



Mom, You Know I Love You But...

Rino Racanelli

Would you mind signing this life insurance application for one million dollars? How would your mom react to that request? If anything, it should get her attention.

I realize this can be an uncomfortable question to ask any parent. Likewise, most parents would be just as uncomfortable discussing this subject with their adult children. In my opinion, this subject cannot be ignored. Not only does buying life insurance on your parent's life help pay for final expenses such as funeral costs, probate fees, executor fees, legal fees, final tax return, and capital gains taxes, in most situations buying life insurance on your parent's life makes good economic sense. The old saying that there is nothing more certain than death and taxes applies here.

Most parents do not own enough life insurance for many reasons. Unfortunately for many senior citizens, they do not own enough life insurance because they simply can't afford the premiums. Most seniors have a fixed income allocated towards maintaining their house, paying medical bills, etc. They would like to own a sufficient amount of life insurance but they simply cannot afford it. This is one of the reasons why it is up to their adult children to ask whether their parents have sufficient life insurance to cover their final expenses. It's also a good idea for adult children and their parents to discuss a number of other financial planning issues.

Three Important Questions

Question 1: Can you buy life insurance on your parents?

Yes, as long as a clear insurable interest exists, your parents can pass a mini-physical, and they sign the application.

In Ontario, legal guidelines have been established on which kinds of family relationships an insurable interest exists. The insurable interest of family members is assumed to be emotional as well as financial. The law allows insurable interest on the presumption that a personal connec-

tion makes the family member more valuable alive than dead. Thus, children have an insurable interest in their parents and vice-versa. For life insurance, the insurable interest only needs to exist at the time the policy is purchased. An insurable interest should be demonstrated in every case prior to any life insurance application approval. (Source: Underwriting Guidelines Insurance Act 2005)

Question 2: How much insurance can you buy on your parents?

The amount of insurance issued should not exceed the demonstrated amount of the monetary loss expected to be sustained at the death of the life insured. Also, the total amount of insurance issued should not exceed the economic human life value of the proposed insured as estimated by some logical and supportable formula. The loss that might be suffered must bear a reasonable relationship to the amount of insurance requested. Insurance amounts up to 50% of a person's net worth to cover taxes payable upon the death of the insured are acceptable. Higher amounts may be given individual consideration, eg. universal life policies used as a savings plan. (Source: Canada Life Underwriting Guidelines 2008)

Question 3: Is it okay to purchase life insurance on your parents without them being offended?

Sure it is. Why not? You'll never know unless you ask. I recall presenting this idea to my mother and she was not the least bit offended. In fact, she thought it was a great idea!

Okay, now you have your mom's attention and you decide to look at the best possible options to pay for her final expenses. You've narrowed it down to the following:

- A - Sell and liquidate her assets.
- B - Borrow the money.
- C - Save the money.
- D - Purchase a life insurance policy.

If you do what most Canadians do, which is nothing, then the first two options are your only choices.

Option A

Option A requires that a number of your mom's best assets will have to be liquidated in order to handle the tax bill. There are several important questions to answer if you choose this option. Can the asset be quickly turned into cash? Is there a market for the asset? A fair market price may be difficult to achieve for the seller since you need the cash as soon as possible and might be forced to sell at less than what the market dictates.

If you decide to sell your parent's assets, don't you think the best time to sell is when the market dictates the right price? With your mom's assets, how important are they to her and the rest of the family? For example, the family cottage or her principal residence may be an asset that your mom wanted to pass on to the next generation.

Investments, saving plans, and the family business represent liquidity, as well as producing some income. These are the assets most likely favoured by the federal government since it will be easier for them to turn into cash. The consequence to your family is the loss of cash and income. You are paying with after-tax dollars for estate taxes, not discounted dollars. Never a good result. Once you pay the tax bill to Revenue Canada, your hard-earned savings plans are gone forever.

Option B

Option B, borrowing the money to pay for the final expenses, is hardly a good option. Why pay the bank interest on an expense that returns nothing to you? No one needs more debt. However, this might be your only choice if you cannot liquidate your mom's assets fast enough, or if her bank requires letters of probate to release the funds to her children.

You could, on the other hand, have a plan. In this plan you have to do something ahead of time. Let's look at the remaining two options using real-life examples where an adult child considers purchasing a 1 million dollar life insurance policy on the life of his parent(s) to cover estate taxes. This will be compared to starting a savings plan in

EXAMPLE 1 - MOTHER, AGE 65

| Years | REGISTERED INVESTMENTS | | NON-REGISTERED INVESTMENTS | | LIFE INSURANCE INVESTMENT | |
|-------|------------------------|-------------|----------------------------|-------------|---------------------------|---------------|
| | Annual Deposit | Balance | Annual Deposit | Balance | Annual Deposit | Death Benefit |
| 1 | \$22,090 | \$23,195 | \$22,090 | \$22,682 | \$22,090 | \$1,000,000 |
| 2 | \$22,090 | \$47,549 | \$22,090 | \$45,972 | \$22,090 | \$1,000,000 |
| 3 | \$22,090 | \$73,121 | \$22,090 | \$69,885 | \$22,090 | \$1,000,000 |
| 4 | \$22,090 | \$99,971 | \$22,090 | \$94,440 | \$22,090 | \$1,000,000 |
| 5 | \$22,090 | \$128,164 | \$22,090 | \$119,652 | \$22,090 | \$1,000,000 |
| 10 | \$22,090 | \$291,738 | \$22,090 | \$256,217 | \$22,090 | \$1,000,000 |
| 15 | \$22,090 | \$548,724 | \$22,090 | \$412,086 | \$22,090 | \$1,000,000 |
| 20 | \$22,090 | \$766,948 | \$22,090 | \$589,986 | \$22,090 | \$1,000,000 |
| 25 | \$22,090 | \$1,107,006 | \$22,090 | \$793,032 | \$22,090 | \$1,000,000 |
| 30 | \$22,090 | \$1,541,016 | \$22,090 | \$1,024,779 | \$22,090 | \$1,000,000 |
| 35 | \$22,090 | \$2,094,934 | \$22,090 | \$1,289,284 | \$22,090 | \$1,000,000 |

Insurance rates are based on standard underwriting and may vary by province. Insurance policy paid on proof of death of the insured.

Illustration assumes your current annual savings plan does not exceed your personal contribution limit for RRSPs, which would include any available carry-forward room from previous years. To find out what your personal contribution limit is, refer to your Notice of Assessment that is mailed to you every year by the Canada Revenue Agency.

Mackenzie Financial Corporation Investment Calculator 2004

either a registered plan (RRSP) or a non-registered plan (non-RRSP), both returning an average of 5%. We will assume the adult child's marginal tax rate is at 46.41% and that both parents are non-smokers and in good health.

Example 1 - Mother, Age 65

The cost for a 1 million dollar life insurance policy is \$22,090 per year, based on a term-to-100 product where the premiums are guaranteed for life and the insurance coverage matures at age 100. The comparison chart above shows depositing \$22,090 every year for 35 years (or until the insured dies) into the life insurance policy, compared to depositing the same amount into your RRSP or non-RRSP savings plan. In 35 years, the accumulated value in your RRSP account will be \$2,094,934, compared to \$1,289,284 in your non-RRSP account. Based on the stated assumptions, the RRSP will return \$805,650 more than your non-RRSP investment. This is the advantage of tax-deferred compounding interest over time. However, the RRSP is fully taxable at your marginal tax rate when withdrawn. In contrast, the tax has already been paid in the non-RRSP savings plan.

The difficulty in comparing the value of insurance to other savings plans is knowing when a claim will be paid. In other words, knowing when your mom will pass away. Since we don't know when that time occurs, we can make assumptions using mortality rates. The latest numbers from Statistics Canada suggest women born and living in Canada have a life expectancy of 77.4 years from birth. Canadian men, on average, live 6.3 years less. However, most Cana-

dian women who have reached the age of 65 can expect to live (on average) another 20 years. The point is if you invested \$22,090 for 20 years in an RRSP you would have accumulated \$766,948, which would be fully taxable when withdrawn. If you invested the same amount into a non-RRSP investment you would have accumulated \$589,986 after tax. Alternatively, you could have purchased a one million dollar life insurance policy on your mother's life and been paid out 1 million dollars tax free the day she passed away.

Example 2 - Mother and Father, Both Age 65

In this example the cost of the insurance is reduced to \$13,120 annually because we are insuring two lives using a joint last-to-die policy. This simply means that the insurance coverage is paid out when both parents die. The risk to the insurance company is less since there are two lives to consider, hence the lower premium. A joint last-to-die policy is specifically designed to pay for capital gains taxes upon death, since the children will be receiving the tax bill when their parents' assets are passed on to them. This example clearly shows the economic value of the insurance plan compared to the two alternate savings plans. After 30 years, your RRSP plan has accumulated \$915,262, which is fully taxable when withdrawn. The non-RRSP plan has accumulated only \$608,651.

Which investment would you prefer? Most people choose the life insurance plan. This is nothing new. This is how people who plan ahead and are well off have been dealing with the government for years – how the rich pay taxes. The rich anticipate their tax bill to preserve the value of their estate. In

other words, all of the liquid and real assets your parents have worked for all their lives can be kept together for future generations and can stay together for their family.

Final Points to Consider

Your parents need to qualify medically and financially for the insurance product first in order to make a proper comparison.

If you and your siblings decide to pay for the insurance plan on the life of your parent, it would be a good idea to make all paying beneficiaries irrevocable. An irrevocable beneficiary means that the owner of the plan (your parent) cannot make any changes (i.e., change the beneficiaries) to the plan without the beneficiaries' consent. This is important because the person(s) paying for the plan would want to be certain that they will be the ones receiving the death benefit as beneficiaries.

Purchasing a life insurance policy on your parents' lives should not replace your RRSP contribution. The RRSP savings plan is used for comparison purposes only. Having an RRSP as part of your retirement plan makes a lot of sense. Not only are you reducing your taxable income in the year you contribute, you are also accumulating your savings tax free and benefiting from compounding interest.

There is one major risk to the buyer if you decide to purchase the insurance plan. If you do not pay the premiums when due, your policy could lapse after the 30-day grace period. You must pay the premiums or you could lose your entire investment. To counter this problem you can purchase insurance plans with dividends or insurance plans that are paid up in 10 and 15 years, at a higher cost, of course.

Some people have always considered purchasing a life insurance policy as one of their worst investments because there is no return to them personally. I respond to that concern by saying, "When it comes time to die, which investment would you want to give the government – your best investment or your worst investment?"

*Rino Racanelli, B.Sc.,
Independent Insurance
Advisor, MRH
Financial Services,
Oakville, ON (416)
880-8552,
racanelli@sympatico.ca*

EXAMPLE 2 - MOTHER AND FATHER, BOTH AGE 65

| Years | REGISTERED INVESTMENT | | NON-REGISTERED INVESTMENT | | LIFE INSURANCE INVESTMENT | |
|-------|-----------------------|-------------|---------------------------|-----------|---------------------------|---------------|
| | Annual Deposit | Balance | Annual Deposit | Balance | Annual Deposit | Death Benefit |
| 1 | \$13,120 | \$13,776 | \$13,120 | \$13,472 | \$13,120 | \$1,000,000 |
| 2 | \$13,120 | \$28,241 | \$13,120 | \$27,304 | \$13,120 | \$1,000,000 |
| 3 | \$13,120 | \$43,429 | \$13,120 | \$41,507 | \$13,120 | \$1,000,000 |
| 4 | \$13,120 | \$59,376 | \$13,120 | \$56,091 | \$13,120 | \$1,000,000 |
| 5 | \$13,120 | \$76,121 | \$13,120 | \$71,065 | \$13,120 | \$1,000,000 |
| 10 | \$13,120 | \$173,273 | \$13,120 | \$152,176 | \$13,120 | \$1,000,000 |
| 15 | \$13,120 | \$297,266 | \$13,120 | \$244,752 | \$13,120 | \$1,000,000 |
| 20 | \$13,120 | \$455,517 | \$13,120 | \$350,413 | \$13,120 | \$1,000,000 |
| 25 | \$13,120 | \$657,489 | \$13,120 | \$471,009 | \$13,120 | \$1,000,000 |
| 30 | \$13,120 | \$915,262 | \$13,120 | \$608,651 | \$13,120 | \$1,000,000 |
| 35 | \$13,120 | \$1,244,253 | \$13,120 | \$765,749 | \$13,120 | \$1,000,000 |

Insurance rates are based on standard underwriting and may vary by province. Insurance policy paid on proof of death of the insured. Illustration assumes your current annual savings plan does not exceed your personal contribution limit for RRSPs, which would include any available carry-forward room from previous years. To find out what your personal contribution limit is, refer to your Notice of Assessment that is mailed to you every year by the Canada Revenue Agency.

Mackenzie Financial Corporation Investment Calculator 2004