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TAX MATTERS

Five reasons you should be nice to your insurance agent

A good friend of mine, Greg, works in a high-stress job on Bay Street. In the summers, he and his wife like to get out of the city to go camping in their motorhome. He finds it very relaxing, but this summer they have found their peace and quiet disturbed by well-meaning, but unwelcome, visits from other campers. Greg has devised a plan that pretty much guarantees they will have privacy. Now, whenever they set up camp, Greg places a sign on the door of their RV that reads: "Insurance agent. Ask about our new term life package."

That does it – every time.

I know that insurance advisers get a bad rap sometimes. But let me say out of the gate that there are some characteristics of life insurance that make it useful as a tax and estate planning tool, namely: Benefits are paid out completely tax free when the insured individual dies.

Further, it's possible to accumulate investments inside an insurance policy on a tax-sheltered basis – not quite like your registered retirement savings plan, but similar.

Next, if a corporation is the beneficiary of a policy on a life, a portion (often 100 per cent) of the benefits paid out upon the death of the insured individual will be credited to the company's "capital dividend account" (CDA). Amounts in the CDA can be paid out as tax-free dividends to shareholders of the company. It's primarily this combination of characteristics that creates many uses for insurance.

The key to buying insurance prudently is understanding three things very clearly: First, what is the purpose of the life insurance you are buying? Second, how much is the right amount of coverage? Finally, what is the right type of life insurance to buy? If you can wrap your mind around the answers to these three questions, you should have confidence in the investment you've made in insurance.

Let's address the first question. There are many reasons why you might consider buying life insurance. These will generally fall into one of five categories:

Provide for Others

If you have dependants who will otherwise face hardship financially if you pass away, it will be important to buy insurance on your life to provide the capital necessary to generate an income for those dependants. In addition, you might want to leave money to others who have needs, such as your favourite charities.

Cover Final Disbursements

When you pass away, there will be costs and debts to pay. Who is going to pay for these? Think about the following types of disbursements: Funeral costs, legal and accounting fees, income taxes, executor fees and probate fees, as well as outstanding mortgages, credit card balances, lines of credit and other loans. You could leave your spouse or others in a bind if you saddle them with the requirement to pay for these things out of their own pockets.

Provide Equitable or Larger Bequests

If it's your desire to treat your kids equally, life insurance can make that possible. For example, suppose you leave your cottage to your daughter who uses it, and your investments of equal value to your son. Suppose also that the cottage gives rise to a tax bill on your death. Where will the cash come from to pay the taxes? Potentially from your son's share of the estate. This could leave him shortchanged. Life insurance can provide the cash to equalize the estate.

Alternatively, perhaps you just want to leave your kids more than you could otherwise without insurance.

Shelter Income From Tax

As I mentioned, life insurance policies can provide tax-sheltered growth. You won't be taxed annually on income earned inside the policy. Now, there are relatively low provincial income taxes paid by the insurance company on investment income inside the policy, but you won't see that tax – or feel it much.

You can expect slightly lower returns inside an insurance policy because of this tax, fees and administrative costs, but historically the returns in some of the whole life insurance policies have been quite stable – and tax sheltered. Speak to an insurance adviser about the performance of participating whole life policies.

Maintain Business Health

As a business owner, consider insurance to provide cash for a surviving partner to buy out the estate of a deceased partner, maintain stability in the business if a key person dies, pay off debts of the business if a key person dies, or repay the business for any significant costs incurred (such as pension contributions).

More on insurance next week.

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