

PARTICIPATING WHOLE LIFE INSURANCE AS A TAX-SHELTERED INVESTMENT RISK-TRANSFER STRATEGY

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Sveatoslav COVALIOV

Senior Insurance Specialist,

Toronto, Canada

Email: stanley.covaliov@gmail.com

Abstract: *Since the turn of the century, the scale of household debt increased drastically for the vast majority of OECD countries (OECD, 2024a). Household debt refers to the financial liabilities of a household that require payments to creditors at a fixed date in the future (OECD, 2024a), which primarily consists of mortgages, car and education loans, and credit card debt.*

For as long as an individual is able to earn income and fulfill their financial obligations to creditors, their household debt can be managed. In the event of their death however, one of the very first responsibilities of the surviving beneficiary appointed by the decedent's will is the settlement of this household debt. The creditor almost never extends the debt to the surviving beneficiary, as in many cases they do not have the same level of income; instead, the beneficiary is forced to settle the debt immediately.

A prototypical scenario is the death of the primary income provider in a single-income family. In such scenario, the creditor does not extend the household debt to the surviving spouse as they are not working and do not have a stable income. As such, the surviving spouse, along with any other surviving dependents, are forced to sell the family home in order to settle the debt. Without an appropriate strategy, this catastrophic scenario could become the reality of the many families States that rely on a single provider for income.

Keywords: *insurance, tax-sheltered, investment, risk-transfer strategy.*

JEL Classification: *G32, G18, G22, H21.*

MOTIVATION

Life insurance as a risk-transfer strategy that trades the possibility of a financial catastrophe in the future, in exchange for the certainty of paying insurance premiums now. In the context of the above scenario, it would allow the family to retain the possession of the home, thereby providing the individual with the assurance that their spouse and dependents will not face a financial catastrophe in the case of their premature death.

Since the eventual death of an individual is certain, the importance of life insurance cannot be overlooked at the individual scale. However, the topic of life insurance, and personal insurance more generally, is becoming increasingly relevant at the government level as well, as climate change, technological advances and globalisation are creating novel challenges for governments around the world. In particular, digital security and privacy risks that have emerged with the growing use of digital technology suggests that the personal insurance market will triple in size in the coming years (OECD, 2024b).

In this article, we give an overview of modern life insurance products. In particular, we explain participating life insurance policy as a combination of life insurance coverage with an opportunity for tax-sheltered investment growth. We also further highlight its benefits for small business owners.

PARTICIPATING WHOLE LIFE INSURANCE

The simplest form of a life insurance product is a term policy. It provides coverage for a term, i.e. a specific period of time, usually 10 or 20 years. In the case that the individual passes away during the term, the beneficiaries receive a benefit payout from the insurer; conversely, if the individual outlives the term, there is no payout. Because of its simplicity and limited features, this form of insurance is typically more affordable than others. Individuals may choose this type of policy to provide financial coverage for temporary financial obligations, those that are certain to end at some

fixed point in the future. For instance, a parent may choose to purchase this product for the duration of their mortgage or while their child is attending a post-secondary institution.

Whole life insurance on the other hand provides coverage over the entire lifetime of the individual, as long as they continue to pay the premiums. It does not expire, meaning beneficiaries will receive a death benefit regardless of when the individual passes away. An important feature of a whole life policy is that it builds up a *cash value* over time, that is part of the premium goes into a savings account. Most whole life policies allow the individual to access this cash value prior to their death, or even surrender the whole policy and receive the *cash surrender value*; some even allow to use the cash value to pay the premiums directly.

Participating whole life insurance is a special kind of whole life insurance, where a portion of premium is used to generate revenue through investment. Contributions paid by different policy owners are pooled together in a professionally managed investment account. As such the cash value grows inside the policy, free of annual taxation. Hence, while term life insurance is more affordable upfront, the cash value of a whole life insurance provides an additional benefit long term.

Importantly, age is the biggest factor in determining life insurance premiums. Since the *risk* of health problems is higher as the individual gets older, meaning the insurer must increase the life insurance policy's premium. Thus, in the long run, it is typically more expensive for an individual to renew a term policy than it is to continue to pay whole life insurance premiums. To account for this difference, insurers sometimes offer the option to convert a term policy to a whole life one.

Insurers typically offer the possibility to transfer the ownership of a policy to a business. If the individual owns a business entity, transferring the ownership of a participating life insurance policy offers unexpected benefits.

When passive income of a business exceeds a certain threshold, it loses its small business tax deduction, and all of its income is taxed at a higher corporate rate. Participating whole life insurance offers the business owner a strategy to keep the small business status of their corporation. since the growth inside an insurance policy's cash value is not subject to annual taxation, assuming the growth remains within the permitted limits, the business may accumulate funds without impacting the corporation's small business deduction limit, all while earning investment growth from a professionally managed portfolio. As such, purchasing a participating whole life insurance makes sense for business owners from the perspective of keeping the small business status of their growing enterprise, while providing them whole life insurance coverage.

UNEXPECTED CHALLENGES IN LIFE INSURANCE INNOVATION

Given the importance of life insurance, innovation in the life insurance industry is critical in the view of the everchanging global and technological landscapes. Innovation in life insurance however is impeded by a diverse range of challenges. On average it takes up to twelve months to launch a new life insurance product from idea to sale (RGA, 2014). In this section we give an overview of the most surprising of these challenges and explain practice ways to address them.

One main challenge is *low awareness* of life insurance products and cultural barriers to it, as many individuals do not fully understand the importance of it or perceive as unnecessary (Kamarlaila, 2024). The best currently feasible solution is tailored communication: life insurance specialists, on behalf of the insuring company, can use personalized outreach to explain how life insurance fits into an individual's personal circumstances. Moreover, as governments turn towards personal insurance as a way to improve their financial resilience to new risks and global shifts, it may become easier to provide individuals with appropriate financial literacy education, through either school or social media.

Regulatory compliance is another major issue in life insurance innovation. As the small business example shows, life insurance companies necessarily operate in a highly regulated environment with stringent requirements related to capital adequacy, solvency, capital adequacy, and anti-money laundering. Maintaining compliance with these ever-evolving regulatory standards is

resource-intensive, while not maintaining this compliance is prohibited by law (Kamarlaila, 2024). While an established insurance company has the resources necessary to keep up, smaller insurers may choose to form a specialized team dedicated to regulatory compliance. The team's role would be to maintain the compliance with local and international regulations, which they can achieve through subscribing to industry publications, attending conferences, and maintaining relationships with regulatory authorities.

Cybersecurity threats are becoming a major challenge in life insurance innovation. While on one hand insurers are able to leverage data analytics and artificial intelligence to personalize their products, pricing, and risk assessment, they are also challenged with protecting against cyber threats, ensuring data privacy and maintaining customer trust (Kamarlaila, 2024). It is critical to conduct cybersecurity audits to identify any weaknesses in the insurer's cybersecurity infrastructure. The insurer must clearly communicate how personal data is collected, used, and protected, and they should only collect the data they need to perform specific tasks.

CONCLUSIONS

Participating whole life insurance offers an individual insurance coverage for their life, with an opportunity to earn tax-advantaged investment growth, which is optimal for protecting families, maintaining businesses, and facilitating the intergenerational transfer of wealth. Participant whole life insurance offers particular benefits to small business owners in particular as they may use it to maintain their small business tax-deductions while earning investment growth.

Participating whole life insurance is an illustrative example of innovation in the industry of life insurance. The process of innovation in life insurance however is impeded by novel, unexpected challenges such as low awareness, the need for regulatory compliance, and cybersecurity threats. Nevertheless, with appropriate strategies all of these challenges can be managed allowing for new innovative products.

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