Retirement: Need For Life Insurance?

Do You Need Life Insurance?

By: Joe the Investor

The whole idea behind life insurance is to have obligations covered off in the event of your death. The old adage about death and taxes is the reason life insurance is considered by many people. When death and taxes come together, life insurance is one potential cure for the combined effects.

What is the premise behind life insurance? What the insurance company hopes to do is to take the money you give them as a premium, invest it over a long period of time, and then repay some of it back to you on death, while keeping a portion of it as a return. The easier it is for them to do this, the cheaper your premium will be. This is possible through the idea of compound interest. To understand how an insurance policy would pay you, you would need a calculator that tabulates interest for an annuity. I have included sources below for this purpose. (1)(2)(3)(4) These formulas are similar to what you saw in elementary school math class. In terms of the concept, the two biggest drivers behind why your money grows over time are the interest rate and the time factor. The higher the interest rate, the faster your money grows. The longer the time you can work with, the faster your money grows. One thing to note is that how fast your money grows will accelerate the more time you give it. The accumulation of money will occur fastest in the last years of the time period in question. This is why you see those advertisements saying: if you contribute $100 per year to an RRSP for 30 years, versus $200 per year for 20 years, you will get more money at the end of the period in the first case with less money contributed. The reason why is if you start sooner, you will get more time for the compounding to do its work.

This compound interest concept shows up in all forms of debt, interest bearing investments, bank accounts, and annuities like life insurance. The word annuity just means a bunch of payments going into an account over time, followed by a bunch of payments coming out from the same account at a later time, usually at a set frequency like monthly or quarterly. Typically, you pay money for a period of time at a set frequency, and then receive money either as a lump sum or over another period of time at another set frequency. These terms are spelled out in the contract – i.e. the life insurance policy.

When You Should Consider Life Insurance

Do you need life insurance? The famous answer to this question is “it depends”. The first questions to ask are: why do I want life insurance? Who do I want the money to protect?

The first common scenario is: “If I die, I want my kids to be provided for because they are too young to look after themselves.” This is fair enough – make sure that when your kids can take care of themselves that this strategy is revisited. This would usually mean a “term policy” which is insurance that lasts for a set number of years. If you have other motives as per the other scenarios below, you want to get a “universal life policy” which will cover you until your death.

The second scenario is “When I die, my estate will get hit with a massive tax bill, and I don’t want my kids having to deal with that reality.” Again, this is a good reason to consider life insurance. The real issue is “how do I minimize the massive tax bill?” Life insurance is one attractive method of doing it, but there are others. You could divide up your estate while you are still alive to avoid the “deemed disposition” that triggers the massive tax bill. Deemed disposition means that something is considered automatically sold because of an event (like death), which means any capital gains taxes are due in the next tax year. This does not apply to principal residences, so if your house is all you own, the tax problem is solved in most cases. (5)(6) If you have assets that would get taxed at a later date (tax deferral), like investments that would produce a capital gain, maybe these can be sold at an opportune time prior to your death to minimize tax consequences? There is also the use of a corporation, where the corporation would be paying the taxes instead, or where beneficiaries can be paid salary, dividends or shares in the company over a longer period of time instead of all at once at the time of death. If you only have RRSPs, and you have a spouse, the RRSP proceeds can be rolled over tax free to the spouse, which would also defer the tax bill beyond your death.

The third scenario is: “I want the insurance to be an investment as well as an insurance policy.” This is also a good reason to consider life insurance. You would also need to consider the investment return versus alternatives, tax implications (these policies tend to tax exempt, but tax rules can change if too many people start taking advantage of them), and restrictions on access to your money.

Considerations For Buying Life Insurance

What do you need to consider when making the decision on buying life insurance?

The first thing to consider is your age. The older you are, the more expensive your life insurance will be, because there is less time for the compounding to accumulate money.

The second thing to consider is your health. Generally speaking, the higher the odds that you will die earlier, the more expensive your life insurance premium will be. Again, this is because there would be less time for the compounding to work. If you know you want life insurance, get it when you are younger and when you are at your optimum health.

This brings me to the third thing: can you simulate life insurance by making an achievable return? If you can generate a return as well as the insurance company can, and you have a long period of time to do it, and you have no issues with early death (such as a situation where you have no dependents and no tax issues), you might want to simulate a life insurance payout by putting a certain dollar amount in a separate account each month, investing it, and at the end of a long time period, you will accumulate a large sum of money. How do you know what return the insurance is giving you? Use one of the annuity calculators below and input how many years you are paying the premium, the monthly or annual premium amount and the final value of the proposed insurance company lump sum payout if it is known. You should be able to get an interest rate. Compare this rate with what you typically earn on your investments and see if you can beat it consistently. Take into account taxes and expenses. There are tax issues with this simulation, as well as risk in generating returns, so this method is for people who are knowledgable about investing. This method also requires discipline in funding the account.

The fourth thing is the assets being protected. If you only have a house, and you have no dependents, you will likely have no extra taxes upon death. You likely don't need life insurance. If you don't have assets, but need to protect your children, you would likely need life insurance if there are no other avenues of protecting them. If you have investments that will generate a huge tax bill, and there aren't many other options, life insurance may be useful.

Combined with this fourth thing is whether you have a financial plan, and whether you have a complex tax situation. This would be if you have complicated investments, a corporation, multiple companies, assets offshore etc. This scenario will need specific professional help from your financial planner, lawyer, accountant and maybe some other specialists for various needs.

The earlier you do your succession planning, the better. There are personal considerations like "I don't believe my kids can manage the money" or "If I divide my estate before I die there may be family squabbles". These are very important considerations. Most often, decisions are driven by your feelings more that your reason. If a consideration like this is preventing you from doing a succession plan, this needs to be examined before you do anything financial, like buying life insurance. If you are in denial of an issue like this – be aware of the limitations that it creates for your plan – and likely extra costs as well to your estate. The more harmonious you are with your money on all levels, the easier it will be to make these decisions like life insurance or estate planning.

The point is that life insurance is not needed by everyone – it depends what would happen to your finances upon death.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This article is intended for people who want to learn about the world of finance and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**

Sources:

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