

LIFE at BOTH ENDS

Often regarded as an investment alternative for prosperous 40- and 50-somethings, universal life has a place for the very young and very old too.

By Paul Grimes

Today more than half of new life insurance policies are universal life (UL) accounts. UL has actually been around for a long time, but it has increased in popularity in recent years. Insurance companies needed a product that could be competitive with the high interest rates of the 1980s and the boom markets of the 1990s.

While Canadian families have seemingly become the target market and most easily prospected group, since UL is perceived by many as an investment product/tax shelter, it can offer significant advantages for children and older clients.

Children are dependants; they don't have dependants. So generally they don't need much, if any, life insurance. However, insurance on children is less about protection and more about guaranteeing the insurability of your child. UL will not only take care of insurability but taking out policies



on children can be excellent investments.

They are especially interesting when you pay these plans up over a short period of time. Let's take an example. Imagine a grandfather with a fair amount of disposable income or savings decides that he wants to make a lasting contribution to the financial well-being of his baby granddaughter. He also wants to minimize probate fees and taxes on his estate, and

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would like to spend some money now to minimize his estate liabilities later. So he applies for a UL policy and then designates the granddaughter as the insured, and someone else, usually her parents, as the beneficiary. He is then the owner of the policy, and he pays the premiums.

Since the premiums for a child are very low, this strategy can be an effective wealth builder for the child. Money will grow in a tax-deferred investment account until the granddaughter withdraws it. Should the child withdraw the cash for university, then she'll probably pay tax at a much lower rate than her parents or grandfather. She could also use the policy as collateral for a loan.

Now, should the grandfather die, the policy goes to the granddaughter tax-free, as long as it is specified in his will. Or he might decide prior to his death to transfer ownership right before she goes to university or decides to buy a house. If Granddad dies and the child is too young to handle the policy, a contingent owner, such as the girl's parents, can be stipulated until the child is old enough.

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This all sounds quite practical, but what kind of growth could we expect and what is the best way to set up such a plan? The best way to set up children's plans is to prepay the policy. There are some companies that even offer a guaranteed prepayment of 10, 15 or 20 years regardless of interest rate credited to the policy or the type of investment held within it. These plans give both agent and consumer peace of mind. Provided the exact premiums are paid each year, these plans "lock in" the policy as fully paid. Lock-in or guaranteed-pay UL policies generally base their costs on level cost of insurance, which is the next important part of setting up any UL plan.

"Quick pays" really shine when you continue to dump money in after the quick-pay period. All the costs of the pro-

gram are long paid off and the investment return is awesome.

You can choose to go with level cost insurance, which means the cost will stay the same for the entire length of the policy, or you can choose yearly renewable term (YRT). With YRT, the amount of premium that goes to cover the actual cost of insurance varies with the client's age. In the early years, when costs are lower, more money is directed toward investments. In the later years, when the risk of death is higher, more premiums go to life insurance coverage, less to investments.

Here is where goal planning needs to come into play. If the main goal is to accumulate and shelter as much money as possible, as quickly as possible, you would choose YRT because you would have more money to invest in the early years, and that money would have more time to grow. This works well if you are investing a lot of money. However, there will come a point when that child gets older and YRT costs start to escalate. At that point, more premium is going towards the life insurance coverage. The downside of YRT is that the increasing costs of insurance could erode the value of your investment.

Do both to cover both the upside and downside. Create your proposal to be YRT to level. This needs to be designated at the time of application and will "hedge" your plan. In other words, let the computer calculate the exact time in the UL plan that this plan should switch itself to a level cost. Most companies offer this feature.

Now let's look at value, using our grandfather/granddaughter example: Let's say Granddad buys a \$475,000 policy on his granddaughter, and commits to \$4,000 per year for 20 years. If the investment returns even a conservative 6%, his granddaughter will have access to cash value of just over \$125,000 by the time she is 19 years old. Her total death benefit will be close to \$1 million. If her parents have contributed to RESPs, she doesn't need to withdraw funds for university. She just leaves the money in the policy untouched until she is 50 years old. Granddad has long since passed away, but he has left her a tax-sheltered legacy in the policy. At that point, the cash value will be in the neighbourhood of \$890,000 and the total death benefit will be nearly \$2.3 million.

The other great thing about this type of planning is that the granddaughter has never had to worry about buying or qualifying for life insurance. Because the policy was

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overfunded early on, it generally creates enough interest or investment earnings to pay for the insurance portion. So Granddad has given two gifts in one.

Finally, for these kinds of policies, the insurer will require that the parents are adequately insured. It may also require the parents to co-sign the application, and of course the child must be healthy. For any large policy issued on a child's life, the insurance company will investigate to make sure all their character concerns are answered.

Older Client Needs

Now that we have covered young Canadians, let's switch to older Canadians. Want to leave the cottage to the kids but worried about a hefty tax bill? Let's look at joint-last-to-die policies.

A joint-last-to-die life insurance policy pays benefits only when the second of the two insured parties (usually spouses) dies. These policies are often used to offset capital gains owing upon death. And because two people are insured under

one policy, joint-last-to-die policies are less expensive than regular policies.

Let's say a cottage is worth \$400,000. Well, 50% of the capital gain will be taxed on the estate. So when the kids inherit the cottage at a 50% marginal tax rate, the estate will end up owing a collective \$100,000 or so in tax. A joint-last-to-die policy could be taken out and paid up over a limited time period, perhaps 10 years, with the \$100,000 death benefit, and the kids as joint beneficiaries. With the death of the second spouse, the policy pays out the death benefit to the kids who use the money to pay the capital gains and voila! The cottage stays in the family and no one child is forced to go into debt or sell their share.

As the population ages and as more and more Canadians are realizing the tax burden that will potentially be placed on their estates, joint-last-to-die plans offer the easy answer for many. Clients pay less in premiums than they would in taxes.

Joint-last-to-die policies tend to be less expensive than regular policies, because two people are insured under one plan.

For pricing purposes, the insurance company converts the ages of the two people into the equivalent single life age: a 68-year-old man and a 65-year-old woman, both non-smokers, might be insured for the price of one 54-year-old.

The second important factor is both do not necessarily need to be in perfect health. In fact, in some instances if one partner is uninsurable yet the other is in good health, the insurance company looks longer range at the second death. At worst, there may be a slight rating applied to a policy. But you would still almost always pay less in premiums than you would gain in benefits.

Let's say the couple mentioned above takes out a joint-last-to-die UL plan with a death benefit of \$200,000, and the premiums on that policy are \$4,000 a year and the second death takes place in 20 years. During that time, they have put in \$80,000, for a net gain of \$120,000. This actually works out to an annual return of something like 8.8% tax-free. That does not even include any cash build-up within the universal plan.

There is one more aspect we do need to look at with joint-

last-to-die estate conservation plans: the premium payment. Most retired Canadians are on a fixed income and therefore, although they do not want to burden their family with taxes, \$4,000 or \$5,000 a year in premiums, either over a limited pay period or for their remaining lifetime is a hefty price. Why not discuss this concept directly with the children? If you don't want to pay the premiums on life insurance that you won't need, give the children the option of paying. It could be a worthwhile investment.

So there you have it, from the young child to the retired person. UL is so flexible, it can be adapted to many and varied situations. The client can prepay a legacy of a lifetime, pass estate value to the next generation for a limited amount and offset potential tax problems for his or her family.

UL is that one insurance tool that, like its name, has universal applications. AE

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