

COMPARING ICF AND IFA



THE ISSUE

Entrepreneurs seeking financing often offer their life insurance policies as collateral security for loans. The policy is sometimes required by the lender as part of the loan security, or sometimes the value of the policy enables the entrepreneur to obtain additional financing.

There are generally two types of collateral loan facilities secured by life insurance policies, commonly referred to as an ICF and an IFA.

An ICF is a collateral loan secured by a life insurance policy, and the policy credits interest on the policy cash value at a fixed discount (currently 2.0%) from the loan interest rate.

An IFA is a collateral loan secured by a life insurance policy, and the policy credits interest on the policy cash value at a rate that is independent of the loan interest rate.

This Viewpoint highlights the key differences between ICFs and IFAs.

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WESTWARD'S VIEWPOINT

The following key features differentiate an ICF from an IFA.

Investment Risk

ICF eliminates investment risk inside the policy by providing a fixed investment return on the policy cash value used to secure the loan. IFA has investment risk inside the policy because the policy cash value earns a variable rate of return, or a fixed investment return that is less than half the ICF fixed investment return.

Interest Rate Risk

ICF reduces interest rate risk by offering fixed ten year loan interest rates. IFA usually exposes the borrower to interest rate risk because the interest rate is usually a floating rate, or a rate fixed for a limited term that rarely exceeds five years.

Tax Risk

ICF and IFA are structurally sound from a tax perspective when implemented properly. CRA has questioned the reasonableness of the ICF (but not the IFA) loan interest rates. CRA is currently reviewing submissions supporting the reasonableness of the ICF loan interest rates, including the methodology of setting the rates and market value comparisons.

Cash Value Accessibility

ICF ensures access to the policy cash value to fully repay the loan (if necessary) by eliminating policy surrender charges. IFA has surrender charges applicable to policy cash values, putting the borrower at risk of insufficient cash value to repay the loan balance.

IIT Refund

ICF eases the tax cost of withdrawing the policy cash value to repay the loan by refunding the policy's investment income tax (IIT) to the policyholder. IFA does not refund IIT to policyholders when making policy withdrawals.

Additional Collateral

ICF does not require additional collateral beyond the policy itself because the risk of the cash surrender value not covering the loan is very low. IFA generally requires additional collateral if the loan balance exceeds 90% of the policy's cash surrender value. The borrower is either limited to small loan draws (due to policy surrender charges) or forced to provide additional collateral to obtain the desired loan.

Borrower

ICF provides financing to any borrower who can obtain the guarantee of the policyholder. IFA generally provides financing only to the policyholder.

Administration Fees

ICF lenders charge a small application fee (max \$250) and do not charge any annual administration fees. IFA lenders typically charge an application fee, legal implementation fees and annual review fees.

Conclusions

The ICF reduces risk or costs for the entrepreneur in almost every area listed above.

The primary difference, and indeed the main reason why the ICF was developed as an alternative to IFA, is that the ICF eliminates interest rate "mismatch" between the cost of borrowing and the cash value earnings, providing assurance to the entrepreneur that the policy cash value will always be sufficient to cover the loan balance. In turn, the ICF ensures that the underlying insurance coverage is not jeopardized and the entrepreneur is not risking his entire life insurance plan by assigning the policy as collateral for the loan.

The reasonableness of the ICF loan interest rate is a manageable tax risk; plenty of documentation supporting the reasonableness of the rate is available if challenged by CRA. A borrower who prefers not to fight such a CRA challenge can continue to benefit from the ICF, and still has the option to access the cash value and IIT refund to repay the loan in full at little or no cost.

