Insurance

The Critical 10

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Three years before retirement

Should I upgrade my existing life policy?

The role of life insurance will change as you get closer to retirement and during your retirement years. When you are working, insurance is purchased to protect against the loss of your human capital. You are protecting your family against the loss of your ability to earn income due to an early death. The present value of all those future pay cheques are particularly important to insure when you are early in your career and have a young family.

During retirement, many Canadians retain life insurance policies to protect the estate against taxes that may occur from various sources. When one spouse dies, for example, all RRSP/RRIF assets can transfer directly to the remaining spouse tax free. If the second spouse should die or if RRSP/RRIF assets are bequeathed to children or someone other than the spouse, all assets in the RRSP/RRIF are deemed to have been regular income in the year you die and are taxed accordingly. While there is no way to stop the government from taxing the estate, you can pay for those taxes with the tax free proceeds of an insurance policy.

A review of all your current insurance coverage is in order during this stage of your retirement planning. The ongoing costs and increasing premiums associated with term policies can be analyzed and compared to the tax savings to the estate associated with the tax free death benefit the policy provides. Permanent policies can also fund future estate tax obligations and may also be considered another source of income during retirement.

With a permanent or Universal Life policy the premium payments are usually higher than simple mortality charges and expenses associated with term insurance. The excess premiums paid create a cash reserve fund that accumulates tax free. This strategy could provide a third leg in a tax assisted investment stool that includes your RRSP and TSFA. The premiums charged to a pre retiree are still age and health based, but in this early stage of retirement planning, you may be able to create good cash reserve with reasonable costs.

Most insurance companies have introduced a wide range of investment options available for the cash reserve fund. These include guaranteed returns, returns based on equity indexes or returns based on funds actively managed by portfolio managers. How you choose to invest these funds should be made in consideration of all your investment asset allocations.

If you withdraw funds from the cash reserve fund you may trigger a tax obligation on the accumulated income, similar to withdrawing assets from a RRSP or RRIF. Owning a Universal Life policy does give you access to tax free funds through a bank loan secured by the insurance policy. The cash reserve values of your policy can be used as collateral against a bank loan. Banks will extend loans based on a percentage of the policy's cash value (somewhere between 50% and 95%, depending on the type of permanent policy). Loan proceeds are paid to the insured tax free and the loan can be structured so that no principal or interest payments need be paid until death of the policy holder. Upon death, the bank loan and accumulated interest obligation is the first to be repaid from the proceeds of all death benefits. The balance still goes to the estate to fund tax obligations or create a legacy.

As you prepare for retirement and have built up significant capital and investment assets as well as potential pension benefits, it is tempting to view insurance from your previous perspective as simply a way to protect against loss of income. There may be a temptation to self-insure and let existing policies lapse. It would be prudent, however, to have an insurance specialist review all you current policies. An objective cost/benefit analysis can be provided and some more advanced strategies may be available to provide you with another source of income in retirement.