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CESTNICK

TAX MATTERS

Decide the coverage right for you

If you're considering the use of life insurance, there are three things to clearly understand: the purpose of the insurance, the type of insurance to purchase and the right amount of insurance. Last week, I spoke about the first of these, and explained the five broad potential reasons for buying life insurance. Today, let's focus on the types of life insurance.

Temporary Insurance

Life insurance comes in two basic types: Temporary and permanent. Temporary insurance is otherwise known as term insurance. This is life insurance that will last for a specified term.

If your life is insured using term insurance, and you don't "mature actuarially" – that is, kick the bucket – before the term is over, then the insurance coverage expires.

Term insurance is most commonly purchased in one-, five-, 10- or 20-year terms. Ten-year terms seem to be the most prevalent.

When you buy term insurance, you're buying pure insurance coverage, and nothing more. There is no accumulating investment fund inside a term policy.

Term insurance is generally the cheapest type of life insurance.

It's important when buying term insurance to make sure that it's guaranteed renewable and convertible. That is, once the term is over, you won't want to be rejected for continued insurance coverage if you really want it. If your term policy is guaranteed renewable, this won't be a problem. Now, you'll generally face an increase in your premiums at the end of each term, but as long as you pay the new premiums, your coverage should continue beyond the end of the term when the policy renews.

If a term policy is convertible, you can convert it into a permanent policy at any time, subject to a new schedule of premiums, of course.

This is an important feature if the temporary coverage provided by the term insurance isn't going to be adequate in the long run. You see, term insurance can't be renewed indefinitely.

Generally, term policies can be renewed until you reach age 75 or 80, depending on the specific life insurance contract. If you live beyond age 80, or whatever age is specified in the contract, you'll be out of luck – that policy won't cover you any longer, and nothing will be paid out upon your death.

The fact is, a very small percentage of term policies actually end up paying death benefits to the named beneficiaries – in the order of about 2 per cent. No wonder these policies are relatively inexpensive.

Permanent Insurance

As attractive as term insurance might be due to the lower cost, it's important to realize that most insurance needs will require permanent coverage. Permanent insurance will cover you, as long as you pay your premiums, for as long as you live.

That is, death benefits will be paid out regardless of the age you pass away.

Permanent insurance comes in three basic flavours: term-to-100, whole life and universal life.

Don't let the name "term-to-100" confuse you. This doesn't mean that the insurance lasts only until you reach age 100. The coverage lasts your entire life. At age 100, however, many insurers will give you a break – you won't have to make any more premium payments.

You can instead put that money into a big celebration on your 100th birthday. In the case of a term-to-100 policy, there is no investment component that accumulates over time, similar to regular term policies.

Whole life and universal life policies have something in common: They allow for the accumulation of investments inside the policy over time. This portfolio can grow tax-sheltered, as I discussed last week.

Upon your death, both the face value of the policy and the accumulated investments inside the policy are all paid out tax free.

When deciding between temporary or permanent insurance, always ask yourself the question: Is it my desire, or is there a need, to have the insurance benefits paid out on my death, regardless of what age I pass away? If the answer is “yes,” then permanent insurance is the way to go.

Temporary insurance might make sense where, for example, you want cash upon your death to pay off a debt with a specified term (such as a mortgage), or to provide support for dependents until they reach a certain age – say, age 25 or 30. In most other cases, permanent insurance is what you'll need.

Next week: More on permanent insurance.

Tim Cestnick, FCA, CPA, CFP, TEP is Managing Director of The WaterStreet Group Inc., and author of The Tax Freedom Zone and 101 Tax Secrets for Canadians 2009, among other titles. tcestnick@waterstreet.ca