The immediate financing arrangement: an option for large insurance cases with cash flow requirements

When you place large cases with Canada Life™, you get access to industry-leading sales strategy expertise. We're experts in the large-case market and know what strategies appeal to which clients, based on their personal circumstances. One of the strategies you can use in the large-case market, where cash flow is a consideration, is the immediate financing arrangement (IFA).

What is an immediate financing arrangement?

There are several ways to access the cash value of a permanent life insurance policy. One of the most common ways, particularly in the large-case market, is through collateral loans. In this case, the policy is assigned to a lender as security for a loan. When the loan begins immediately or shortly after the policy is acquired, the arrangement is called an immediate financing arrangement (IFA).

Under an IFA, the amount one can borrow is flexible. For instance, the borrower can borrow an amount from a third-party lender equivalent to a portion of the policy's total cash value (up to 100% in some circumstances), by assigning the policy's cash value as collateral. Alternatively, they can borrow back all of the premiums paid into the policy by assigning other collateral (in addition to the policy) as security. While the loan may be repaid at any time, generally the intent is for it to be repaid using a portion of the insurance proceeds on death. As a result, an IFA typically remains in place for a long period of time.

Benefits of an IFA

The benefits of an IFA are easy to see. It allows the borrower to fund a permanent life insurance policy, while reducing cash outflows by borrowing back all or a portion of the premiums. The loan effectively replaces all or a portion of the funds used to pay insurance premiums and can be used to reinvest in a business or investment. Where the loan is used for business or investment purposes and the policy is used as collateral, tax deductions may also be available (more on this below). Furthermore, the loan can be repaid using a portion of the insurance proceeds on death. Any excess insurance proceeds after loan repayment can be used to meet the needs for which the insurance was originally intended.

An IFA may not be for everyone

Collateral loans involve risks, and an IFA may heighten the risks. Given the long-term nature of these arrangements, it's important to address all the risk factors and considerations carefully. At times, some considerations may be overlooked or not addressed with the level of attention required. Here are just some (among many) considerations that should be examined more closely before recommending an IFA.

Structuring the lending arrangement

When a corporately owned policy is assigned to a lender as security for a loan, the loan can be made directly to the corporation or directly to the shareholder. When the loan is made directly to the shareholder, there are additional tax risks and considerations that need to be addressed, two of which include guarantee fees and loan repayment at death.

Guarantee fees: Using a corporate asset (i.e., corporate policy) for personal purposes (i.e., securing a personal loan) may result in a taxable shareholder benefit. Paying a reasonable guarantee fee annually to the corporation for the personal use of a corporate asset may help minimize this risk. Generally, the fee is calculated as a small percentage of the outstanding loan balance so the guarantee fee may start out as a relatively small expense when the loan first begins but can become a significant expense in later years, as the outstanding loan balance increases (especially if the net

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interest costs are also capitalized to the loan balance). Also, the expense will only cease when the full loan balance is repaid, so you'll need to address the shareholder's ability to pay this expense annually, especially in later years when loan balances may be significant.

Loan repayment at death: If the shareholder's personal loan is repaid directly from the death benefit proceeds of the corporately owned policy, a taxable shareholder benefit equal to the amount of the loan will arise. For this reason, the repayment process should be structured so that the personal loan is not repaid directly from the corporate policy (or corporation). The steps required to do so can be complex and may differ, depending on the lender. In some cases, a lender's repayment process may also require having access to additional capital or security at the time of death, which may or may not be available so it's best to address the loan repayment issue and requirements at the beginning of the arrangement.

May require access to additional capital

Under the lending arrangement, the borrower will need to comply with the lender's loan-margin requirements. IFA illustrations contain many assumptions, including future loan interest rates and future growth-of-policy cash values. If loan interest rates are higher than what was originally forecasted, or if policy cash values are lower than originally projected, the borrower may unintentionally exceed the loan margins. In this case, the lender will require the borrower to become compliant with the loan-margin requirements.

The borrower can typically do so by providing additional collateral or repaying a portion of the outstanding loan balance. Either way, the borrower will need to have access to additional capital (if the borrower needs to sell assets, there may be tax implications from the sale). Otherwise, the lender can exercise their rights under the collateral assignment agreement and cause a partial or full surrender of the policy. This can cause additional issues, including:

- Loss or reduction of insurance coverage to meet the needs for which the insurance was originally acquired
- Difficulty in potentially obtaining new coverage if health status has negatively changed
- Potential taxable policy gains (a policy surrender is a disposition for tax purposes and may give rise to a policy gain that is subject to tax)
- Possible taxable shareholder benefit issues if loans were made directly to the shareholder (since cash values of a corporately owned policy are used to repay the shareholder's personal loan)

Ability to use tax deductions

If the IFA loan is used for business or investment purposes and the policy is used as collateral, tax deductions may be available (provided that the relevant tax rules within the Income Tax Act, which are beyond the scope of this article, are satisfied). An assumption often made when illustrating an IFA is that tax savings will be realized from the interest and collateral insurance deduction, which, in turn, reduce the annual net out-of-pocket interest costs (or the loan balance where net interest costs are effectively capitalized). Assuming the borrower can meet the requirements of the respective tax rules, they can only save on tax if they have enough income to make use of the deductions. Where this is not the case, then the annual net out of pockets costs or cumulative loan balance will be higher than originally illustrated. Generating sufficient income to utilize the deductions in the early years of the IFA strategy maybe manageable but can be more difficult in later years when the deductions become more significant as the loan balance grows, especially in situations where the interest is effectively capitalized. Failure to fully utilize the deductions may have a significant impact on the benefits originally illustrated and should be carefully addressed and monitored annually.

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The IFA requires careful consideration

In the right circumstances, an IFA leveraging strategy may provide the ability to purchase a permanent policy while preserving cash flow for other financial needs. There are numerous risks and considerations (including those discussed in this article) that you'll need to address before recommending this strategy. This arrangement may not be suitable for everyone. Consider it carefully and seek professional legal and tax advice to ensure it's the right solution for your client.

At Canada Life, we pride ourselves on our expertise, particularly in the large-case market. Every case is different and the best way to get the right solution for your clients is to deal directly with the experts. We're here to help you succeed.

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