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Understanding your insurance needs

Depending on an individual's needs, desires and health condition, there are many types of insurance available. These include life insurance, disability insurance, critical illness insurance and long-term care insurance.

Life insurance

Temporary coverage
"Temporary" life and health insurance is a way of looking at certain financial risks that would be devastating if they arise, but which most often we live past. For example, the loss of an income earner, especially early in life, can cause extreme financial hardship for those left behind. How will the mortgage be paid? How will the children's education be funded? Will the family have enough income to maintain their standard of living?

Term insurance

Term insurance is often used to provide coverage for these temporary situations. With term insurance policies, your premiums only pay for the cost of the insurance; there is no savings component or cash value. As a result, the initial premiums on a term insurance policy are generally lower than the premiums on a comparable permanent insurance policy. If you stop paying premiums, coverage ceases. Term life insurance premiums often increase every 5 or 10 years, although some policies provide for level premiums over longer periods of time.

Permanent coverage

Regardless of when an individual dies, there will likely be taxes, funeral costs and other expenses due at death. In addition, some individuals may desire to leave a bequest at the time of their death. For these permanent needs, there are insurance products such as permanent term insurance (term-to-100), whole life insurance or universal life insurance.

Permanent term (term-to-100)

Unlike other term insurance products, which are intended to meet needs arising within a limited time period (e.g., 20 years or by age 75), term-to-100 (also known as permanent term) is intended to carry throughout the insured's lifetime. In addition, some term-to-100 policies provide for cash values or other non-forfeiture options (see next section, "Whole life").

Whole life

Whole life insurance generally has level premiums throughout the term of the policy. A surplus is built up in the early years to help offset the rising cost of insurance in the later years, which is often expressed as the cash value in the policy. The cash value can be used to:

- Pay annual premiums if the need arises
- Purchase a fully paid permanent policy with a reduced face value
- Purchase a limited duration term policy for the same face value
- Fund a policy loan to the policyholder

The first three options are referred to as "non-forfeiture options," as they would provide continued insurance coverage in the event the policyholder stops paying the premiums. The continued coverage provided under a non-forfeiture option may be of limited duration or reduced value, depending on the option chosen and the cash value of the policy at the time.

Example

William is 45 years old and has a whole life insurance policy on which he has been paying monthly premiums for 15 years. William has run into some financial difficulty. He has the following options available to him:

- Use the cash value of the policy to pay the premiums for the short term and resume paying premiums in the future. The death benefit will remain intact
- Use the cash value of the policy to pay the premiums on a term insurance policy until the cash value runs out and the term policy lapses. No further premium payments would be required on his part. The death benefit on the term policy would be the same as the death benefit on the whole life policy
- Use the cash value to purchase reduced paid-up insurance. No further premiums payments would be required
- Take a policy loan against the policy in order to access emergency funds. The cash value would decrease and he would continue to pay the premiums. In this instance, the death benefit would be reduced by any outstanding policy loan at the time of death. Note that there may be tax consequences associated with such a policy loan
- Cash-in the policy and receive the cash value. This could also result in a tax liability to the policyholder. This would cause the insurance coverage to terminate

Universal life

Universal life is an "unbundled" permanent insurance product with separate insurance and tax-deferred savings components. A universal life insurance policy gives the policyholder the option of paying a premium in excess of the cost of insurance. The policyholder can choose to direct this excess to any number of investments offered within the policy.

If the amount of these investments remains within prescribed limits, the growth on these investments will not be taxed unless and until withdrawn from the plan. Generally, the policyholder can choose an option for any balance in this account at death to pass tax-free to the beneficiary in addition to the death benefit. The savings component may also be used as collateral for a loan to provide income during life. This can be paid back out of the insurance proceeds at death.

Advanced planning strategies using life insurance

Life insurance is often used for complex estate planning strategies, such as business buy-sell arrangements and "key person insurance." In a buy-sell arrangement, the insurance is designated to enable a surviving business partner to buy out a deceased partner's interest. As a result, the surviving partner is free to continue to operate the business and the deceased's beneficiaries receive their interest in the estate without being tied to a business in which they have no continuing interest.

The death of an owner/manager or executive of a business can be costly for a company as he or she can often be difficult to replace, and business can come to a standstill without the owner. "Key person insurance" is designed to protect against this. The business owns insurance on the life of a key employee. In the event of the death of the employee, the insurance benefit is paid to the business, which can then use the proceeds to find a replacement and to pay ongoing bills while business may slow down.

Example

Andrew and Sam are equal shareholders in a thriving custom pool installation business. Sam has a wife who is not involved or interested in the business and two teenaged children. The business is worth $2 million. Andrew and Sam have a buy-sell arrangement, funded by insurance. The buy-sell arrangement states that if either partner should die, the surviving partner agrees to buy the deceased partner's interest in the business from the deceased's estate. Andrew owns a $1 million life insurance policy on Sam, on which Andrew is the beneficiary. Sam owns a $1 million life insurance policy on Andrew, on which Sam is the beneficiary. When Sam died, Andrew received insurance proceeds of $1 million, which he used to buy Sam's shares in the company from Sam's estate. Sam's wife, who was the beneficiary of the estate, received $1 million cash from the estate. Now Andrew is the sole shareholder in the company.

Disability insurance

During a disability, household bills still need to be paid. Disability insurance provides a benefit, usually 60-70% of salary, in the event the insured becomes disabled and is unable to work. There are various types of disability coverage, ranging from policies that will only pay benefits if you are unable to work at any job to policies that will pay benefits provided you are unable to perform the duties required for your regular job.

Many employers offer their employees group disability insurance coverage. However, self-employed individuals or individuals who are not covered through their employers should ensure that they have adequate insurance coverage to continue to pay their costs of living while they are unable to earn a paycheque.

Critical illness insurance

Critical illness insurance is a relatively new product, which was introduced in the 1980s. It pays a benefit to the insured in the event the individual is diagnosed with any of a specified list of critical illnesses, such as cancer or a heart attack, and survives a waiting period that is usually 30 days. Some critical illness insurance plans may cover as few as three or four illnesses while others cover two dozen or more. Whereas disability insurance usually pays a monthly benefit equal to a percentage of your salary in the event you are unable to work, critical illness insurance pays a lump-sum benefit shortly after diagnosis, regardless of the ability to work. This can help pay for items related to the illness, such as medical expenses that are not covered by a health plan, or a much needed vacation.

Long-term care insurance

As the population ages, more and more people require expensive long-term care. Canadians want the peace of mind of knowing that they will be able to afford the care they need without burdening their families with the costs. Long-term care insurance provides a benefit that helps cover the cost of nursing home fees or attendant care fees. Most plans generally pay a stated daily or weekly benefit once it is determined that the insured is no longer able to adequately care for himself or herself.

Conclusion

Insurance is an important part of a financial and estate plan. From the payment of the first premium, protection of one's income and estate can be established. With all types of insurance, you get what you pay for. There are relatively inexpensive basic plans and more expensive comprehensive plans. It's important to consult a licensed insurance agent to determine the most appropriate solution to your needs.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

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