

The Role of Life Insurance in Protecting Your Assets

The most obvious and significant benefit of life insurance is the lump sum payment it provides when the insured person dies. This lump sum is paid directly to the beneficiary designated in the life insurance policy and is not taxable. The specific need this lump sum payment addresses will vary with your needs, which could include protection for surviving dependants, estate preservation or creation and funding to ensure that an estate is distributed equitably.

In this article we will examine the role of life insurance in estate creation and estate preservation.

Life insurance as an estate planning tool

Life insurance can play an important role in estate planning. There are two aspects to this:

- Estate creation: tax-free insurance proceeds can be used to create an instant estate for your family or beneficiaries.
- Estate preservation: life insurance proceeds can defray expenses and liabilities arising on death. Tax-free insurance proceeds can be used to pay funeral expenses, debts and tax liabilities so that the estate itself can be left fully intact for beneficiaries.

Let us examine each of these in more depth.

Estate preservation: Funding to settle liabilities on death

The following is a summary of debts, tax liabilities and other expenses which can arise on death and which will erode the value of your estate:

1. Capital gains taxes on deemed disposition

When a person dies, the Income Tax Act (ITA) considers him or her to have disposed of each capital property he or she owned immediately before death, at a price equal to the fair market value (FMV) of such property at that time. Examples of capital property are shares of a corporation, partnership interests, mutual or segregated fund units, cottage properties and land.

The result of this deemed disposition is that, if the capital property has appreciated in price since it was acquired and there is an accrued capital gain this gain is deemed to have been realized, thus triggering a tax liability. The capital gain is calculated as the difference between the FMV of the property and the property's adjusted cost base (ACB). Fifty percent of the capital gain must be included in the deceased person's final income tax return as a taxable capital gain.

Taxable capital gains can be offset by any remaining capital gains exemption that the deceased is eligible for, but only if the property in question consists of "qualified small business corporation shares" or "qualified farm property", as defined by the ITA. Any taxable capital gains that are not sheltered by the capital gains exemption will be taxed in the hands of the deceased person in their year of death.

One way to finance the payment of capital gains tax arising from a deemed disposition on death is the use of life insurance proceeds. Cash provided can be used to settle the tax liability, which is extremely important especially if the beneficiaries wish to retain the property for either sentimental reasons or because market conditions are currently unfavorable.

In situations where capital property is inherited by the surviving spouse or common law partner (hereinafter collectively will be referred to as the "Partner"), the tax liability can be deferred to the time when the surviving Partner disposes of the property or dies. A joint and last



survivor policy will provide funds to offset the eventual tax liability with proceeds payable on the death of the last Partner.

Hence, the estate value is conserved for the eventual heirs without erosion by taxes.

2. Income inclusion of registered plans on death

When a person dies, the full value of their registered assets will be included as regular income and becomes fully taxable in the year of their death, unless:

- it is rolled over to the registered account of his or her Partner;
- it is rolled over to the registered account of a disabled child or grandchild who is financially dependent upon him or her; or
- it is used to purchase an eligible annuity up to age 18 for a child or grandchild who is financially dependent upon him or her.

This income inclusion will create a tax liability for the estate. Depending on the size of the registered asset the potential tax liability can be quite substantial, and again, life insurance can provide funding for the tax liability.

3. Estate taxes in other jurisdictions

At the present time, there are no succession duties levied by either federal or provincial governments in Canada. However, the executor of the estate of a deceased person may be liable for estate taxes in other jurisdictions. For example, the United States imposes estate taxes (income and gift taxes) on its citizens' worldwide assets, regardless of where they live.

In addition, the United States also imposes U.S. estate taxes on non-U.S. citizens, if they own U.S. situs properties and have a worldwide net worth that exceeds certain threshold levels.

4. Probate, legal and other estate costs

Probate is the process of validating a deceased's Will and confirming the appointment of the executor by the court. Probate costs are based on the value of the estate and vary from province to province. The provinces of Ontario and British Columbia currently have the highest probate costs in the country, while Alberta has capped its probate cost and Quebec has virtually no probate costs.

It should be noted that the estate may be liable for probate costs in more than one province. Unfortunately, there is no mechanism to credit costs paid in one jurisdiction against costs owing in another jurisdiction.

Naming a beneficiary in a life insurance policy or an annuity contract is one way to avoid probate costs. Life insurance proceeds are paid directly to the named beneficiary and therefore do not form part of the assets of the estate for valuation purposes.

Without a proper beneficiary designation or if the estate is named as the beneficiary of the insurance policy, the proceeds from the life insurance policy would become part of the estate assets and be subject to probate costs.

Other estate costs could include funeral and burial expenses, estate administration costs such as executors' fees, valuator or appraiser fees, and legal and accounting fees.

Estate creation: Capital replacement

Because the proceeds of an exempt life insurance policy are paid tax-free to the beneficiary(ies), life insurance can be an efficient way to create an instant estate and to transfer wealth to later generations.

Here are a few illustrations of how this works:

Tax-free accumulation

Investing money into an "exempt policy" (i.e. a policy which is issued mainly for insurance protection and not for investment purposes) can potentially provide more funds to heirs than would be the case if the funds were invested outside the policy. This is because the growth on funds invested in a non-registered account is generally subject to annual accrual taxation, whereas an exempt life insurance policy grows tax-free and the death benefit is paid tax-free to the beneficiary.

Facilitating charitable donations

During their life, some people choose to donate property to a charity and they then receive tax credits for that donation. To make sure the estate is not depleted by a charitable donation of property, the donor can purchase life insurance to replace the donated capital.

Estate equalization

Life insurance can also be used to facilitate an equitable distribution of an estate among beneficiaries. A common example is where an estate includes shares of a family business that will be distributed only to family members who are active in that business. Often, the business is the estate's major asset and the amount remaining for family members who are not involved in the business is significantly less. Life insurance can provide a lump sum to the family members who do not have an interest in the business, to ensure a fair inheritance.

Insured Annuity

This is a strategy that can provide a conservative investor with a guaranteed retirement income that is greater than what can be obtained by investing in conventional interest-bearing instruments and at the same time facilitate the creation of an estate.

With this strategy, an initial sum of money is set aside to purchase the annuity. The annuity then provides the annuitant with a regular income stream during his or her lifetime. In terms of tax treatment, a portion of the annuity payment is considered to be return of capital and the remainder, which is the return on investment, is taxable income to the annuitant. Usually, a portion of the annuity income is used to pay the premiums for a life insurance policy with a face value (insurance benefit) equal to the amount of the annuity principal. Upon death of the annuitant, the tax-free life insurance death benefit is paid to the annuitant's beneficiary(ies) to replace the capital originally invested in the annuity.

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