

Clientel



*The central message of Clientel is that I value my clients.
I'm as close as your telephone, and available
and anxious to serve you.*

David Chalmers BA, FLMI, CLU, CFP, RFP, ChFC

Welcome to another edition of Clientel.

This issue focuses on the subject of life insurance. I'm also providing an *update* on my support team.

Should You Own Life Insurance?

Many of my clients have asked me whether they should own life insurance. Usually the context in which the question is asked is a concern over taxes to be paid at death on RRIF proceeds.

I decided, therefore, to dedicate an entire issue of Clientel to life insurance. The purpose of this newsletter is to provide a brief "university course" in life insurance (condensed to a few pages). This may provide some information on the uses of life insurance that many people may have not considered. As I speak about a number of hypothetical client situations in this newsletter, you may recognize circumstances similar to your own.

"Insurance 101"

As I am tackling a very large subject in a limited space, I decided to lay out an outline of "the course." I will then elaborate on the outline with some explanatory text.

Here is the outline:

- Introduction
- Types of Insurance
 - *Temporary (term), permanent, Universal Life*
- Costs (premiums)
 - *Temporary (term), permanent, Universal Life male/female, smoker/non-smoker, joint last-to-die/joint first-to-die*
- Reasons for Owning (or not owning) Insurance
 - *Breadwinner/homemaker, debt, estate planning (maximization, liquidity, equalization, investment)*
 - *Business (formal and informal)*
 - *Partners/keypersons*
- Specialty
 - *Insured annuity, tax shelter, pension or RRIF maximization, potential creditor protection, charitable gifting*
- Combination
 - *Example: Breadwinner/tax shelter/estate maximization*
- Applying/qualifying for life insurance
- My role as an advisor/insurance broker

Introduction

Life insurance is a very misunderstood subject. People tell jokes about life insurance salesmen (my favourite depiction of a life insurance salesman is in the movie, "Groundhog Day," starring Bill Murray). Quite often, articles that appear in magazines or newspapers are quite polarized in their position.

There are people who are *anti-insurance* and there are those who are *pro-insurance*. (Often, those who write newspaper articles that are pro-insurance turn out to be insurance salespersons). This newsletter is meant to be neither "pro" nor "con," but to point out those situations where insurance can be used to achieve specific objectives.

In very rare situations (which I do not explore in this newsletter), life insurance premiums can be tax-deductible or life insurance benefits can be taxable. Consider that for all of the examples in this newsletter, life insurance premiums are paid with after-tax dollars and life insurance proceeds are tax free (with the possible exception of charitable gifting, where there is a potential tax credit for paying premiums, which I allude to under the specialty section).

Types of Insurance

Temporary or **term** insurance has premiums paid for a specified period of time, and coverage is provided for a specified period of time. This type of coverage is most appropriate where there is a *temporary* need for insurance coverage. This will be explored in the "*reasons for owning*" insurance section (*to follow*) ... with focus on the breadwinner (homemaker) and debt items.

Permanent insurance means that the coverage will be *permanent*. Unless you fail to pay a premium or you cancel the policy, the benefit *will* be paid by the insurance company.

Universal Life coverage is a hybrid of term and permanent insurance. It is basically a form of term insurance combined with an investment account. As long as there is enough money in the account to pay the current premium, the coverage remains in force. Thus, whether the coverage is temporary or permanent depends on how much money is deposited into the account (I'll make some

additional comments with respect to Universal Life under the specialty/tax shelter section).

Cost of Insurance

The older you are, the greater your chance of dying and, thus, the more expensive it is to buy insurance. Temporary or term insurance is relatively inexpensive, as the insurance company does not expect to pay the benefit. Term insurance policies usually expire at an age such as 65 or 75 (the policy is designed to terminate before you do).

Permanent insurance is more expensive, as the insurance company realizes that there is a chance that the benefit will be paid out. You may, actually, hold the policy until death.

Males pay more than females for insurance, because females tend to live longer. (As an aside, the reverse is true with annuities, which are, in essence, the opposite of life insurance. For a given amount of annuity deposit, a female will receive a lower income than will a male, as the insurance company expects to pay the annuity income to the female for a longer period of time.)

Smokers pay more for insurance than non-smokers, as non-smokers are expected to live longer.

An insurance policy can cover one person, or it can cover two people at the same time. A very common form of insurance used for estate planning considerations is *joint last-to-die*, or *joint and survivor* insurance. This means that the death benefit is paid when the second of two people dies.

Let's assume that we have a male and female, both non-smokers, who are the same age. The female will pay less in insurance premiums than the male. The cost of a joint last-to-die policy covering both lives will be considerably less than the cost of covering the female. There is a misconception that joint last-to-die insurance is expensive. It is, in fact, less expensive than insurance covering individual lives.

A joint policy that pays a benefit when the *first* of two persons dies is called a *joint first-to-die* policy. This form of coverage is more expensive than coverage on the individual lives.

Reasons for Owning (or not owning) Insurance

Breadwinner (homemaker). Perhaps the most common reason for owning insurance is that the policyholder has dependents who are reliant on his or her income. Thus, if the “breadwinner” dies, the family needs ongoing support. This can be provided by life insurance. Perhaps both spouses or partners are breadwinners (in which case both may require life insurance). Or perhaps one spouse is a “homemaker” who also cares for children. He or she may also need life insurance (while I’m trying to stay “gender neutral” in my comments, I’ll use the following “old fashioned” example).

If Ricky dies, Lucy will need money to take care of little Ricky. If Lucy dies, Ricky will need money to pay for a nanny or daycare for little Ricky.

Debt. A family may feel that they would be in good shape financially if only their mortgage were paid off. Thus, they may hold term insurance equal to the outstanding balance of the mortgage. As there would be some financial strain in the event of the death of either partner, the “mortgage insurance” (it’s really life insurance) would be established on a *joint first-to-die* basis.

I note that a mortgage amortized over a period of time can generally be covered with term insurance, as it is a temporary need for coverage. Similarly, insurance to provide for a family during the dependency period of children usually represents a temporary need and can be covered with term insurance. This tends to be the least expensive way of providing coverage for these fixed period obligations.

Estate Planning. We now come to the area that may be relevant to a number of my retired, or close to retired, clients. *Let’s look at four subheadings:*

1. Maximization
2. Liquidity
3. Equalization
4. Investment

1. Maximization

The act of buying insurance will increase your estate. The most cost-effective way to do this is to hold *joint last-to-die* insurance. Estate maximization simply means that you don’t consider your estate to be large enough to provide an adequate legacy for your children.

Let’s take the example of someone who is in a pension plan. Some pension plans allow you to roll the pension balance to an RRSP and, subsequently, to a RRIF. At your death, the RRIF balance can be transferred to your surviving spouse. At the death of the last surviving spouse, the balance is taxable in full (usually at the top marginal tax rate). Thus, approximately 50% of the “asset” will not find its way to your heirs. If, as a result, you feel that you will not be leaving as much as you would like to your children, you can consider life insurance as a solution.

A more striking example is that of a pension plan that does *not* allow you to transfer the balance to an RRSP and then to a RRIF (or, where you elect to not transfer the balance to an RRSP). You will have a pension for as long as you live, which may continue to your surviving spouse. At the death of the last surviving spouse, there will usually not be anything going to the children or grandchildren. Insurance can be used to provide an estate asset.

2. Liquidity

If you hold investments or real estate (other than your principal residence), any unrealized gain in those investments will be taxed at your death. *Consider the following example:*

You have one child. Many years ago, you bought a beautiful cottage for a fairly reasonable price. The cottage has gone up in value substantially. When you die, there will be a huge capital gains tax liability. The tax liability is so large that your child is going to have to sell the cottage to raise money to pay the tax. If, by comparison, you are leaving an investment portfolio to your child, he or she could sell one-third of the portfolio to pay the tax. It is difficult to sell one-third of a cottage ... thus, your estate has a “liquidity” problem.

A solution is to hold life insurance (most probably, joint last-to-die insurance) to provide liquidity for your estate.

3. Equalization

Let's assume that you project your net estate to be \$1.5 million and that you have three children. Your "net estate" is calculated as the value of your home, plus your registered funds (RRSP and RRIF) less the tax payable on those registered funds (assume 50%), plus your investments less the capital gains tax paid on those investments (possibly, as high as 33%). (Then, you have to take about 1.4% from all of that to pay probate fees).

The problem, in this particular situation, is that the house is worth \$750,000 and the other items combined are worth \$750,000. One of the children has expressed a strong wish to have the house when you pass away, and you would like to leave the house to him or her. If you leave an asset of \$750,000 to one child, there is not enough in the other pools of money to "equalize" the position of the other two children.

Life insurance (probably, joint last-to-die insurance) can solve this.

4. Investment

I have seen a number of situations where clients don't "need" insurance at all. They simply view life insurance as an investment. One looks at the premiums that are required for an insurance policy, and then looks at the "tax-free" benefit that will be paid at death.

Assuming that death occurs at life expectancy, one compares the amount of money that would be accumulated if those premiums were otherwise invested to the results of owning the insurance policy. Sometimes (usually, when both spouses are non-smokers and where joint last-to-die coverage is used), the insurance can turn out to be quite a good investment. The theory here is that the money would have been invested and passed to the children, in any event, so why not choose that investment which maximizes their position?

Business (formal and informal). People who are in business together will often hold insurance on each other's lives. *For example*, if Smith and Jones are joint owners of a business enterprise, each may want to ensure that, at their death, the survivor will be able to buy out their interest, so that the deceased's family

receives cash and the surviving business partner can carry on with the business. In a moment of weakness, Smith will probably admit that he doesn't want to be business partners with Jones' widow or widower.

There can also be *informal* business arrangements. Sometimes a group of people will pool their money to buy a condo in Hawaii or at Whistler. They may not consider themselves to be business partners. There can, however, be some significant problems if one of the joint owners of the property dies and the others are not in a position to buy the deceased partner's share.

Both formal and informal business arrangements can be covered by drawing up an agreement, which specifies what will happen if someone dies (usually called a *buy-sell agreement*). Life insurance is often used to "fund" the agreement.

Partners/Keypersons. There are a number of other business situations where insurance is used. A common usage is *keyperson* insurance. If the viability of a business enterprise is dependent on the skills of a valuable individual, that enterprise may hold insurance on that person's life.

Business enterprises, sports teams, television networks, and a variety of other enterprises will hold *keyperson* insurance on the lives of certain individuals. (Readers might be interested in knowing that *The Rogers Group* has very carefully structured buy-sell and keyperson insurance to make sure that our enterprise continues, and that our clients are well served if any one of our advisors dies.)

Specialty Uses of Insurance

There are numerous "specialty" uses of insurance. *I have focused on five such uses:*

Insured Annuity. A financial advantage can be obtained by purchasing a life insurance policy and a life annuity simultaneously. The money is deposited to a life annuity that will pay a guaranteed income for as long as you live. A portion of the after-tax income from the annuity is used to purchase a life insurance policy. When you die, the annuity stops and the insurance policy replenishes the capital to your estate. The income that you receive after paying tax on the annuity income, and after subtracting the cost of the life insurance premium will, in a number

of cases, be considerably higher than the after-tax income that you would earn from holding a guaranteed investment certificate or a bond.

If you are over 60 and a non-smoker, and at least in the middle income tax bracket (a taxable income of over \$30,000 per year), you will find that an insured annuity will provide a higher after-tax return to you than a GIC or a bond.

Tax-Shelter. Under the discussion of types of insurance, I referred to *Universal Life*. With this form of insurance, money is deposited into an account from which insurance charges are drawn. The money remaining in the account earns investment income (the money may be invested in interest bearing investments or in investment funds).

Within specified limits, the investment income that is earned is exempt from tax. The limits are such that very substantial deposits can be made and, thus, income can be earned on a tax-deferred basis for an extended period of time. Ultimately, some tax is paid when money is withdrawn from the account (just as one would pay tax on withdrawals from a RRIF); however, at death, any money remaining in the account can be paid out tax-free to a surviving beneficiary.

Using *Universal Life* insurance as a tax-shelter is generally of interest to anyone who is in the top marginal tax bracket (a taxable income of \$60,000 or more), who continually makes a maximum RRSP deposit, and who has no debt for which the interest isn't tax-deductible.

Pension or RRIF Maximization. If you are a member of a pension plan, you need (at retirement) to elect whether the pension will be paid to you alone or whether it will continue to your spouse or partner if he or she survives you. The greater the survivor benefit that is provided, the lower the pension that is paid.

For example, Bedrock Quarries may pay a pension, which can be either \$3,000 per month to Fred Flintstone for his life ... but, ceasing on his death, or \$2,400 per month to Fred for as long as he lives, and then continuing to Wilma if she survives him. Sometimes, it can be cost-effective for Fred to take the higher pension,

and then purchase life insurance to provide for Wilma should she survive him.

Here's a more common example:

Ricky and Lucy (both retired) have a large amount of money in RRIFs. If either one dies, their RRIF will pass to the survivor without tax; thus, the family income continues. At the death of the last survivor, all the RRIF monies are taxed before passing to little Ricky. An alternate approach is that Ricky and Lucy both purchase joint and survivor life annuities to provide an income for as long as either one of them lives. The income may be substantially higher than the RRIF income that they are now receiving. They acknowledge that the annuities will cease at the death of the last survivor. They plan, however, to leave tax-free money to little Ricky by holding a joint last-to-die life insurance policy.

"Pension maximization" and "RRIF maximization" arrangements work *sometimes*. It's a case of looking at each individual set of facts, and doing calculations to see whether or not these approaches provide an increased after-tax pension position, or an increased after-tax estate position. (I am more than happy to do these calculations for my clients.)

Potential Creditor Protection. When money is deposited with a life insurance company, it is potentially exempt from seizure by creditors if a beneficiary is named who is a member of your immediate family. Sometimes, therefore, there is some appeal to holding money in a life insurance contract, which may enjoy this *potential* creditor protection. Please note that I use the word "*potential*," as there could always be a court case which overturns this position. Recent court cases have reinforced the creditor-protected nature of insurance contracts. This approach can be of interest to professionals—such as dentists, lawyers, or architects—who could be sued (frivolously or otherwise) by patients or clients.

(I note that some investment products issued by life insurance companies may also provide potential creditor protection.)

Charitable Gifting. In my introductory notes, I stated that insurance premiums are paid with after-tax dollars and the estate benefit is paid out tax-free. Where life insurance is used to fund a bequest to a

charity (provided the correct procedures are followed), the premiums can be tax-deductible and the benefit is still paid out tax-free. (To be, technically correct, the premiums generate a “tax credit” which turns out to be as good as, or even better, than a “tax deduction.”).

There are a whole host of ways that life insurance and annuities can be combined to maximize the position of both the donor and the charity.

Combination of Uses

Here is an *example* of how several of the uses, which I have outlined, can be combined to assist an individual in meeting financial objectives:

A 45-year-old professional feels that there is not enough money to provide for his spouse and children if he dies prematurely. He decides to increase his estate position by purchasing \$500,000 of “Universal Life” coverage. He pays only a very small amount in premiums, as his main focus is on paying down the mortgage on the family home.

By age 55, the children have grown, the mortgage is paid off, and his income has increased substantially. He is maximizing his RRSP and is building an investment portfolio. He now changes his focus to saving tax and deposits very large amounts of money into his Universal Life policy, creating a fund that accumulates on a tax-sheltered basis.

At age 65, he retires and stops funding the insurance policy. The policy stays in force as the insurance charges are drawn from the accumulated investment account. At age 70, he reviews his estate plan and decides that (assuming that he will die before his wife, who is several years younger), he would like some money to be distributed to his children and grandchildren at his death, rather than have everything go to his wife to be distributed at her subsequent death. He simply changes the beneficiary designation under the insurance policy to reflect this wish.

At age 75, his assets have grown substantially, and he turns his mind to helping his favourite charity. There is more than enough money for the bequest to his children, and to provide for his wife. There is a substantial investment value in his policy (as he made large deposits in his late 50s). He withdraws some money from the policy and makes gifts to his children

and grandchildren, and then assigns the ownership of the policy to his church or favourite charity and realizes a very substantial tax credit.

I note that the long-term results from a Universal Life policy will be dependant on the return that is generated by the policy’s investment account (just as the long-term retirement income you realize from your RRSP will depend on the investment return you realize). Like an RRSP, the effectiveness of a Universal Life policy is enhanced by the fact that investment earnings are tax sheltered.

Applying/Qualifying for Insurance

While I have outlined a number of potential uses for insurance in this newsletter, that does not mean that one should necessarily pursue life insurance as a financial solution. One has to evaluate the costs and benefits in every situation to determine the most appropriate course of action.

Generally, however, I feel that life insurance is a solution that is “under-rated” and “under-utilized.” The results from some solutions such as an insured annuity can be most impressive.

As many of my clients are seniors, however, there may be a feeling that they are unable to qualify for insurance. Generally, you can qualify for insurance if you are in average health for your age.

There are a number of *guaranteed issue* insurance products available. Some companies advertise heavily on television. These types of products may be very expensive relative to the products that are available in the marketplace.

Sometimes, these products don’t pay any benefits if death occurs within a specified period of time, or pay “graded” benefits (a low benefit in the early years, gradually rising to a full benefit, after the policy has been in force for several years).

I would recommend that clients explore their alternatives before considering guaranteed issue products.

My Role as an Advisor/Facilitator

Ultimately, my role is to try to understand the financial objectives that my clients have, and to try to chart that course of action which will give them

the greatest likelihood of achieving those objectives. There are a whole host of strategies and financial products that can be used. Insurance and annuity products work to fulfill some objectives. We can also utilize mutual funds, guaranteed investment certificates, and a myriad of other products that may fulfill other objectives.

Some insurance salespeople start with the objective of selling insurance and try to make the client's situation fit the insurance sale. I believe that the process should be the other way around. Advisors should try to understand their client's objectives, and then seek to find that combination of products which best meets those objectives. Hopefully, this course in "Insurance 101" will provide some insight into situations where insurance (often in combination with other financial products) can help people meet specific objectives.

An Update on my Support Team

In my June 2000 Clientel, I provided an update on the organization of my support team (those people who help me in providing service to my clients). Here's an additional update: Nancy Custodio and Diana Wilensky have been my client service assistants for a number of years (in Nancy's case, more than 10 years), with Tania DeSantis and Lanie Collins assisting me with administrative work.

Diana has been offered the position of senior assistant to my colleague Cory Hill, and she has accepted that position. I'd like to thank Diana for doing an outstanding job! As Diana will now be working with Cory, Tania DeSantis will take over as a client service assistant (working alongside Nancy Custodio).

Tania has been working with me for three years and is very capable. Please don't hesitate to call either Nancy or Tania if you need any assistance. Tania's former position will, in turn, be filled by Jeanette Mackie (who will be working alongside Lanie Collins).

Chris Eynon has now been working with me for two years and he has obtained his CFP designation. He is playing an increasing role in assisting me on the advisory side.

I'm sure that you will find all of my support team to be enthusiastic and more than ready to provide the best possible service.

Clientel

Thank you, again, for reading this edition of Clientel. Please don't hesitate to call me or any member of my support team if we can be of any assistance. As always, the central message in Clientel is that I value my clients and I am as close as the phone.

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