulate significant wealth that they don’t intend to spend in their lifetime. Or, a client who is a shareholder of a Canadian controlled private corporation (CCPC) may have run a successful business which led to a large amount of assets in their holding company.

These clients may have similar immediate and long-term financial planning objectives, including minimizing taxes they need to pay, and ensuring their families are financially secure when they are gone. Unfortunately, tax on investment income can work against a client’s goals and objectives. The Individual Investment Shelter (IIS) and Corporate Investment Shelter (CIS) strategies demonstrate how a permanent life insurance policy can help reduce the overall tax bill and provide a larger estate than taxable investments alone. The strategies compare the net estate value of a tax-exempt life insurance policy to a traditional investment portfolio.

**TARGET MARKET**

The IIS and CIS strategy may be suitable for clients with excess income and/or assets who want to maximize the value of their estate or their business.

<table>
<thead>
<tr>
<th>IIS</th>
<th>CIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual, age 60+ and in good health</td>
<td>Primary or key shareholder of a Canadian controlled private corporation, age 50+ and in good health</td>
</tr>
<tr>
<td>Has significant non-registered assets or excess income not required to fund their lifestyle</td>
<td>Has significant retained earnings or excess cash flow not required to fund business operations</td>
</tr>
<tr>
<td>Wants to maximize estate value for their beneficiaries</td>
<td>Wants to maximize the value of their business at death</td>
</tr>
<tr>
<td>Has high income and net worth with a secure financial future</td>
<td>Has a successful business with stable cash flow and a sound future outlook</td>
</tr>
<tr>
<td>Is interested in reducing the taxes they pay on their investments</td>
<td>Is interested in reducing tax on corporate investment income</td>
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</tbody>
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Consider the following questions to help determine if the IIS or CIS is the right fit for clients:

**Does the client have a sufficient amount of income or excess assets?**

The IIS and CIS strategies involve the transfer of taxable investment to a cash value life insurance policy. These strategies should be used with individuals or corporations that have either excess income or assets that they do not require to fund lifestyle needs or company operations. These strategies may not be suitable for clients with variable income and fewer assets.
Is the client healthy?
The IIS and CIS strategies use life insurance, so clients must be reasonably healthy and able to qualify for coverage to take advantage of its benefits.

Does the client have a long-term planning view?
The IIS and CIS strategies are intended to be in place for the life of the insured. A long-term view is essential to maximizing the benefits of this strategy.

Does the client want to maximize the value of their legacy?
This is an important consideration. For most clients the answer will be yes although their definition of legacy may differ. Ensure that maximizing the value of assets passed on after death is consistent with client’s goals and what they want to achieve.

TAX CHALLENGES

Tax challenges while living
It’s not what you earn, it’s what you keep. Income a client earns on investments outside of a registered plan – such as interest, dividends or capital gains – may be subject to tax. Annual taxes paid reduce the overall net return and can substantially slow the accumulation of a client’s assets and estate value over time.

Taxes must be paid on capital gains from selling investments, slowing any asset growth and reducing the net estate value. Having too much investment income may also result in other unintended consequences. For individuals, it may mean a reduction in Old Age Security benefits. For corporations, it may limit the advantages that the small business deduction can provide.

Tax challenges at death
At death, assets are deemed to be disposed of for their fair market value (FMV). When an asset is sold for more than its adjusted cost base, a capital gain is incurred. Currently, 50 per cent of the capital gain is subject to income taxes, which can significantly reduce the final estate value.

In a corporate setting, assets passed from the corporation to the deceased shareholder’s beneficiaries will be treated as either regular income, or as a dividend and are taxable. This further reduces the amount the beneficiaries are eligible to receive.

In addition to capital gains taxes payable on traditional non-registered investment assets, probate, legal fees and administrative costs may also apply, further reducing the amount available to beneficiaries.
Individual Investment Shelter

The IIS strategy compares the net estate value of a tax-exempt life insurance policy to that of a traditional investment portfolio.

An individual or a couple purchases a permanent cash value life insurance policy. They pay their premiums with either excess income or transfers from taxable non-registered assets.

Cash value growth within a life insurance policy is tax-free, within limits. By transferring funds from taxable non-registered investments to a tax-preferred cash value life insurance policy, an individual can reduce their taxable income, potentially resulting in greater asset growth.

Upon death of the insured, or upon death of the second spouse for a joint last-to-die plan, the life insurance death benefit proceeds can be paid directly to a named beneficiary, tax free. As for non-registered assets, the proceeds at death may form part of the estate, resulting in additional costs and ultimately reducing the amount payable to the beneficiaries of the estate.

In addition, any taxable investments will be deemed to be disposed of at their FMV at death, potentially resulting in a capital gain. Any gain must be reported on the final tax return of the deceased. Estate taxes must be paid before the executor can distribute assets to the beneficiaries. By transferring assets to a tax-preferred life insurance policy, individuals can limit the amount of taxable capital gains.
Corporate Investment Shelter

Conceptually, the CIS strategy works similarly to the IIS strategy, though subject to a couple of key differences relating to corporate tax rules and the corporate tax environment. These include the use of the capital dividend account (CDA) and the refundable dividend tax on hand (RDTOH) credits. The CDA is a notional account* used to track tax-free surpluses accumulated by a private corporation. RDTOH is also a notional account designed to more closely integrate personal and corporate tax outcomes. For more information on the CDA and RDTOH, please refer to the Technical Reference Guide: “The Capital Dividend Account” and to our Advisor Notes article, “What is RDTOH?”

*Created under section 89 of the Income Tax Act (ITA).

In addition, any taxable non-registered corporate-owned investments will be deemed to be disposed of at their FMV. Any resulting capital gain is taxable to the corporation in the year of disposition. The tax-free portion of the capital gain creates a credit to the CDA which can be paid tax-free to the shareholder’s estate. The after-tax balance of the non-registered investment can be paid to the shareholder’s estate as a taxable dividend.

The CIS strategy compares the net estate value of a tax-exempt life insurance policy to that of a corporate owned taxable investment. A Canadian controlled private corporation purchases, makes payments to and is the beneficiary of the policy. The primary or key shareholder is the life insured. Premiums for the life insurance policy can be paid either with excess corporate income or through transfers from corporately held taxable investment assets.

Like an individually-owned life insurance policy, cash value growth within a corporate-owned policy is also tax-free within limits. By transferring funds from taxable corporate-owned non-registered investments to the tax-preferred environment of a cash value life insurance policy, the corporation can reduce its taxable income, potentially resulting in greater asset growth.

At death, the life insurance proceeds are paid directly to the corporation as beneficiary on a tax-free basis. Proceeds in excess of the policy’s adjusted cost basis (ACB) create a credit to the corporation’s CDA.

The corporation can then make an election to pay a tax-free capital dividend** for an amount equal to the balance in the CDA to the shareholder’s estate. The balance of the death benefit can be paid to the shareholder’s estate as a taxable dividend. As a result, the net estate values provided by life insurance can exceed those provided by taxable investments.

By transferring assets to the tax-preferred environment of the corporate life insurance policy, corporations can potentially limit the amount of taxable investment income and as a result, maximize the value of assets to the corporation.

**An election under subsection 83(2) of the ITA must be made to treat the dividend as a tax-free capital dividend.
The difference in distribution of death benefit

**IIS**

Life insurance policy → Death benefit → Beneficiaries

**CIS**

Life insurance policy → Death benefit → Corporation → Capital dividends and dividends → Beneficiaries

**THE BENEFITS OF LIFE INSURANCE**

Life insurance is the driving force behind the success of the IIS and CIS strategies. Here is a summary of the benefits that life insurance can provide individual and corporate owners:

**Tax-preferred cash accumulation** – There is no tax payable on the growth of the policy’s cash value as long as it remains within the policy.

**Tax-free death benefit** – At death, the estate or beneficiary receives the entire death benefit tax-free. By avoiding settlement costs, a larger amount can be passed directly to beneficiaries compared to using taxable investments.

**Liquidity** – Cash value life insurance policies provide clients with additional flexibility. If the policy owner requires access to the accumulated funds within their policy, they have the option of taking a policy loan, withdrawal or collateral assignment of the policy in exchange for a loan from a third party financial institution. There may be tax consequences associated with a policy loan or withdrawal.

**Potential creditor protection** – For personally-owned policies, the accumulated cash value of the policy may be protected from the claims of the policy owner’s creditors during the policy owner’s life and after death. Creditor protection is more limited for corporate-owned policies.
Protection in the event of failing health – Some life insurance policies offer optional protection against the risk of disability. In the event of total disability of the insured, premiums will be paid, ensuring that the life insurance protection will remain intact during a potentially difficult time.

Protection of privacy – By naming a beneficiary, life insurance proceeds do not pass through the client’s estate but go directly to the person or organization named. The benefit is not part of the probate process and does not become a matter of public record. This helps clients keep their final wishes private and pass on their assets privately.

ILLUSTRATING IIS AND CIS WITH EOS

Both the IIS and CIS strategies compare the net estate value of an exempt life insurance plan to a taxable investment. These strategies are available on your Eos system with the following permanent life insurance products:

- Sun Par Protector
- SunUniversalLife / SunUniversalLife Max
- Sun Limited Pay Life
- Sun Par Accumulator

You need Microsoft Excel installed on your system in order to operate the IIS and CIS strategies.

Step 1: Select and illustrate the permanent insurance product on Eos

After you and the client have determined the type and appropriate amount of permanent life insurance, complete the Eos illustration.

- Include all excess payments where applicable (for example, Plus premium benefit on Sun Par Protector and Sun Par Accumulator).
- Ensure premiums are made for the desired duration.

Step 2: Select the IIS or CIS strategy

- From the left hand margin, select the ‘Concept’ icon. Select either “Individual Investment Shelter” or “Corporate Investment Shelter” from the dropdown menu.
- Would you like to export data only? ... Select ‘No’. This will launch the Excel program.
- From the Excel toolbar, select the button titled “Import Sun Life...”. This will pull the required data from the life insurance illustration into the IIS or CIS strategy.
- Once you have named the strategy, a Data Entry box with tabs will appear.

Step 3: Complete the Data Entry tabs

The Data Entry tabs give you the opportunity to provide the details needed to compare the life insurance solution with the alternate investment. Two Data Entry modes are available. You can select Basic or Advanced modes from the Tools menu on the Sun Life toolbar. The ‘basic’ mode consists of five tabs for IIS, and four tabs for CIS. The ‘advanced’ mode consists of seven tabs for IIS and six tabs for CIS. Both strategies include two additional tabs for alternate investment return / allocation details.

- **Representative tab:** This tab contains advisor details including relevant contact information.
- **Investment Assumptions tab:** This tab contains information for the current market value of the alternate investment balance and its adjusted cost base (ACB). If the life insurance premiums are to be paid from the investment balance, click the ‘Fund premiums from investments’ check box. If this box is unchecked, the strategy assumes that life insurance premiums are paid from free cash flow. To ensure a fair comparison, an amount equal to the life insurance premium will be added to the alternate investment.
• **Solve for premium amount button:** The software solves for the maximum premium that could be supported by the alternate investment for the purpose of paying the life insurance premiums. Please note that the concept will not use the result of the solve procedure. It is for reference only. Make the following inputs in the window that appears:

- **No. of years of deposit:** Enter the number of years for which the premiums will be withdrawn from the alternate investment.
- **The Year to solve to:** Enter the year at which you wish to arrive at the investment balance entered in the next field.

• **Offset with RDTOH & CDA credits checkbox (CIS only):** This option is available for the CIS strategy if the user chooses to fund premiums from the alternate investment. This option will result in an illustration that assumes that the client offsets the premium payable with the value of RDTOH and CDA credits generated by the investment account. This is a theoretical setting, however the shareholder does benefit from these credits when they are paid dividends from the corporation. The CIS program reduces the withdrawal for premiums to account for the real value of the credits generated by withdrawing the premiums from the investment account.

**Investment Allocation tab (Advanced Mode only):**
This tab allows the user to specify the weightings of the asset class makeup of the alternate investment. Current weightings for each asset class can be specified. The user can modify these weightings at the insured’s age 65 (default) or a specified age. Total weighting in each column must total 100 per cent.

- **Without IIS/CIS:** The allocation of the alternate investment where it is assumed that the IIS/CIS strategy is not implemented (ie. no insurance is purchased).
- **With IIS/CIS:** The allocation of the alternate investments where it is assumed that the IIS/CIS concept is implemented (ie. life insurance is purchased).
- **Change at age:** input the age where the asset allocation changes under both the “Without CIS” and “With CIS” areas.

**Investment Returns tab (Advanced Mode only):**
This tab allows the user to specify the rate of return earned for each asset class. The user can further specify the breakdown of that return by interest, dividends and deferred capital gains. Values in these three columns must add up to 100 per cent. You can also specify annual realized gains for each of these asset classes. When running the IIS/CIS strategy with Sun Par Protector or Sun Par Accumulator you have the option of illustrating at current, current – 1 per cent or current – 2 per cent dividend scales.
Withdrawals/Investment Withdrawals tab:
This tab allows you to illustrate withdrawals from the alternate investment and helps to highlight the flexibility that the IIS and CIS strategies can offer.
- **Amount**: Input the amount of the annual withdrawal.
- **From age and to age**: Input the age where the annual income stream begins and ends.
- **Index**: Input the amount of the annual income increase if desired.
- **Solve for amount**: This is a solve that calculates a possible withdrawal stream leading to a specified investment balance at a specified age.

Tax Assumptions tab: This tab highlights the tax assumptions to be used in the illustration.
- **Marginal tax rate on interest (IIS only)**: Enter the insured’s marginal tax rate. This should correspond with the marginal tax rate field entered on Eos.
- **Corporate investment tax rate (CIS only)**: Enter the rate at which corporate investment income is taxed. This should correspond with the marginal tax rate field entered on Eos.
- **Marginal tax rate on dividends (IIS only)**: For simplicity the dividend gross up and tax credit is not applied to dividend income. Instead, enter the rate at which dividend income is to be taxed after considering the effect the dividend gross up and tax credit will have on the client’s tax position.
- **Shareholder dividend tax rate (CIS only)**: Enter the rate at which corporate dividend income is to be taxed. This should be the rate the shareholder pays after taking the gross up and dividend tax credit into account.
- **Annual portfolio turnover**: Enter the rate at which the investments in the portfolio are turned over by trading. A low rate would reflect a buy and hold strategy, whereas a high rate would reflect an actively traded portfolio.
- **Capital gains inclusion rate**: The current capital gains inclusion rate is 50 per cent.

Estate Settlement tab (IIS only):
This tab allows the user to enter details on the settlement costs of the alternate investment.
- **Policy Benefit**: There will be two fields that will determine the portion of the death benefit that will be paid to the named beneficiary. The allocation inputted will be indicated in the Assumptions section of the report.
- **Settlement Costs**: The user can select an amount to be applied to the alternate investment assets that compensates for the costs of settling an estate (probate, legal, admin). Choose from a fixed dollar amount or a percentage of alternate investment assets.
The IIS and CIS presentations are built on an Excel platform. Each Excel tab represents a different section of the presentation.

As a whole, the presentation is designed to give clients a professional, high level description of how the strategy works and how the strategy will perform under the assumptions the client and you select. The first five tabs (Cover, Contents, Summary, Analysis and Conclusion) outline how clients will benefit from using the IIS/CIS strategies, the challenges they face, how the strategies work, and a numerical comparison of the estate value of the life insurance solution to a taxable non-registered portfolio.

**Comparison of Estate Values**

The remaining tabs (Assumptions, Chart, Ledger 1, Ledger 2, Ledger 3, Investment and IIS/CIS-Insurance) provide data as described below:

**Assumptions tab**

Provides a summary of the assumptions used to create the IIS and CIS strategies, including the life insurance policy details, non-registered investment assumptions and investment returns.

**Chart tab**

This tab compares the liquidation values and estate values of both the taxable non-registered investments and the IIS/CIS solution using life insurance. For example, the chart below can be found in this tab.

**Ledger 1 tab**

This table compares the net estate values of a taxable non-registered investment to the IIS/CIS solution using life insurance. It displays a year by year summary of payments made, liquidation values and net estate values. The CIS strategy will incorporate any applicable tax-free capital dividends.
Ledger 2 tab
This chart more extensively shows the year by year details for the taxable non-registered investments. Investment income is broken down by category (interest, dividends, realized and deferred gains). The ledger also summarizes the annual tax owing, estate settlement costs and the net benefit payable to the beneficiaries. RDTOH and CDA credits are incorporated when you illustrate the CIS strategy.

Ledger 3 tab
This chart shows the year by year value for the IIS/CIS solution with life insurance. It includes details on the policy surrender value, policy death benefit, estate settlement costs and the net benefit payable to beneficiaries. CIS illustrations will reflect RDTOH credits and any tax-free capital dividends.

Investment and IIS/CIS insurance tabs
These two tabs include a detailed summary of the values specific to the taxable investment and IIS/CIS scenarios. These tabs are primarily for reference and include values that are critical to the end result, but which do not appear on the other tabs.

IIS AND CIS PLANNING CONSIDERATIONS

The IIS and CIS strategies are excellent ways to demonstrate how life insurance can help individuals and corporations increase the after-tax estate value of their excess income or assets compared to using taxable investments. The tax rules surrounding these strategies can be complicated. Advisors and clients should consider a number of factors prior to implementing the IIS and CIS strategies. Clients should understand there are many variables that contribute to the projection of any values in the report. Even a small change in the assumptions used in the strategies can have a significant impact in their effectiveness.

Transferring funds to the life insurance policy
Transferring funds from individually or corporate-owned investments such as stocks or mutual funds to a life insurance policy may trigger capital gains, which could result in taxes owing. Clients should consult their tax advisor to ensure a tax-efficient transfer can be made where possible.

Policy performance
When comparing the growth of a life insurance policy to a taxable investment, policy performance is an important consideration. When using participating whole life, illustrate at alternate dividend scales to help clients understand the impact of a reduction in dividend scale on the net estate benefit of their life insurance plan. When using universal life, illustrate at various rates of return to help clients understand the impact of fluctuating values on the net estate value of their life insurance plan.

Asset allocation and return of the taxable investment
The effectiveness of the IIS/CIS strategy depends on many variables, including the type of assets and rate of return projections of the taxable investment. The IIS/CIS strategies may be more effective against a bond and GIC portfolio than against a stock or mutual fund portfolio that generates tax-preferred income such as dividends or capital gains.
Life insurance coverage type

For couples, illustrating a joint-last-to-die policy may help to improve the effectiveness of the IIS strategy by reducing the premium commitment compared to a single life contract.

Corporate cash accessibility

While accessing cash from a corporate-owned life insurance policy is straightforward, it may be less desirable than using taxable investments. Tax may be payable on withdrawals from a corporate-owned life insurance policy. In addition, no CDA credit will result from a withdrawal or surrender. Policy loans and collateral assignment of the policy are other available options, each of which comes with its own associated risks. Clients should consult their tax advisor for complete details.

Corporate tax liabilities at death

While corporate-owned life insurance can increase the after-tax value to the estate, it may also increase the tax liability on the shareholder’s terminal tax return. Shares of a closely held corporation are deemed to be disposed of at death for their FMV immediately before death. The value of all the assets the corporation owns, including the cash value of any life insurance policies it owns, helps determine the FMV of the corporation’s shares. The significant cash value growth of the insurance policy may exceed what would otherwise have accumulated in the taxable investment. This may increase the tax liability on the terminal return and reduce the advantage of the corporate-owned insurance.

PRODUCT SELECTION WITH IIS AND CIS

The IIS and CIS strategies are available with participating whole life and universal life policies. Choose the policy type based on the unique characteristics of the client including their risk profile and desire for flexibility.

Both universal life insurance and participating whole life insurance allow for the accumulation of significant cash values over time. The Plus premium benefit available with Sun Par Protector and Sun Par Accumulator increases the amount of paid-up additional insurance purchased, resulting in more rapid accumulation of cash value within the policy. SunUniversalLife offers clients the option of making payments to their policy well in excess of the monthly charges, allowing them to benefit from the tax-preferred advantages that UL plans were designed for. Clients should be aware that there are limits on the amount of money they can put into a universal life insurance policy.

Why consider participating whole life insurance?

- **Stable growth** – The combination of a long-term investment strategy, a large, well established par account and a prudent management philosophy contributes to strong, stable returns for policy owners. A stable stream of returns can help to reduce the variability of policy performance.

- **Low maintenance** – Policy owners do not have to pick and manage the investments within the policy. The Sun Life Participating Account is managed by a team of dedicated investment professionals.

- **Diversification opportunities** – Participating policies have access to the participating account through dividends and consist of a diversified mix of bonds, real estate, equities and mortgages. An asset class on its own, participating whole life plans allow for diversification of a client’s existing corporate asset base.

- **Guarantees** – Participating whole life insurance plans come with guaranteed cash values that continue to increase over the life of the contract.
- **Vesting of dividends** – Once a dividend is paid to the policyholder, it cannot be taken away unless directed by them. This helps to reduce cash value variability and adds stability to the long-term values in the policy.

**Why consider universal life insurance?**

- **Premium flexibility** – Universal life allows for greater premium flexibility than participating whole life. Only the monthly policy charges need to be paid to ensure the policy stays in force. This may be beneficial to corporations with variable cash flow.

- **Investment choice** – Universal life plans allow policy owners to select from a wide variety of equity, fixed income and guaranteed investment options. This can enable a business owner to replicate the asset classes already held within their corporation.

- **Transparency** – Universal life plans allow policy owners the opportunity to see the breakdown of the premiums paid to the policy, including cost of insurance, premium tax, and additional benefits.

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**MAKING IT EASY**

Our goal is very simple – to make it as easy as possible for you to sell and service our products. By providing clients with a concrete summary of the issues that face them, you will be better positioned to help them structure an effective financial solution. That’s why we offer the following tools that you can use to explain the benefits of the IIS and CIS strategies.
IIS/CIS TOOLS

**Client fact sheets – participating whole life:** This fact sheet sets out how the IIS and CIS strategies work with participating whole life, highlights the benefits and encourages clients to contact you for more information.

**Client fact sheet – universal life:** This fact sheet sets out how the IIS and CIS strategies work with universal life, highlights the benefits and encourages clients to contact you for more information.

**IIS and CIS illustrations:** With Sun Life's powerful Eos software, you can create detailed client needs analysis reports based on the client’s actual financial situation. With a minimal amount of effort, you can clearly compare how permanent cash value life insurance can provide more favorable long term potential over taxable.

**Client reports:** Our Eos software produces a full-colour report with text and colour graphs for a powerful presentation of the problem and solution.
We’re here to help

We’ve been a trusted and reliable company for over 145 years. As a leading international financial services organization, we continue to build on that strong foundation with a focus on market-leading products, expert advice and innovative solutions.

Our team of insurance and investment focused sales directors and advanced tax and estate planning specialists understand your needs and work with you to help you make the best decisions.

Contact your sales director or visit www.sunlife.ca today.