

## **The 10/8 Strategy**

*Highly taxed, successful advisors may benefit from a different approach to life insurance*

The consequence of running a successful mortgage practice is that many advisors rarely have time to stop and think about their own personal financial affairs, and often miss out on potential opportunities to improve their situation.

One such opportunity is an insurance concept known as the “10/8 strategy”. This niche strategy is not often utilized, and is therefore often poorly understood by many financial professionals. However, the specific criteria of the strategy can make the 10/8 concept very attractive for mortgage professionals who earn a high income and have a high risk tolerance. Understanding how it could benefit you may require taking a different vantage point on the concept of life insurance.

Mortgage advisors are already well aware of the benefits of proper life insurance coverage when it comes to making sure that their clients are properly protecting their home equity. Given the proliferation of mortgage life insurance programs from lenders and other third parties, brokers should consider it a fiduciary responsibility to ensure that clients are, at the very least, aware of the financial consequences on their surviving beneficiaries in the event of their death.

Based on the needs and financial circumstances of the majority of these clients, life insurance is generally viewed and positioned as a form of (a) debt reduction, and (b) income protection.

Unfortunately, many mortgage professionals never get past this viewpoint, and miss out on opportunities to use life insurance as a tool for wealth building in their own lives. The 10/8 strategy is one such opportunity.

*What is the 10/8 strategy?*

Similar to most life insurance concepts, the 10/8 strategy starts with a desire to protect your family and/or business in the event of your death. At its core, the strategy allows you to put suitable life insurance in place to support your thriving business and protect your family. Understanding what type of coverage you need is an essential starting point. (Lest you be left in a position of advocating proper protection for your clients without taking the time to put the right coverage in place yourself!)

Although there are many versions of this particular strategy, it is usually referred to as a “10/8 strategy” because of the way the scenario is most commonly structured. The name “10/8” comes from an arrangement with the insurance company, which is designed to pay the policyholder a guaranteed 8% rate of return on assets held in the universal life collateral account. Essentially, when funds are leveraged out of the plan, the value equal to the loan amount is transferred to a collateral account where an 8% interest rate may be

applied. It should be noted that only funds that are collaterally securing the loans can be placed in the collateral account. The insurance company then charges the client a 10% interest rate on the borrowed amount of the funds. On the surface, borrowing money at 10% to earn 8% doesn't seem like a winning formula.

However, the strategy hinges on Canada Revenue Agency's taxation rules, which may allow the interest payments to be deducted if the proceeds are used to generate income. In this instance, the ability to deduct interest reduces the after-tax cost of borrowing from 10% to approximately 5.5%, for a taxpayer in the highest marginal tax bracket.

One area where the strategy can sometimes fall short is that most people don't have access to investments that would satisfy the Canada Revenue Agency's criteria regarding Reasonable Expectation of Profit ("REOP"). The average Canadian may find it difficult to demonstrate an expectation of profit in a balanced investment account; after all, even a diversified stock and bond portfolio may not be expected to achieve annual gains that outstrip the 10% annual cost of borrowing.

Mortgage brokers, on the other hand, may have less difficulty clearing this hurdle. For mortgage professionals who own their own business, history may indicate that capital injected into their business would be expected to grow at a higher than 10% rate. Alternately, those advisors who invest in private mortgage deals might demonstrate that rates of return are usually well north of 10%. In either or both circumstances, the taxpayer would likely have a strong case with CRA to support a REOP claim. Furthermore, the borrower would clearly require enough taxable income in order to make use of the deductions.

The impact of tax deductibility of these interest payments can be profound. Some choose to think of the subsequent tax refunds as lowering or even eliminating their cost of insurance (hence the occasional promotional piece referring to "free insurance"). Others prefer to focus on how the tax savings have improved their investment rate of return, although it goes without saying that the strategy requires the investments to actually perform as anticipated.

#### *How is it structured?*

Fundamentally, there are two different structural approaches: a) an internal policy loan or b) an external policy loan. There are limitations, benefits, and technical differences between the two approaches that will ultimately propel you toward one over the other, depending on your circumstances. For example, in the external loan approach, it may be possible to deduct a portion of the actual insurance costs – an unusual benefit.

Since the structure of a 10/8 strategy is highly dependent on the specific situation of the policyholder, illustrations based on fictitious circumstances can be misleading and must be personalized to truly be relevant.

### *Who is it suited for?*

Just as with any insurance policy, the 10/8 strategy is customizable depending on your circumstances. The actual cost of the policy and the features associated with it will vary depending on your age, health, and other needs. Since the backbone of the strategy is life insurance, you will need to qualify medically.

You also need to be extremely comfortable with leveraging and its associated risks. Optimally, the policyholder is in the highest marginal tax bracket with significant taxable income, and is looking to both reduce tax and build wealth.

### *What are the risks?*

There are a number of financial and tax risks associated with leveraged insurance strategies, not the least of which being the risk associated with leverage itself; in other words, the possibility of having to repay a debt even if the corresponding investment asset has substantially fallen in value.

As well, keep in mind that it is not advisable to undertake a life insurance strategy solely on the basis of favourable taxation. After all, the CRA's rules around deductibility of interest payments are always subject to revision, and the context for this specific strategy is no different. As an example, taxpayers may need to be able to defend that the 10% cost of borrowing remains reasonable in this lower-rate interest environment.

You are also advised to review any arrangement with both a financial advisor and a professional tax accountant, to consider whether the benefits you expect to achieve under the proposed strategy outweigh the associated risks.

Also, as a more complicated strategy, it's even more important to read the fine print. For example, some insurance companies that offer the 10/8 strategy may not actually guarantee the 8% interest rate for the life of the contract.

### *Summary*

The 10/8 strategy involves leveraging a life insurance policy, through either an internal or external policy loan. With the proper arrangement in place, you can access funds to invest in your business or other qualified investment. If structured properly, the interest payments on the loan qualify for tax deductibility, and the funds can be used to support your high growth investment opportunities, such as growing your business or your private mortgage loan portfolio.

Commonly, mortgage professionals attempt to put a value on the business they've worked hard to build, with a view towards someday unlocking that wealth. Unfortunately, for some, "business succession" arrives unexpectedly in the case of a premature death. Bear in mind that your heirs may find it extremely difficult, if not

impossible, to extract any value out of a company where the primary asset – you – has been removed.

Although many people select term life insurance as the low-cost, default form of protection, mortgage professionals in particular may find that permanent insurance offers excellent taxation and creditor-protection benefits. Whether or not the 10/8 strategy is right for you will depend on a whole host of factors. In any case, as your business and income expand, a change in mindset may be needed to move from seeing insurance as a “cost” to viewing it as a gateway to a larger wealth plan that involves robust tax, estate and business succession components.

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## *CALL-OUT*

Who is the 10/8 strategy ideally suited for?

- ⇒ High income
- ⇒ Highly taxed
- ⇒ Has access to high-rate of return investment opportunities
- ⇒ Aggressive, risk taking
- ⇒ Looking to actively grow wealth
- ⇒ Minimal additional debt
- ⇒ Insurable (i.e. medically capable of obtaining insurance)
- ⇒ Continually able to maximize deductions
- ⇒ Comfortable with significant levels of debt
- ⇒ Needs life insurance coverage