Leveraged Life Policy and the Infamous "Knuckleball":

Does a leveraged life policy have a lot in common with the infamous "knuckleball", that bad boy of quantum flight in the game of baseball? Yes!

If you are a tax practitioner, banker, finance hand, business owner, or just awestruck by the math of physics expressed in everyday events, this article is for you.

First a few details about the knuckleball for general comparison:

1. It is slow in flight. On average the ball travels about 27% slower than today's best fastball pitchers. That all by itself is enough to put off scouts, managers and catchers who dislike the pitch.
2. Knuckleball pitchers do their best do ensure the ball might only rotate at worst once after leaving their hand and before reaching the strike zone.
3. The knuckle pitch does strange things on its way to the batter. And even worse no one knows what the ball will do from one pitch to the next. The ball's flight characteristics are not what one would expect and best described as "quantum".

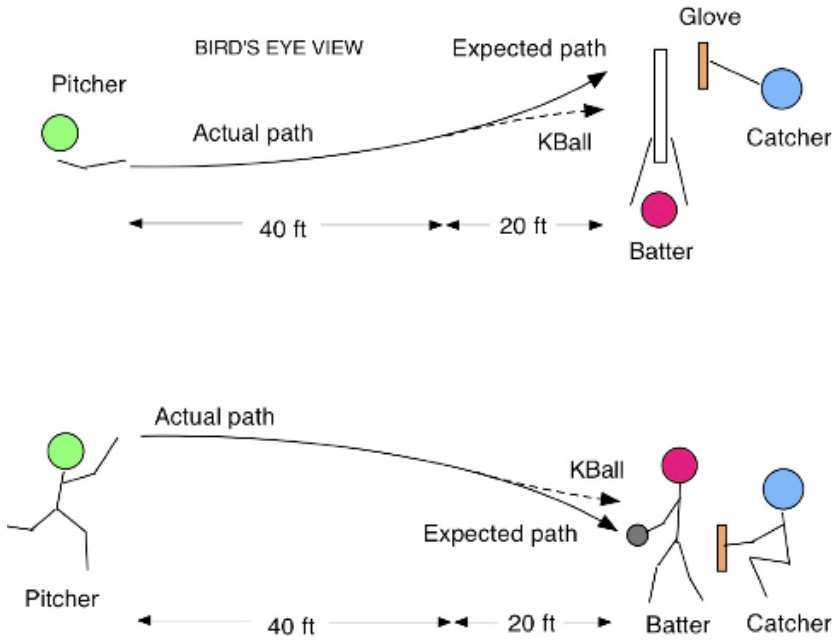

Figure 1.1: The batter and the catch both tend to make the same mistake when predicting the path of a knuckleball.

And now a few details about the leveraged life policy:

1. Like the knuckleball, a leveraged life policy strategy is slow, it takes many years to complete. Nevertheless, the strategy packs a powerful financial punch with inexorable guaranteed results.
2. Universal Life policies are the vehicle of choice for most business owners because of the early and rising cash values that accrue in the policy and as a matter of course are recorded as cash on the balance sheet. Most policies of this type see a constant turnover of investment assets due to market conditions and rising and falling fortunes of publicly traded firms in any of the large investment indexes.
3. However, with leveraged life policies and a common feature with the knuckleball pitch, there is almost ***no rotation*** of the investment mix from year to year.
4. The effect of a leveraged life policy carefully designed and managed in reinvestment has a lot in common

with the trajectory of the knuckle ball. It can be, ***spooky and counter-intuitive***. Lenders need not be concerned as their loans are secured with policy assets that are 100% in cash and assigned as collateral.

The effect of the "grind" can be seen in the combination of the:

1. Cost of deductible interest;
2. CRA pre-approved Net Cost of Pure Insurance (NCPI) a tax credit that comes with life policies used to secure loans in the event of death of an insured;
3. A guaranteed cash bonus paid by Lifecos (in addition to guaranteed interest) just to keep cash in the policy and on a balance sheet;
4. The extent of leverage of the policy cash assets ranging from 60% to 100%; and
5. A firm's weighted average Return on Capital (ROC) or Return on Assets (ROA)

Here is a list of the strange and spooky effects this strategy can produce:

A. Want to have an Internal Rate of Return that is so high a spreadsheet can't compute? Yup, very possible.
B. Like the idea of driving the net cost curve of this strategy so low that most of the time the execution strategy is in the "no net cost" zone? Yup, very possible.
C. Love the idea of CRA paying your firm more in actual quarterly tax refunds in cash than the cost of the bank interest? Yup, very possible.
D. Want to be able to back out of the strategy, pay off the loan and not have to worry about extra taxes from CRA? You can do that any day of the week.
E. Want to always have enough working capital to support an increasing asset base on the balance sheet that is climbing at 15% per year? Yup very possible.
F. Know in advance your bank will extend a special rate of ***prime flat*** for this strategy? You can have it if you want it.

Is the strategy for everyone? It is best suited for a business with consistent profits, ample cashflow, bright prospects for expansion and a "secret sauce" comprised of a sustainable model with a low cost of products and services sold.

Have a look at this simple **Case Study** to see how effective this strategy can be for business owners with multiple point agendas.

Jack is age 66, has a few health concerns and is waiting for the issue of a new policy to be owned by his business. He already had insurance in place but realized it was not going to be enough to pay the capital gains taxes due at his life expectancy in about 20 years. The policy will be issued with a risk rating because of his health.

He is getting a little tired and likes the idea of not being involved every day of the year. Luckily, he has a daughter who is getting burned out working at a global management consulting firm and is looking for an opportunity to work for her father's firm and manage it into the future.

Like most business owners he has a small amount of cash in RRSP's. Once the life policy is issued he plans to assign it to the bank for instant loans he can put back into operations.

By working with his Capital Planner, he has determined he would like to set up an IPP or Personal Pension Plan, so he gets income from that pile of cash rather than from the business that his daughter has agreed to manage.

The loan from the bank will be used to fund the IPP. By using life insurance, the bank has more than enough security for the loan. The IPP contribution is expensed from the income statement so there is no tax to pay on the transfer as there would be if a dividend was paid. The combination of the lifetime tax sheltering and split income with his wife will give Jack and his spouse an ample retirement income.

While the bank is willing to extend a loan for 100% of the cash value, Jack thinks it is best to only go to 60% as it still gives a reserve for a fallback position if required in a downturn. Besides, if the strategy in the end only delivers

an IRR of 15% it almost exactly matches the firm's long term weighted annual ROA of 15%.

By using the leveraged life policy and putting the loans back into operations Jack thinks that the added value of assets that will accrue to his life expectancy is about $8 million.

Back of the envelope math indicates the capital gains tax due at that point is about $1.9 million.

While alternatively he could transfer his shares into a spousal trust and freeze the capital gains tax he has decided to let it be, just in case for whatever reason his daughter does not stick with the plan. This will give him the option of selling the business if things change. He will issue his daughter preferred convertible, retractable, refundable shares for her future benefit.

His Capital Planer has assured him that the life insurance benefit payable at life expectancy will be more than enough to pay off the bank loan and pay the capital gains taxes due.

In summary here is what his planning will achieve:

- ✓ They will secure a tax-deductible loan for a retirement income via an IPP/PPP and there is very little tax to pay on the lifetime income of $2 million plus because he and his wife can split the income.

- ✓ The fully secured bank loans will have been put into operations and driven the assets $8 million higher at life expectancy, from today's value.

- ✓ The Life policy will pay the capital gains tax, so his daughter will have no liabilities on her father's passing. In addition, a Capital Dividend Account will be created worth about $3.8 million and the bank loan will be paid out 100%, tax free. Which means after his passing his daughter can push out $3.8 million of cash from future profits, tax free.

- ✓ The combination of tax refunds due from CRA will be slightly less than the cost of the interest because he chose to not leverage the policy to full value.

<u>All-in Jack has created a lot of values for very little expenses incurred.</u>

In sum the value creations include:

	$2 million for the IPP income
	$8 million in asset expansion
	$2 million for cap gains taxes
	$3.8 million as a tax-free exit window for future profits
Total:	$15.8 million

The net after tax cost to make the strategy work is about $650 per month which is less than he spends on gas and maintenance for his pick-up truck. Now you can understand why sometimes a spreadsheet can't compute the net IRR. The net result of the arbitrage of CRA rules for deductible interest, NCPI, CDA values, loan costs, and rising values on the balance sheet are indeed spooky and counter-intuitive. And like the knuckle ball, the grind on the launch is a form of financial art.

Our firm specializes in this type of restructuring. Call to see our Case Study.

Article Courtesy: John Lindsay, ProfitExits.Ca, MacDonald Management