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UL may trump RRSP, in some cases

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The RRSP may be the most familiar retirement saving strategy, but it might no longer be the automatic choice. The popularity of the RRSP mushroomed when investors had few other tax shelters available, but the financial landscape has changed, and the well-rounded advisor knows there are other options.

Tax-Free Savings Accounts are an obvious tool for generating tax-advantaged retirement income, but other strategies might rely on various insurance products that now offer tax-planning options.

Under certain circumstances, universal life insurance may offer a more effective tax-advantaged strategy than RRSP contributions, suggests Asher Tward, vice-president, estate planning at Toronto-based TriDelta Financial Inc.

While every situation is different, those circumstances include a client aged approximately 35 years old, with 20 or 25-year retirement horizon and a parent over 60 years of age. In this scenario, the parent allows the client to take out a UL policy on the parent's life. The client pays the premiums, owns the policy and stands as beneficiary at time of the parent's decease.

In effect, this amounts to using UL for the child's retirement planning as a totally separate consideration from the parent's use of UL for estate planning. As a retirement tool, the policy is funded and owned by the child. As an estate planning tool, the policy is funded and owned by the parent, with the proceeds earmarked to minimize or eliminate the estate's tax liabilities.

Actual dollar values involved are not an issue since calculations are scalable. In this case the face amount of the policy is more determined by the amount of cash the client has available for monthly premiums than by a desired face amount.

"If you're in a lower tax bracket, then you don't get as much benefit from the RRSP contribution," Tward says.

Tward suggests that in this context a UL policy without an investment account is preferable to a whole life policy because it is neater and simpler. "You're insuring a parent; you want to keep it as efficient as possible." That means focussing mainly on the mortality gain of the policy.

Moreover, whole life dividends involve more risk than is often perceived, because they may be connected to real estate, mortgage or bond holdings.

In a prototypical scenario calculated by Tward, the 35-year client insures his or her 70-year old mother. (The calculations here differ for a father of the same age.) The scenario assumes a client paying tax at the 46% marginal rate and UL premiums of $1,000 per month for fifteen years.

That payment period is guaranteed and removes any question of extra expense due to longevity. The figures assume that the 35-year old client is unlikely to need the funds before 55 years of age and five to ten years away from retirement.

Under this scenario, the client ultimately receives $361,000 as tax-free death benefits from the insurance policy at time of the parent's death, assuming the parent lives at least fifteen years after policy signing. An earlier decease could mean a smaller payout but a shorter period of time in which the client's money is tied up creating a significant advantage.

Throughout the life of the policy, the client continues to generate unused RRSP contribution room. The $180,000 in missed contributions would have generated up to $83,000 in income tax refunds.

In this scenario, the client can elect to deploy part of the tax-free death benefit ($361,000) to use up that contribution room at the time of the parent's death, taking into account the client's own tax position. That could produce a lower tax bracket during the years in which the client is approaching retirement.

Going the conventional RRSP-only route could cost the client up to $80,000 in unrealized gains at year fifteen. Five years later, the situation changes. "The two scenarios deliver similar returns at the 20 year mark," he explains.

Tward calculates that if the client invested the $1,000 monthly for 15 years as RRSP contributions, it would generate approximately $281,000 after tax, including re-invested tax rebates. This is based on an assumed 6% annual capital gains and assumes liquidation of the RRSP for the sake of direct comparison.

"Any way you view it, until year 20, using universal life should be more effective than the alternative of RRSP contributions," he says, adding that this strategy produces these results without volatility.

The strategy also assumes that the client has a sufficiently close relationship to the parent that he or she can comfortably approach the parent with what might strike some as an uncomfortable suggestion.

"Certain people have certain values and they're entitled to them. They can't just do the numbers. They see the emotion," Tward says.

Case study data

We are going to assume a level Capital Gain of 6%/yr in both non-registered and Registered funds.

Notional RSP Tax Rebate is based on unused room - which may be used upon payout of the policy.

Break Even Point A: The point at which the after-tax assets in the RRSP scenario = the after tax assets in the insurance scenario

Break Even Point B: The point at which the after-tax assets in the RRSP scenario = the after tax assets in the insurance scenario + the notional RSP rebate

Year	Age	Investment	Tax Rebate at 46%	Total Invested Registered	Total Invested Non-Registered	Total Assets After Tax	Total Return of Insurance	Notional RSP Tax Rebate	Total Assets
1	71	12,000	5,520	12,720	5,775	12,644	193,000	5,520	198,520
2	72	12,000	5,520	26,203	11,817	25,967	205,000	11,040	216,040
3	73	12,000	5,520	40,495	18,138	40,005	217,000	16,560	233,560
4	74	12,000	5,520	55,645	24,751	54,799	229,000	22,080	251,080
5	75	12,000	5,520	71,704	31,669	70,389	241,000	27,600	268,600
6	76	12,000	5,520	88,726	38,907	86,820	253,000	33,120	286,120
7	77	12,000	5,520	106,770	46,480	104,136	265,000	38,640	303,640
8	78	12,000	5,520	125,896	54,402	122,386	277,000	44,160	321,160
9	79	12,000	5,520	146,170	62,691	141,622	289,000	49,680	338,680
10	80	12,000	5,520	167,660	71,362	161,898	301,000	55,200	356,200
11	81	12,000	5,520	190,439	80,434	183,271	313,000	60,720	373,720
12	82	12,000	5,520	214,586	89,925	205,801	325,000	66,240	391,240
13	83	12,000	5,520	240,181	99,855	229,552	337,000	71,760	408,760
14	84	12,000	5,520	267,312	110,243	254,591	349,000	77,280	426,280
15	85	12,000	5,520	296,070	121,111	280,989	361,000	82,800	443,800
16	86	0	0	313,835	126,707	296,177	361,000	82,800	443,800

17	87	0	0	332,665	132,561	312,199	361,000	82,800	443,800
18	88	0	0	352,625	138,685	329,102	361,000	82,800	443,800
19	89	0	0	373,782	145,092	346,934	361,000	82,800	443,800
20	90	0	0	396,209	151,795	365,748	361,000	82,800	443,800
21	91	0	0	419,981	158,808	385,598	361,000	82,800	443,800
22	92	0	0	445,180	166,145	406,543	361,000	82,800	443,800
23	93	0	0	471,891	173,821	428,642	361,000	82,800	443,800
24	94	0	0	500,205	181,852	451,962	361,000	82,800	443,800
25	95	0	0	530,217	190,253	476,570	361,000	82,800	443,800
26	96	0	0	562,030	199,043	502,539	361,000	82,800	443,800
27	97	0	0	595,752	208,239	529,945	361,000	82,800	443,800
28	98	0	0	631,497	217,859	558,868	361,000	82,800	443,800
29	99	0	0	669,387	227,924	589,393	361,000	82,800	443,800
30	100	0	0	709,550	238,455	621,611	361,000	82,800	443,800

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