Death and Taxes: Are You Prepared?

By Gordon Clarke, CFP, CIM, O.L.S. (Retired)

Life insurance!! Do your eyes glaze over at the mere mention of the phrase? Is your worst nightmare being stuck in an elevator with an insurance salesman? Ask yourself the following question. From the day you are born, what is the one thing that will happen to you, which you can predict with absolute certainty? Yes, someday you will die. When Benjamin Franklin uttered that famous phrase, "In this world, nothing is certain but death and taxes"; he knew what he was talking about. Given the inevitable end to life, it logically follows that we should all be well prepared for this eventuality. Unfortunately many of us are not. The following is a brief outline of some common life insurance needs, which may assist those who have not considered the possibility of their own mortality.

Income replacement is the most common and easiest to understand reason that most of us buy life insurance. A 35-year-old making $50,000 per year would probably take home close to a million dollars over the rest of a working life. Should that person die, the challenge would be to determine how much of that income needs to be replaced to maintain a reasonable quality of life for his or her dependents. Would a two times salary group plan policy do the job? If you invested the $100,000 insurance proceeds at a 6% rate of return and were lucky enough not to need any of it for last expenses such as medical bills, income taxes, funeral costs and probate taxes, it might generate an income of $8,000 per year for 20 years. Remember, although the initial $100,000 is tax-free, the income derived from it is taxed at the beneficiary's marginal rate. Depending on other sources of income, it might mean that only $5,000 per year would be left. If your family can manage with your take home pay being cut to $5,000, then you are adequately insured. If not, then think about getting more coverage.

The purpose of life insurance is to help your survivors, so if you do not have anyone dependent on your income you may not really need insurance. Other than to pay funeral expenses, does a 10-year-old child need to be insured?

Something else to consider is the value of mortgage insurance. The bank will tack on this coverage to your mortgage payment so that in the event of your death your mortgage will be free and clear. On the surface the concept appears to be a good one but on closer examination you will find a few problems. Think back to the purpose of life insurance and how it is designed to replace an income or in other words, insure your paycheque. A mortgage payment is just another living expense along with food, utilities, clothing, etc. While paying off the mortgage is certainly something to consider, it is only one option and may not in fact be the best one for your beneficiaries. Low mortgage rates may mean that it would be better for them to invest the insurance proceeds rather than pay down the mortgage or they may prefer to use the funds for educational purposes or starting a business. With mortgage insurance, the funds go to the bank, but with life insurance the proceeds go to the beneficiaries and it is the beneficiaries' choice to use them in their own best interest.

Life insurance benefits are non-taxable and it is this fact that makes insurance an effective estate planning tool. Consider the following scenario. The last surviving spouse has passed away leaving a $200,000 RRSP to an only adult child. Unfortunately the child will not receive all of that money because upon death the RRSP has to be de-registered and the full amount added to the deceased's final tax return. I do not need to tell you what this will do to a tax bill! There is virtually no way to shelter those funds and the net effect is to take the money that was so carefully saved over the course of a working career and hand almost half of it, approximately $90,000, to the government. However, if the last surviving spouse just happened to have a $90,000 life insurance policy, set up many years ago, possibly not with income replacement in mind, but with the intention of protecting the estate, then the tax free insurance benefit would cover the tax bill. This is where that two hours stuck in the elevator with the insurance agent could turn from a nightmare into a sweet dream. You might get the information on how a Term to 100 or a Universal Life policy could allow you to pass on your estate to your children while minimizing the effects of taxes.

Business people should also hope for an occasional elevator power failure. There are some very interesting ways to use insurance for business suc-

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cession purposes. Buy-sell agreements offer a large number of benefits to the partners and their heirs. They assure a continuity of the business, provide the full purchase price in cash, eliminate disputes between surviving partners and heirs and provide an instant market for the deceased's interest in the business. A proper agreement using insurance as the base will provide the funding for a buy-out so that it will not be necessary to go into business with your partner's spouse.

Ben Franklin was absolutely right about death and taxes, but he likely did not have the opportunity to know how to use insurance proceeds to protect his family and business from one of life's two certainties. Don't be like Ben; don't fly kites during an electrical storm. Do ask your financial advisor to analyze your insurance needs.

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