CISRO / OCRA

Life insurance

Life Licence Qualification Program (LLQP) Exam Preparation Manual

E-311 – 9th Edition, 2022

9th Edition, 2022

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1st Edition, 2015 and 2nd Edition, 2015

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Legal deposit – *Bibliothèque et Archives nationales du Québec,* 2022

ISBN 978-2-551-26859-7 (PDF)

FOREWORD

This manual is an exam preparation tool for future life insurance agents registered in the Life License Qualification Program (LLQP). Its contents will help candidates develop the competency targeted in the life insurance module of the LLQP Curriculum: *Recommend individual and group life insurance products adapted to the client's needs and situation*.

Chapter overview page

The first page of every Chapter outlines the Curriculum module competency components and sub-components that will be covered. Highlighting which of the evaluation objectives are addressed in each of the manual's Chapters serves to identify the contents that are essential to attain these objectives.

It is thus recommended that candidates regularly review the competency components and subcomponents in order to contextualize and assimilate them as they read each Chapter. This will help develop an understanding of the nature and scope of the evaluated competency. Candidates must have fully understood the knowledge, strategies and skills covered in each Chapter in order to successfully pass the corresponding module of the LLQP licensing exam.

In this text, the masculine form is used for both men and women.

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LIST OF ABBREVIATIONS

ACB	Adjusted cost basis
AD	Accidental death
AD&D	Accidental death and dismemberment
APL	Automatic premium loans
APS	Attending physician's statement
AWCBC	Association of Workers' Compensation Boards of Canada
CCPC	Canadian-Controlled Private Corporations
CDA	Capital dividend account
CI	Critical illness
CLHIA	Canadian Life and Health Insurance Association
COI	Cost of insurance
COO	Chief operating officer
CPI	Consumer price index
CPP	Canada Pension Plan
CRA	Canada Revenue Agency
CSV	Cash surrender value
CV	Cash value
DBPP	Defined benefit pension plan
DCPP	Defined contribution pension plan
DD	Dread disease
DI	Disability benefit
DIA	Daily interest account
DUI	Driving under the influence
EI	Employment Insurance
ETF	Exchange traded funds
ETP	Exempt test policy
FMV	Fair market value
GIA	Guaranteed investment account
GIB	Guaranteed insurability benefit
GIC	Guaranteed investment certificates
LCGE	Lifetime capital gains exemption

LCOI	Level cost of insurance
LIRD	Life insurance replacement declaration
LOC	Line of credit
MIB	Medical Information Bureau
MTAR	Maximum Tax Actuarial Reserve
MVR	Motor vehicle record
NAAR	Net amount at risk
NCPI	Net cost of pure insurance
Non-par	Non-participating
OAS	Old Age Security
Par	Participating
PUA	Paid-up additions
QPP	Québec Pension Plan
QSBC	Qualified small business corporation
RESP	Registered education savings plan
RRIF	Registered retirement income fund
RRSP	Registered retirement savings plan
T-100	Term-100
TFSA	Tax-free savings plan
TI	Terminal illness
TIA	Temporary insurance agreement
UL	Universal life
WC	Workers' Compensation
YRT	Yearly renewable term

CHAPTER 1
INTRODUCTION TO LIFE INSURANCE MODULE

Competency component

- Assess the client's needs and situation.

Competency sub-component

- Articulate the client's needs based on the risks that could affect his financial situation.

This is an introductory Chapter and there are no strong ties to one specific part of the Curriculum.

1
INTRODUCTION TO LIFE INSURANCE MODULE

It has often been said that the only certainties in life are death and taxes. It could be argued that some people will not have to pay income taxes, because they have little or no taxable income or because they manage to structure their financial affairs to avoid them. However, there is no denying that everyone is going to die sometime, and death has implications for their estate and surviving family members.

This Chapter provides an introduction to the risk of death and its financial implications. It also discusses general risk management strategies as they apply to the risk of death.

1.1 Risk of death

One of the reasons people delay buying life insurance is that they do not want to think about their own death. They either refuse to consider it at all, or they say that it is too far away in the future to worry about today. But the fact is that everyone is constantly exposed to the risk of death – every day, every minute, every second. The probability of dying today might be much smaller than it will be 40 years from now, but the risk is still very real, and it needs to be addressed. In insurance terms, the probability of dying at a specific age is referred to as the mortality rate.

There are many factors that influence a person's risk of death, including age, gender, family history health, smoking status, and even their job and income level. Life insurance companies try to classify or categorize people into groups with a similar risk profile. They then compile historical mortality data for each group, and use that as a basis for estimating an individual's risk of death. This is discussed further in Chapter 9 *Application and underwriting*.

There are two ways of looking at the risk of death: life expectancy and probability of death. Life expectancy is the average number of years that a person within a certain group and of a certain age can expect to live from that age forward. It assumes that the past mortality experience of the group to which that person belongs will hold true in the future. For example, according to data compiled by Statistics Canada, if we consider all males in Canada who are aged 65, the median male within that group will live another 19.5 years.[1] This means that on average, 50% of men currently aged 65 will live until age 84.5 or longer, while 50% will die before reaching age 84.5.

1. Statistics Canada. *Life expectancy and other elements of the life table, Canada, all provinces except Prince Edward Island*, (Table 13-10-0114-01, 2018 to 2020). [online]. [Consulted May 2, 2022]. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1310011401

The probability of death is the statistical probability that a person within a certain group and of a certain age will die before reaching his next birthday. It assumes that the past mortality experience of the group to which that person belongs will hold true in the future. The same Statistics Canada study shows that of all of the males in Canada who just turned 65 years of age, 1.116 out of every 100 of those men will die before their 66th birthday.[2] In other words, their probability of death is 1.116%. Chapter 9 discusses how insurance companies use this probability of death when they underwrite a life insurance policy and determine the appropriate premiums.

Life expectancy and probability of death statistics are compiled for each unique and defined group of people, and are often presented in a format called a "life table" (sometimes also known as a "mortality table"). An extract from a Statistics Canada Life table is provided in Table 1.1. With the exception of the first few years of life, an individual's probability of death starts quite low and increases very slowly until around age 40. After age 40, it begins to increase more dramatically year over year due to age-related health problems, such as cardiovascular disease.

TABLE 1.1

Probability of death and life expectancy vs. age[3]

AGE	PROBABILITY OF DEATH (%) WITHIN THE YEAR FOR MALES	PROBABILITY OF DEATH (%) WITHIN THE YEAR FOR FEMALES	LIFE EXPECTANCY (YEARS) FOR MALES	LIFE EXPECTANCY (YEARS) FOR FEMALES
0	0.485%	0.410%	79.8	84.1
1	0.024%	0.023%	79.2	83.5
10	0.008%	0.007%	70.3	74.5
20	0.069%	0.032%	60.5	64.6
30	0.112%	0.038%	51.1	54.9
40	0.154%	0.051%	41.6	45.2
50	0.305%	0.186%	32.3	35.7
60	0.711%	0.441%	23.6	26.5
65	1.116%	0.705%	19.5	22.2
70	1.787%	1.158%	15.7	18.1
75	2.918%	1.955%	12.2	14.2
80	4.858%	3.386%	9.1	10.7
85	8.247%	6.025%	6.5	7.7
90	14.272%	11.007%	4.5	5.3
95	23.547%	19.303%	3.1	3.6
100	34.335%	30.042%	2.2	2.5

2. *Ibid.*
3. *Ibid.*

This Table shows that a female's risk of death is lower than a male's risk of death at the same age. For this reason, gender is one of the factors that influence an individual's life insurance premiums, as discussed in Chapter 9.

The way an agent uses this information depends on the specific needs he is trying to address. If he is developing a retirement savings plan or retirement income plan, the focus would be on the client's life expectancy because it helps determine the appropriate planning horizon. When doing insurance needs analysis, the agent may find it useful to educate a client on his probability of death, to help him understand that the risk is real, and that he needs to address it.

1.2 Potential financial impact of death

Death is a tragedy, whether it is the loss of a spouse, a child, a friend or a key employee. That tragedy is magnified by the financial consequences of that death.

This Section introduces the types of financial impacts that an agent would be thinking about when he explores the risk of death with a client. It does not cover all possible financial impacts, but is simply meant to provide some context before discussing the various types of life insurance. Chapter 10 *Assessing the client's situation* provides a more detailed explanation of the financial impacts that an agent should quantify when completing a life insurance needs analysis for a client.

1.2.1 Loss of income

One of the most devastating financial impacts results from the death of an income earner, particularly if he was supporting a young family that relied on that income.

EXAMPLE

Justin and Tanya are both 30 years old and they have three children (1, 3 and 4 years old). Tanya currently stays at home with the children so Justin is the sole income earner. How would this young family cope financially if Justin died? The loss of Justin's income would be devastating.

1.2.2 Loss of caregiver

Even the death of a non-income earner can have a significant impact on the surviving family's finances, particularly if the deceased took care of the family's children or other dependant family members.

EXAMPLE (CONT.)

Now consider what would happen if Tanya was the one who died. As the sole income-earner, Justin would not be able to afford to stop working to care for the children. Unless another person could step in and assume the role of caregiver to the children free of charge (such as one of Justin's or Tanya's parents), Justin would have to hire someone to assume this role.

1.2.3 Debt repayment

When a person dies, one of the first responsibilities of the executor[4] of the estate is to pay off any outstanding debts, including mortgages, car loans and credit card debt. In some cases, the lender may be willing to extend the loan to the surviving spouse or another beneficiary who inherits the property that is encumbered by the debt, but usually only after ensuring that this person has the income needed to make the loan payments. If the lender decides that the risk of default is too high, it will recall the loan, demanding payment in full.

EXAMPLE (CONT.)

If Justin dies, the bank is unlikely to extend the mortgage to Tanya because she is not working. She would have to sell the family home to pay off the debt.

1.2.4 Income taxes

The income tax liability that arises upon death can seriously erode an estate. When a person dies, he is usually deemed to have sold all of his property for its fair market value (unless a rollover applies), which can trigger a taxable capital gain. If the estate does not have enough money to pay the resulting income tax, the executor may have to sell assets that were intended to be left to the beneficiaries.

EXAMPLE

Arnold bought a cottage in 1981 and he left the cottage to his daughter, Linda, in his will. When he died in 2022, the tax liability on the cottage amounted to $80,000. If the estate does not have enough money to pay this income tax, the executor would have to sell the cottage to pay the tax, or Linda would have to pay the tax personally.

4. In Québec, executor can also be called liquidator.

When a person dies, his registered assets (e.g., registered retirement savings plan (RRSP), registered retirement income fund (RRIF)) will also be deregistered (unless a rollover applies), which means the full amount will be taxed at his marginal tax rate at death, which could easily be in the top tax bracket, which ranges from a low of 44.5% (Nunavut) to 54.0% (Nova Scotia), depending on the province.

1.2.5 Estate creation

When contemplating their future death, clients often reflect that they want to leave something behind, to have "something to show" for their life. For people who are just starting out in their adult life, with little or no net worth, leaving behind an estate can seem impossible. Some common estate objectives are discussed below.

1.2.5.1 Education funds

A person with children might say that he wants to make sure that his children can go to university or college, even if he dies.

EXAMPLE (CONT.)

Justin and Tanya feel it is important to pay for their children's education. Depending on the educational program and its location, they estimate this could cost $20,000 per year, per child, or about $240,000 for a four-year program for all three children.

1.2.5.2 Legacies

A person might also want to make a financial gift to someone special upon death, perhaps in appreciation of that person's past service or support, or to help someone get a start in life.

EXAMPLE (CONT.)

Tanya received a lump sum bequest of $100,000 when her father died, and they used it as the down payment to buy a house. They would like to be able to leave a similar legacy to their children if they should die, to help them buy their first house or start a business.

1.2.5.3 Charitable giving

Many people would like to remember their favourite charity upon their death, and perhaps support them in a way they were not financially able to during their lifetime. Some people also make donations for the tax benefits, which will be discussed in Chapter 7.

EXAMPLE (CONT.)

Justin had a difficult time growing up and he spent a year living on the streets before he entered a youth support program that completely turned his life around. He credits that program with helping him achieve the satisfying life he leads today, and he would very much like to support the program with a significant cash donation when his finances permit, or upon death.

1.2.6 Business impacts

The death of a key employee or shareholder can have a devastating impact on a business, sometimes even resulting in its collapse (see Section *Key person life insurance*).

EXAMPLE

Allen owned a thriving boutique restaurant called Vertical. Some of its success was due to its amazing location, quirky interior decorating and personable staff, but the real draw was Vertical's chef, Luigi. Customers raved over Luigi's signature dishes and his tableside manner; he always visited each table personally to say hello and to make sure each meal was to the customer's satisfaction. When Luigi died suddenly, the restaurant's revenue dropped dramatically. It took Allen almost six months to find a chef of the same calibre, and then Allen had to launch an expensive marketing campaign to lure customers back to the restaurant. The financial strain during this time came very close to bankrupting Allen.

1.3 Risk management strategies

Regardless of the type of risk, there are four general strategies that should be considered to deal with that risk:

- Risk avoidance;
- Risk reduction;
- Risk retention;
- Risk transfer.

The strategies can be used alone or in combination. The agent and his client will need to decide which strategies are most appropriate to deal with the client's risk of death.

1.3.1 Risk avoidance

The first risk management strategy is risk avoidance, which is simply deciding not to expose oneself to the risk in the first place. For example, a person could avoid the risk of having a car accident, by choosing to not drive a car, perhaps relying on public transit instead. Unfortunately, it is impossible to avoid the risk of death; simply by the act of living, everyone is exposed to the risk of death. Therefore, other strategies are needed to address the risk of death.

1.3.2 Risk reduction

If it is not possible to avoid a risk entirely, it may be possible to take action to reduce the probability or severity of that risk. This is called "risk reduction." Consider the person who has to drive a car because it is his only option for getting to work. He can reduce his risk of having a car accident by obeying traffic rules, making sure the car's brakes and tires are in good condition, or taking lessons in defensive driving.

Similarly, a person can reduce his risk of death by maintaining a healthy lifestyle and avoiding hazardous activities. However, this will not completely eliminate the risk of death; it will just reduce the probability of a premature death. Therefore, additional strategies are needed to deal with the remaining risk of death.

1.3.3 Risk retention

The third option or strategy is risk retention, which means that the person accepts the fact that he is exposed to the risk, and will accept the consequences if that risk is realized. Risk retention is most appropriate for risks of low severity, meaning risks with a manageable financial impact. For example, consider a person who buys a new appliance and who has the option of buying an extended warranty. He can pay for the extended warranty, and he will be protected if the appliance breaks during the extended warranty period. He can also refuse the extended warranty, and retain the risk that, if the appliance breaks after the original warranty period expires, he will have to pay for the repairs or a replacement.

The risk of death is usually considered to be a high severity risk because of the significant financial impact it can have. Most clients will not have sufficient financial resources to be able to manage the financial impact of death, so they need another strategy to deal with this risk.

1.3.4 Risk transfer

The final risk management strategy is "risk transfer," which means finding someone else who is willing to assume the consequences if the risk is realized. Insurance is a risk transfer strategy. To deal with the risk of death, a person can trade the possibility of financial catastrophe if death occurs now, for the certainty of paying annual insurance premiums. Insurance is sometimes also referred to as risk sharing, because it shares or spreads the losses of the few amongst the many. In other words, it shares the financial losses of those few people who experience the insured event with all of those who buy insurance to protect themselves against that event.

EXAMPLE

James and Mary are married. They are both concerned about having a car accident and the possibility of dying as a result. James adopts a risk avoidance strategy by choosing to take public transit instead of driving to work. Mary understands the risk of driving; by deciding to keep driving to work, she adopts a risk retention strategy. She also adopts risk reduction strategies by choosing a car with a high safety rating, and wearing her seatbelt and obeying all traffic rules when driving. Mary is aware of the financial impacts that could result from a car accident, so she purchased automobile insurance[5] and life insurance. This is a risk transfer strategy because if she does have a car accident, the insurance company assumes the financial liability.

5. Automobile third-party liability insurance is mandatory across Canada, but the amount of coverage required varies by jurisdiction. The insurance may be public, private or a combination of both, depending on the jurisdiction. In Québec, car insurance is mandatory and the Automobile Insurance Act has a compensation system in place for injury or death.

CHAPTER 2
TERM LIFE INSURANCE

Competency component

- Analyze the available products that meet the client’s needs.

Competency sub-component

- Analyze the types of contracts that meet the client’s needs.

2

TERM LIFE INSURANCE

A client can transfer his risk of death to a life insurance company by purchasing a life insurance policy. There are several types of life insurance, including term life, term-100, whole life and universal life insurance, and the marketplace offers many variations of each type. Life insurance agents must identify the best type of insurance for each client, based on their unique needs.

This Chapter explores term life insurance, which is the simplest form of life insurance available.

2.1 What "term" means

Term life insurance is a contract that specifies that, in exchange for a premium, the life insurance company promises to pay a death benefit if the life insured dies within the fixed term of the contract. The "term" is the period of time during which the coverage is guaranteed to remain in place, as long as the policy's premiums are paid.

2.1.1 Typical terms

The most common terms for life insurance are 1 year, 5 years, 10 years or 20 years, or to a specific age (e.g., to age 60). However, other terms, such as 3 years, 15 years or 30 years, may also be available, depending on the insurance provider.

2.1.2 Age limits

Most insurance companies will not provide term insurance coverage past a specific age, often around age 75 or 80, simply because the risk of having to make a payout is too great. This means that they will stop issuing new policies at about age 65 or age 70, depending on the policy's term. When insurance is provided to older ages, the premiums are very expensive.

2.2 Policyholder vs. life/lives insured

The policyholder is the person who purchases the life insurance contract, or who later acquires ownership of it via gift or assignment. The policyholder is responsible for making all decisions regarding the contract, including naming the beneficiary of the policy, paying the premiums, cancelling the policy, or assigning the policy to another individual.

The life insured is the person on whose life the insurance contract is based. If the life insured dies during the term of the life insurance policy, then the life insurance company must pay the death benefit. Some insurance products may also refer to the life insured as the annuitant.

The policyholder can also be the life insured, but this does not have to be the case.

EXAMPLE

Sandra would like to leave a legacy to her adult son, Tristan, when she dies, so she bought a $300,000 10-year term life insurance policy on her own life, with Tristan named as the beneficiary. Sandra is both the policyholder and the life insured.

Sandra works for ABC Ltd., and she is very important to the success of the business. ABC Ltd. bought a life insurance policy on Sandra's life. ABC Ltd. named itself as the beneficiary, and they plan to use the death benefit to help them recruit and train a replacement if Sandra dies. In this case, Sandra is the life insured, but ABC Ltd. is both the policyholder and the beneficiary.

Sometimes the policyholder is referred to as "the insured," which is not the same thing as "the life insured." A policyholder is referred to as "the insured" because he bought protection from the financial loss that would otherwise result if the life insured dies.

2.2.1 Single life

Most term insurance policies are single life policies, meaning that only one person is insured, and the death benefit will only be paid if that person dies within the term of the policy.

2.2.2 Joint first-to-die

While most life insurance policies are single life policies, there are two types of life insurance policies that are based on the lives of two or more people.

With a joint first-to-die life insurance policy, a single amount of coverage is placed on two or more lives insured, and the death benefit is paid out upon the death of the first person to die.

Joint first-to-die life insurance coverage might be appropriate whenever two or more people share a debt obligation.

EXAMPLE

Sue and Cindy are common-law partners and they recently bought a house together, with an outstanding mortgage of $250,000. While they can comfortably manage the mortgage payments with their combined incomes, if one of them were to die, the survivor would have a hard time making those mortgage payments. To ensure that the survivor would be able to keep the house Sue and Cindy took out a $250,000 10-year term joint first-to-die policy, naming the survivor as the beneficiary. So, if Sue dies, Cindy will receive the death benefit and can pay off the mortgage, and vice versa.

Joint first-to-die life insurance coverage is also often used to fund business buy-sell agreements, as discussed further in Chapter 8 *Business life insurance*.

Joint first-to-die contracts usually terminate upon the death of the first person to die. However, some contracts give the surviving life insured the choice of continuing the same level of coverage on their own life under a new policy, without having to provide proof of insurability.[6] This can be particularly advantageous if the survivor's health has deteriorated to the extent that he would otherwise find it difficult to obtain insurance. Usually, this option must be exercised within a certain time after the first death (e.g., 30 days).

EXAMPLE (CONT.)

Four years after Sue and Cindy bought their joint first-to-die policy, Sue was killed in a car accident, and Cindy received the $250,000 death benefit. Cindy and Sue adopted a baby two years before Sue's death, and Cindy wants to make sure the baby is provided for if she dies. For health reasons, Cindy might find it difficult to buy life insurance with reasonable premiums. Luckily, their joint first-to-die policy gives Cindy the option of continuing coverage of $250,000, as long as she exercises the option within 30 days of Sue's death.

A joint first-to-die life insurance policy on two lives is typically less expensive than two separate life insurance policies of the same coverage amount on each life individually. This is because the insurance company only assumes the risk of paying out one death benefit under the joint policy, while it risks having to pay out two benefits if two separate policies are purchased.

Joint life insurance should not be confused with combined insurance, which is a marketing concept. Some insurance companies allow two individual policies to be purchased under a single insurance contract. The advantage is that only a single administration fee is charged, and a small discount on the premiums may also apply. A combined insurance contract will pay out two separate death benefits if the lives insured die at the same time during the term of the contract. If only one of the lives insured dies, the coverage will continue for the other life insured at single person rates.

2.2.3 Joint last-to-die

With a joint last-to-die life insurance policy, a single amount of coverage is placed on two or more lives insured, and the death benefit is paid out upon the death of the last person to die.

Joint last-to-die life insurance policies are most appropriate when the risk being insured against does not arise until the death of the last person covered by the policy. One such risk is the tax liability that can arise upon the death of the second spouse.

6. "Proof of insurability" refers to providing sufficient evidence of good health to the insurer so they are willing to undertake the risk of providing the desired coverage. Essentially it means undergoing some form of the underwriting process discussed in Chapter 9.

When a person dies, he is deemed to have disposed of all of his capital property for its fair market value just before he died, and this can result in a significant taxable capital gain for his estate. An exception to this rule occurs if the property passes to his spouse or common-law partner. In this case, there is no deemed disposition of the property until the spouse disposes of the property or dies, which is when the large tax bill can arise. Couples therefore often use joint last-to-die life insurance to pay the tax bill on the death of the second spouse, particularly with respect to property such as a cottage or a business that they want to pass on intact to their children.

EXAMPLE

Hamish and Elizabeth, both aged 55, bought a cottage 20 years ago and it has appreciated significantly in value. They would like the cottage to pass to their children when they die, but they are worried about the income tax liability at death, which their accountant has advised them could be more than $100,000. If Hamish dies first, his share will go to Elizabeth and it will not trigger a capital gain because of the spousal rollover rules. However, when Elizabeth dies after him, a joint last-to-die insurance policy would ensure that the estate has enough money to pay this tax bill.

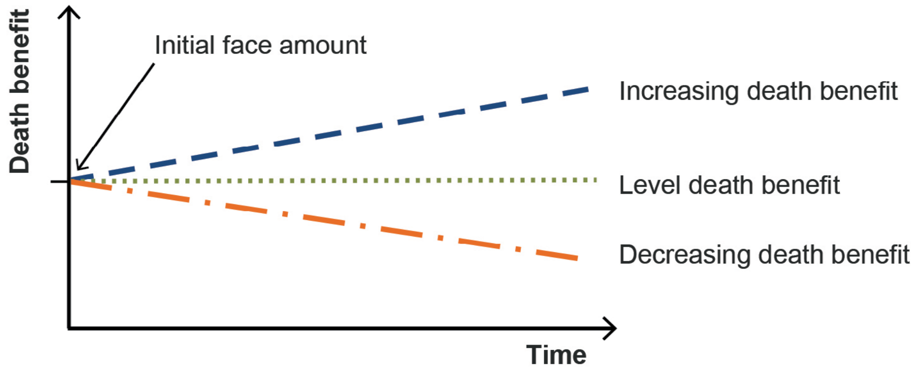
However, because term life insurance is usually not available past age 65 or 70, except at great cost, joint last-to-die life term insurance policies more commonly take the form of permanent life insurance policies.

2.3 Death benefit

The death benefit is the amount that the insurance company will pay if the life insured dies while the policy is in force. Term insurance policies are purchased for an initial amount of coverage, which is called the “face amount.” However, the death benefit of a term insurance policy may increase or decrease over time, depending on the type of policy, as shown in Diagram 2.1.

DIAGRAM 2.1

Death benefit for level, decreasing or increasing term insurance



2.3.1 Level term

The majority of term life insurance policies offer a level death benefit, meaning that the death benefit equals the initial face amount, regardless of when the life insured dies during the term of coverage.

A level death benefit is most appropriate when the insurance need is not expected to change significantly over the term of the contract.

EXAMPLE

Brad borrowed $100,000 from his father, Steven, to start a new business. Brad promised to pay it off in a lump sum in five years, when Steven plans to retire. Knowing that his father needs the money to be able to retire, Brad wants to make sure that he can repay the loan, even if he dies. Brad purchased a 5-year term policy with a level death benefit of $100,000.

Many people who buy term life insurance often ignore the fact that their needs might change over the term of the policy. They buy a policy with a level death benefit because it is simple, what they are most familiar with, and most often promoted. However, this means they may be under-insured or over-insured at some point during the term.

2.3.2 Decreasing term

Decreasing term insurance provides a death benefit that decreases over the course of the term, while the premium remains level. The premium on a decreasing term policy with an initial face amount of $100,000 should be less than the premium on a $100,000 level term policy. This reflects the fact that the amount at risk for a decreasing term policy declines over time.

Decreasing term insurance is most often used by people who have mortgages, because the amount at risk (i.e., the outstanding mortgage) decreases over time. In fact, banks commonly encouraged their mortgage customers to buy “mortgage insurance,” which essentially is decreasing term insurance, sold as group insurance by a company affiliated with the bank.

EXAMPLE

Ranjit and Alisha bought their first home in 2012 with a $200,000 mortgage amortized over 25 years. They bought a joint first-to-die $200,000 25-year decreasing term insurance policy to ensure that if one of them died, the other would be able to pay off the mortgage.

Few insurance companies currently offer decreasing term insurance for individuals. As noted above, it is mainly offered on a group basis.

2.3.3 Increasing term

Increasing term insurance provides a death benefit that increases over the course of the term. The increase in the death benefit is usually applied at predetermined times, such as annually or every five years. The increase in the death benefit can take the form of a fixed dollar amount (e.g., $50,000 every fifth year) or a fixed percentage (e.g., 5% annually). Less commonly, it can also be tied to inflation (e.g., increased annually by the Consumer Price Index (CPI)).

The premiums for an increasing term policy usually increase at the same time as the death benefit increases, and by a proportionate amount. For example, if the death benefit increased by $10,000 on an initial $100,000 policy, the premium would also increase by 10%.

Increases in the death benefit are usually restricted, either by a cap on the maximum death benefit (e.g., 150% of the original face amount), or a cap on the number of increases (e.g., every year for 10 years).

Increasing term insurance has become increasingly difficult to find in Canada, but it is still offered in the United States. In Canada, the same effect may be achieved by adding a rider to the policy. Riders are discussed in Chapter 5 *Riders and supplementary benefits*.

Increasing term insurance is useful in situations where the amount at risk is expected to increase over time, perhaps due to inflation, investment returns or salary increases.

EXAMPLE

Connor is a business executive who is driven to succeed, and he expects his income to continue to increase at about 10% per year. If he dies, he would like to ensure that his wife receives a lump sum that equals ten times his annual salary. Connor could buy increasing term insurance with an indexing factor of 10%, with an initial face amount equal to 10 times his current salary.

One of the benefits of increasing term insurance is that the coverage increases even if the life insured experiences a decline in his health. The death benefit will continue to increase, up to the cap specified by the policy, as long as the policyholder pays the increased premiums, and the premium increases are known in advance.

2.4 Term insurance premiums

A premium on a term life insurance policy is the amount the policyholder pays to the insurance company in exchange for the company's promise to pay the death benefit if the life insured dies during the term covered by the policy.

With the exception of increasing term insurance, term insurance premiums are typically level over the term. The policyholder usually has the option of paying them monthly or annually, by cheque or by pre-authorized direct payment from a bank account.

Provinces and territories charge a premium tax ranging from 2% to 5% on life insurance premiums charged by licensed insurers. This premium tax is incorporated into the premiums charged to the policyholder. For example, if a policyholder pays a premium of $102 in a province that has a 2% premium tax, the insurance company must remit $2 of that premium to the provincial government.

2.4.1 How premiums are set

Term life insurance is pure insurance, meaning that its value relates solely to the benefit that is paid out upon death. The premiums are simply a combination of the mortality costs experienced by the insurance company, and the expenses (including the company's profits) incurred in providing that insurance.

2.4.1.1 Mortality costs

Mortality costs approximate the insurance company's cost of paying out policy death benefits. On a per policy basis, the annual mortality cost is estimated by multiplying the policy's face amount by the life insured's probability of death during the year.

The insured's probability of death depends on many factors, including age, gender, and health status. During the underwriting process, the life insurance company tries to estimate the life insured's probability of death by classifying him in a group of similar people with known mortality experience.

2.4.1.2 Expenses

Premiums also have to cover the insurance company's expenses, including the cost of selling the policy (e.g., marketing, salaries or commissions to agents), underwriting the policy (e.g., processing applications, undertaking medical exams), issuing and administering the policy, investigating claims, paying death benefits and the profits sought by shareholders.

If the insurance company invests the premiums, the resulting investment income may be used to offset the expenses.

2.4.2 Sample premiums

Table 2.1 shows sample annual premiums for 10-, 20- and 30-year term life insurance coverage on a male non-smoker in excellent health with a $100,000 death benefit. The figures given include the annual policy fee, which covers administrative expenses.

TABLE 2.1

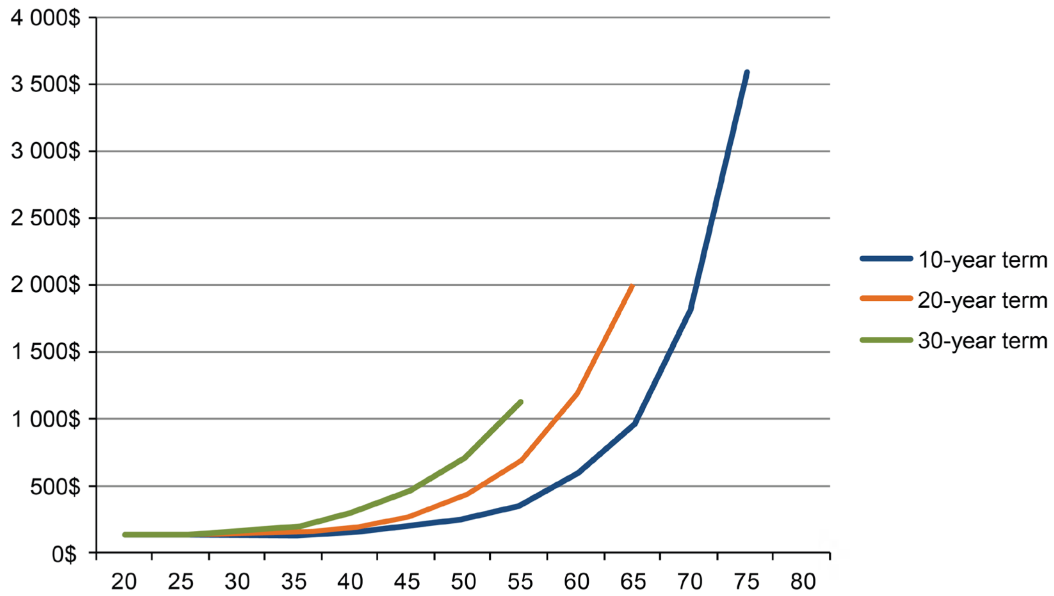
Sample annual premiums, $100,000 term life insurance, male non-smoker

AGE	10-YEAR TERM	20-YEAR TERM	30-YEAR TERM
20	$134	$144	$152
25	$134	$144	$156
30	$134	$147	$174
35	$136	$158	$210
40	$148	$197	$307
45	$190	$283	$467
50	$252	$439	$723
55	$370	$700	$1130
60	$602	$1,203	Not available
65	$958	$2,022	Not available
70	$1,793	Not available	Not available
75	$3,580	Not available	Not available
80	Not available	Not available	Not available

This data is also provided graphically in Diagram 2.2 below.

DIAGRAM 2.2

Annual term insurance premiums based on term and age of issue



Notice how the premiums do not change very much between ages 20 to 35 for the 10-year term, but they start increasing significantly at about age 40, with very dramatic increases from age 55 onwards. This suggests that clients who opt for term life insurance should purchase it sooner rather than later.

Also, the annual premium does not vary significantly between the 10-year and 20-year terms until about age 35, making the longer term more attractive for younger clients.

2.5 Renewable vs. non-renewable term insurance

Term life insurance can be either renewable or non-renewable. With a renewable term insurance policy, the policyholder is guaranteed the right to renew the policy at the end of the term for another term, without having to provide proof of insurability at the time of renewal. The right to renew is usually limited to a specific age (e.g., to age 70).

With a non-renewable term insurance policy, the policy expires at the end of the term, and the policyholder has to apply for new life insurance if he requires continued coverage. If the health of the life insured has deteriorated, the policyholder risks higher premiums or even being denied coverage.

EXAMPLE

Henry bought a $200,000 five-year renewable term life insurance policy on his own life when he was 30 years old. Because of his great health at the time, he got the best rates possible. When he turned 35, he renewed the policy and his premiums increased to reflect his age, as specified by his original contract. When he was 38, Henry was diagnosed with cancer. When Henry turned 40, he renewed the policy for another five-year term, and again the premiums increased, but only to recognize his increased age at the time of renewal. His cancer diagnosis did not impact his premiums, and he could not be denied continued coverage.

Renewable policies are more expensive than non-renewable policies. With a renewable policy, the insurance company is taking the added risk that they may have to continue coverage on the life insured after the end of the term, even if his health has declined.

2.5.1 Renewal provisions

The premiums upon renewal may vary, depending upon the policy provisions.

2.5.1.1 Renewable with guaranteed rates

While the policyholder of a renewable policy is guaranteed the right to renew the policy at the end of the term, the new premiums will reflect the age of the life insured at renewal. Most policies provide a guaranteed schedule of renewal rates when the policy is first issued.

EXAMPLE

Prena purchased a 5-year renewable term life insurance policy when she was 25, with premiums of $155 per year. Her policy offers the following guaranteed rates upon renewal:

Age of life insured at renewal	Annual premium for the new term ($)
30	$170
35	$190
40	$230
45	$280
50	$350
55	$450
60	$610
65	Ineligible for renewal

So, Prena can rest assured that she can maintain her insurance coverage until age 65, as long as she is willing to pay the increased premiums upon renewal.

2.5.1.2 Re-entry term with adjustable rates

Some insurance companies offer re-entry insurance, which essentially is a renewable policy that can be subject to two different renewal rate schedules: a guaranteed renewal rate and a lower rate that is adjusted for the good health of the life insured.

The life insurance company will reassess the health of the life insured at the time of renewal. If he is in great health, he will qualify for lower premiums on renewal. If his health has deteriorated, he still has the right to renew the policy, but the guaranteed renewal rates are higher than those for a renewable policy that does not have the re-entry provision.

The advantage of a renewable policy with a re-entry provision is that the initial premium tends to be lower, so the policyholder can save money in the early years of the policy. This is because the policyholder is retaining a portion of the risk; the insurance company is assuming less risk by requiring those with decreasing health to accept the higher guaranteed renewal premiums if they want to maintain their coverage.

Re-entry policies may be a good deal if coverage is only required for a term or two, or if the life insured has reason to expect continued good health, perhaps due to his family's excellent health history. If the policyholder thinks he may want to renew the policy beyond that timeframe, he would assume less risk by purchasing a regular renewable term insurance policy.

2.6 Convertible term insurance

Convertible term insurance gives the policyholder the option of converting the term policy to some form of permanent life insurance (i.e., whole life, term-100 or universal life insurance) at some future date. The conversion does not require proof of continued insurability, so the policyholder can acquire lifetime protection even if the life insured is no longer insurable.

EXAMPLE

Anya has learned that a rare medical condition runs in her family. The condition usually doesn't develop until after the person reaches 30 years of age. Anya is not afflicted, but her teenage daughter, Jeanette, has a 25% chance of developing the condition. Anya is worried that this may prevent Jeanette from being able to buy life insurance when she is older. She bought a $200,000 renewable and convertible term policy on Jeanette's life, and she plans to assign (i.e., transfer ownership) of that policy to Jeanette when she is an adult. If Jeanette does develop the condition, she will still be able to convert the policy to a $200,000 whole life policy, giving her access to lifetime insurance protection.

Convertible term insurance is more expensive than term insurance that does not include a conversion option, because it exposes the insurance company to additional risk beyond the original term. In fact, the people who are most likely to convert the policy are those who have experienced a decline in their health, which would make a new life insurance policy too expensive or even impossible to get.

The insurance company may also restrict the age at which conversion is permitted.

2.6.1 Incontestability and suicide provisions

The new policy issued as a result of the conversion is usually treated as an extension of the original policy for contractual purposes. This means that the clock is not reset for the purposes of applying important legal provisions, such as the incontestability limitation and suicide limitation.

Under the mandatory incontestability limitation, an insurance company only has two years after it issues the policy to void the policy if it discovers an error in a material fact in the application. A material fact is any piece of information that would have influenced the insurance company's decision about providing the insurance coverage (e.g., smoking status, known health issues, age), had it known about it during the underwriting process. This two-year period is called the "contestability period." Once the contestability period has passed, the policy becomes incontestable and the insurance company can only void the policy if it can prove that the policyholder committed fraud when applying for the policy.

EXAMPLE

When Marie filled out her insurance application, she answered "no" to the question about having a heart condition. However, a few years ago, Marie went to the emergency room complaining of chest pains. The diagnosis was inconclusive, and Marie never followed up with the recommended heart specialist, so she didn't think she needed to mention it. If the insurance company discovers this fact within the first two years of the policy, it will have the option of voiding the policy. However, once the contestability period has passed, they cannot cancel the policy.

Insurance contracts also usually include a suicide exclusion clause, which states that the insurance company will not pay the death benefit if the life insured dies by suicide within a specified period of time (typically two years) after the contract was issued. If the life insured dies by suicide after the suicide exclusion period ends, the insurance company will pay the death benefit.

By exercising the conversion option of a convertible term life insurance policy, the policyholder acquires a permanent policy without being subject to a new two-year contestability period or suicide exclusion period.

2.6.2 Attained-age vs. original-age conversions

Attained age is the age on which the life insurance premiums are based. Depending on the administrative policy of the insurance company, attained age may be considered to be the age of the life insured as of his last birthday, his next birthday, or his nearest birthday.

EXAMPLE

Manuel bought a term life insurance policy on August 12, 2022. His date of birth is November 1, 1988. His premiums will be based on:

- Age 33, if attained age is based on his last birthday;
- Age 34, if attained age is based on his nearest birthday;
- Age 34, if attained age is based on his next birthday.

Depending on the convertible policy, the premiums for permanent life insurance upon conversion may be based on the attained age of the life insured at the time of the conversion to the permanent policy. This is called an "attained-age conversion."

Some policies base the permanent life insurance premiums on the original age of the life insured at the time the insurance contract was first issued. This is called an "original-age conversion," or a "retroactive conversion."

EXAMPLE

Patrick was born on June 1, 1968. His insurance company uses the nearest birthday when determining attained age. He bought a $500,000 5-year renewable and convertible term insurance policy on September 15, 2013, when his attained age was 45. The policy permits conversions at any time up to age 65.

Patrick renewed the policy in 2018, and he decided to convert the policy on May 10, 2022. If this is an original-age conversion, his permanent life insurance premiums will be based on age 45. If this is an attained-age conversion, his permanent life insurance premiums will be based on age 54, because his attained age on May 10, 2022, is based on his nearest birthday, which would be June 1, 2022.

Original-age conversions would result in lower premiums for the permanent life insurance, which would appear to be advantageous. However, the initial premiums for an original-age convertible term policy will be higher than the premiums for an attained-age convertible term policy. This is because the insurance company is taking on the risk of providing lifetime coverage at a lower rate if the original-age conversion is exercised.

Furthermore, in the case of an original-age conversion, the policyholder would have to pay the insurer a lump sum equal to catch up. For some policies, the lump sum is equal to the cash value that would have accumulated if the policyholder had chosen the permanent insurance policy from the beginning. Other policies require the policyholder to pay a lump sum that is equal to the difference in the premiums he actually paid and the premiums he would have paid had he started with the permanent insurance from the beginning. Regardless of the method used, the lump sum can be substantial, and for this reason most insurers either do not offer original-age convertible policies, or they require the conversion to take place within the first five or ten years after the policyholder bought the convertible policy.

2.7 Advantages and disadvantages of term life insurance

The advantages and disadvantages of term life insurance are summarized in Table 2.2.

TABLE 2.2

Advantages and disadvantages of term life insurance

ADVANTAGES	DISADVANTAGES
▪ Low initial cost. In the early years of the policy, the premiums for term insurance will be lower than those for permanent insurance, making it affordable for those who cannot afford permanent insurance; ▪ Premiums are guaranteed over the term; ▪ Renewable and convertible provisions can be used to extend coverage; ▪ Term of coverage can be customized to meet a specific need.	▪ Premiums and coverage are not guaranteed beyond the term or renewal period; ▪ Premiums increase as the life insured ages, and can become prohibitive; ▪ Coverage is usually not available past a certain age; ▪ Policy is worthless at the end of the term.

2.8 Using term insurance

As a general rule, term insurance should only be considered to be temporary insurance, to be used for risks that will end before the life insured reaches 60 or 70 years of age. If the risk will extend until life expectancy, some form of permanent insurance should be considered.

This Section provides some examples of when term insurance might be appropriate.

2.8.1 Short-term risks

Term insurance is particularly suited for short-term risks of known duration. If there is a possibility that the risk could extend beyond the anticipated duration, the policyholder should choose a renewable policy.

EXAMPLE

As the owner of a new business, Felix was able to get a $100,000 loan from a private investor. The loan is interest only for 5 years, when it is payable in full. As a condition of the loan, Felix is required to obtain life insurance with a minimum death benefit of $100,000, with the lender named as the beneficiary. A $100,000 5-year term insurance policy would be the most cost-effective option for Felix and it is ideal for covering a 5-year risk.

2.8.2 Decreasing risks

Decreasing term insurance may be well suited for covering risks that diminish over time, such as mortgages or other loans that are repaid over a known amortization period. Examples of other risks that diminish over time are given below.

EXAMPLE 1

Mohammed left his position as vice-president of ABC Ltd. at age 55, and he will receive a full pension starting at age 60. The pension will continue undiminished, payable to his spouse Helena, if he dies while receiving the pension. In the meantime, Mohammed is self-employed as a consultant, earning $100,000 per year and he plans to retire at age 60, when his pension from ABC Ltd. starts. Because he no longer works for ABC Ltd., he is no longer covered by their group life insurance plan. Mohammed wants to protect Helena from the loss of his income if he should die prior to retirement. Mohammed can purchase a 5-year, $500,000 decreasing term policy to address this risk.

EXAMPLE 2

When Rob and Gabriella divorced, the court ordered that Rob must provide Gabriella with child support of $50,000 per year until their twin boys finish university or reach age 23, whichever comes first. The boys are currently 13 years old. Rob can purchase a 10-year, $500,000 decreasing term policy to meet this obligation in the event of his death.

2.8.3 Limited cash flow

Perhaps one of the most common reasons people opt for term insurance over a permanent policy, is that they simply do not have the cash flow to put towards a permanent policy.

EXAMPLE

Angela and Doug are in their late twenties. They have been married for three years and just bought their first house. While they both have promising careers, they have just had their first child and Angela is home on maternity leave. With Angela's reduced income while on leave, together with a new mortgage, a car loan, and student loans, cash flow is very tight, and yet they realize that their young family needs life insurance protection. At this time, term insurance provides them with the most viable option. Because their finances are expected to improve over time, they should consider a convertible term policy, because it will give them the more affordable term insurance coverage now, while giving them the option of converting that to permanent coverage when their finances permit.

Another reason some people opt for term insurance over permanent insurance is that they would rather use the difference in premiums for investment purposes, because otherwise they would not have enough free cash flow to contribute to their registered retirement savings plan (RRSP), tax-free saving account (TFSA), registered education savings plan (RESP), etc. This approach of "buy term and invest the difference" can certainly build wealth over time, provided that the policyholder is disciplined enough to actually make those investments, and that those investments actually perform well over time.

CHAPTER 3

WHOLE LIFE AND TERM-100 INSURANCE

Competency component

- Analyze the available products that meet the client's needs.

Competency sub-component

- Analyze the types of contracts that meet the client's needs.

3
WHOLE LIFE AND TERM-100 INSURANCE

This Chapter introduces the concept of permanent life insurance, and explores two types of permanent life insurance, whole life and term-100 (T-100).

3.1 Concept of permanent insurance

Permanent life insurance provides coverage over the entire lifetime of the life insured. It does not expire (as long as the required premiums are paid), and it does not need to be renewed.

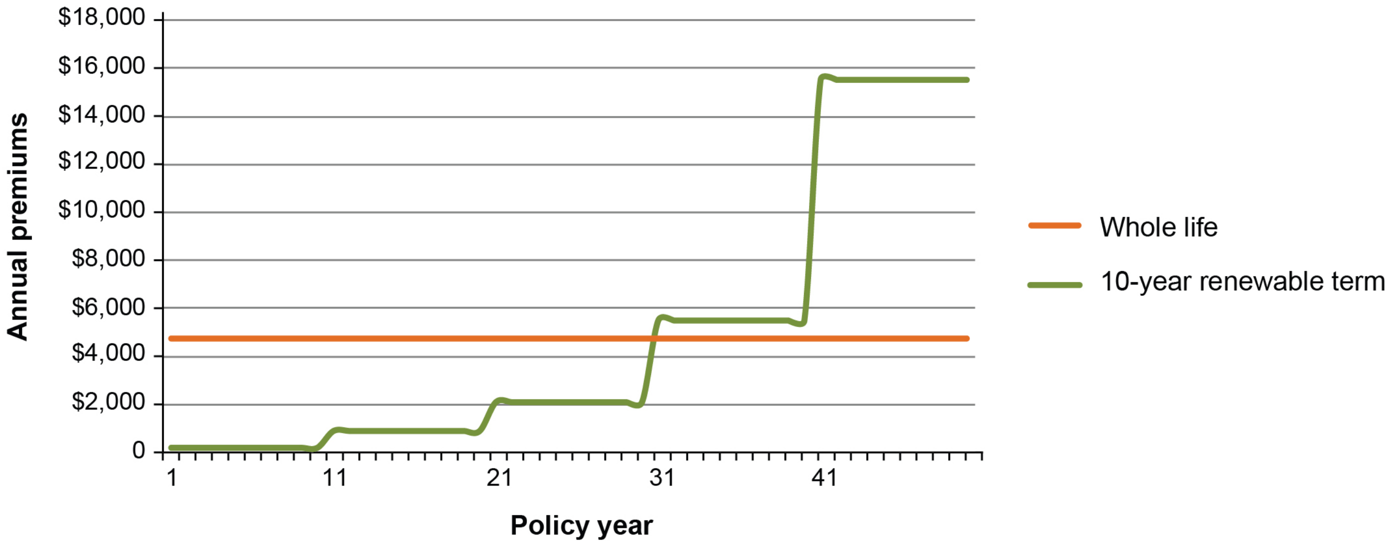
3.1.1 How permanent insurance differs from term insurance

One of the drawbacks of term insurance is that coverage ends at the end of the term, unless the policy can be renewed. Most insurance companies will not provide term insurance coverage past a specific age, often around age 75 or 80. This means that they will stop issuing new policies at about age 65 or age 70, depending on the policy's term. So, term insurance cannot provide adequate protection against the risk of death for people who might live beyond this age. Permanent life insurance can provide the extended protection needed for risks that do not have an expiry date.

The premiums for term insurance coverage typically increase with the age of the life insured, as shown in Diagram 3.1 below.

DIAGRAM 3.1

Comparing 10-year renewable term and whole life premiums for coverage of $250,000[7]



At advanced ages, term insurance can become prohibitively expensive. Premiums for permanent insurance typically remain level over the lifetime of the life insured. Premiums in the early years of a permanent insurance policy tend to be higher than premiums for a comparable amount of term life insurance.

The excess amount paid for a permanent policy is used to build up a reserve that helps fund the higher cost of insurance later in life.

3.1.2 Types of permanent insurance

There are three main types or categories of permanent life insurance. They are:

- Whole life;
- Term-100 (T-100);
- Universal life (UL).

They are introduced briefly below. Whole life and term-100 (T-100) are discussed in detail in this Chapter, while universal life is covered in the following Chapter.

7. Based on a 35-year-old male non-smoker, for either 10-year renewable term to age 85, or participating whole life insurance.

3.1.2.1 Whole life

Whole life insurance provides coverage for the entire lifetime of the life insured, with a premium that typically remains level over the duration of the contract. A whole life policy builds up a cash surrender value (CSV) over time, and if the policyholder surrenders the policy prior to the death of the life insured, he may be entitled to receive payment of that CSV, less any surrender charges, if applicable.

3.1.2.2 Term-100 (T-100)

Term-100 (T-100) life insurance also provides coverage for the entire lifetime of the life insured, but the policy matures at age 100, such that premiums are no longer payable. T-100 policies typically do not have a CSV. “Term-to-100” is also a name widely used in the industry for this product.

3.1.2.3 Universal life (UL)

Universal life (UL) insurance provides coverage for the entire lifetime of the life insured, but it also includes a savings component that is created through the deposit of excess premiums. Within certain limits, the policyholder can use a UL policy to accumulate savings that are completely sheltered from tax if they form part of the death benefit, or tax-deferred if they are withdrawn prior to death. UL insurance policies are noted for the flexibility they provide the policyholder.

3.2 Overview of whole life insurance

Whole life insurance is a form of permanent life insurance that typically guarantees the premiums, the death benefit, and minimum cash surrender values (CSV) for the policy. It is sometimes referred to as “straight life” or “ordinary” life insurance.

3.2.1 Coverage term

Whole life insurance provides coverage over the entire or whole life of the life insured. Unlike term life insurance, a whole life policy does not expire, does not require renewal, and cannot be cancelled by the life insurance company, other than for non-payment of premiums.

3.2.2 Policy reserve

Premiums for a whole life policy typically remain level over time. In the early years, these premiums exceed the amount needed to cover the actual risk of death. This “overpayment” creates a policy reserve, which the insurance company invests to achieve even more growth. In the later years of the policy, the premiums paid fall short of the amount needed to cover the mortality costs and expenses of the policy. The policy reserve is used to offset or subsidize this deficit.

3.2.3 How premiums are set

Premiums for whole life insurance policies are based on long-term assumptions about mortality costs, expenses and investment returns. The insurance company must project these factors over the duration of the contract, which could mean 50 or 60 years, or even more into the future. Because of this long time horizon, the insurance company uses very conservative assumptions.

3.2.3.1 Mortality costs

Mortality costs approximate the insurance company's cost of paying out policy death benefits. In the case of a term life insurance policy, the annual mortality cost of the policy is estimated by multiplying the policy's face amount by the life insured's probability of death during that year. With term insurance, there is a chance that the insurance company will not have to pay out the death benefit, because the policy term could expire before the life insured dies.

In the case of a whole life insurance policy, the annual mortality cost is still estimated by multiplying the policy's face amount by the life insured's probability of death during the year. However, with a whole life policy, the insurance company knows that it will eventually have to pay out the death benefit (unless the policyholder decides to surrender the policy prior to death). When calculating the premiums for a whole life policy, the insurance company spreads the cumulative annual mortality costs over the anticipated duration of the life insurance contract.

3.2.3.2 Expenses

As with a term insurance policy, the premiums for a whole life policy have to cover the insurance company's expenses, including:

- Cost of selling the policy (e.g., marketing, salaries or commissions to agents);
- Underwriting the policy (e.g., processing applications, paying for medical exams);
- Issuing and administering the policy;
- Paying income taxes;
- Investigating claims;
- Paying death benefits and the profits sought by shareholders.

With a whole life policy, the insurance company must make assumptions about these expenses well into the future.

3.2.3.3 Investment returns

The insurance company invests the policy reserve to achieve additional growth. When determining the appropriate premiums for a whole life insurance contract, the life insurance company must make assumptions about the returns it will make on those investments over the duration of the life insurance contract. Stock market history has repeatedly demonstrated that actual investment returns can vary greatly from projections.

3.2.3.4 Impact of modal factor

Life insurance premiums are normally quoted on an annual basis, and premiums are payable in advance. For example, if a new policy is issued on March 1st, the annual premium paid on March 1st would provide coverage over the following 12 months.

Remember that one of the pricing factors that affect insurance premiums is the rate of return the insurance company expects to get on invested premiums. When premiums are paid annually in advance, the insurance company gets the benefit of investing those funds for up to a year.

However, the policyholder can usually choose to pay those premiums semi-annually, quarterly or monthly. The insurance company calculates the periodic premium payment by applying a modal factor that reflects the insurance company's loss of investment income, compared to the income it could have earned on an annual premium.

Sample modal factors for terms and whole life policies are shown in Table 3.1.

TABLE 3.1

Sample modal factors

PAYMENT FREQUENCY	MODAL FACTOR[8]
Semi-annually	0.51 to 0.53
Quarterly	0.26 to 0.30
Monthly	0.087 to 0.09

When the policyholder opts for monthly, quarterly or semi-annual payments on a term or whole life policy, the total amount paid over the year (called the "annualized premium") will always be higher than the quoted annual premium.

8. Anthony Steuer. *Questions and* Answers *on Life Insurance: The Life Insurance Toolbook*. [online]. Revised 2011. [Cited May 2, 2022]. Extract from: https://www.google.ca/books/edition/Questions_and_Answers_on_Life_Insurance/MkZ9z9aSQwcC?hl=en&gbpv=1&dq=%22Anthony+Steuer%22+modal+factor&pg=PA64&printsec=frontcover

EXAMPLE

Victor bought a whole life policy with an annual premium of $956, but he wants to pay the premiums monthly.

If the modal factor is 0.088, his monthly premiums will be $84.13, calculated as ($956 × 0.088).

Over the course of one year, he will pay a total of $1009.56 in premiums, calculated as ($84.13 × 12).

This annualized premium is 6% higher than the quoted annual premium.

3.2.4 Premium options

Depending on the whole life insurance contract, the policyholder may have several options for paying the premiums such as:

- Ongoing premiums;
- Single premium;
- Limited payment.

3.2.4.1 Ongoing premiums

The traditional option involves paying a fixed premium for the duration of the contract (i.e., until the life insured dies or the policyholder surrenders the policy). This is sometimes referred to as a "lifetime-pay policy".

EXAMPLE

Helena is 40 years old, a non-smoker and in excellent health. She just obtained a $500,000 whole life policy on her own life. Her premiums will be $11,065 annually and they are guaranteed to never increase.

3.2.4.2 Single premium

At the other extreme, it may be possible for the policyholder to pay a single lump-sum premium for life insurance coverage that will last for the entire lifetime of the life insured. An insurance policy is said to be "paid-up" if no more premiums are needed to keep the policy in force for the life of the life insured, so by definition a single premium policy is also a paid-up policy.

3.2.4.3 Limited payment

Limited payment whole life insurance is somewhere between these two extremes, with premiums payable for a specific period of time (e.g., for 10 or 20 years) or to a specific age (e.g., to age 65 or age 100), after which the policy is deemed to be a paid-up policy. Limited payment policies are discussed in more detail later in this Chapter.

3.2.5 Death benefit options

Depending on the insurance company, the policyholder may also have some choice as to how the death benefit is determined. The policyholder has a choice between guaranteed whole life and adjustable whole life.

3.2.5.1 Guaranteed whole life

A guaranteed whole life insurance policy offers a death benefit and premiums that are guaranteed not to change over time, regardless of the insurance company's experience with mortality costs, expenses and investment returns. By offering these guarantees, the insurance company is taking on all of the risk stemming from its assumptions about these pricing factors. This risk can be significant over the long-time horizon of a permanent insurance policy.

3.2.5.2 Adjustable whole life

In contrast, an adjustable whole life insurance policy offers a death benefit and premiums that the insurance company may adjust periodically to reflect its actual experience. Usually the insurance company will guarantee the death benefit and premiums for a certain period of time initially, such as five years. At the end of that period, the insurance company will compare its actual experience to its projections, and also update its assumptions about mortality rates, investment returns and expenses. As a result of this review, it may increase, decrease or maintain the premiums and the death benefit.

This exposes the policyholder to more risk than a guaranteed whole life policy. As a result, the premiums on an adjustable whole life policy will be lower than the premiums on a comparable guaranteed whole life policy.

EXAMPLE 1

Ranjit purchased an adjustable whole life policy 10 years ago, with an annual premium of $6,500 guaranteed for 10 years. As a result of its 10-year review, the insurance company determined that men who had purchased the same policy as Ranjit are actually living longer than expected, so the company has had to pay out fewer death benefits than expected. The insurance company reduced Ranjit's premiums to $6,415 annually, guaranteed for the next 10 years.

EXAMPLE 2

Helmuth purchased an adjustable whole life policy five years ago, with an annual premium of $11,600 guaranteed for five years. As a result of its five-year review, his insurance company noted that market interest rates had dropped, and that as a result they have earned less income on their policy reserves than expected. The insurance company increased Helmuth's premiums to $12,100, guaranteed for the next five years.

While adjustable whole life policies are no longer common in Canada, they were along the evolutionary path that ultimately led to the development of universal life (UL) insurance.

3.3 Non-participating vs. participating whole life policies

Whole life insurance policies are classified as either non-participating or participating, depending on how the insurance company handles any surpluses that result from the policies in that category.

3.3.1 How shortfalls or surpluses occur

Insurance companies base whole life insurance premiums on assumptions for mortality costs, expenses and investment returns. They typically are very conservative in their assumptions to reduce their risk exposure, and this can result in surplus revenues. For example, surpluses would occur if:

- Fewer people died than expected (i.e., actual mortality rates were lower than projected);
- Investment returns were higher than expected;
- Administrative expenses were lower than expected.

The insurance company retains some of this surplus to boost policy reserves, in case they experience a shortfall in revenue in the future. In fact, regulators specify the level of policy reserves that an insurance company must maintain to fund future liabilities.

3.3.2 Non-participating policies

When non-participating (non-par) whole life insurance policies generate excess revenues, the insurance company will use some of this excess to keep their policy reserves at the levels required by the provincial insurance regulators. To the extent that the excess revenues are not needed for policy reserves, the insurance company keeps the surplus as profit. This profit will be added to the insurance company's retained earnings, thereby increasing the company's shareholders' equity, and/or paid as a taxable corporate dividend to the shareholders of the insurance company.

If the insurance company is not conservative enough in its assumptions for its non-participating policies and it realizes a revenue shortfall, the company alone bears the burden of that shortfall; the policy and the policyholder are not affected.

3.3.3 Participating policies

When participating (par) whole life insurance policies generate excess revenues, the insurance company will still use some of this excess to keep their policy reserves at the levels required by the provincial insurance regulators. However, to the extent that the excess revenues are not needed for policy reserves, the insurance company may distribute some or the entire surplus as policy dividends to the participating policyholders.

While they are called "dividends," policy dividends should not be confused with the regular dividends that a corporation might pay to its shareholders because they are taxed differently.

If the insurance company is not conservative enough in its assumptions for its participating policies and it realizes a revenue shortfall, the company still bears the burden of that shortfall alone. Participating policyholders do not assume any risk for shortfalls; they will not be asked to pay additional premiums and their death benefits will not be reduced.

In summary, participating policyholders have the potential to share in revenue surpluses while non-participating policyholders do not. For this reason, the premiums for participating policies are typically higher than the premiums for comparable non-participating policies.

3.3.3.1 Identifying the difference

Most participating whole life insurance products include the word "participating" in the product name. Also, participating policy contracts will clearly specify how and when policy dividends will be paid, and will include a caveat that policy dividends are not guaranteed and are only paid at the discretion of the insurance company's Board of Directors.

3.4 Dividend payment options for participating policies

Depending on the insurance company and the specific insurance product, the policyholder may have the choice of several dividend payment options. The policyholder usually makes this choice when he first purchases the insurance, but in most cases, he can switch to another option at a later date. The most common dividend options are listed and described below:

- Cash;
- Premium reduction;
- Accumulation;
- Paid-up additions (PUA);
- Term insurance;
- Impact on death benefits and cash values.

3.4.1 Cash

Under the cash option, the insurance company will pay policy dividends to the policyholder in cash, by either cheque or direct deposit. Cash dividends are normally paid annually. The policyholder can then spend or invest this money in any manner he chooses.

3.4.2 Premium reduction

If the policyholder chooses the premium reduction option, the insurance company will apply the policy dividend to reduce the premiums payable for the coming year. The policyholder will receive a premium notice for the balance of the premiums due.

In the early years of a policy, the policy dividend is usually less than the premium. However, if the policy has been in force for quite some time, the policy dividend may entirely offset the annual premium. If the policy dividend exceeds the premium, the excess can be paid out or allocated according to one of the other dividend options chosen by the policyholder.

The premium reduction option is sometimes referred to as a premium offset option. Premium offset policies used to be a popular marketing concept, as discussed later in this Chapter.

3.4.3 Accumulation

If the policyholder chooses the accumulation option, the insurance company will deposit the policy dividends into a separate accumulation account (also known as a “side account”), which is invested to provide additional growth.

While the policy dividends may or may not be taxable, income earned as a result of the investment of these dividends will be taxable to the policyholder.

The policyholder can withdraw the policy dividends and accumulated investment income at any time.

3.4.3.1 Investment options

Funds in the accumulation account normally earn interest income. Some insurance companies also provide the option of investing the policy dividends in their segregated funds. The number of segregated fund units that can be purchased will depend on the amount of the policy dividend and the fund’s unit value at the time of purchase.

3.4.3.2 Upon death

While the policyholder can withdraw funds from the accumulation account at any time, he is not required to do so. Any funds left in the accumulation account on the death of the life insured are typically paid to the beneficiary of the policy.

3.4.4 Paid-up additions (PUA)

Under the paid-up additions (PUA) option, the annual policy dividend is used as a single premium to buy additional whole life coverage that is paid-up. This additional insurance takes the same form as the base policy, and will have its own death benefit and cash surrender value (CSV). The policyholder can usually surrender a PUA separately from the main policy, and receive its CSV without affecting the main policy.

New medical evidence of insurability is not required to take advantage of the PUA option, because the insurance company takes the potential increase in coverage via PUAs into account when underwriting the base policy. PUAs provide a great way to increase the amount of coverage on the life insured, even if his health has deteriorated to the point where he would not normally qualify for new coverage. For this reason, PUAs are the most popular dividend payment option, with over 90% of whole life policies sold using the PUA option.

The amount of the PUA depends on the size of the dividend. While the PUA does not require any evidence of insurability, the amount of coverage acquired will depend on the size of the dividend and the attained age of the life insured at the time of purchase.

3.4.5 Term insurance

Under the term insurance option, the annual policy dividend is used as a single premium to buy one-year term insurance. As with the PUA option, medical evidence of insurability is not required. The amount of term insurance acquired depends on the size of the dividend and the attained age of the life insured.

3.4.6 Impact on death benefits and cash values

Depending on which payment option the policyholder chooses, participating policy dividends may affect the death benefit and the CSV of the policy (including any additions). For example:

- The paid-up additions (PUA) option may increase both the CSV and the death benefit;
- The accumulation option may increase the death benefit (assuming the policyholder does not withdraw all of the funds in the accumulation account);
- The term insurance option may temporarily increase the death benefit (for the duration of the one-year term only).

3.4.6.1 Dividend illustrations

To help policyholders understand how their participating policy works, agents often provide a dividend illustration, which is a graph or chart that shows what might happen to the policy's CSV and death benefit over time.

When determining dividends, an insurance company will first group policies together based on certain factors, such as the type of policy and when it was issued. The insurance company will then determine a dividend scale for that block of policies, which specifies how the insurance company's surplus will be distributed. The dividend scale is based on a series of complex calculations that factor in the insurance company's experience with mortality, expenses and investment returns for that particular block of policies.

A dividend illustration assumes that the insurance company's dividend scale will remain the same for the duration of the contract. Because these factors cannot be guaranteed, the dividend scale can and often does change over time. In fact, many dividend illustrations now provide projections based on two or more dividend scale scenarios. Agents should ensure that policyholders understand that the results shown in the dividend illustration are not actual projections, and that they do not represent guaranteed results.

3.5 Non-forfeiture benefits

When a policyholder cancels a term life insurance policy or when the term expires, the policyholder is left with nothing of value. Whole life insurance policies typically offer non-forfeiture benefits, which are benefits that the policyholder does not forfeit, even if he stops paying the premiums.

Non-forfeiture benefits are made possible because of the buildup of the CSV in the policy. As a result, the non-forfeiture benefits usually increase in value the longer the policy is in force. During the first few years of the policy, non-forfeiture benefits will be negligible because the policy has not yet had a chance to build up a CSV. As the CSV is depleted (e.g., via withdrawals or automatic premium loans (APL)), the non-forfeiture benefits will also be reduced.

Depending on the insurance company and the contract, the policyholder may be able to take advantage of one or more of the non-forfeiture benefits described below.

3.5.1 Cash surrender value (CSV)

If a policyholder cancels his life insurance coverage, he is said to have surrendered the policy. The cash surrender value (CSV) of a life insurance policy is the amount that the insurance company will pay to the policyholder if the policyholder surrenders the contract. A portion of the CSV will be taxable when received by the policyholder, as discussed in a later Chapter.

In the early years of a whole life insurance policy, the premiums exceed the insurance company's actual costs for the policy, and some or the entire surplus is used to help create a policy reserve. The CSV represents the fair or equitable portion of the policy reserve and any paid-up additions (PUA) that the insurance company will return to the policyholder if he surrenders the policy.

A whole life insurance policy will typically specify what the guaranteed CSV will be at the end of each policy year. If it is a participating policy with a PUA option, the illustration may also show an additional non-guaranteed CSV amount that could potentially result from the policy's dividends.

3.5.1.1 Surrender charges

It costs an insurance company a significant amount of money to issue an insurance policy, including underwriting and administrative costs and agent commissions. As a result, they usually levy surrender charges against a policy's cash value to discourage a policyholder from surrendering or cashing in his policy before they can recoup their expenses. The surrender charges usually decrease over time and are eventually eliminated entirely.

For whole life insurance policies, the surrender charges are usually not specifically spelled out in the insurance contract. Instead, the illustration of the policy's guaranteed CSVs will show $0 for the first three to ten years, depending on the policy, before beginning to increase gradually.

3.5.1.2 Policy loans

When a policyholder owns a life insurance policy, he can usually obtain a policy loan from the insurance company of up to 90% of the policy's CSV. While policy loans do not have a specific payback schedule, the policyholder will be charged interest at current rates. If the policyholder surrenders the policy, the amount he would have otherwise received as the CSV will be reduced by the outstanding balance of the loan, plus accrued interest. Similarly, if the life insured dies while a policy loan is outstanding, the death benefit will be reduced by the loan balance plus interest.

EXAMPLE

Yolanda owned a $500,000 whole life policy on her own life with a CSV of $120,000. She took an $80,000 policy loan to use as the down payment for a cottage, and the loan's interest rate is 5%, compounded annually. Two years later, she decided to surrender the policy. At that time, the CSV had increased to $136,000 and she still had not made any payments on the loan.

Yolanda will receive $47,800 upon surrendering her policy, which is calculated as the CSV of $136,000, minus the $80,000 outstanding loan and minus accrued interest of $8,200.

If she had died instead of surrendering the policy, her beneficiary would have received $411,800, which is calculated as the death benefit of $500,000, minus the $80,000 loan and the $8,200 in accrued interest.

3.5.2 Automatic premium loans (APL)

Most whole life insurance policies offer an automatic premium loan (APL) option once the policy has developed enough of a cash surrender value (CSV). Under this option, if the policyholder fails to make a scheduled premium payment, the insurance company will automatically make a loan against the CSV for the amount of the missed premium.

The APL option prevents the policy from lapsing if the policyholder forgets to make a premium payment, or if he needs to take a break from paying premiums for personal financial reasons. The APL provision can be used for more than one missed premium. In fact, if the policyholder misses multiple premium payments, the APL provision will be applied repeatedly, until the total of the policy loans plus interest equals the maximum set by the policy (usually between 90 and 100% of the CSV). Once this limit is reached and after a 30-day grace period, the policy will be terminated and the residual CSV, if any, will be paid to the policyholder.

EXAMPLE

Ella owns a $500,000 whole life insurance policy with a CSV of $226,000 and annual premiums of $11,500. She has been forced into early retirement, resulting in a substantial drop in income. She would like to keep the policy in force to meet her estate planning needs, but she cannot afford the premiums until her Canada Pension Plan (CPP) and Old Age Security (OAS) benefits commence in about five years. Ella can skip premiums for the next five years by using the APL provision because she has enough CSV to support this option. While this will reduce the death benefit by the amount of the unpaid premiums plus interest, it will allow her to keep the policy. She will also always have the option of repaying the loan and interest if/when she can afford to, which would restore the death benefit.

3.5.3 Reduced paid-up insurance

The reduced paid-up insurance option allows the policyholder to stop paying premiums entirely, while still keeping some life insurance coverage in place for life. Basically, the policyholder uses the CSV as a single premium to buy a reduced amount of paid-up life insurance coverage. The amount of paid-up coverage will depend on the size of the CSV and the attained age of the life insured.

No medical evidence of insurability is required, because the amount of paid-up coverage will be less than the coverage provided by the original whole life policy.

EXAMPLE (CONT.)

If Ella feels that she will never again be able to afford the $11,500 in annual premiums on her $500,000 whole life policy, she may be able to use the CSV of $226,000 (assuming she never exercised the APL option) as a single premium to purchase a paid-up permanent insurance policy. The exact amount of the death benefit will depend on her age, but it will be less than the $500,000 provided by her original policy.

3.5.4 Extended term insurance

The extended term insurance option allows the policyholder to stop paying premiums entirely, while keeping the same level of coverage in place in the form of a term insurance policy instead of a permanent policy. The duration of the term will depend on the CSV of the whole life policy, and the attained age of the life insured.

EXAMPLE (CONT.)

If Ella feels that she will never again be able to afford the $11,500 in annual premiums on her $500,000 whole life policy but she wants to keep coverage for the full $500,000 in place as long as possible, she may be able to use the CSV of $226,000 (assuming she never exercised the APL option) as a single premium to buy $500,000 of term insurance. The exact term of that policy will depend on her age.

3.6 Limited payment whole life

Limited payment life is a whole life insurance policy that provides lifelong insurance coverage, while only requiring premiums for a specified guaranteed period of time.

EXAMPLE

Hamish bought a 25-pay life policy on his own life when he was 45 years old. He only has to pay premiums for 25 years, at which point he will be 70 years old. However, the coverage will continue past age 70, right up until his death.

Some limited payment life policies specify an age, instead of the number of years. For example, a limited payment life policy might only require premiums until age 65, while providing lifelong coverage. Once premiums are no longer required, the policy is said to endow.

The premiums for a limited payment life policy will be higher than for a whole life policy where premiums are payable for life. This makes up for the fact that the coverage continues after payments cease.

The insurance company determines the limited payment premiums by first estimating the total premiums it would have collected if the policyholder paid premiums for his entire life, based on his assumed life expectancy. It then determines the premiums it would have to collect over the limited payment period to provide the insurance company with the same financial result.

Although the premiums for a limited payment life policy are higher than premiums for a lifetime payment policy, there are several benefits for the policyholder:

- He knows exactly when the premiums will end. Often the pay period is chosen to coincide with retirement, particularly if the policyholder expects to have a lower level of disposable income in retirement;
- It eliminates his longevity risk, which is the risk of living longer than anticipated or longer than average. For a regular whole life policy, premiums are payable for life, even if that extends to age 100 or even longer;
- The insurance company applies the time-value-of-money principle, which reduces the cost to the client over the long term because the insurer has the use of his money earlier than a normal lifetime payment policy.

3.7 Premium offset policies

Earlier in this Chapter, it is stated that participating whole life policies typically offer several policy dividend payment options, and two of these have the potential to eventually cover premiums entirely. They are described below:

- Under the premium reduction option, policy dividends are applied against the premium owing. After the policy has been in force for some time, this can significantly reduce or even completely cover the premiums required;
- Under the paid-up additions (PUA) option, the annual policy dividend is used as a single premium to purchase an additional amount of paid-up insurance. These PUAs have their own cash surrender values (CSV), which increase over time. Once the policy has been in force for some time, the policyholder can use the CSVs of those PUAs, together with the annual policy dividends, to completely cover the premiums required.

These two premium offset options are both valid and viable ways of reducing or eliminating premium payments. However, history has shown that agents need to exercise caution when marketing policies with these provisions to prospective clients because policy dividends are not guaranteed.

3.7.1 Illustrations and disclosure

In the 1970s and early 1980s, insurance companies packaged and marketed participating whole life policies with aggressive policy dividend illustrations, promoting them as “quick pay” or “vanishing premium” policies. The illustrations were based on dividend scales that reflected the high interest rates that could be earned at the time. As a result, the illustrations often showed the premiums vanishing in as little as 10 years.

However, interest rates began to drop in the late 1980s and into the 1990s, and insurance companies dropped their dividend scales in response. Even a drop in the dividend scale by 1% significantly reduces policy dividends, and the decreases during the late 1980s and 1990s were much more dramatic. Policyholders who had expected their premiums to “vanish” or be fully offset in 8 or 10 years found out they would have to pay premiums for 20 or even 30 years.

The illustrations used to sell these policies were not meant to be guarantees of performance. However, the way these policies were marketed made many policyholders believe that the results were guaranteed. And even when policyholders agreed that the illustrations were not guarantees, they maintained that they were never warned about how dramatically even a small change in interest rates would affect the dividend scale and ultimately how long they would have to pay premiums.

For this reason, agents must be very cautious when providing policy illustrations to their clients. Agents must clearly disclose that the illustrations are based on the current dividend scale, that the dividend scale could change and that as a result the projections are not guaranteed. Furthermore, agents should emphasize that even small changes in the dividend scale could result in markedly different results than those shown in the illustration.

Some insurance companies go as far as providing multiple illustrations: a primary illustration that is based on the current dividend scale, and a second reduced illustration that is based on a slightly lower dividend scale.

3.8 Advantages and disadvantages of whole life insurance

The advantages and disadvantages of whole life insurance policies are summarized in Table 3.2.

TABLE 3.2

Advantages and disadvantages of whole life insurance

ADVANTAGES	DISADVANTAGES
▪ Premiums are guaranteed for life; ▪ Coverage continues for life, regardless of the age or health of the life insured; ▪ Participating whole life policies may result in policy dividends, which the policyholder can receive in cash, choose to accumulate in an investment account (i.e., side account), or use to buy paid-up additions (PUA) or one-year term insurance; ▪ A whole life policy builds up a cash surrender value (CSV) over time, which the policyholder may receive if he cancels or surrenders the policy; ▪ In the later years, whole life policy premiums will likely be less than the premiums for the same amount of term insurance on a person of the same age; ▪ A whole life policy may offer non-forfeiture benefits in addition to the CSV, including automatic premium loans (APL), reduced paid-up additions, and extended term insurance; ▪ Policyholder may be able to obtain a policy loan against the CSV of the policy; ▪ Compared to more traditional guaranteed investments, the dividend payment rate on participating policies has historically had a lower standard deviation (i.e., lower volatility in the returns).	▪ High initial cost. In the early years of the policy, the premiums for whole life insurance will be higher than those for the same amount of term insurance, which may make it cost-prohibitive for people with limited cash flow; ▪ Policyholder has little or no choice over how the policy reserve is invested; ▪ For participating whole life policies, policy dividends are not guaranteed. Even a small change in the dividend scale can significantly alter the long-term performance results; ▪ There is a theory that suggests buying term insurance and investing the difference may result in a better financial outcome (provided the policyholder is disciplined to invest the difference); ▪ The way the policy reserve is invested/ managed is not entirely transparent to the public.

3.9 Comparing term and whole life insurance

Table 3.3 summarizes the differences between term insurance and whole life insurance.

TABLE 3.3

Term life insurance vs. whole life insurance

	TERM LIFE INSURANCE	WHOLE LIFE INSURANCE
COVERAGE	▪ Provides insurance coverage for a specified period or term. ▪ Coverage is usually not available past a certain age (e.g., 75 or 80). ▪ The term can be selected to meet a need of specific duration.	▪ Provides insurance coverage for life. ▪ Coverage is available for life, regardless of age. ▪ Term cannot be customized to a specific duration, but can be surrendered at any time.
PREMIUMS	▪ Premiums generally increase with the age of the life insured. ▪ While the life insured is relatively young, the premiums are generally lower than premiums for the same amount of whole life coverage. ▪ As the life insured ages, the premiums eventually become higher than premiums for the same amount of whole life coverage, and may eventually become cost-prohibitive.	▪ Premiums generally remain constant regardless of the age of the life insured. ▪ While the life insured is relatively young, premiums are generally higher than premiums for the same amount of term life coverage. ▪ As the life insured ages, the premiums remain level; eventually they will be lower than premiums for the same amount of term coverage.
RENEWABILITY	▪ Depending on the contract, the policy may be non-renewable, or the life insured may have to provide medical evidence of insurability for renewal. However, some term policies are convertible, which allows the policyholder to convert the policy to whole life insurance without providing new medical evidence of insurability.	▪ Policy never requires renewal and will remain in force even if the health of the life insured declines.
CASH SURRENDER VALUE (CSV)	▪ Policy does not build up a cash value, so policy has no value upon expiry or termination.	▪ Policy never expires, and it builds up a cash surrender value (CSV) over time; policyholder can receive CSV if he terminates or surrenders the policy.

	TERM LIFE INSURANCE	WHOLE LIFE INSURANCE
INVESTMENT	▪ Policy will not provide dividends. ▪ Policyholder cannot borrow from the policy.	▪ A participating whole life policy may provide policy dividends, although they are not guaranteed. ▪ Policyholder may be able to take out a policy loan against the CSV.
BENEFITS	▪ Policy does not provide non-forfeiture benefits. ▪ Death benefit cannot be increased without providing medical proof of insurability and without payment of additional premiums.	▪ Policy may provide non-forfeiture benefits, which generally increase in value the longer the policy is in force. ▪ Death benefit can be increased, without providing proof of insurability and without paying additional premiums, by using a paid-up additions (PUA) option or by leaving policy dividends in the accumulation account.

3.10 Using whole life insurance

As a general rule, whole life insurance is more suitable than term insurance for addressing risks of unknown or long duration. Some of the issues that need to be considered when determining if whole life insurance is appropriate include how long the coverage is needed, how much the policyholder can afford to pay in premiums, his income stability, his willingness to pay premiums for life, his need for increasing coverage, and his investment objectives.

This Section provides some examples of when whole life insurance might be appropriate.

3.10.1 Taxes upon death

Probably one of the strongest arguments for whole life insurance revolves around managing the income taxes that come due upon death. This is particularly true for people who own cottages (i.e., cabins), business shares or other investment assets that they want to leave intact to their children, and that are expected to appreciate significantly prior to death.

EXAMPLE

Henry is 50 years old and he is in great health. He is widowed with one son, Jack, who is currently 14 years old. Henry and Jack enjoy the time they spend together at the cottage, and Henry would like Jack to receive title to the property when he dies. Based on his family history, Henry believes he will live until at least age 90.

Henry expects the value of the cottage to triple by the time he dies, and he is worried that there will not be enough money in his estate to pay the income tax on the taxable capital gain that will result from the deemed disposition of the cottage when he dies. He estimates that this tax liability could be $200,000 or even higher, depending on the real estate market.

Henry would like to use life insurance to make sure that this risk is covered. However, he will not be able to get term insurance coverage that lasts until age 90 or beyond. A whole life policy would give him the protection he is looking for. If he changes his mind about leaving the cottage to Jack and he instead decides to sell the cottage before he dies, he can always keep the policy for other estate needs or surrender the policy and use the cash surrender value (CSV) as he chooses.

3.10.2 Future insurability

One of the benefits of whole life insurance is that it can provide lifetime protection at a guaranteed fixed price. Furthermore, if the insurance is acquired when the life insured is relatively young and before any health problems occur, it can be quite affordable.

EXAMPLE

Eric is already 45, and he had not even considered life insurance until his recent marriage and the birth of his son, Oliver, last year. Eric's sedentary lifestyle has resulted in him being overweight, with high blood pressure and the onset of Type 2 diabetes. He was dismayed to learn how much the life insurance would cost because of his health, and even more dismayed to learn how much cheaper it would have been had he bought it when he was young and healthy.

This prompted him to purchase a whole life policy on Oliver's life, so he would always have insurance protection. When Oliver is an adult, Eric can transfer ownership of the policy to him, with the added benefit that Oliver will be able to take out a policy loan against the CSV if needed for his education or for the down payment on a home.

3.10.3 Increasing coverage

Participating whole life insurance can provide an easy way to increase insurance coverage without increasing premiums, even if the health of the life insured declines.

EXAMPLE

Tony is 33 years old with a young family, and he would like to obtain life insurance coverage for 10 times his salary. His salary is currently $60,000, but he expects it to increase dramatically over the coming years. He would like his new insurance coverage to keep pace with the increases in his salary, preferably without increasing his premiums.

While Tony is currently in good health and would have no trouble obtaining life insurance, he knows that his father and his uncle both started experiencing significant health issues at about age 40. Tony is worried that if his health follows family history, he might be unable to buy additional coverage at an affordable cost in the future.

A $600,000 participating whole life policy with a paid-up additions (PUA) option would be a good choice for Tony. The PUAs will increase his coverage without increasing his premiums, and without requiring proof of insurability. If it turns out that the PUAs add more coverage than Tony needs, he can always use the additional coverage to address other estate needs or surrender part of the policy and use the resulting cash surrender value (CSV) for other purposes.

3.11 Term-100 (T-100) life insurance

Term-100 (T-100) life insurance, also called "Term-to-100" in the industry, combines elements of term insurance and permanent insurance.

3.11.1 Duration of coverage

T-100 provides coverage for life. Some T-100 policies mature at age 100, meaning the death benefit is paid when the life insured reaches age 100 or dies, whichever comes first.

Other T-100 policies only pay the death benefit when the life insured dies, but premiums cease at age 100, so the policy essentially becomes a paid-up policy.

3.11.2 Premiums

Premiums for a T-100 policy cease when the life insured reaches age 100, even if the death benefit has not yet been paid out.

Because T-100 policies generally do not accumulate a CSV and do not provide non-forfeiture benefits, the premiums are typically lower than those for the same amount of regular whole life insurance. However, because T-100 provides protection for life, premiums are higher than those for the same amount of term insurance coverage that stops at age 75 or 80.

Because T-100 policies generally do not accumulate a CSV, the policyholder cannot rely on automatic premium loans (APL) to cover any missed premium payments. This means that if the policyholder accidentally misses a payment and does not rectify this within the allowable grace period of 30 days, the policy will lapse. Essentially, the policy will be worthless, even if the policyholder has been faithfully paying premiums for decades up until that point.

Some T-100 contracts allow policyholders to reactivate lapsed policies, provided they do so within a specified timeframe (usually two years) and they also pay the missed premiums.

3.11.2.1 Level cost of insurance (LCOI)

Most T-100 policies guarantee that the premiums will remain level for the duration of the contract (i.e., until age 100), and they do not provide for the accumulation of any cash surrender value or other non-forfeiture benefits. The level premium schedule for this type of T-100 policy is referred to as level cost of insurance (LCOI).

Although T-100 premiums remain constant for life once a policy is implemented, it is important to note that those premiums will depend on the attained age of the life insured at the time the policy is issued. The younger the life insured is at the time of issue, the lower the premiums for life.

3.11.2.2 Limited payment T-100

T-100 policies can also be issued on a limited-pay basis, meaning that coverage is provided for life, but premiums are only payable for a limited number of years (e.g., 10 or 20 years) or until a predetermined age (e.g., age 65). At the end of the payment period, the policy becomes a paid-up policy. Limited payment T-100 policies are not widely available in Canada today, but they have been issued in the past and these policies do still exist.

Limited payment T-100 insurance commands a higher premium than the same amount of straight T-100 coverage, because the premiums are being paid over a shorter period of time. These premiums are held in reserve to help offset the higher costs of insurance as the life insured ages. As with the whole life policies discussed earlier in this Chapter, this policy reserve generally results in a cash surrender value (CSV) that the policyholder can access if he surrenders the policy after it has been in force for a certain amount of time.

Limited payment T-100 policies may also offer the option for automatic premium loans (APL), which could help prevent the policy from lapsing if the policyholder misses any premium payments.

3.11.3 Death benefit

The death benefit of a T-100 policy is fixed for the duration of the contract.

3.11.4 Upon age 100

What happens when the life insured reaches age 100 depends on the insurance company and the details of the contract. Some policies specify that the death benefit will be paid to the beneficiary when the life insured turns 100. Other policies specify that the payment of premiums ceases at age 100, but coverage continues until death.

3.11.5 Availability from insurers

Basic T-100 policies (those without a CSV and with premiums payable until age 100) are readily available from major insurance companies and other financial institutions.

Limited-payment T-100 policies are no longer common in Canada, but they are available in the US market.

3.11.6 Using Term-100

Term-100 insurance may be appropriate when the following conditions apply:

- The policyholder requires a fixed amount of insurance to cover a need that is not expected to increase prior to death, regardless of when that death might occur;
- The policyholder is certain that he will never want to surrender the policy;
- The policyholder has no need of the investment opportunities provided by universal life (UL) insurance.

EXAMPLE

Trevor recently lost his wife after a long battle against cancer. He was overwhelmed by the support that the local Hospice Centre provided to his wife, himself and their children during the last two months before she died. Trevor is absolutely determined to donate $500,000 to the Hospice Centre upon his own death.

Trevor decided to buy a $500,000 T-100 policy now, while the premiums are still affordable, because this will ensure that he will be able to make that gift even if he lives to be 110 and depletes all of his own resources. He has no intention of ever cancelling the policy, so he does not need a policy that builds up a cash surrender value (CSV).

CHAPTER 4
UNIVERSAL LIFE INSURANCE

Competency component

- Analyze the available products that meet the client’s needs.

Competency sub-component

- Analyze the types of contracts that meet the client’s needs.

4
UNIVERSAL LIFE INSURANCE

This Chapter explores the third type of permanent insurance, universal life (UL) insurance, which evolved after numerous modifications to whole life insurance.

Whole life insurance generally offers a fixed death benefit and guaranteed minimum cash surrender values (CSV) in exchange for fixed premiums. While adjustable whole life insurance has a death benefit and premiums that may increase or decrease periodically, these changes are initiated by the insurance company, after they compare their actual experience with mortality rates, investment returns and expenses against their previous projections. The policyholder had no control over these changes.

The disappearance of mixed policies and the evolution of adjustable whole life policies ultimately resulted in the creation of universal life (UL) insurance policies. UL insurance combines permanent insurance with tax-advantaged investing, within limits. UL insurance is considered to be the most flexible type of life insurance, because the policyholder can modify the policy in various ways in the future, as discussed in this Chapter.

It should be noted that a major reform came into effect on January 1, 2017. It introduced significant changes in the calculation of parameters used for determining the tax advantages of these policies. However, policies issued prior to January 1, 2017 maintain the rights that had been acquired ("vested" or "grandfathered" rights) prior to the reform. Caution is therefore recommended because a number of changes made to these policies could cause some of the vested rights to be lost under the new rules.

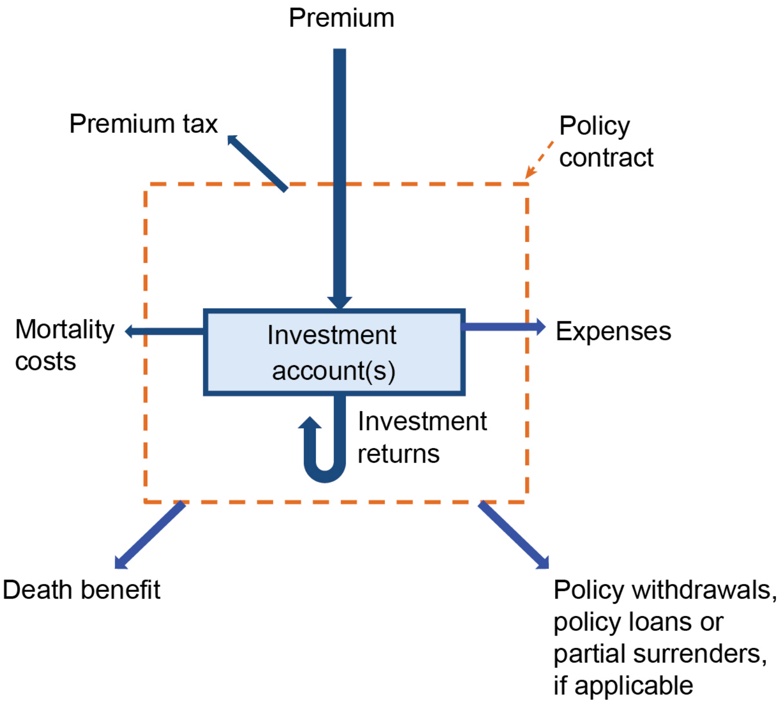
4.1 Transparency through unbundling

With term insurance and guaranteed whole life insurance, the three pricing factors (mortality costs, investment returns and expenses) are said to be bundled together, and they are fixed for the life of the contract. The policyholder typically does not know what portion of his premium goes towards mortality costs or expenses.

With UL policies, the three pricing factors are unbundled and they are not necessarily fixed. Diagram 4.1 shows how money flows through a UL policy.

DIAGRAM 4.1

Flow of money through a universal life (UL) policy



UL policies disclose how the mortality costs are applied, how the expense charges are calculated, and any guaranteed investment returns that apply to the policy. This gives the policyholder a better understanding of how the cost of insurance and the expenses vary over time, and how they can impact the cash value of the policy. The cash value (CV) of a UL policy is the value of the investment account(s) within the policy. It may or may not be equal to the cash surrender value (CSV) of the policy, depending on whether or not surrender charges apply, as discussed later.

4.1.1 Premium tax

Because UL policies are the hybridization of insurance and investment, contract and sales literature often refer to the amounts that a policyholder pays into the policy as “deposits,” not “premiums.” However, for consistency, the term “premiums’ will be used to refer to them in this Chapter.

Whenever the policyholder pays a premium into a UL policy, the insurance company passes a percentage of that premium on to the provincial or territorial government, in the form of a premium tax. Depending on the jurisdiction, the tax ranges from 2% to 4%, and it is charged on the entire premium, not just the portion that covers the cost of insurance. The remainder of the premium goes into the policy’s investment account(s). In contrast, if the policyholder were to invest that same money outside of a policy (for example, by investing in mutual funds or guaranteed investment certificates), the amount invested would not be subject to premium tax.

4.1.2 Mortality charges

As with term and whole life insurance policies, the mortality costs for a UL policy reflect the insurance company's cost of paying out the death benefits. For a UL policy, the insurance company deducts these mortality costs from the policy's investment account. The policyholder has some choice in how these mortality costs are calculated, as discussed in the Section *Pricing the insurance component*.

4.1.3 Administrative expenses

The insurance company also deducts its expenses from the investment account. These include, for example, the cost of selling, underwriting and issuing policies, income taxes, the cost of investigating and paying claims, and the profits sought by shareholders. Depending on the insurance company, these expenses might be charged as a percentage of the annual premium, or as a flat monthly fee. Because of the complexity and flexibility of UL insurance, the administrative expenses tend to be higher than for other forms of permanent insurance.

4.1.4 Investment income

The policyholder of a UL policy has considerable flexibility in how investments are made within the policy, as discussed later in the Section *Investment choices.* And because the policy discloses how the mortality costs and administrative expenses are calculated, the policyholder gets a clearer picture of how the investments held within the policy are performing, based on the changes in the policy's cash value.

Investment income accumulates within the policy tax-free as long as certain limits set by the *Income Tax Act* are not exceeded, as discussed in the Section *Exemption test.*

4.2 Flexibility for the policyholder

Universal life (UL) insurance is sometimes promoted as "the only insurance you'll ever need" because it can be highly customized, both at the time of issue and once coverage is already in place. The flexibility can be seen in the following:

- Timing and amount of premiums;
- Face amount;
- Life/lives insured.

4.2.1 Timing and amount of premiums

Within limits, the policyholder can decide how much to pay in premiums, and when to pay them. The suggested minimum premiums should be enough to cover the premium tax and the insurance company's mortality costs and administrative expenses for that policy. The minimum premiums are designed to keep the policy in force until age 100, but they are not enough to build up the investment account within the policy. If the policyholder only pays the minimum amount, the policy is said to be a minimally funded UL policy. A significant number of the UL policies sold today are minimally funded.

The policyholder can choose to pay an amount that is higher than the minimum premiums when the policy is first issued, to take advantage of the tax-sheltered growth that can happen in the UL policy and to build up the policy's cash value.

The policyholder can increase the annual or monthly premiums in the future, but most policies place a maximum on the premiums, to ensure the policy maintains its tax-exempt status, discussed in the Section *Exemption test*. If the policyholder is always paying the maximum amount, the policy is said to be a "maximum-funded" UL policy.

The policyholder can also deposit lump-sum premiums at any time, again subject to the minimum and maximum amounts specified in the policy.

The policyholder can reduce or even stop the premiums for a period of time, as long as the investment account can support the insurance company's mortality and expense deductions.

EXAMPLE

Elaine has a UL policy on her own life. The policy specifies minimum premiums of $325 per month, but she currently deposits premiums of $500 per month, and the policy has a cash value of $2,900.

4.2.1.1 Insufficient account value

A UL policy will remain in force as long as the investment account value is sufficient to support the mortality and expense deductions. There are several key factors that could result in an insufficient account value, which would increase the risk of the policy lapsing:

- The policy was always minimally funded;
- The policyholder made withdrawals from the policy;
- The policyholder decreased or stopped premium payments;
- The investment returns were lower than anticipated, or possibly even negative.

EXAMPLE (CONT.)

Elaine is pregnant and she plans to take a one-year maternity leave from her job, which will result in decreased income for that period. To ease the pressure on her cash flow, Elaine can reduce her premiums, or even stop paying premiums for a period of time. If she stops the premiums entirely, the policy would likely lapse after about eight or nine months ($2,900 ÷ $325), because the account value would be exhausted by the mortality and expense deductions.

4.2.1.2 Modal factors for UL policies

For term insurance and whole life insurance policies, the modal factors almost always reflect an interest charge that the policyholder must pay to the insurance company in exchange for spreading the premium out over a series of payments.

For most UL policies, the modal factor is simply (1 ÷ number of payments per year). This means that the insurer does not apply the modal factor to this type of policy.

EXAMPLE

In the previous Chapter, an example showed a term policy with a modal factor of 0.088, such that an annual premium of $956 became a monthly premium of $84.12, calculated as ($956 x 0.088). Over the course of one year, the total premiums would be $1009.56, calculated as ($84.12 × 12), which is 6% higher than the quoted premium of $956.

For the majority of universal life policies:

> Modal factor for monthly payments is 0.0833, calculated as (1 ÷ 12).
>
> Modal factor for semi-annual policy is 0.50, calculated as (1 ÷ 2).

In this case, the annual and annualized premiums are the same.

4.2.2 Face amount

The policyholder must select a face amount when first acquiring the UL policy, subject to any minimums or maximums imposed by the issuing insurance company. If the policyholder needs additional coverage in the future, he can add that additional coverage to the existing policy on an attained age basis; he does not have to take out a new policy. However, any increase in the face amount will require the insured person to provide evidence of insurability (i.e., meet certain standards set by the insurance company to prove that he does not pose a significant risk to that company), unless the policy includes a rider for a guaranteed insurability benefit. Riders and the concept of insurability are discussed in later Chapters.

EXAMPLE

Richard and Maria, ages 38 and 42, already have two children, ages 15 and 17. Richard has a $500,000 UL policy on his own life. Maria is employed and earns a good salary, and they have no major debts. Richard bought a UL policy a few years ago to ensure that, if he died, Maria would have enough money to raise the children right through their post-secondary education. Much to their surprise, Richard and Maria have just learned that Maria is pregnant with twins. Richard decided to increase his UL coverage by $500,000. He was able to do so within his existing UL policy, after providing proof of insurability. If their cash flow is limited while Maria is on maternity leave and there is sufficient cash value within the policy, Richard may be able to have this increased coverage without increasing his premiums for the time being, as discussed shortly.

The policyholder can also decrease the amount of coverage. To minimize administrative expenses, insurance companies will usually restrict increases or decreases to a minimum amount (e.g., increase of at least $25,000 or decrease of at least $10,000).

Changing the face amount can impact how quickly the cash value of the policy grows, because the mortality costs are directly linked to the face amount. If the face amount increases, the insurance company will increase its mortality cost deductions from the policy's investment account. Unless the policyholder compensates by increasing premiums, this will leave a smaller amount for investment purposes and may even erode the policy's cash value.

Conversely, if the face amount decreases, the insurance company will decrease its mortality cost deductions and, if the policyholder does not change his premiums, this means more money will be available for investment, which should result in a higher cash value.

4.2.3 Life/lives insured

One universal life (UL) policy can be used to insure multiple lives, either on a joint-life basis, a single-life basis or, depending on the insurance company, sometimes both.

EXAMPLE

Joe bought a UL policy that included $500,000 of joint-last-to-die coverage on the lives of himself and his wife, Sherry, and another $1,000,000 in individual coverage on his own life. The joint coverage is payable to the estate of the last to die, and is intended to be used to offset the tax liability that will be triggered upon the last of their deaths on certain estate assets they want to leave to their children. The individual coverage is payable to Sherry upon Joe's death, and is intended to help replace the family's lost income if Joe dies first.

UL policies may allow the policyholder to add or even substitute a new life insured under the policy, as long as the new person can provide evidence of insurability.

EXAMPLE (CONT.)

Sherry is no longer able to care for their young children because she was paralyzed in an accident. Joe's sister, Deborah, has moved in with them and she has become an integral and essential part of the family. Joe decided to add Deborah as a new single life insured under his existing UL policy. Deborah had to provide proof of insurability before Joe could add her to the policy.

4.3 Pricing the insurance component

The mortality cost deductions that the insurance company draws from a UL policy's investment account are a reflection of the net amount at risk and the mortality costing method used, as discussed below in this order:

- Net amount at risk (NAAR);
- Yearly renewable term (YRT);
- Level cost of insurance (LCOI);
- Choosing between YRT and LCOI costing;
- Guaranteed vs. adjustable mortality deductions.

4.3.1 Net amount at risk (NAAR)

From the insurance company's point of view, the amount at risk for a term life policy is the death benefit offered by that policy. However, permanent insurance policies, including UL, build up a policy reserve over time, and this decreases the amount at risk for the insurance company.

For a UL policy, the mortality deductions are based on the net amount at risk (NAAR), which is calculated as follows:

NAAR = death benefit – the investment account value

Note that the "death benefit" included in this formula refers to the full amount payable upon death, which could be more than the original face amount of the policy. This is discussed more fully in the Section *Death benefit options*.

EXAMPLE

Pratik owns a UL policy with a death benefit of $500,000 and an account value of $128,000. The current NAAR of his policy is $372,000, calculated as ($500,000 – $128,000).

4.3.2 Yearly renewable term (YRT)

Mortality costing, or cost of insurance (COI), is usually expressed as a dollar amount per $1,000 of risk, or in the case of a UL policy, per $1,000 of the NAAR.

EXAMPLE (CONT.)

Suppose that for the current policy year, Pratik's policy had a COI of $18.57. The insurance company would make a mortality deduction of $6,908 from his account, calculated as ($18.57 × $372,000 ÷ $1,000).

For a UL policy, the policyholder can choose one of two ways of applying the risk of death to the NAAR. The first is based on yearly renewable term insurance costing.

Recall that, for term insurance, the mortality cost for a period of time is equal to the death benefit (i.e., the amount at risk) multiplied by the probability of death, or the risk that the life insured will die during that period. Yearly renewable term (YRT) is one-year term insurance that renews at the end of every policy year. The annual YRT premium for a specific year is based on the life insured's risk of death for that year.

So, for UL insurance based on YRT, the cost per $1,000 at risk generally increases each year because the risk of death tends to increase with age (with the exception of the first few years of life).

4.3.3 Level cost of insurance (LCOI)

The second mortality costing option is based on the concept of level cost of insurance (LCOI). Recall that LCOI refers to the premiums required by a basic term-to-100 (T-100) life insurance contract, meaning one without a cash surrender value and without non-forfeiture benefits. T-100 premiums are guaranteed to remain level for life because the amount at risk (i.e., the death benefit) remains constant and the risk of death is spread evenly over the duration of the policy.

For a UL policy based on LCOI, the cost per $1,000 at risk generally remains constant over the duration of the policy.

4.3.4 Choosing between yearly renewable term (YRT) and level cost of insurance (LCOI) costing

Table 4.1 compares mortality deductions for YRT and LCOI costing methods, for a universal life (UL) policy purchased for a 40-year-old healthy woman.[9]

TABLE 4.1

Cost of insurance (COI) per $1,000 using yearly renewable term (YRT) vs. level cost of insurance (LCOI) costing

POLICY YEAR	YRT COST PER $1,000	LCOI COST PER $1,000	YRT COST PER $500,000	LCOI COST PER $500,000
1	$1.13	$7.44	$563	$3,720
6	$1.44	$7.44	$722	$3,720
11	$1.90	$7.44	$952	$3,720
16	$2.83	$7.44	$1,413	$3,720
21	$4.31	$7.44	$2,156	$3,720
26	$7.25	$7.44	$3,625	$3,720
31	$12.81	$7.44	$6,406	$3,720
36	$22.60	$7.44	$11,301	$3,720
41	$40.96	$7.44	$20,481	$3,720
46	$71.11	$7.44	$35,556	$3,720
50	$109.04	$7.44	$54,521	$3,720

Note how the cost of insurance (COI) under YRT costing is lower than the COI for LCOI costing for the first 25 years or so. The lower deductions under YRT costing during the policy's early years mean that this costing method provides the best potential for growth of the investment account over the short to mid policy terms. However, the mortality deductions later in life under YRT deductions can become onerous and may quickly erode the policy's cash value, unless they are offset by high investment returns in those later years.

Under LCOI costing, the mortality cost deductions will be greater during the early years, meaning less money left to work in the investment account, which in turn can result in lower account values mid-policy. However, mortality cost deductions under LCOI will be much lower than under YRT towards the later years of the policy, which will help preserve the policy's cash value.

9. Based on a death benefit of $500,000 plus account value, for a 40-year-old female smoker in good health.

Agents should consider the client's goals when helping them choose between YRT and LCOI costing:

- If a client is looking for greater short-term policy fund values, he would likely be better off choosing the YRT costing option, at least initially;
- If a client is looking for longer-term policy values, he would likely be better off choosing the LCOI costing option, because it locks him into a level rate for life.

Some policies allow the policyholder to switch from YRT costing to LCOI costing after the policy is issued, but the LCOI rates will be based on the age of the life insured at the time of the switch. The policyholder generally is not permitted to switch from LCOI to YRT costing after the policy is issued.

4.3.5 Guaranteed vs. adjustable mortality deductions

The discussion so far has assumed that the yearly renewable term (YRT) or level cost of insurance (LCOI) costing schedule is set when the universal life (UL) policy is issued, and that it is guaranteed for the life of the policy. While this may be true, it is not always the case.

UL policyholders would probably prefer the certainty of knowing exactly how mortality deductions are going to be calculated in the future. This is particularly true for YRT costing, which already increases dramatically at older ages. However, the insurance companies would prefer to be able to adjust the COI schedules to reflect their actual experience with mortality, investment returns and administrative expenses. Agents should understand policies to determine whether the costing schedules are guaranteed for life, or subject to adjustment, and they should advise clients accordingly.

4.3.5.1 Open-ended or restricted increases

Where UL policies are subject to mortality costing adjustments, there is a further distinction between open-ended and restricted increases. A policy that allows open-ended increases in mortality costs results in significant risk for the policyholder. Most adjustable policies place a restriction on increases, such as limiting increases to 25%, 50% or 100% of the original schedule, or a specific dollar amount.

4.4 Death benefit options

Depending on the policy, a UL policyholder can choose from a variety of death benefit options, based on the beneficiary's needs and the policyholder's investment objectives. The most common options are discussed in this Section, but insurance companies may offer other creative options.

Remember that the death benefit affects the net amount at risk (NAAR), and thus the mortality deductions from the investment account, so the choice of death benefit option can affect the investment performance of the policy.

4.4.1 Level death benefit

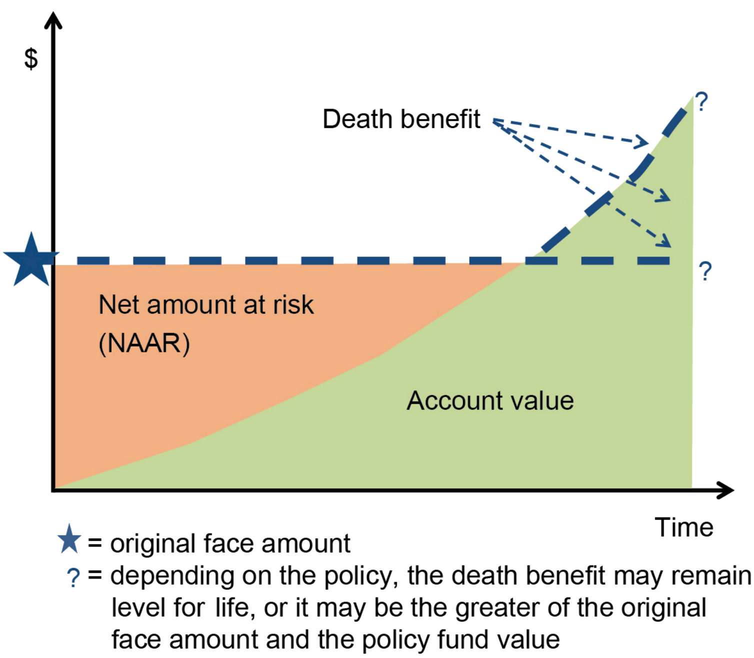
The most straightforward option is the level death benefit. Depending on the policy, the amount the beneficiary will receive under this option will either:

- Remain constant at the original face amount, regardless of when the life insured dies;
- Equal the policy's account value once it exceeds the original face amount.

Diagram 4.2 illustrates how the policy's account value is equalled once it exceeds the original face amount.

DIAGRAM 4.2

Level death benefit option



If the policyholder deposits premiums that are greater than the minimum amount required, the policy's investment account will likely grow over time. Recall that the NAAR equals the death benefit minus the account value, so as the account value grows, the NAAR decreases. Because mortality deductions are based in part on the NAAR, this means that the mortality deductions will also decrease over time. These reduced mortality deductions allow the investment account to grow more quickly, which reduces the NAAR.

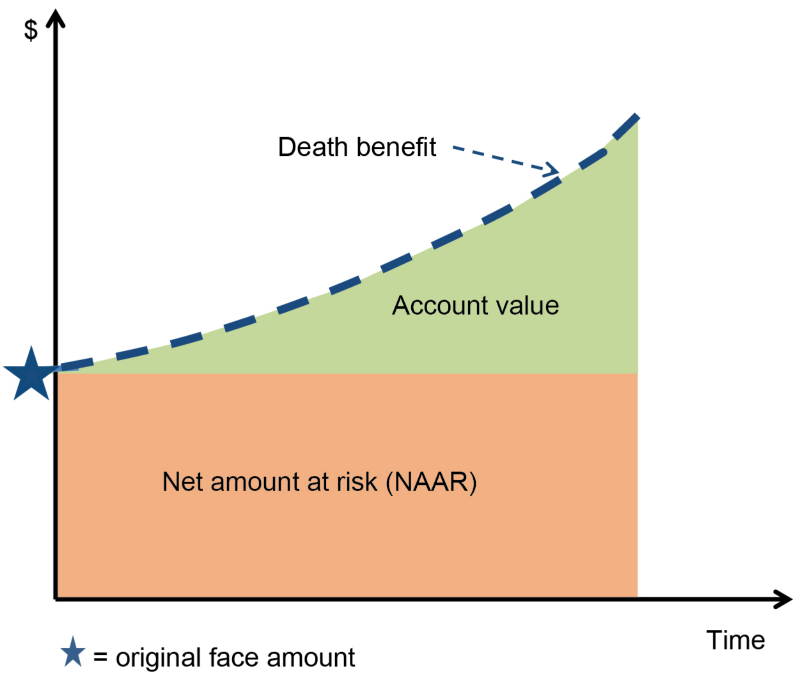
The level death benefit option is the least expensive of the death benefit options, and it is most suitable for clients who do not have an increasing insurance need.

4.4.2 Level death benefit plus account value

The level death benefit plus account value option is somewhat of a misnomer, because the death benefit actually equals the original face amount of insurance under the policy (which remains constant), plus the value of the investment account. In this case, the NAAR remains level over time, while the death benefit increases, as shown in Diagram 4.3.

DIAGRAM 4.3

Level death benefit plus account value



Because the NAAR remains level over time, the mortality deductions will be greater than those for a comparable UL policy with a level death benefit, which means the investment account will grow more slowly. However, the beneficiary will receive the original amount of insurance, plus the full account value, as a tax-free death benefit.

This death benefit option may be suitable for those who deposit large premiums in excess of the amount required to minimally fund the policy.

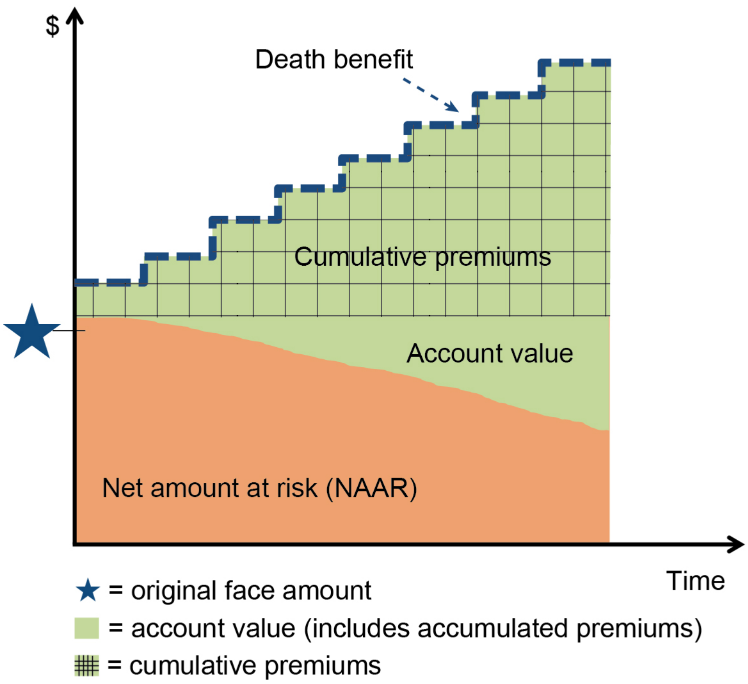
4.4.3 Level death benefit plus cumulative premiums

The level death benefit plus cumulative premiums option tends to be the most expensive option because the beneficiary receives the original face amount plus the gross amount of each premium (i.e., before mortality and expense deductions). This essentially provides a full refund of premiums when the life insured dies.

The NAAR equals the original face amount plus the cumulative premiums, minus the account value, as shown in Diagram 4.4.

DIAGRAM 4.4

Death benefit plus cumulative premiums



This option may be suitable for policyholders who intend to maximize their premiums, because it ensures that those premiums are not forfeited to the insurance company if they happen to die during the early years of the policy. It also reduces the NAAR fairly quickly, which in turn reduces the mortality deductions and allows the investment account to grow more rapidly. However, if the account value exceeds the sum of the original face amount and cumulative premiums, any excess amount would be retained by the insurance company when the life insured dies.

4.4.4 Indexed death benefit

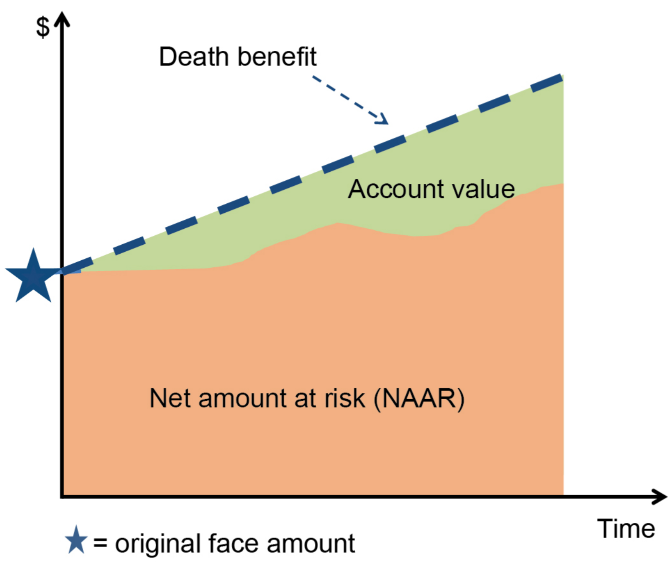
The indexed death benefit option provides a death benefit equal to the original face amount, indexed for some measure of inflation.

Some policies index the death benefit to the Consumer Price Index (CPI), while others allow the policyholder to choose an indexation rate when acquiring the policy, usually ranging from 1% to 8% annually.

The NAAR for a UL policy with an indexed death benefit will not be level, as shown in Diagram 4.5 below. Depending on the growth rate of the investment account and the index rate chosen by the policyholder, the NAAR (and thus the mortality deductions) could be increasing over time.

DIAGRAM 4.5

Indexed death benefit



An indexed death benefit might be appropriate to cover an end-of-life risk that is expected to increase over time, such as the tax liability on assets that appreciate in value.

4.5 Investment components

The investment attributes of universal life insurance are one of the key differentiators between UL and other forms of life insurance. It requires ongoing management by the policyholder. They are discussed in the following order:

- Net premiums;
- Tax deferral;
- Investment choices;
- Impact of investment return on policy viability.

4.5.1 Net premiums

Whenever a policyholder deposits a premium to his UL policy, the net premium (i.e., the gross premium less the premium tax and the mortality and expense deductions) is invested within the policy's investment account according to the choices preselected by the policyholder. As the mortality deductions decrease, the amount available for investment increases, assuming the gross premiums are constant.

4.5.1.1 Exemption test

One of the key benefits of a UL policy is that it gives the policyholder a way to invest in a tax-sheltered environment. The insurance company may limit the policyholder's net premiums to ensure that the policy remains tax-exempt. The exemption test will be covered in detail in Chapter 7 under "Taxation of exempt vs. non-exempt policies." If the policyholder deposits an amount that exceeds the maximum net premium, the excess is directed to a non-exempt side fund, and any investment income earned within the side fund is taxable annually.

4.5.2 Tax deferral

Investment income earned within the policy's tax-exempt investment account is not taxable at the time it is earned, much like income earned within a registered retirement savings plan (RRSP) is not taxable as long as it remains in the plan. This allows the full amount of earned investment income to be reinvested within the policy. These compounding investment returns can result in significant growth over the life of the policy, and tax on that growth is deferred until the policy is surrendered (tax on policy surrender is covered in a later Chapter). In fact, if the death benefit includes the account value, the growth may never be subject to tax.

4.5.3 Investment choices

UL policies typically offer a wide range of fixed income and equity investment choices, giving the policyholder the ability to actively manage the investment mix. This is different from other permanent insurance policies, where the insurance company decides how policy funds are invested.

The policyholder is not limited to a single investment choice; he can have his net premiums divided or spread out to a number of different investment choices, although some of them may have minimum investment amounts. The policyholder can adjust the investment mix over time (subject to any restrictions imposed by the insurance company), to address changing investment objectives or risk tolerance.

The investment choices may vary by insurance company and policy, but some of the common options are listed below.

4.5.3.1 Daily interest accounts

Daily interest accounts (DIA) usually offer a minimum interest rate based on the yield of a specified benchmark, such a percentage of the yield on a 30-day Government of Canada treasury bill. The absolute minimum return is set at 0%, so the principal is guaranteed.

4.5.3.2 Guaranteed investment accounts

Guaranteed investment accounts (GIA) offer a fixed interest rate for 1, 3, 5, 10 or even 20-year terms, and they operate similar to guaranteed investment certificates (GIC). As a GIA matures, the proceeds are rolled over into the policy's active investment account, unless the policyholder requests that they roll over to a new GIA of the same term. GIAs typically guarantee a minimum interest rate that is based on a specified benchmark, such as 90% of the yield of Government of Canada bonds with the same term and issue date, less 1.75%. The absolute minimum return is set at 0%, so the principal is guaranteed. A market value adjustment or penalty may apply if the policyholder redeems the GIA prior to its maturity.

4.5.3.3 Index fund investments

If the policyholder chooses an index fund investment option, he does not acquire a legal interest in the index fund, or in the securities that make up that index. Instead, interest is credited to the policy's investment account based on the performance of the chosen index. Because market performance fluctuates, the interest can be positive or negative. Agents should ensure that the policyholder understands that this means that it is possible for the investment account to decline in value.

Index options may be diversified by location, asset mix (e.g., equity, bond, balanced), market capitalization (e.g., large cap, small cap) or income objective (e.g., capital growth vs. income).

Index account options may be subject to management fees, which will reduce investment performance.

4.5.3.4 Mutual fund investments

UL policyholders may also choose to receive interest income that is based on the performance of a selection of mutual funds. Because market performance fluctuates, the interest can be positive or negative, meaning that is possible for the investment account to decline in value.

Mutual fund options typically represent a range of management styles and asset mixes, including Canadian, American and global offerings.

Mutual fund options may be subject to management fees, which will reduce investment performance.

4.5.4 Impact of investment returns on policy viability

While UL policies unbundle premiums, mortality deductions, expenses and investment returns, this does not mean that these factors operate in isolation. In fact, they are interrelated and must be kept in balance for the long-term viability of the policy. For example, if mortality deductions increase, the investment account will grow more slowly or even decline in value, unless, either the policyholder deposits additional premiums, or investment returns increase.

Similarly, if investment returns are lower than expected, then the mortality deductions will erode the account value more quickly. If investment returns are negative, which is a possibility if the policyholder chooses to base his interest income on index funds or mutual funds, then there is a very real possibility of the policy lapsing, unless the policyholder deposits additional premiums.

4.5.4.1 Policy illustrations

UL policy documentation typically includes a policy illustration, which is a chart or table that shows projected values for the premiums, mortality deductions, investment account value, cash surrender value and death benefit for each year in the future. However, these projections are only intended to demonstrate how the policy works, and are not a prediction of guaranteed or expected performance.

UL policy outcomes are very sensitive to even small changes in investment performance, particularly over the long life of these policies. To highlight this sensitivity, most policy illustrations now include at least two sets of projections. The first will be at the current or requested rate of return, and second will be based on a slightly lower rate of return.

Policy illustrations are usually accompanied by strong disclaimers, and agents must ensure that policyholders understand that the projections are not predictions of future performance. In fact, the policyholder is typically required to sign the illustration, acknowledging that he understands the limitations of the illustration.

4.6 Accumulating fund

The investment account or accumulating fund of a UL policy plays the same role as the accumulating fund within a whole life policy, in that it can provide the policyholder with a number of non-forfeiture benefits, including those discussed below:

- Surrendering the policy;
- Policy withdrawals (partial surrender);
- Premium offsets;
- Policy loans;
- Collateral for third-party loans;
- Leveraging;
- Distribution upon death.

4.6.1 Surrendering the policy

If a UL policyholder no longer needs the coverage provided by the policy, he may want to terminate or surrender the policy. Upon surrender, he is entitled to benefit from the funds that have accumulated within the policy's investment account(s). The amount he will receive is the cash surrender value, which is the cash value of the investment account, less any applicable surrender charges.

Generally, surrender charges are normally charged if the policy is surrendered during the first 5 to 10 years of coverage. They are intended to both encourage policyholders to keep their policies for the long term and compensate the insurance company for the expenses associated with underwriting and issuing the policy.

UL policy surrender charges are usually calculated as a multiple or percentage of the annual mortality deduction that would apply under LCOI costing. That multiple or percentage gradually decreases over time until it is completely eliminated. However, the surrender charge would never exceed the value of the investment account, so the policyholder will not have to pay a surrender charge if the policy does not have a cash value.

EXAMPLE

Fiona recently purchased a UL policy, and she wants to know what her options are for surrendering the policy in the next few years. The annual mortality deduction that would apply under LCOI costing is $500, and a surrender charge multiple applies for the first 10 years of the policy. The following table shows how the surrender charge would be applied, based on the assumed policy cash values:

Policy Year	A Investment account value (i.e., cash value)	B Surrender multiple	C Surrender charge (B × $500)	D Cash surrender value (CSV) (greater of zero or A – C)
1	$200	2	$1,000	$0
2	$800	4	$2,000	$0
3	$1,800	4	$2,000	$0
4	$3,000	4	$2,000	$1,000
5	$4,200	4	$2,000	$2,200
6	$3,400	3	$1,500	$1,900
7	$8,200	3	$1,500	$6,700
8	$11,000	3	$1,500	$9,500
9	$14,200	2	$1,000	$13,200
10	$18,200	1	$500	$17,700
11	$24,400	0	$0	$24,400

In most cases, surrendering a UL policy will result in a taxable policy gain. Taxation when surrendering or disposing of a life insurance policy is discussed in a later Chapter.

4.6.2 Policy withdrawals (partial surrender)

A UL policyholder can also withdraw funds from the policy. A withdrawal is considered to be a partial surrender, and it may result in taxable income to the policyholder, as discussed in a later Chapter.

The insurance company may impose a minimum withdrawal amount, and the maximum amount is the policy's cash surrender value. Surrender charges may also apply, depending on the contract and the timing of the withdrawal.

The funds come from the policy's investment account, which is used to pay the policy's mortality and expense deductions. As a result, withdrawals will impede the growth of the investment account, and may affect the long-term viability of the policy.

EXAMPLE

Andrew has a UL policy with a level death benefit of $200,000 and a current cash value of $21,000. The policy is based on LCOI mortality costing, with mortality deductions of $3,800 per year. Andrew lost his job and he is running short of funds, so he is thinking about withdrawing $20,000 from his UL policy.

While his contract allows the withdrawal, Andrew should know that it would reduce his death benefit to $180,000, and the cash value of the policy would decrease to only $1,000. This puts the policy in danger of lapsing because there won't be enough money in the account to cover the next mortality deduction of $3,800, unless Andrew can deposit additional premiums before the deduction comes due.

4.6.3 Premium offsets

Participating whole life policies provide the policyholder with the choice of using policy dividends to offset their premiums. Because of the way the investment account of a UL policy works, premiums are naturally offset by investment income and the policyholder's deposits to the investment account. Depending on the premiums deposited into the policy and the investment returns earned within the policy, the investment account can grow to such a size that it can be used to fund future mortality and expense deductions indefinitely. In other words, the policyholder can stop paying the premiums while maintaining his policy in force.

EXAMPLE

Walter bought a $500,000 UL policy several decades ago, based on LCOI mortality deductions of $10,500 annually. Walter always deposited the maximum premium permitted to the policy and he has made some rewarding investment choices. As a result, the policy currently has a cash value of $460,000. Because Walter is currently 65 years old, he could stop paying premiums and the policy would likely remain in force for the duration of his lifetime. However, if he wants to do this, he should adjust his investment mix within the policy to those investments that offer a principal guarantee.

4.6.4 Policy loans

As with whole life insurance policies, the UL policyholder can usually obtain a loan from the insurance company against the cash surrender value of the policy. The loan is limited to a percentage (typically between 50% and 90%) of the cash value. The interest rate will be set at the time of the loan.

The policyholder is not required to pay back the loan, but the loan balance plus any accumulated interest will reduce the death benefit payable under the policy.

A policy loan is also considered to be a taxable disposition, which may result in taxable income to the policyholder, as discussed in a later Chapter.

EXAMPLE

Joshua had a UL policy that named his daughter Rebecca as the beneficiary. The policy had a $250,000 level death benefit and a cash surrender value of $35,600 when he took a policy loan of $30,000 at an interest rate of 4% annually to help pay for her post-secondary education. By taking the policy loan, Joshua also had to report taxable income of $1,800, according to the information provided by his insurance company. One year later, Joshua died. Assuming he did not make any principal or interest payments on the policy loan, Rebecca would receive a death benefit of $218,800, calculated as ($250,000 – $30,000 – ($30,000 × 4%)).

One of the advantages of taking a policy loan instead of simply withdrawing money from the policy is that funds continue to earn tax-sheltered income within the policy's investment account. However, the interest rate charged on a policy loan may be higher than the return on the funds.

4.6.5 Collateral for third-party loans

If the UL policyholder wants access to the capital within his policy but does not want the taxable disposition that would result from either a withdrawal or a policy loan, he may be able to use the cash surrender value of the policy as collateral for a loan from a third party. In this case, the loan arrangement is usually made with a financial institution, which may require additional proof of assets or income before granting the loan. Depending on the arrangement, principal and interest repayments may or may not be required. However, the full cash value stays in the policy, where it continues to grow on a tax-sheltered basis.

EXAMPLE (CONT.)

Suppose that instead of taking out a policy loan of $30,000, Joshua had taken a 5-year loan from his local bank at 4% interest, using his UL policy as collateral.

At the end of the first year of the loan, Joshua made a repayment of $6,738 to the bank ($5,538 principal, $1,200 interest).

When Joshua died one year after taking out the loan, the bank received a death benefit of $24,462, calculated as ($30,000 – $5,538), and Rebecca received the balance of $225,538, calculated as ($250,000 – $24,462).

4.6.6 Leveraging

Leveraging is a variation of a third-party loan. A UL policyholder may be able to obtain a loan, or series of loans, from a bank, where the cash surrender value and death benefit are used as collateral. In this case, the principal and interest generally is not repaid while the life insured is living. The accrued debt (i.e., the principal plus accrued interest) is discharged only upon the death of the life insured.

These loans are not taxable, so the policyholder can then use the full amount of the loan, or series of loans, to invest elsewhere, or to supplement his income. If the proceeds are invested to produce property income (i.e., dividends, interest or rents), the loan interest being accrued against the policy loan is even tax-deductible to the policyholder.

EXAMPLE

Wendy has a UL policy with a $500,000 death benefit and a CSV of $260,000. She retired at 55, earlier than anticipated, and thinks she may need to draw on her UL policy to support her retirement income until her CPP and OAS benefits start. However, if she simply withdraws the money from the policy, it will result in taxable income. Instead, she approached a bank about receiving a loan of $10,000 each year for 10 years, using her UL policy as collateral. She will receive the loan proceeds tax-free, resulting in greater after-tax income than if she had withdrawn $10,000 from the policy each year.

This can be a dangerous strategy if investment returns are lower than anticipated. UL policyholders who leverage their policies should pay close attention to how quickly loan interest is accruing, relative to the investment growth within the policy and the mortality and expense deductions. If the value of the loan(s) plus accrued interest exceeds the cash surrender value of the policy, the bank may decide to demand repayment of the loan. If the policyholder does not have any other funds to satisfy this debt, he could be forced to surrender the policy to pay off the loan, leaving him uninsured, and with a potential tax liability as well.

EXAMPLE (CONT.)

Wendy will need to monitor the investment returns earned within the policy, to ensure that the loans and ongoing mortality and expense deductions do not reduce the policy's cash surrender value to the point where it is less than the outstanding loans plus accrued interest.

4.6.7 Distribution upon death

What happens to the investment account (i.e., accumulating fund) within the UL policy upon death of the life insured depends on the death benefit option provided by that policy. As discussed earlier in the Section *Death benefit options*:

- **Under the level death benefit option:**

  The insurance company usually only pays out the face amount, although some policies will pay out the value of the investment account that exceeds the policy's face amount.

- **Under the level death benefit plus account value option:**

  The policy will pay out the original face amount, plus the full value of the investment account.

- **Under the level death benefit plus cumulative premiums option:**

  The policy will pay out the original face amount, plus the sum of all of the premiums, regardless of the value of the investment account. Any excess that may remain in the investment account is retained by the insurance company.

- **Under the indexed death benefit option:**

  The policy will pay out the original face amount, indexed according to the rate specified in the policy, regardless of the value of the investment account. Any excess is retained by the insurance company.

4.7 Advantages and disadvantages of universal life (UL) insurance

The advantages and disadvantages of UL insurance are summarized in Table 4.2.

TABLE 4.2

Advantages and disadvantages of universal life (UL) insurance

ADVANTAGES	DISADVANTAGES
▪ Offers considerable flexibility to the policyholder; ▪ Policyholder can increase, decrease or even suspend premiums, as long as the policy's account value can support the mortality and expense deductions; ▪ Policyholder has a choice of investment products; ▪ Offers the opportunity for tax-sheltered investing, within limits.	▪ Product is complex and may be difficult for the policyholder to understand; ▪ Policyholder needs to actively monitor the performance of the investment account, and make adjustments to policy investments as needs change; ▪ Entire premium is subject to premium tax; ▪ Policy performance is sensitive to changes in investment performance.

4.8 Comparing universal life (UL) and whole life

Table 4.3 summarizes the differences between whole life insurance and UL insurance.

TABLE 4.3

Whole life insurance vs. universal life (UL) insurance

	UNIVERSAL LIFE INSURANCE	WHOLE LIFE INSURANCE
MORTALITY DEDUCTIONS AND EXPENSES	▪ Mortality deductions and expenses are deducted from investment account. ▪ Mortality deductions may be based on YRT or LCOI costing.	▪ Mortality deductions and expenses are taken from policy reserves.
PREMIUMS	▪ A missed premium does not trigger a premium loan; mortality deductions and expenses continue to be drawn from the investment account. Policy may lapse once the account value becomes insufficient to cover these deductions (subject to grace period).	▪ Premiums are typically level for the life of the policy (unless it is an adjustable policy). ▪ A missed premium will trigger an automatic premium loan. ▪ Additional automatic premium loans will be made until the CSV becomes zero, when the policy will lapse (subject to grace period).
DIVIDENDS	▪ Does not provide policy dividends.	▪ Policy may pay dividends.
DEATH BENEFIT	▪ Policyholder has options with respect to the death benefit (e.g., death benefit plus account value, death benefit plus cumulative premiums).	▪ Death benefit is generally not affected by the value of the investment account.
MODAL FACTORS	▪ Modal factors generally are not used.	▪ Modal factors apply if premiums are paid other than annually.
INVESTMENT	▪ Policyholder can choose how the investment account is invested.	▪ Insurance company chooses how the policy reserves are invested.

4.9 Using universal life (UL) insurance

Universal life insurance is most appropriate for an investment-savvy policyholder who has long-term insurance needs and who is also looking for tax-advantaged investment opportunities.

This Section provides a few examples of when UL insurance might be appropriate.

4.9.1 Maxed out registered retirement savings plan (RRSP) and tax-free savings account (TFSA)

Universal life insurance policies may be attractive to people who have already maxed out their RRSPs and TFSAs, especially if they have a high marginal tax rate. From a tax-efficiency standpoint, repayment of non-deductible debts before using UL insurance policies for investment purposes is also recommended.

EXAMPLE

Alistair is 45 years old and a senior project manager at an engineering company. His company offers a defined benefit pension plan, which severely limits his personal RRSP contribution room. He has already maxed out his TFSAs, and he is looking for additional tax-advantaged ways to save for retirement. He also wants $500,000 of life insurance coverage to create a scholarship fund upon his death.

Alistair may be interested in a universal life insurance policy. If he maximizes his premiums to the policy, the investment account will grow tax-free. If he chooses a UL policy that pays out the death benefit plus account value upon death, the entire amount will be paid out tax-free, leaving an even larger legacy.

4.9.2 Tax-free retirement income

Leveraging a UL policy can provide a tax-free source of retirement income.

EXAMPLE

Joan expects to be in the highest marginal tax rate during her retirement, so she is looking for sources of retirement income that will not be subject to tax. She has already maxed out her tax-free saving account (TFSA), and does not want to put more money into registered retirement savings plans (RRSP) because the withdrawals will be highly taxed due to her marginal tax rate. She can maximum fund a UL policy, which will provide tax-free investment growth. During retirement, she can obtain a series of loans, using the policy's cash value as collateral. Because she won't actually be withdrawing the funds, no income tax is triggered. Furthermore, the investment account remains intact, so it can continue to earn tax-free income.

CHAPTER 5

RIDERS AND SUPPLEMENTARY BENEFITS

Competency component

- Analyze the available products that meet the client's needs.

Competency sub-component

- Analyze the riders that meet the client's needs.

5
RIDERS AND SUPPLEMENTARY BENEFITS

This Chapter covers the most common riders and supplementary benefits that can be added to life insurance policies. While the terms “riders” and “supplementary benefits” are often used interchangeably, riders provide additional benefits upon death, and supplementary benefits provide benefits before the death of the life insured. Collectively, riders and supplementary benefits are the “extras” that can be added to customize a policy to better address a policyholder’s unique needs.

Riders and supplementary benefits are usually added at the time of issue, although sometimes they can be added to an existing contract. Most riders and supplementary benefits can apply to both term insurance and permanent insurance policies.

Riders and supplementary benefits typically require the payment of additional premiums and, with the exception of the paid-up additions rider, they do not increase the policy’s cash surrender value.

5.1 Riders that provide additional benefits upon death

Riders can be used to expand upon the death benefit offered by the base policy. They are discussed in the following order:

- Paid-up additions (PUA) rider;
- Term insurance riders;
- Accidental death (AD) rider;
- Guaranteed insurability benefit (GIB) rider.

5.1.1 Paid-up additions (PUA) rider

A paid-up additions (PUA) rider allows the policyholder of a whole life or universal life (UL) insurance policy to pay additional lump-sum premiums to buy small amounts of paid-up permanent life insurance during the lifetime of the base policy. These PUAs increase the death benefit and the cash surrender value (CSV) of the policy. This is similar to the PUA dividend option under a participating whole life insurance policy, where policy dividends are automatically used to purchase additional amounts of paid-up insurance.

The PUA rider is underwritten at the same time as the base policy, so no additional evidence of insurability is required when the policyholder purchases the PUAs. However, the insurance contract usually places limits on the rider, such as:

- The minimum PUA that can be purchased at any one time;
- The maximum PUAs that can be purchased in any one year;

- The cumulative maximum PUAs that can be purchased over the life of the policy;
- When the policyholder can purchase PUAs (e.g., on policy anniversary);
- The maximum age of the life insured at the time of purchase.

The minimum PUA restriction is to reduce administrative expenses associated with the purchase. The remaining restrictions ensure that the policyholder does not wait until his health fails before making a significant increase in coverage.

EXAMPLE

Valerie is a business professional and she is the main income earner for her family. She expects her salary to increase at a rate of 5% per year. She has a $500,000 whole life insurance policy with a PUA rider. Under this rider, she is permitted to buy additional coverage of $10,000 per year for the next 20 years, without proving her insurability, by making lump-sum payments. She likes this option because she can increase her coverage as her salary increases. She is not required to purchase the additional coverage in any one year, but if she does not do so, she cannot carry that purchase forward (i.e., she cannot purchase $20,000 of coverage in the following year).

5.1.2 Term insurance riders

A term insurance rider adds additional coverage for death, over and above that provided by the base policy, for a limited period of time (i.e., the term).

The term insurance rider can apply to the life insured under the base policy (i.e., the primary insured), or it can apply to someone else. In the latter case, the coverage on the additional person is underwritten separately from the coverage on the primary insured under the base policy. The amount of coverage on the term insurance rider is independent of the coverage provided by the base policy, and can in fact be for a greater amount.

A term insurance rider cannot have a term that exceeds the term of the underlying policy. Once the base policy expires, so does the rider. If this is a concern, the policyholder should look for a term insurance rider that has a conversion option, so the rider coverage can be converted to a stand-alone policy upon expiry of the base policy, without having to provide proof of insurability.

There are several variations of term insurance riders, as discussed below.

5.1.2.1 On a term policy

It is quite common for term insurance riders to be added to term insurance policies.

For example, the family or child coverage riders discussed later in this Section could be added to a term insurance policy.

The primary reasons for covering these additional people with a rider instead of obtaining coverage under a separate policy are convenience and cost. By using a rider, the policyholder only has to manage a single policy, and pay one premium. It also reduces the administrative fees paid by the policyholder. The premiums for most life insurance policies include an annual policy fee, typically in the order of $50 to $100, to help cover the costs of administering the policy. The policy fee is usually a fixed sum regardless of the amount of coverage provided, and it is usually not affected by the addition of one or more riders.

5.1.2.2 On a permanent policy

Often a policyholder will have a mix of long-term and short-term insurance needs. To satisfy both needs, that person could buy some form of permanent insurance to cover the long-term needs, along with a term insurance rider to cover the shorter-term needs.

EXAMPLE

Zoltan is a business owner and he hopes to pass his business on to his children when he dies, but he expects that a tax liability of $500,000 will result at death. He also has a $200,000 mortgage with 10 years remaining, that he would like to have paid off if he dies. The insurance need with respect to the mortgage has a specific duration (10 years) that could be covered with term insurance. The insurance need with respect to the business shares has no defined time limit, so permanent insurance might be appropriate. Zoltan could cover both needs by acquiring a $500,000 whole life insurance policy with a 10-year $200,000 term insurance rider. This would be more cost-effective than paying for a $700,000 whole life insurance policy.

5.1.2.3 Family coverage rider

The family coverage rider is a common addition for policyholders who have a spouse and children. It is sold in units that cover all eligible family members (i.e., the spouse and all eligible children). For example, a unit might provide coverage of $5,000 for the spouse and $1,000 for each child.

The insurance company normally limits the number of units that can be purchased under the rider, but that limit is usually sufficient to cover or at least offset the funeral or burial expenses the policyholder might incur upon the death of a spouse or child.

The family coverage rider is underwritten based on the spouse's attained age when the rider is issued. The spousal coverage usually will not extend past a certain age, such as 65.

The number of children covered under a family coverage rider does not affect the premium. Once the rider is in place, every child in the family, including adopted children, is automatically covered once they reach 15 days of age, without any increase in the premium. Death during the first two weeks of life is not covered under this rider. The coverage usually continues until the child reaches a certain age, such as 21 or 25.

EXAMPLE (CONT.)

Valerie's husband, Robert, is a stay-at-home father, taking care of their two-year-old twins, Rebecca and Charlotte. Valerie is currently seven months pregnant, but she intends to return to work four months after giving birth. Robert's role as caregiver is essential to the financial health of the family, particularly until the children are in school full-time, so Valerie added a family coverage rider to her whole life policy, for $100,000 of term coverage on Robert, and $20,000 of coverage on each of Rebecca and Charlotte. When their son is born in a few months, he will automatically be covered for $20,000 under the rider once he reaches 15 days old, and Valerie's premium will not increase.

5.1.2.4 Child coverage rider

If the policyholder wants to obtain coverage for his children but he does not have a spouse (or does not want to obtain coverage for his spouse), he can add a child coverage rider to his individual insurance policy.

Like the family coverage rider, every child is automatically covered once they reach 15 days of age, without any increase in the premium, and coverage continues to a specific age, such as 21 or 25.

The amount of child coverage is limited to the maximum specified by the rider. The death benefit can be used to offset the funeral or burial costs the policyholder may incur upon the child's death, or for other purposes.

5.1.2.5 Converting child or family coverage riders

A child who is covered under a child or family coverage rider usually has the option of converting that coverage to individual permanent life insurance. The option is usually available at any time while the rider is in effect, up until coverage under the rider expires.

The child does not have to provide proof of insurability. Some riders allow the child to obtain up to five times as much coverage as that provided by the rider itself. The premium for the individual coverage will be based on the child's attained age when the new policy is issued.

EXAMPLE (CONT.)

The family coverage rider on Valerie's policy will cover each child until age 25, and it gives each child the right to convert the term coverage to a whole life policy with a face amount of up to five times the term coverage, or $100,000, without providing proof of insurability. Rebecca has a congenital heart defect that increases her risk of premature death. As long as Rebecca acts before the term insurance coverage expires at age 25, she can still obtain $100,000 of whole life coverage even though she may otherwise be uninsurable.

This same conversion option is usually available to a spouse who is insured under a family coverage rider, although the coverage amount will probably be restricted to the amount covered under the rider.

5.1.3 Accidental death (AD) rider

A life insurance policy with an accidental death (AD) rider will provide an extra benefit, over and above the regular death benefit, if the life insured dies as a result of an accident.

Depending on the insurance company, AD rider coverage may be offered in units (e.g., in multiples of $25,000, to a specified maximum), or it may be a multiple of the death benefit. The most common multiple is two times the death benefit, and as a result this rider is sometimes referred to as "double indemnity."

An accidental death is one that occurs as a result of an unexpected violent or traumatic event. To qualify for the AD benefit, the death must occur within a fixed time after that event (e.g., one year). The AD rider typically excludes deaths resulting from suicide, self-inflicted injuries, war, or the commission of a crime.

Only deaths resulting from accidents are covered; deaths resulting from sudden illnesses are not. Sometimes it may be difficult to determine if the death was caused by an accident or natural causes; in this case a detailed autopsy and analysis of the circumstances leading to death would be required.

EXAMPLE

Janet had a $250,000 whole life insurance policy with a rider that doubles her death benefit for accidental death. She was found dead at the wheel of her car after it struck a concrete bridge. Her autopsy showed that she suffered a mild heart attack, which likely contributed to the accident, but that ultimately she died as a result of injuries sustained in the crash. Janet's beneficiary will receive death benefit proceeds of $500,000. However, if the autopsy had shown that Janet had died instantly from a massive coronary event, her beneficiary would likely only receive the original $250,000 death benefit.

AD rider coverage may be limited to certain ages, even if the base policy is not subject to the same limitations. For example:

- The policyholder may have to apply for AD coverage before the life insured reaches a certain age, such as 55;
- The AD coverage may only continue until the life insured reaches a certain age, such as 60;
- The AD coverage may be reduced once the life insured reaches a certain age, such as 65.

AD benefits are often packaged along with accidental dismemberment benefits, which are discussed separately in the Section *Supplementary benefits*. If the rider offers coverage for both accidental death and accidental dismemberment, it is called an "accidental death and dismemberment (AD&D) rider."

5.1.4 Guaranteed insurability benefit (GIB) rider

A guaranteed insurability benefit (GIB) rider gives the policyholder the option to buy additional life insurance coverage in the future without providing proof of insurability. The premiums for the additional insurance will be based on the attained age of the life insured at the time of the addition, but will assume that his health remains the same.

A GIB rider is very useful for those who currently do not have a large insurance need, or who cannot currently afford a larger amount of insurance, but expect they will want to increase their coverage in the future. By adding a GIB rider to a term or permanent policy now, they are guaranteed the right to increase their coverage even if their health declines.

EXAMPLE

Doug recently got engaged, and he and his fiancée Noma plan to have several children. Doug is only 25 and his cash flow is tight, but he knows that he will need a fair amount of insurance protection once they start their family. He purchased a 10-year $300,000 term policy now, along with a GIB rider that will allow him to increase his coverage by up to $20,000 each year.

GIB riders normally include a number of restrictions, such as:

- The option to increase the coverage may only be permitted at certain times, such as within one month of each policy anniversary;
- The amount of each increase may be limited to a specific dollar amount or percentage of the original face amount;
- The total increase may be limited to a specific dollar amount or percentage of the original face amount;

- The number of times the option can be exercised may be limited, such as five times over the duration of the contract;
- The option to increase coverage may only be available until a certain age, such as 50.

5.2 Supplementary benefits (benefits in addition to the death benefit)

Supplementary benefits are those that may be available before the death of the life insured. They may or may not affect the death benefit that is paid upon the death of the life insured and are discussed in the following order:

- Accelerated death benefits;
- Accidental dismemberment benefit;
- Waiver of premium for total disability benefit;
- Parent/payor waiver benefit.

5.2.1 Accelerated death benefits

When accelerated death benefits are added to a life insurance policy, the insurance company will pay out a portion of the death benefit prior to death of the life insured, if certain conditions are met. Accelerated death benefits are sometimes also referred to as living benefits.

There are two types of accelerated death benefits, discussed below.

5.2.1.1 Terminal illness (TI) benefit

A terminal illness (TI) benefit allows the policyholder to apply for an advance on the death benefit if the life insured has been diagnosed with a terminal illness that is expected to result in death within a fixed period of time, such as one year or 24 months. The request must be supported with a diagnosis and prognosis made by a qualified physician.

Many insurance companies build the TI benefit right into their insurance policies. If this is the case, the policyholder does not have to pay an extra premium. Some insurance companies will even extend this benefit on compassionate grounds, even if it is not a contractual obligation.

The TI benefit is usually restricted to a maximum amount, which may be expressed as percentage of the original face amount, ranging from 25% to 75%, and/or a dollar limit (e.g., 50% of the face amount to a maximum of $50,000).

The TI benefit is payable to the policyholder, regardless of who is named as the beneficiary of the life insurance policy. If the beneficiary designation is irrevocable, the policyholder will have to obtain the beneficiary’s permission before applying for a TI benefit.

Because it is an advance of the death benefit, and death benefits are generally not taxable, TI benefits received by the policyholder are tax-free.

The TI benefit reduces the death benefit paid upon the death of the life insured. Some insurance companies structure the TI benefit as a loan at a fixed rate of interest, where the loan is secured by the death benefit. In this case, the death benefit will be reduced by the loan amount plus cumulative interest.

EXAMPLE

William has a $500,000 term life insurance policy on his own life, with his wife, Alyssa, named as the revocable beneficiary. He bought the policy to help Alyssa maintain the family's standard of living if he died prematurely and the family no longer received his employment income. The policy provides for a terminal illness benefit of up to 25% of the death benefit, to a maximum of $100,000.

Unfortunately, William was recently diagnosed with a terminal form of cancer and he is no longer able to work. His oncologist has told him that he will likely die within 6 to 12 months. Alyssa has reduced her work hours to help care for William and to spend more time with him. To help compensate for their loss of income, William applied for, and received, a non-taxable terminal illness benefit of $100,000. When he dies, Alyssa will receive a death benefit of $400,000, which is the original face amount of $500,000 minus the TI benefit of $100,000.

5.2.1.2 Dread disease (DD) benefit (a.k.a. critical illness or CI benefit)

The dread disease (DD) benefit allows the policyholder to receive a benefit if the life insured is diagnosed with one of the conditions specified by the contract. The life insured does not have to be in danger of dying as a result of the condition, but the diagnosis must be supported by a qualified physician.

The conditions covered will vary with the insurance company and the contract. Most policies will cover the "Big 4" (heart attack, stroke, coronary bypass surgery and life-threatening cancer), but many policies cover other conditions as well. In fact, the number of covered conditions may be as high as 25 or even more. The policyholder should review each policy carefully, to understand what is covered and what is not.

The DD benefit is usually paid out as a lump sum, once the life insured has survived for a specified period of time after the diagnosis, such as 30 days. Because it is an acceleration of the death benefit, it is not taxable.

EXAMPLE

Scott has a $500,000 whole life insurance policy that includes a $100,000 dread disease benefit. He recently suffered a stroke that has left him almost fully paralyzed. Provided that he survives at least 30 days following the stroke, he can apply to receive the DD benefit of $100,000.

The conditions under a DD benefit may be similar to those covered under an individual critical illness (CI) insurance policy. In fact, the dread disease benefit is sometimes referred to as a critical illness benefit. This CI-like coverage may allow the policyholder to save money compared to buying separate life and CI policies.

The terminology used by various life insurance companies is often inconsistent and can be confusing. If a life insurance policy uses the term “critical illness benefit” or “critical illness rider”, the policyholder should read the terms of coverage carefully. If the amount paid out when the insured suffers a covered condition reduces the death benefit, the policy is offering an accelerated death benefit, in the form of a dread disease (DD) benefit. If the amount paid out when the insured suffers a covered condition does not affect the death benefit (i.e., it is paid in addition to the death benefit), it is not an accelerated death benefit and is likely a critical illness rider for which an additional premium must be paid.

5.2.2 Accidental dismemberment benefit

The accidental dismemberment benefit is usually found coupled with the accidental death (AD) benefit discussed earlier in the Section *Accidental death (AD) rider*; together they form the accidental death and dismemberment (AD&D) rider.

An accidental dismemberment benefit is a lump sum amount that will be paid if the life insured loses a specific body part or body function as a result of an accident. The losses, and the resulting lump sums, that are payable as a result of each loss are typically laid out in a Schedule of loss, such as the sample shown in Table 5.1.

TABLE 5.1

Sample accidental death and dismemberment (AD&D) Schedule of loss[10]

ACCIDENTAL LOSS	PERCENTAGE OF BENEFIT PAYABLE*
Both hands or both feet	100%
Entire sight of one eye	66 ⅔%
Entire sight of both eyes	100%
Hearing in one ear	16 ⅔%
Hemiplegia (complete paralysis of upper and lower limbs on one side of the body)	100%
Life	100%
One arm or one leg	75%
One foot and the entire sight of one eye	100%
One hand and one foot	100%
One hand and the entire sight of one eye	100%
One hand or one foot	66 ⅔%
Paraplegia (complete paraysis of both lower limbs)	100%
Quadriplegia (complete paralysis of both upper and lower limbs)	100%
Speech and hearing in both ears	100%
Speech, or hearing in both ears	50%
Thumb and index finger of either hand	33 ⅓%

* The maximum payable for any one accident or event is limited to 100% of the death benefit.

The accidental dismemberment benefit will only be paid out if the loss occurs as a result of an unexpected violent or traumatic event, within a fixed time (e.g., one year) of that event. Losses incurred via self-inflicted injuries, war or the commission of a crime are generally excluded.

10. IA Financial Group. *Accidental Death & Dismemberment Insurance*. [online]. [Consulted May 2, 2022]. https://specialmarkets.ia.ca/bcpha/coverage?id=accidental-death-and-dismemberment-insurance

5.2.3 Waiver of premium for total disability benefit

Under the waiver of premium benefit, the insurance company will waive the premiums on the life insurance policy, including premiums for any riders or supplementary benefits, if the life insured becomes totally disabled.[11] The definition of total disability varies with the policy. For example, total disability might be defined as the life insured being unable to carry out his regular employment for the first two years of disability, and unable to do any other job thereafter for which he is reasonably qualified by education, training or experience.

While premiums are being waived, benefits continue to accrue under the policy. This means that dividends will continue to be paid (if it is a participating policy), cash values may continue to grow, and all riders and supplementary benefits remain in force.

5.2.3.1 Waiting period

Premiums will only be waived once the life insured has been disabled for the waiting period specified in the policy. Some policies provide for a retroactive waiving of premiums to the start of the disability, while others only waive premiums that come due after the waiting period has expired.

5.2.3.2 Renewable or convertible term policies

If the base policy is a renewable term insurance policy, then the premiums will continue to be waived after renewal. If the base policy is a convertible term insurance policy, at the end of the term the policy will be converted to a whole life policy, and premiums will continue to be waived for life, or as long as the life insured is disabled.

5.2.4 Parent/payor waiver benefit

The parent waiver benefit (if the life insured is the policyholder's child) or payor waiver benefit (if the life insured is someone other than the policyholder's child) operates much like the waiver of premium benefit that was just discussed, with three notable differences:

- Depending on the policy, premiums may be waived upon the policyholder's death, as well as upon his total disability;
- Because the policyholder is not the same person as the life insured, the policyholder will have to provide proof of insurability for himself as well as for the life insured;
- If the life insured is a child, some policies will state that premiums will be waived until that child reaches a specified age (e.g., 18, 21 or 25).

11. The waiver of premium for total disability benefit may be applied if the policyholder is also the life insured. If the policyholder is not also the life insured, then the policyholder should consider adding a parent/payor waiver, discussed in the following Section.

EXAMPLE

Anwar is the primary income earner in his family; his wife Anya currently cares for their three children, who are all under the age of five. He has a $1,000,000 whole life insurance policy on his own life. He also has a $300,000 term life insurance policy on Anya's life because he knows that he would have to hire someone to care for their children if she were to die. He is the policyholder. He has added a waiver of premium for total disability benefit to the policy on his own life, and a payor waiver benefit to the policy on Anya's life, to ensure that both policies will remain in place if he becomes totally disabled.

5.3 Using riders and supplementary benefits to customize coverage

A policyholder can add riders and supplementary benefits to his base insurance policy to customize or enhance the coverage. This Section explores some of the things a policyholder should consider when determining if these extras are appropriate for him.

5.3.1 Cost of coverage

Each rider or supplementary benefit has a cost associated with it, and in most cases this results in an additional premium for the policyholder. A few of the benefits, such as the terminal illness benefit or the waiver of premium upon total disability benefit, may be built into the base policy, but the policyholder is still paying for those benefits through his premiums for the base policy because the insurance company will have factored those costs into them.

Sometimes the coverage provided by a rider or supplementary benefit is also available as a stand-alone product (e.g., a term insurance rider or critical illness benefit). Usually the coverage via rider or supplementary benefit will be cheaper than the stand-alone product because only one policy fee will be charged. The insurance company may also have lower underwriting costs because they can use the same medical information for both products.

5.3.2 Value of coverage

Of course, a rider or supplementary benefit only has value to the policyholder if it provides the protection he needs, at a reasonable cost.

Consider the accidental death (AD) benefit. Is the policyholder's need for coverage going to be different if the life insured dies from natural causes than if he dies as a result of an accident? The tax liability upon death is going to be the same, and the survivors are going to have the same income needs regardless of how the life insured dies. If an insurance needs analysis shows that insurance protection of $500,000 is needed upon death, should the agent only recommend coverage of $250,000 in the base policy, plus an AD rider that would pay double the benefit if the life insured dies from an accident? Generally, the answer would be no; the full need of $500,000 should be covered regardless of the manner of death. However, if the policyholder cannot afford the premiums for a $500,000 policy, a $250,000 policy with an AD benefit might be a good compromise.

The policyholder also needs to determine if it is coverage he can count on, so he should consider any limitations or exclusions that apply to the riders or supplementary benefits, as discussed below.

5.3.2.1 Limitations

The policyholder should be aware of what conditions would trigger payments under a rider or supplementary benefit, and what the limits on those payments would be. For example:

- Under the accidental death (AD) rider, what is considered to be an accidental death, and what time limits are involved?
- Under a family coverage rider, when is a child eligible for coverage, and when does that coverage cease?
- Under a guaranteed insurability benefit (GIB), by how much can the coverage increase and when are those increases allowed?
- What is the maximum amount that can be added under a paid-up additions (PUA) rider?
- Which health conditions are covered under a critical illness (CI) benefit?

5.3.2.2 Exclusions

The policyholder should also be aware of those conditions under which payments would not be made under a rider or supplementary benefit. For example, accidental death and dismemberment (AD&D) benefits may not be paid if the death or dismemberment occurred as a result of self-inflicted injuries, during the commission of a crime, or as a result of war. These same exclusions often apply to the disability income (DI) benefit, the waiver of premium for total disability benefit, and the payor/parent waiver benefit.

5.3.3 Differences between companies

The death benefit provided by life insurance operates the same way across insurance companies. If the life insured dies, the death benefit is paid (less any outstanding policy loans). The amount of the benefit and the way the benefit is triggered is pretty black and white, without room for interpretation.

However, the various riders and supplementary benefits that can be added to a life insurance policy vary greatly between companies, and even between life insurance products issued by the same company.

EXAMPLES

- Elias decided to take Company A's insurance policy because the waiting period imposed for the waiver of premium benefit is three months and not six months as imposed by some other insurance companies.
- Jackson would like to obtain the maximum dread disease (DD) benefit possible. He compares Companies A and B. He decides on Company B because it provides a DD benefit of 50% of the face amount as opposed to 25% provided by Company A.
- For family history reasons, it is very important for Cindy to find a DD benefit that covers Alzheimer's. Company B does not but she is happy to see that Company A does.

So when policyholders are comparing life insurance policies between companies, they should also pay close attention to the terms and conditions of the riders and supplementary benefits.

5.4 Advantages and disadvantages of riders and supplementary benefits

The advantages and disadvantages of riders and supplementary benefits are summarized in Table 5.2.

TABLE 5.2

Advantages and disadvantages of riders and supplementary benefits

ADVANTAGES	DISADVANTAGES
▪ Can be used to customize coverage to meet policyholder's unique needs; ▪ Some benefits may be cheaper when acquired via a rider or supplementary benefit than when acquired as a stand-alone policy; ▪ Conversion to individual stand-alone coverage without proof of insurability may be possible for term insurance riders; ▪ May give the policyholder access to higher coverage later, without providing proof of insurability (for GIB and PUA riders), while allowing him to pay for a lower amount of coverage now.	▪ Additional premiums are usually required; ▪ There may be limitations and exclusions on coverage; ▪ Coverage expires when the base policy expires; ▪ Depending on the benefit, separate underwriting on the life insured and the policyholder may be required.

CHAPTER 6
GROUP LIFE INSURANCE

Competency component

- Analyze the available products that meet the client's needs.

Competency sub-component

- Analyze the types of contracts that meet the client's needs.

6
GROUP LIFE INSURANCE

Group insurance policies can provide a variety of benefits that are often packaged together, including medical and dental benefits, disability benefits and life insurance. This Chapter concentrates on life insurance provided through a group insurance plan. The remaining group insurance benefits are covered in the *Accident and sickness insurance* Module.

6.1 How group life insurance works

Group life insurance is coverage that is offered by a plan sponsor to a group of people who have some form of common association with that sponsor.

6.1.1 What constitutes a group

Almost any group that has a sufficient number of people with a common characteristic can be insured under a group life insurance plan. For example, group life insurance plans may be available to:

- All employees of a certain employer;
- Executives and managers of a certain employer;
- Alumni from a specific university;
- Members of an occupational association;
- Members of a business association;
- Members of a retail association.

EXAMPLE

Helen is a university graduate with an engineering degree, and she is registered as a professional engineer with an occupational association. She is self-employed as a consultant and is a member of her local Chamber of Commerce. She has also purchased memberships with two retail associations. Because she is self-employed, she cannot obtain life insurance through her employer. However, she frequently receives invitations to apply for group life insurance through the university's alumni association and the other associations.

6.1.2 Policyholder

The policyholder of a group life insurance plan is the business or organization that enters into a contract with an insurance company to provide life-insurance coverage to the members of its group. The policyholder is often referred to as the "plan sponsor."

6.1.3 Master contract

A group life insurance plan is governed by a master contract between the plan sponsor and the life insurance company. There is no direct contract between the life insured and the insurance company. This means that the plan member has no control over the contract beyond naming the beneficiary and potentially buying additional optional coverage if the plan permits.

EXAMPLE

Derek suffers from a health problem that will not allow him to buy life insurance. His employer offers a group life insurance plan with $100,000 of coverage for which he is eligible despite his medical condition.

Because the group member is not the policyholder, he does not get a copy of the master contract. However, all of his benefits and rights under the contract will be described in a benefit booklet, which he will receive upon joining the plan.[12]

6.1.4 Group membership

A group plan member is a person who is insured under the group plan's master contract. To obtain coverage under a group life insurance plan, the plan member must meet the eligibility criteria that define the group, as set by the plan sponsor.

If the plan is sponsored by a membership association (e.g., an alumni association, professional association, Chamber of Commerce), the person generally has to be a current association member in good standing to obtain coverage under the group life insurance plan. For these types of group plans, membership in the group plan is optional and the member has to apply for coverage. Group members generally must maintain their membership in the sponsoring organization to continue coverage over time. Some plans give the member an option to convert to individual term or permanent coverage if they terminate their association membership, as discussed in the Section *Conversion privileges*.

12. In Québec, the plan member can consult and obtain a copy of the master contract from the plan sponsor.

If the group life insurance plan is sponsored by an employer, new employees are generally eligible to become members of the plan upon satisfying the group's probationary period, which is the length of time they must work for that employer before they are eligible for coverage. The probationary period, which is often in the order of three months, may also be referred to as the waiting period.

Some employers automatically enroll employees in the group life insurance plan as soon as they have satisfied the probationary period. Other employers give the employee the option of becoming a plan member, particularly if the plan requires employee contributions. If membership is optional, the employee usually has a limited period of time called the enrolment period, which occurs after the probationary period, during which time he can enroll in the group plan and obtain life insurance coverage without providing any evidence of insurability.

6.1.4.1 Actively-at-work requirement

For employer-sponsored group plans, one additional requirement is that the employee must be actively at work on the day his coverage under the group plan starts. If enrolment is optional and the employee decides to enroll in the plan partway through the enrolment period, he must actually be at work before coverage will commence. If he is away from work due to illness or vacation, his coverage will not begin until he returns to work.

6.1.4.2 Membership classes

The amount of coverage available under a group life insurance plan is generally determined the same way for everyone within that group, as discussed in the Section *Schedule of benefits*.

However, some employer-sponsored group plans may have more than one membership class under a single group plan, with different amounts of coverage for each class.

EXAMPLE

The DEF Company, manufacturer of kitchen cupboards, sponsors a group insurance plan for its employees. The plan provides a death benefit equal to one times salary for all full-time factory floor employees, and two times salary for all salaried managerial staff.

6.1.5 Premiums

The premiums for group life insurance are based on the makeup of the group as a whole, and not the specifics of each individual. For example, the life insurance company might charge $0.20 for every $1,000 of coverage, and that rate will apply to each person in the group, regardless of that person's age, gender or smoking status. However, the insurance company will usually recalculate the premium every year, to reflect changes in the group's demographics over time. For example, if the group's average age increases, the premiums per member will likely increase as well to reflect the greater risk of death.

Most group life insurance plans require the employer to cover at least 50% of the premiums themselves, but some employers choose to pay the full amount. If the group plan is contributory (i.e., if the employees must cover a portion of the premiums), the employer remits the full amount of premiums to the insurance company, and then deducts the employees' contributions directly from their pay.

6.1.5.1 Tax treatment for employer

If an employer pays some or all of the premiums for a group life insurance plan, it can deduct those premiums as a business expense.

6.1.5.2 Tax treatment for employee

If an employer pays some or all of the premiums for a group life insurance plan, those premiums are considered to be a taxable benefit for the employee.

Any premiums paid by the employee are not deductible to either the employer or the employee. The premiums paid by the employee via payroll deduction are taken from his pay.

EXAMPLE

Aimee is a member of her employer's group life insurance plan. The annual premiums for Aimee's participation in the plan amount to $500, and the employer pays 60% of these premiums, or $300. This results in a taxable benefit of $300 for Aimee, which will be added to her annual income. The employer also deducts $200 from her pay to cover her share of the premiums.

Regardless of who pays the premiums, any death benefits paid out under a group life insurance plan are not taxable to the employee, his estate or the beneficiary of the policy.

6.1.5.3 Sales tax on premiums

Like individual life insurance premiums, premiums paid under a group life insurance plan are subject to a provincial insurance premium tax, which ranges from 2% to 5% of life insurance premiums, depending on the province. This provincial insurance tax is usually built right into the price quoted by the insurance company.

However, unlike individual life insurance premiums, premiums paid under a group life insurance plan are also subject to provincial retail sales tax in some provinces, as follows:[13]

- 8% in Ontario;
- 9% in Québec;
- 7% in Manitoba.

In addition, GST/HST is charged on any administrative fees associated with a group life insurance plan.

6.2 Group term insurance coverage

With individual life insurance, the policyholder has considerable freedom when deciding on the amount of coverage to purchase. Under a group life insurance plan, the coverage is restricted by the terms of the plan. All members of the plan receive a prescribed amount of base coverage (i.e., the coverage that is automatically provided for each member of the plan). Depending on the plan, they may or may not be able to buy additional optional coverage.

Most group life insurance takes the form of yearly renewable term insurance, particularly for the base coverage.

6.2.1 Schedule of benefits

The base level of coverage provided by a group insurance plan is usually prescribed by a schedule of benefits that is part of the master contract. If the group plan has different membership classes, then a different schedule of benefits will apply to each class.

The schedule of benefits usually takes one of the following formats:

- Earnings multiple;
- Flat rate;
- Length of service;
- Combination.

These are explained in more detail below.

13. PWC. *Insurance Industry: Key tax rates and updates.* [online]. Revised August 27, 2021. [Consulted May 2, 2022]. https://www.pwc.com/ca/en/industries/insurance/publications/insurance-industry-key-tax-rates-updates.html

6.2.1.1 Earnings multiple

The most common schedule of benefits is an earnings multiple schedule, which provides coverage equal to a multiple or fraction of the member's base salary (i.e., excluding bonuses or overtime).

Coverage provided under an earnings multiple schedule may be limited to a maximum specified by the plan.

6.2.1.2 Flat rate

Under a flat rate schedule, every group member receives the same dollar amount of life insurance coverage, regardless of their position, salary or wage. Flat rate benefit schedules are often used by unionized groups that cover employees who earn an hourly wage.

6.2.1.3 Length of service

Some older plans may be based on length of service to the employer; they were intended to reward long-serving employees. However, this type of schedule is rarely used today.

6.2.1.4 Combination

Some employers opt for a combination schedule that incorporates several factors, such as earnings and position. For example, a schedule of benefits may provide an earnings multiple benefit to salaried employees, and a flat rate to hourly employees.

EXAMPLE

Sandy, Maria and Rob all work for a company that manufactures electronics. Their employer's group life insurance plan offers the following:

Life insured and salary	Category	Benefit provided by the group life insurance plan
Sandy works on the assembly line and earns $23 per hour.	Hourly-paid employees	Flat rate coverage of $50,000
Rob is a manager with a salary of $92,000, plus an annual bonus which is typically around $10,000.	Manager	Amount equivalent to one times the annual salary
Maria is the vice president and her salary is $190,000, with the potential for a bonus of up to 30%.	Executive	Amount equivalent to twice the annual salary

So, Sandy's life is insured for $50,000, Rob's life is insured for $92,000, and Maria's life is insured for $380,000.

6.2.2 Coverage maximums

Most group life insurance plans place a cap on the amount of coverage for any single plan member, particularly when coverage is a multiple of earnings for highly paid employees.

6.2.3 Reductions for older or retired group members

Recall that the risk of death generally increases with age, and thus the cost of insurance also increases with age. To keep costs reasonable for the group as a whole, the plan's schedule of benefits may specify reduced coverage for older or retired members. Depending on the plan, the reduced coverage may be determined as:

- A fixed percentage of pre-retirement coverage;
- A fixed dollar amount;
- A gradual decline each year until the specified minimum is reached.

EXAMPLE

Carl is a member of his employer's group life insurance plan, which provides a base benefit of $100,000. He plans to retire next year, when he turns 60 years old. At that time, his coverage will drop to 50% of the base coverage. At age 65 it will drop to 25% of the base coverage, and at age 70 coverage ceases completely.

6.2.4 Optional additional coverage

In addition to the base coverage that is provided to all group members, some group plans allow members to purchase additional coverage. This allows the member some ability to customize the coverage to his unique needs. The member must be enrolled in the plan's base life insurance plan before he can buy the additional coverage.

Usually the group member will have to provide evidence of insurability when applying for the additional coverage, because the ability to choose the coverage amount creates the potential for adverse selection, also known as "anti-selection." Adverse selection refers to the phenomenon where someone who is at greater risk (or who perceives himself to be at greater risk) is more likely to buy insurance to cover that risk, and is more likely to make a claim than the average person within the group.

However, some group plans allow the member to buy additional coverage without providing evidence of insurability if they do so within a specified period of time (e.g., within 60 days of being eligible for group life insurance). This prevents the plan member from waiting until he experiences signs of illness to buy the additional coverage, which is an example of adverse selection.

While the employer usually pays at least 50% of the premiums for the group plan's base coverage, the member typically must pay the full amount of premiums for any optional coverage.

6.2.4.1 Term coverage

The majority of this additional coverage takes the form of term life insurance. It is usually available in multiples of fixed units (e.g., $25,000 per unit). Members can buy as many additional units as they want, up to a maximum. Members cannot buy partial units. The total amount of coverage (base coverage plus additional coverage) is usually subject to an overall maximum amount.

EXAMPLE

Mario is 55 years old and he recently started a new job. He was automatically enrolled in the company's group life insurance plan last week, which covers him for $75,000. He just took out a new mortgage for $200,000, and he would like to add $200,000 of life insurance to cover this debt if he dies. Because of health issues, individual insurance would be very expensive, assuming he could even get coverage. However, his group life insurance plan allows members to buy up to 10 units of additional term insurance coverage, where each unit is $25,000. As long as they apply for this coverage within 60 days of joining the plan, no evidence of insurability is required. Thus, Mario can take advantage of the group life insurance plan to get the coverage he needs at a more affordable cost.

Some plans extend this optional coverage to the member's spouse, with the same coverage units and maximums. This is separate from the coverage that may be available on the spouse under a dependant coverage provision, as discussed in the Section *Dependant life coverage*.

6.2.4.2 Permanent coverage

In rare cases, the optional coverage may include some type of permanent life insurance, such as whole life. However, permanent life insurance is more commonly an option upon policy conversion, as discussed in the Section *Conversion privileges*.

6.3 Dependant life coverage

Most group life insurance plans give members the option of buying life insurance coverage on their dependants. As long as they place this coverage within a short time of joining the plan (e.g., 60 days), they will not have to provide proof of insurability for those dependants. If a member's marital status changes, some plans allow the member to place coverage on the dependant(s) without proof of insurability as long as it is done within a specified period of time.

Because dependant coverage is optional, the principal of adverse selection applies. A member is more likely to take advantage of the dependant coverage if that dependant is a poor insurance risk. As a result, premiums for dependant coverage are often higher than premiums on an independent single life policy.

6.3.1 Definition of dependant

The definition of dependant for the purpose of group life insurance may vary with each group plan, but it typically includes:

- The plan member's spouse or common-law partner (includes both opposite-sex and same-sex relationships);
- The plan member's children, if they depend on the member for financial support and they are between the ages of 14 days and an upper limit (often 18, 19 or 21 years of age). Coverage applies to biological, adopted and step-children. Extended coverage may be available past the specified age as long as the child continues to attend school full-time, up to a maximum age (usually between 23 to 25 years of age). If the child is disabled and unable to work, coverage may be available indefinitely.

In many group plans, dependant coverage applies to all of the member's dependants, regardless of the number of dependants.

EXAMPLE

Chuck and Paul both work at the same company, and they are both covered for $200,000 under their employer's group life insurance plan. Chuck is married, but he and his wife do not have any children. Paul has a wife and two young children, and they expect a third child in a few months. Chuck and Paul both opted to buy the optional dependant coverage offered by their group plan. Despite the difference in the number of their dependants, Chuck and Paul will pay the same premiums. Also, Paul's newborn will automatically be covered under the plan after reaching 14 days of age.

However, some group plans require the plan member to apply and pay for separate coverage for each eligible dependant.

6.3.2 Death benefit amount

The death benefit under dependant life coverage is quite modest compared to the coverage on the member's own life or the optional spousal coverage available under some plans. While the actual amount will vary with the policy, dependant coverage is usually in the range of $5,000 to $20,000 on the spouse's life, with 50% of this amount on the life of each dependent child.

6.3.3 Premiums

Premiums for dependant life insurance are usually the same for each group plan member, regardless of his age or number of his dependants. However, some group life insurance plans do require a separate premium for each dependant. Because the amount of coverage is so low, the annual premium is quite small (e.g., dependant life insurance that covers all children for $10,000 might cost in the order of $2 per month).

6.4 Survivor income benefits

Some group life insurance plans also provide a monthly survivor income benefit in addition to a death benefit when a group plan member dies. The survivor income benefit is normally an optional benefit that can be purchased by the plan member.

6.4.1 Beneficiaries

The survivor income benefit is normally payable to the plan member's surviving spouse or common-law partner, until that person reaches age 65, remarries or dies.

Survivor income benefits may also be payable to the plan member's surviving children, until they reach a certain age (e.g., until age 21). This duration may be extended for children who are attending school full-time.

Some plans give the plan member the option of choosing survivor income benefits that are only payable to the surviving children.

6.4.2 Benefit amount

While the exact amount will depend on the group plan, the survivor income benefit is normally expressed as a percentage of the group member's monthly salary just prior to death.

EXAMPLE

A group life insurance plan offered by University ABC allows plan members to buy coverage that will pay monthly survival income benefits equal to 25% of the member's monthly basic earnings to the surviving spouse, plus 5% of monthly basic earnings to each surviving child.

Some plans call for higher benefits to be paid to the surviving children if the plan member's spouse predeceased him (i.e., if the children were orphaned by the plan member's death).

Survivor income benefits may be subject to a monthly, annual or cumulative cap, depending on the plan.

6.5 Accidental death and dismemberment (AD&D)

Group life insurance plans often provide accidental death and dismemberment (AD&D) benefits.

Under the accidental death portion of AD&D coverage, the insurance company will pay an extra benefit, over and above the regular death benefit, if the plan member dies as a result of an accident. This extra benefit is usually equal to the basic death benefit.

Under the accidental dismemberment portion of AD&D coverage, the insurance company will pay a lump sum if the plan member loses a specific body part or body function as a result of an accident. The lump sum is usually equal to, or a fixed percentage of, the basic death benefit, depending on the extent of the loss. This is covered in more detail in the *Accident and sickness insurance* Module.

6.5.1 Basic vs. voluntary AD&D

Some group life insurance plans automatically provide AD&D coverage to plan members; this is referred to as basic AD&D. The amount of basic AD&D benefits is usually tied to the benefit otherwise payable upon death.

Other plans give plan members the option of buying AD&D coverage; this is referred to as "voluntary AD&D." Like optional life insurance coverage, voluntary AD&D is usually purchased in multiples of a specific unit (e.g., $10,000 or $25,000), and the member can buy multiple units up to a maximum amount.

EXAMPLE

Charlotte's group life insurance plan provides a death benefit equal to her annual salary, or $120,000. She also purchased four units of voluntary AD&D coverage, at $25,000 per unit. If she dies as a result of an accident, her beneficiaries will receive a total of $220,000, calculated as:

($120,000 + (4 × $25,000))

However, if she dies as a result of an illness, her beneficiaries will only receive $120,000.

Because AD&D benefits are only payable as a result of an accident, evidence of insurability is not required.

6.5.1.1 Coverage for dependants

Some group insurance plans also allow the member to buy AD&D coverage for his spouse and/or children. Usually, coverage for the dependants is a fixed percentage of the coverage on the plan member himself.

EXAMPLE

The group life insurance plan for University DEF Alumni allows members to buy $25,000 of AD&D coverage for $1.00 per month for member-only coverage, or $1.38 for the "member and family plan." Under this plan, the member's spouse and children are covered for a percentage of the member's own AD&D benefits, as follows:

Eligible family members	% of member's benefit applicable
Spouse only	50%
Spouse and dependent children	Spouse: 40% Each dependent child: 5%
Dependent children only (no spouse)	Each dependent child: 15%

6.5.2 Exclusions

AD&D benefits will only be paid if the loss occurs as a result of an unexpected violent or traumatic event. However, losses due to certain activities or events are often excluded. Common exclusions include losses that result from:

- Self-inflicted injuries;
- War;
- Active service in the armed forces;
- Commission of a crime by the insured;
- Driving while impaired;
- Piloting a non-commercial aircraft.

6.5.3 Overall limits

If voluntary AD&D coverage is available in multiples of a fixed unit, the group plan will typically place an overall limit on the number of units that a group member can buy (e.g., units of $10,000 to a maximum of 10 units or $100,000).

6.6 Conversion privileges

A member of a group life insurance plan generally has the right to convert some or all of his group life insurance coverage to individual coverage with the same insurance company, without providing proof of insurability, if:

- He leaves the plan because he retires or changes employers;
- He is no longer a member of the sponsoring organization;
- The plan itself is terminated.

EXAMPLE

Derek's employer is experiencing financial hardship and it has terminated the group plan to cut costs. While Derek may be able to convert his coverage to an individual policy (see the Section *Conversion privileges*), it will still be considerably more expensive than the group insurance coverage, and he will have to pay the premiums himself.

6.6.1 In Québec

The Québec *Act respecting insurance* includes specific rules that protect a group member's rights when he leaves a group life insurance plan, or when the master contract expires or is cancelled.

6.6.1.1 Leaving the plan

The Québec *Act respecting insurance*[14] specifies that if a group life insurance plan member leaves the group prior to age 65, he must be given the option of converting some or all of his life insurance coverage into the same amount of individual insurance. This also applies to any spousal or dependant life insurance coverage that existed under the group plan.

The amount of insurance on the participant's life that is eligible for conversion must be at least \$10,000 and may not exceed \$400,000. In addition, the amount of dependant life insurance that may be converted must be at least \$5,000 for his spouse and for each dependant, without exceeding the amount of insurance on the life of those persons on the conversion date.

The plan member must be allowed to exercise these conversion rights for at least 31 days after leaving the group, without providing evidence of insurability for himself, his spouse or dependants. The group insurance will remain in force during that 31-day period, or until it is converted into individual insurance.

14. Gouvernement du Québec. *Regulation under the Act respecting insurance – Insurers Act, s.62*. [online]. Current to 2021-12-01. [Consulted May 2, 2022]. https://www.canlii.org/en/qc/laws/regu/cqlr-c-a-32.1-r-1/196499/cqlr-c-a-32.1-r-1.html

The member must be given the following options upon conversion:

- Coverage that is comparable to that provided by the group insurance contract as to the amount and the term; or
- Individual life insurance for one year, providing protection comparable to that provided under the group insurance contract, but convertible at the end of the year into permanent protection.

6.6.1.2 Master contract terminates

If the master contract expires and is not replaced, or if it is replaced with a contract that provides for a lesser amount of insurance, any plan member who has been insured under the expired contract for at least five years must be given the option of converting all or a part of his coverage into individual life insurance within 31 days of expiry of the master contract. The amount of insurance eligible for conversion upon expiry of the master contract must be at least $10,000 or 25% of the amount of the member's life insurance, whichever amount is greater.

6.6.2 In the rest of Canada

While conversion privileges are not governed by provincial laws in the rest of Canada, the industry does follow the guidelines set forth by the Canadian Life and Health Insurance Association[15] (CLHIA). These guidelines provide similar protection, in that:

- On or before reaching age 65, a plan member should be able to convert up to $200,000 of the group-life coverage on his own life to individual insurance without providing proof of insurability;
- At a minimum, he should have the option of choosing yearly-renewable term, or term-to-age 65.

The plan member must apply for the conversion within 31 days of the termination of his coverage under the group life insurance plan.

Note that unlike Québec, the CLHIA guidelines are silent on conversion privileges for coverage on the plan member's spouse or other dependants. In practice, most group insurance plans that provide optional group coverage on the life of the member's spouse extend the same conversion privileges to that coverage. However, dependant coverage is often not convertible.

15. Canadian Life and Health Insurance Association. *Guideline G3 - Group life and group health insurance*. [online]. Released June 12, 2013. [Consulted May 2, 2022]. https://www.clhia.ca/web/clhia_lp4w_lnd_webstation.nsf/page/13CD6FF39333FBBE8525784F0058BAC4/$file/G3.pdf

6.6.3 Premiums upon conversion

When a group member leaves the plan and converts his group life insurance to individual coverage, he should compare the premiums for that coverage to the premiums for a brand new individual policy. In the case of the converted policy, adverse selection applies; in other words, a person who is otherwise uninsurable or who has a higher risk of dying is more likely to convert his group coverage to individual coverage. Also, the insurance company does not get the chance to perform its normal medical underwriting that would apply to a brand new applicant. These factors increase the insurance company's risk, which results in higher premiums on the converted coverage.

6.7 Replacement contracts

Employers are always looking for ways to reduce the cost of the benefits they provide to their employees, or to enhance those benefits without increasing costs. This means that they sometimes change group insurance providers and replace existing contracts with new ones.

The CLHIA guidelines are designed to ensure that a group life insurance plan member does not lose coverage solely because the plan sponsor has decided to change insurers, or because he was not actively at work at the time of the change.

However, if there were several classes of membership under the old plan (e.g., management, clerical and labour), and one of those classes is not covered by the replacement plan, then members of the old plan who fall into that class would not be entitled to coverage under the new plan.

6.7.1 Benefit amounts

As long as the plan member is eligible for insurance under the terms of the replacement contract, then he should be covered for the same amount under the replacement contract, subject to the maximums of that replacement contract.

6.8 Disabled members

Group life insurance policies typically include a waiver of premium provision, which stipulates that, if the member is disabled, the insurance company will waive the premiums for a specific period of time specified in the contract, while still providing coverage. In fact, CLHIA guidelines require that the premium must continue to be waived and coverage continued even if the employer terminates the group contract with the insurance company.

6.9 Group creditor insurance

Financial institutions often encourage their borrowers to obtain life insurance to cover the debts they have with that financial institution. This most commonly occurs with mortgages, but can apply to any consumer debt.

While the borrowers are free to obtain that life insurance elsewhere, most lenders offer the convenience of group creditor insurance to their customers. This is a subset of group life insurance, where the financial institution is the policyholder, and the borrowers are the plan members. Because consumers often have misconceptions about how creditor insurance works, the Canadian Life and Health Insurance Association (CLHIA) has published guidelines[16] to help protect borrowers who purchase group creditor insurance. These guidelines require the lender to disclose the following to the borrower at the time of applying for the creditor insurance:

- That the insurance coverage is voluntary, and is not required for approval of the loan;
- That the borrower has at least 20 days after receiving the Certificate of Insurance to cancel the coverage and obtain a full refund;
- That the borrower has the right to cancel the coverage at any time;
- All terms and conditions that might limit, restrict or exclude coverage, such as, but not limited to, pre-existing conditions and the consequences of misrepresentation;
- The amount of the premium or how it is calculated;
- That the coverage is subject to acceptance by the insurer;
- Any further steps the borrower must take;
- The insurer's obligation to notify the borrower if coverage is declined;
- The terms upon which coverage starts, if the application is accepted.

6.9.1 Death benefit

The amount of the death benefit payable under group creditor insurance is generally limited to the amount of the debt outstanding. If this is the case, then the death benefit decreases as the debt is repaid.

16. Canadian Life and Health Insurance association. *Guideline 7 - Creditor's group insurance*. [online]. Released June 6, 2016. [Consulted May 2, 2022]. https://www.clhia.ca/web/CLHIA_LP4W_LND_Webstation.nsf/page/8ED833F2B02CD1EF85257841005B27FE/$file/G7.pdf

6.9.2 Beneficiary

The beneficiary of group creditor insurance is the lending financial institution, which will use the proceeds to extinguish the debt. Because the death benefit is generally limited to the amount of the debt outstanding, there is no residual benefit to the borrower's estate.

6.9.3 Premiums

Premiums for group creditor insurance are typically based on the borrower's age (within a range of 5 to 10 years) and smoking status.

How these rates are applied depends on the policy and the type of loan. Mortgage insurance, for example, typically bases the premium on the original mortgage amount. It is essentially decreasing term insurance; the premium will not change, even as the mortgage balance (and thus the death benefit) declines over time.

The premiums for creditor life insurance on a line of credit, however, tend to be based on the outstanding loan at the end of each month, or averaged over the year.

6.9.4 Additional coverage

Some group creditor life insurance providers also offer coverage if the borrower becomes disabled, suffers a critical illness, or even becomes unemployed. This protection may be provided as part of the base creditor life insurance package, or it may be offered separately.

6.9.4.1 Disability

Group creditor disability insurance will pay the lender a monthly benefit if the borrower becomes disabled and is unable to work. The amount will be the lesser of the monthly loan payment or a specified maximum. Benefits may continue as long as the borrower remains disabled, or for a limited period of time. A cumulative maximum may also apply.

6.9.4.2 Critical illness

Group creditor critical illness insurance will pay off the outstanding debt if the borrower is diagnosed with a covered illness. The benefit is paid regardless of whether the borrower can work or not.

6.9.4.3 Unemployment

Group creditor unemployment insurance will pay the lender a monthly benefit if the borrower loses his job through no fault of his own. These benefits are normally limited to a specific dollar amount or duration.

6.10 Group life insurance vs. individual life insurance

The differences between group life and individual life insurance are highlighted in Table 6.1.

TABLE 6.1

Group life insurance vs. individual life insurance

	GROUP LIFE INSURANCE	INDIVIDUAL LIFE INSURANCE
CONTROL OF POLICY	▪ The employer or plan sponsor owns and controls the policy.	▪ The policyholder owns and controls the policy.
EVIDENCE OF INSURABILITY	▪ Generally no evidence of insurability is required during the enrolment period.	▪ Evidence of insurability is required.
PREMIUMS	▪ Premiums are based on the makeup of the group.	▪ Premiums are based on the health of the individual.
POOR HEALTH STATUS	▪ People in poor health can get coverage at affordable rates.	▪ People in poor health will be denied coverage, or will have to pay higher premiums.
GUARANTEED PREMIUMS	▪ Premiums are only guaranteed for one year at a time.	▪ The policyholder can choose yearly-renewal-term coverage, 5-year term, 20-year term, etc., where rates are guaranteed for the term.
COVERAGE	▪ Coverage rarely continues past age 65. ▪ Base coverage amounts are dictated by the plan, and optional coverage is usually limited.	▪ Can obtain term coverage to age 75 or 80, or permanent coverage until death. ▪ Coverage can be customized to the individual needs.

6.11 Advantages and disadvantages of group life insurance

The advantages and disadvantages of group life insurance are summarized in Table 6.2.

TABLE 6.2

Advantages and disadvantages of group life insurance

ADVANTAGES	DISADVANTAGES
▪ No evidence of insurability is required. Individuals who are in poor health, have a pre-existing condition or who smoke will still be covered, with affordable premiums. ▪ Some or all of the premiums may be paid by the employer. ▪ It is convenient for the employee. ▪ Coverage may be converted to individual coverage without proof of insurability if the policy terminates or the member leaves the plan.	▪ People in very good health will pay the same premiums as the rest of the group. ▪ The employer or plan sponsor controls the plan and can make changes without consulting the group members. ▪ The amount of coverage may not be what the plan member needs. ▪ The premiums for individual coverage upon conversion are not guaranteed and may not be favourable. ▪ Employer-paid premiums are a taxable benefit.

CHAPTER 7

TAXATION OF LIFE INSURANCE AND TAX STRATEGIES

Competency components

- Analyze the available products that meet the client's needs;
- Assess the client's needs and situation;
- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Analyze the types of contracts that meet the client's needs;
- Assess the appropriateness of the client's existing coverage in regards to his or her situation;
- Propose a recommendation adapted to the client's needs and situation.

7
TAXATION OF LIFE INSURANCE AND TAX STRATEGIES

Life insurance was originally designed to help people manage the financial risks associated with death. However, Canadians are increasingly using life insurance as a wealth accumulation and preservation tool, often for the purpose of creating an estate. One of the reasons it is used in this manner is the potential tax benefits it can provide. To advise their clients appropriately, agents need to have a good understanding of the tax implications of owning a life insurance policy and disposing of it.

This Chapter focuses on the taxation of personally owned life insurance, as well as using life insurance to manage taxes that may arise upon death. The taxation of corporate-owned life insurance is covered in Chapter 8.

The Booklet entitled *Life insurance taxation principles* is a prerequisite to understanding the product-specific aspects of taxation covered in this Chapter.

7.1 Key concepts

There are several concepts that are key to understanding how life insurance is taxed, including:

- Tax-free nature of the death benefit;
- Policy dispositions;
- Policy gains;
- Adjusted cost basis (ACB).

7.1.1 Tax-free death benefit

The death benefit from a personally held life insurance policy is exempt from tax. This holds true regardless of how long the policy has been in place, or how much the policyholder has paid in premiums or even the type of policy (term, permanent, group, mortgage, etc.). While the potential to receive a death benefit should not be considered to be an “investment,” the fact that the death benefit is always paid out tax-free certainly makes it quite attractive.

EXAMPLE

Susan bought a $500,000 whole life policy on her husband, Andrew, just a few months ago, and she has only paid $2,300 in premiums to date. Unfortunately, Andrew has just died. Susan will receive the entire death benefit of $500,000 tax-free.

The death benefit includes the entire amount paid out upon the death of the life insured, not just the original face amount. For example, if a universal life (UL) policy offers a level death benefit plus account value, the beneficiary will receive the original face amount plus the value of the investment account tax-free.

EXAMPLE

Carl bought a $100,000 UL policy 6 years ago, naming his wife, Sarah, as the beneficiary. The policy provides for a death benefit equal to the initial coverage plus account value. To date, he has paid $9,250 in premiums, and the account value is $2,993. If Carl dies today, Sarah will receive a total of $102,993 tax-free.

However, if the policyholder receives any other benefits while the policy is in force (i.e., before the death of the life insured), it may have immediate tax consequences, as discussed below.

7.1.2 Policy dispositions

Whenever a policyholder disposes of an insurance policy, there may be tax consequences. An actual disposition occurs when the policyholder gives up all ownership rights to the policy, by selling or surrendering the policy. However, other events or transactions can result in a deemed disposition for tax purposes, which means the *Income Tax Act* treats the policyholder as if he had actually disposed of the property and received proceeds from that disposition, even though there is no transfer of ownership, in some cases, or actual proceeds.

Common situations that could result in an actual or deemed disposition of an insurance policy include:

- Policyholder surrenders all or a part of the policy;
- Policyholder withdraws cash from the policy;
- Policyholder takes out a policy loan;
- Participating policy pays out dividends;
- Policy becomes non-exempt;

- Policyholder absolutely assigns or transfers ownership of the policy to another party;
- Policyholder dies and is not the life insured, such that ownership of the policy is transferred to another party.

Proceeds of disposition are any amount the policyholder receives, or is deemed to have received, as a result of a disposition. These dispositions are discussed later in this Chapter.

7.1.3 Policy gains

A policyholder may realize a policy gain upon the disposition of all or a portion of his interest in a life insurance policy and, if so, he will have to report 100% of that policy gain as income. A policy gain is calculated as follows:

Policy gain = proceeds of disposition – adjusted cost basis (ACB)

EXAMPLE

Brian surrendered his whole life insurance policy and received proceeds of $46,000. The insurance company advised him that his adjusted cost basis (ACB) was $20,000, so he had a policy gain of $26,000 and 100% of this was taxable.

Policy gain = $46,000 – $20,000 = $26,000

7.1.4 Adjusted cost basis (ACB)

The adjusted cost basis (ACB) is the cost base of an insurance policy for tax purposes.[17] The ACB of an insurance policy generally changes over time and the insurance company will usually provide the policyholder with this number when a taxable disposition occurs. However, it is important for agents to understand what factors can affect the ACB over the life of a policy, because it will impact how much tax the policyholder will pay when disposing of the policy.

7.1.4.1 Last acquired date

There are three ways to calculate a policy's ACB, depending on when the policy was last acquired. "Last acquired" means the latest of the following dates:

17. Note that for the purpose of calculating the policy gain on a life insurance policy, the acronym "ACB" stands for "adjusted cost basis". When disposing of capital property, such as a rental property or company shares, and calculating the capital gain, the acronym "ACB" stands for "adjusted cost base".

- When the policy was first purchased;
- When ownership of the policy was transferred to the current policyholder;
- When coverage under the policy was last modified or reinstated.

The last acquired date is also an important factor when determining a policy's exempt or non-exempt status, as discussed later in the Section *Taxation of exempt vs. non-exempt policies*.

For simplicity, policies can be categorized in three groups for tax purposes[18]:

- Group 1 (G1) policies are those that were acquired prior to December 2, 1982 and that have not been transferred to another policyholder or been modified since that time.
- Group 2 (G2) policies are those were acquired after December 1, 1982 but before January 1, 2017, or previously G1 policies that have lost their status.
- Group 3 (G3) policies are those that were issued after December 31, 2016, or previously G2 policies that have lost their status.

A G1 policy will lose its status and become a G2 policy if ownership is transferred to another policyholder or if coverage is modified. Because G1 policies provide some significant tax advantages, agents should be careful about changing this status.

A G2 policy will lose its status and become a G3 policy if it is converted to another type of policy on or after January 1, 2017. For example, a term policy that was issued in 2015 but that is converted to a permanent policy in May 2022 will be a G3 policy from that point forward. A G2 policy can also lose its status and become a G3 policy if any coverage that requires medical underwriting is added to the policy after January 1, 2017. Some examples include increasing the amount of coverage, adding a term rider to the policy, or substituting the life insured under the policy.

7.1.4.2 G1 policies

The calculation of the ACB of G1 policies (sometimes referred to as "grandfathered policies") is simply the cumulative premiums paid to date, less the cumulative dividends paid out of the policy.

While 1982 was over 30 years ago, agents may still encounter active whole life or UL policies that were issued prior to December 2, 1982. The ACB calculated under the old method will generally be higher than the ACB calculated under the methods for G2 or G3 policies. Remember that a policy gain is calculated as (proceeds of disposition – ACB), so a bigger ACB means a smaller policy gain, and thus a smaller tax liability for the policyholder.

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18. Manulife. *2017 Changes to the Exempt Test and Life Insurance Policy Taxation.* [online]. Revised January 2017. [Consulted May 2, 2022]. https://www.manulife.ca/advisors/insurance/tax-retirement-and-estate-planning/technical-planning-support/2017-changes-to-the-exempt-test-and-life-insurance-policy-taxation.html

Other tax advantages for these grandfathered policies are covered in the Section *Taxation of exempt vs. non-exempt policies*.

7.1.4.3 G2 and G3 policies

For G2 and G3 policies, the key factors that determine a policy's ACB are the cumulative premiums less the net cost of pure insurance (NCPI). The NCPI is a measure of the pure mortality costs under the policy for a given year, and it reflects a combination of the net amount at risk (NAAR) and the mortality risk for the life insured.

In the early years of a policy, the ACB of a policy increases because the NCPI is less than the premiums. However, as the life insured ages, his mortality risk increases to the point where the NCPI exceeds the premiums and the ACB of the policy decreases. Over time, the ACB can reduce to zero, but it can never be negative.

Regulations to the Income Tax Act prescribe different methods of calculating both the NCPI and the NAAR for G2 and G3 policies. These regulations also prescribe the use of updated standardized mortality tables for G3 policies, reflecting increases in life expectancies. We aren't going to get into the specifics of these methods, but the general result of these changes is that:

- The NCPI of a G3 policy tends to be lower during the early years of the policy, compared to a G2 policy.
- Given the same premiums or deposits, this in turn means that the ACB of a G3 policy will tend to grow faster in the early years of the policy, compared to a G2 policy.
- It will take longer for the ACB of a G3 policy to reach zero as the life insured ages.

These differences become important when you recall that the policy gain upon the disposition of an individually owned life insurance policy is the difference between the proceeds and the ACB.

The situation becomes more complex if policy dividends, policy withdrawals or policy loans are involved, and further adjustments to the ACB are required, as summarized in Table 7.1.

TABLE 7.1

Factors affecting a policy's adjusted cost basis (ACB)

ACB = (CUMULATIVE PREMIUMS, INCLUDING RATINGS – CUMULATIVE NCPI)
PLUS OR MINUS

	Plus	Minus
PARTICIPATING POLICY DIVIDENDS	Dividends used for paid-up additions or additional term insurance, or to repay a policy loan.	Dividends paid out to the policyholder in cash.
POLICY LOANS	Interest paid on a policy loan, unless the interest is deductible as a business or investment expense.	The amount of a policy loan taken against the cash surrender value (CSV) of the policy. See the Section *Taxation of policy loans* for more information.
POLICY LOAN REPAYMENTS	The amount of a policy loan repayment, to the extent it exceeds any policy gain reported as income when taking out the loan. See the Section *Repaying a policy loan* for more information.	
WITHDRAWALS OR PARTIAL SURRENDERS		A prorated portion of the ACB, depending on the size of the withdrawal or the percentage surrendered. See the Section *Taxation of partial surrender* for more information.
POLICY GAINS INCLUDED IN INCOME	Any policy gain the policyholder had to include in income as a result of a policy loan, withdrawal or partial surrender.	

7.2 Taxation of policy dividends

According to the *Income Tax Act,* the payment of policy dividends triggers a deemed disposition of an interest in the insurance policy. The proceeds of disposition are deemed to be the amount of the policy dividend, less any amount that was used to pay an eligible premium. As a result, the policy gain is calculated as follows:

Policy gain = (policy dividend – amount used to pay an eligible premium) – policy's ACB

In most cases where the premiums are directed to internal transactions, (i.e., through a paid-up addition (PUA) or term insurance dividend payment option, or to repay a policy loan), the resulting proceeds of disposition will be zero, and thus there is no policy gain and no taxable income. Recall also that premiums paid by the policyholder increase the policy's ACB by the same amount, while dividends paid out to the policyholder in cash reduce the ACB. As a result, most policy dividends paid out to the policyholder end up being a tax-free return of premiums.

However, for G2 policies, the "premiums" for the purpose of calculating the policy's ACB for tax purposes exclude amounts the policyholder paid for accidental death benefits, disability payments, ratings for substandard lives, the cost of conversion rights or guaranteed insurability benefits, or any other supplementary benefit. For G3 policies, the full premiums are added to the ACB as they are paid, but then the cost of insurance related to any of these non-death benefits is deducted from the ACB as they are charged to the policy. Thus, if a G2 or G3 policy includes these types of benefits and if policy dividends are actually paid out to the policyholder, then there is a possibility that a policy gain may arise. The calculation of that gain is beyond the scope of this Course.

7.3 Taxation of a full surrender

A policyholder is said to fully surrender a life insurance policy when he cancels or terminates the policy, such that he has no further rights or obligations under that policy. A full surrender is considered to be a disposition for tax purposes.

7.3.1 Policy gain calculation

Recall that when a policyholder disposes of an insurance policy, he will realize a policy gain that is calculated as follows:

Policy gain = proceeds of disposition – adjusted cost basis (ACB)

In the case of a full surrender, the proceeds of this disposition are equal to the cash surrender value (CSV) of the policy, less any outstanding policy loans (including interest) or unpaid premiums.

EXAMPLE

Alicia is thinking about terminating her $200,000 whole life insurance contract. The policy has a CSV of $24,000 and an ACB of $10,000. There are no outstanding policy loans or unpaid premiums. If she cancels the contract, Alicia will realize a policy gain of $14,000 and this will be fully taxable to her.

Policy gain = $24,000 – $10,000 = $14,000

Assuming her marginal tax rate is 35%, this would result in $4,900 of tax payable.

Tax payable = $14,000 × 35% = $4,900

So Alicia would have $19,100 left after tax, calculated as ($24,000 – $4,900).

7.4 Taxation of a partial surrender

A policyholder is said to have partially surrendered his policy if he reduces the coverage or withdraws part of the accumulating fund, as discussed below.

7.4.1 Reducing coverage

If the policyholder decides to reduce the amount of coverage, it is considered to be a disposition, so a policy gain can arise.

For G2 policies, the policy gain on a partial surrender is calculated on a prorated basis, so the CSV and ACB used reflect the reduction in the coverage.

EXAMPLE (CONT.)

Suppose that instead of surrendering the policy entirely, Alicia decides to reduce her coverage from $200,000 to $150,000. This is considered to be a partial surrender, and she is deemed to have disposed of 25% of her policy.

Percentage disposed = ($200,000 – $150,000) ÷ $200,000 = 25%

Recall that the policy has a CSV of $24,000 and an ACB of $10,000. Alicia will receive $6,000 upon reducing the coverage, which is the CSV associated with the reduction.

CSV upon partial surrender = $24,000 × 25% = $6,000

The ACB associated with the reduction is $2,500.

Prorated ACB = $10,000 × 25% = $2,500

This will result in a policy gain of $3,500 and $1,225 in tax payable.

Policy gain = $6,000 – $2,500 = $3,500

Tax payable = $3,500 × 35% = $1,225

For a G3 policy, the policy gain is also calculated on a prorated basis, but in this case the prorating is based on the ratio of the ACB of the policy to the policy's net cash value (i.e., the CSV less outstanding policy loans).

For G1 policies, no prorating is required. Withdrawals only result in a policy gain once cumulative withdrawals exceed the entire policy's ACB.

7.4.2 Policy withdrawals

A partial surrender may also refer to a withdrawal the policyholder makes from the accumulating fund of a UL policy, even if he does not reduce the coverage. To calculate the policy gain for G2 and G3 policies, the same prorated methodology is used as for a partial policy surrender.

For a G2 policy, this would be calculated as follows:

$$\text{Prorated ACB} = \frac{\text{amount withdrawn}}{\text{cash value of accumulating fund}} \times \text{ACB of policy}$$

$$\text{Policy gain} = \text{amount withdrawn} - \text{prorated ACB}$$

For a G3 policy, the calculation would be based on the policy's net cash value (i.e., the CSV less outstanding policy loans).

EXAMPLE

Janine has a $200,000 UL policy with an ACB of $65,000 and an accumulating fund with a cash value of $80,000. She wants to withdraw $40,000 from the policy, and her marginal tax rate is 35%.

The prorated ACB of her withdrawal would be $32,500.

Prorated ACB = ($40,000 ÷ $80,000) × $65,000 = $32,500

Her policy gain would be $7,500.

Policy gain = $40,000 – $32,500 = $7,500

She would have to pay income tax of $2,625 as a result of her withdrawal.

Tax payable = $7,500 × 35% = $2,625

For G1 policies, no prorating is required. Withdrawals only result in a policy gain once cumulative withdrawals exceed the entire policy's ACB.

7.5 Taxation of policy loans

If the policyholder takes out a policy loan, the proceeds of disposition equal the amount of the loan, less any amount of that loan that is applied to pay a premium under the policy. In the case of an automatic premium loan (APL), the deemed proceeds are nil, because the full amount of the loan is used to pay the premiums.

If the policyholder takes out a policy loan that is less than the adjusted cost basis (ACB), he will not have a policy gain, but the ACB will be reduced by the amount of the loan.

EXAMPLE (CONT.)

If Alicia only took out a policy loan of $4,000, the policy's ACB would be reduced to $6,000.

New ACB = $10,000 – $4,000 = $6,000

She would not have to report a policy gain.

If a policyholder takes out a policy loan that is greater than the policy's ACB, he will have a policy gain equal to the amount of the loan, minus the ACB. The ACB of the policy will be reduced to zero.

EXAMPLE (CONT.)

Suppose that Alicia instead takes out a policy loan of $19,000. She would have a policy gain of $9,000 and $3,150 in tax payable.

Policy gain = $19,000 – $10,000 = $9,000

Tax payable = $9,000 × 35%

Her policy would now have an ACB of $0.

7.5.1 Repaying a policy loan

If a policyholder repays a policy loan, he will be able to deduct the repayment from his taxable income, up to the amount of the policy gain he had to report when he took out the loan. If he repays more than this amount, the excess will increase the policy's ACB.

EXAMPLE (CONT.)

Suppose that Alicia repays $12,000 of her $19,000 policy loan. She would be able to claim a tax deduction of $9,000, which is the amount of the policy gain she had to include in her income as a result of the loan. The ACB of her policy would increase to $3,000.

ACB calculated as ($12,000 – $9,000).

7.5.2 Policy loan interest

When a policyholder takes out a policy loan, the insurance company will charge interest on that loan. If the policyholder invests the loan proceeds for the purpose of earning property or business income, then he can deduct the interest he pays on that loan from his taxable income. Property income includes dividends, rent and interest, but it excludes capital gains. If the loan is for personal purposes (e.g., to buy a car) or if it is invested with the sole intention of realizing capital gains only, the interest is not deductible. If the policyholder pays interest but cannot deduct it, then the ACB of the policy will increase by the amount of that interest.

7.6 Taxation of exempt vs. non-exempt policies

An exempt life insurance policy is a permanent insurance policy that was either:

- Last acquired prior to December 2, 1982 (i.e., a G1 policy);
- Last acquired after December 1, 1982 (i.e., a G2 or a G3 policy), and used by the policyholder primarily for insurance purposes, rather than investment purposes.

A non-exempt policy is a policy that was last acquired after December 1, 1982, that fails to meet the exemption requirements set out by the *Income Tax Act*, discussed shortly. Non-exempt policies are subject to annual accrual taxation, which means that the policyholder must report the investment income earned within the policy as taxable income in the year it is earned.

If an insurance policy is an exempt policy, the policy's investment account (i.e., often referred to as the accumulating fund) can grow on a tax-deferred or tax-free basis. Tax-deferred means the investment income is not taxable during the year it was earned, but it may be taxed later if there is a policy disposition prior to the death of the life insured (e.g., if the policyholder makes a policy withdrawal or takes a policy loan). If the investment account is paid out upon death of the life insured as part of the death benefit, the accumulated investment income is paid out tax-free, meaning it is never subject to tax.

This Section explains:

- The conditions a G2 or G3 policy must meet to be classified as exempt;
- What happens if a policy becomes non-exempt;
- What can be done (if anything) to recover that exempt status.

Policies last acquired prior to December 2, 1982 (i.e., G1 policies), are always exempt.

7.6.1 Purpose of exempt test - insurance or investment?

The exempt test applies two rules (Maximum Tax Actuarial Reserve (MTAR) and "anti-dump-in" rules) designed to answer the question "Is this policy really insurance, or is it more like an investment vehicle disguised as insurance?" These rules prevent taxpayers from taking unfair advantage of the favourable tax treatment of investment income that may be provided within an insurance policy. A policy that emphasizes investment opportunities over insurance protection will break one or both of these rules and will thus fail the exempt test.

G1 policies are not subject to the exempt test and are not subject to annual accrual taxation.

7.6.2 Maximum Tax Actuarial Reserve (MTAR) rule

To maintain exempt status, the cash value of a policy's accumulating fund (i.e., investment account) cannot exceed the Maximum Tax Actuarial Reserve (MTAR), which is the projected cash value of the accumulating fund of an exempt test policy. An exempt test policy (ETP) is a hypothetical policy that serves as a benchmark. It has the same death benefit and the same life insured as the real policy, with the remaining parameters set by the *Income Tax Act*, as discussed shortly.

Furthermore, the projected future values of the accumulating fund cannot exceed the projected MTAR at any time in the future, up until the date the life insured reaches a specified age (85 for G2 policies and 90 for G3 policies).

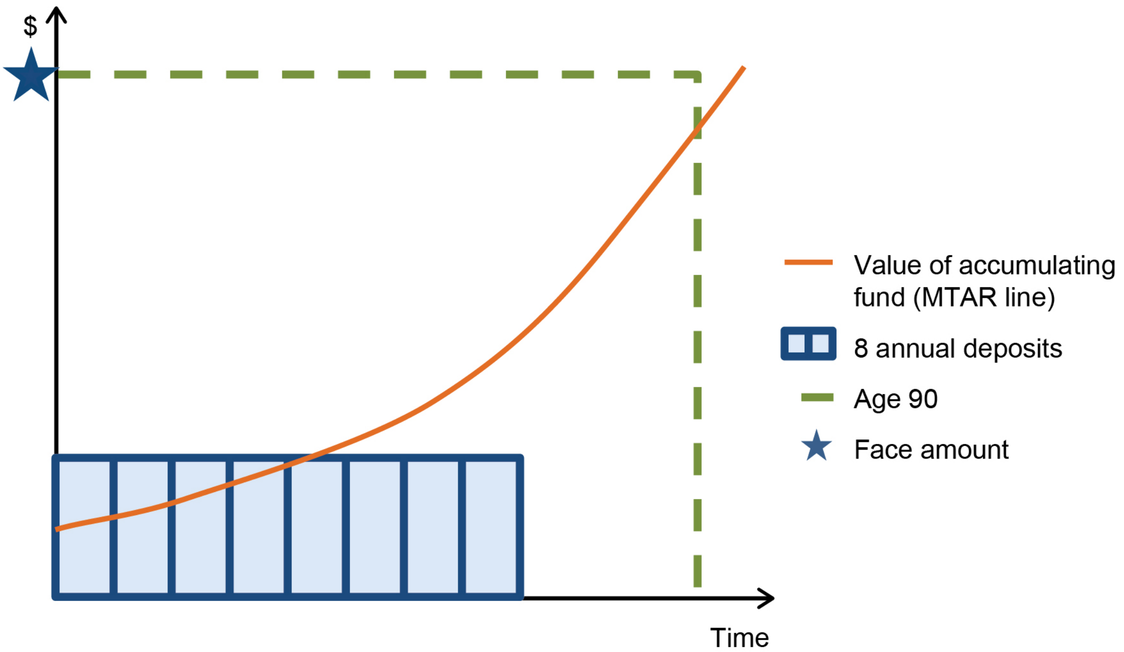
On the policy's issue date and on every policy anniversary thereafter, the insurance company must compare the current and projected cash values of the actual policy's accumulating fund with the MTAR of the ETP, and report the results to the Canada Revenue Agency (CRA).

7.6.2.1 8-Pay endowment at age 90 for G3 policies

For policies issued after December 31, 2016 (i.e., G3 policies), the ETP is deemed to receive annual deposits over 8 years, and the deposits are large enough to ensure that the policy will endow at age 90. Essentially it is a limited payment whole life policy, as discussed in Chapter 3. A policy endows when its cash surrender value (CSV) equals the policy's face amount. This is shown graphically in Diagram 7.1.

DIAGRAM 7.1

Maximum Tax Actuarial Reserve (MTAR)



In other words, the MTAR line of the ETP describes an accumulating fund that will grow to equal the death benefit by the time the life insured reaches age 90, based on fixed deposits for 8 years, and growth at an assumed interest rate, minus the cost of insurance. This rate should be 3.5% minimum. (Adjustments are made if the policy was issued after age 65, but that is beyond the scope of this Chapter).

For G3 policies, when comparing the cash values of the actual policy to the ETP, the accumulating fund is calculated as the cash value determined without regard to surrender. If this value is less than the MTAR of the ETP, then the policy is exempt from annual accrual taxation.

7.6.2.2 20-Pay endowment at age 85 for G2 policies

For G2 policies, the ETP is deemed to receive annual deposits over 20 years, and the deposits are large enough to ensure that the policy will endow at age 85. In other words, for G2 policies the MTAR line of the ETP describes an accumulating fund that will grow to equal the death benefit by the time the life insured reaches age 85, based on fixed deposits over 20 years and growth at an assumed interest rate of at least 4%, minus the cost of insurance.

The impact of the changes implemented for G3 policies effective for January 1, 2017 will vary by insurance company, but in general the maximum deposits permitted for a G3 policy while still maintaining exempt status will be lower than the maximum deposits permitted for a G2 policy.

7.6.3 Maximum Tax Actuarial Reserve (MTAR) remedies

While life insurance policies are initially designed to be exempt, it is possible for a policy to become non-exempt after issue, usually due to investment returns that were higher than expected. Fortunately, neither the policyholder nor the agent is responsible for applying or monitoring the results of the MTAR rule. Usually the terms of the life insurance contract specify that the insurance company is responsible for ensuring that the policy remains exempt.

If the policy fails the MTAR test on its anniversary, the *Income Tax Act* allows a grace period of 60 days after that date for the problem to be fixed before the policy officially loses its exempt status. Once an exempt policy is declared to be non-exempt (i.e., if it cannot be restored during the 60-day grace period), it remains non-exempt forever.

Most policies are designed to implement changes automatically if needed, using one or more of the methods discussed below.

7.6.3.1 Increasing the face amount

The death benefit can be increased by up to 8% per year. The death benefit of the ETP will increase by the same percentage, which will raise the MTAR line.

Some universal life (UL) policies call for an automatic 8% increase in the death benefit every year, even if the policy does not fail the exempt test on the policy anniversary, because it increases the maximum amount that can be deposited to the policy.

7.6.3.2 Withdrawing premiums

The policyholder can make a withdrawal from the accumulating fund, which will reduce the policy's cash value. However, this may result in a policy gain if the withdrawal exceeds the prorated ACB, as discussed in an earlier Section *Taxation of a partial surrender*.

EXAMPLE

James had a UL policy with an ACB of $226,000 and CSV of $400,000. He had to withdraw $10,000 from the accumulating fund to maintain the policy's exempt status. The prorated ACB of his withdrawal is $5,650.

Prorated ACB = ($10,000 ÷ $400,000) × $226,000 = $5,650

This will result in a policy gain of $4,350.

Policy gain = $10,000 – $5,650 = $4,350

7.6.3.3 Side funds

Most policies include a provision whereby any excess amount will be moved from the accumulating fund into a “taxable side fund” (or “shuttle account”) to prevent the entire policy from becoming non-exempt. With a shuttle account, the funds will be moved back to the accumulating fund if and when the policy’s accumulating fund is less than the MTAR line.

7.6.4 Anti-dump-in rule

A second rule, called the 250% rule or anti-dump-in rule, prevents the policyholder from making large lump-sum deposits to the policy after its 7th anniversary. This rule applies to both G2 and G3 policies.

7.6.4.1 Applying the 250% rule

Beginning on the policy’s 10th anniversary and every anniversary thereafter, the accumulating fund on that anniversary date is compared to the accumulating fund three years previous. So, the cash value on the 10th anniversary is compared to the cash value on the 7th anniversary; the cash value on the 11th anniversary is compared to the cash value on the 8th anniversary, and so on.

If the value of the fund is 250% or more of the value of the fund three years prior, the anti-dump-in provision will apply.

EXAMPLE

On its 7th anniversary, Dean’s policy had a cash value of $4,200. On its 10th anniversary, the policy had a cash value of $15,600. This is 371 % of its value three years prior.

Current cash value = ($15,600 ÷ $4,200) x 100 = 371%

Because this exceeds 250%, the anti-dump-in provision will apply.

The anti-dump-in provision resets the date of the exempt test policy (ETP) to the third preceding anniversary. The policy’s cash value is then compared with the (usually lower) MTAR of the re-dated ETP, which will make it more prone to failing the exempt test, unless the remedial measures mentioned earlier can be applied (i.e., increasing the death benefit, withdrawing cash from the accumulating fund, or moving it to a taxable side account).

7.6.4.2 Implications for minimum-funded policies

The anti-dump-in rule can be problematic for UL policies that have been minimum funded in the early years, which is a common occurrence, particularly for young families who intend to increase their deposits as their incomes increase and/or their expenses decrease.

When a policy is minimum-funded in the early years, the policy's cash values remain relatively low. If the policyholder later makes large deposits, this could easily result in a substantial increase in the policy's cash value, which in turn could trigger the application of the anti-dump-in rule and increase the potential for the policy losing its exempt status.

However, beginning January 1, 2017, a relief measure was introduced to relax the 250% rule somewhat for under-endowed policies. This new provision allows the accumulating fund of the policy to grow by more than 250% over the three-year period specified by the test if the value of the accumulating fund of the actual policy is less than 15% of the value of the ETP's accumulating fund for G2 polices or 37.5% of the ETP's accumulating fund for G3 policies.

7.6.5 If a policy becomes non-exempt

It is very rare for a policy to fail the exempt test, because of the safeguards built into the policy and MTAR remedies discussed earlier. However, it still does happen upon occasion, and the consequences can be quite severe. Some of the situations that have the potential to make a policy fail the exempt test include:

- Paid-up additions (PUAs), because they have a high ratio of cash value relative to the amount of coverage they provide;
- Better investment returns than expected;
- Extra deposits to participating policies;
- Extra deposits to the policy.

7.6.5.1 Deemed disposition

If a policy becomes non-exempt, it is considered to be a policy disposition for tax purposes. This means that the policyholder will incur a policy gain equal to its cash surrender value (CSV) minus its adjusted cost basis (ACB).

Note that no actual disposition takes place; the policyholder has not surrendered the policy and does not actually receive the CSV, but he will still have a policy gain that will be taxed at his marginal tax rate.

7.6.5.2 Annual accrual rules

If a policy becomes non-exempt, the policyholder will have to report the income earned within the investment account on an annual basis.

7.7 Tax implications of replacing an existing policy

In relatively rare circumstances, a policyholder may decide to replace an existing insurance policy with a new one. There are many issues the agent must consider when recommending or assisting with a replacement, as discussed in the Module *Ethics and professional practice.* This Section deals specifically with the tax implications of policy replacement.

7.7.1 Policy disposition

Replacing a life insurance policy involves first putting the new life insurance in place, and then cancelling the existing policy. This cancellation is a policy disposition, so it will result in a policy gain to the extent that the policy's CSV exceeds its ACB.

7.7.2 Tax advantages of older policies

G1 policies have extra tax advantages that are not available to newer policies, so this should be carefully considered before replacing an older policy.

As discussed earlier in the Section *G1 policies,* the ACB was calculated simply as (cumulative premiums paid to date – dividends paid out of the policy). The ACB calculated under this older method will generally be higher than the ACB calculated on a newer policy, so the disposition of a G1 policy will likely result in a lower policy gain.

In addition, G1 policies are not subject to exempt testing, and they are not subject to annual accrual taxation, so they can potentially accumulate larger cash values.

Replacing a G2 policy with a G3 policy could also have tax implications.

7.8 Absolute assignments

A policyholder can usually transfer ownership, control and rights under a life insurance policy to another person; this is called an absolute assignment. Absolute assignments can occur with or without compensation.

The tax consequences of an absolute assignment depend on who receives ownership and how the transfer was accomplished. This Section discusses the general rule, as well as special situations including absolute assignments to:

- A non-arm's length party (other than the policyholder's spouse or child);
- The policyholder's spouse;
- The policyholder's child or grandchild.

7.8.1 General rule

As a general rule, if a policyholder absolutely assigns his life insurance policy to an arm's length party, his proceeds are deemed to be the amount he received in compensation (i.e., the transfer price), and his policy gain will be equal to the transfer price minus the policy's adjusted cost basis (ACB) immediately prior to the transfer. The transferee acquires the policy with an ACB equal to the transfer price.

Two people are said to be dealing at arm's length if they are unrelated and they complete a transaction by acting entirely in their own independent economic interests. Very few absolute life insurance assignments are actually done at arm's length, and one of the following situations is more likely to apply.

7.8.2 To a non-arm's length party

Exceptions to the general rule apply if the absolute assignment occurs via one of the following situations, regardless of the amount (if any) that the policyholder received in compensation:

- The transfer is via gift or bequest;
- The transfer is from a corporation;
- The transfer is a result of the operation of law (e.g., transfer to a successor owner or a joint owner with right of survivorship);
- The transfer is to any other non-arm's length party.

A non-arm's length relationship is deemed to exist between relatives, or any two unrelated parties who have a common interest and do not carry out a transaction in a way that two complete strangers might.

If any of the above situations apply, then the proceeds of disposition are deemed to be equal to the amount that the policyholder would have received if he had fully surrendered the policy (unless the spousal or child rollover rules apply, as discussed shortly in Sections *Assigning a policy to a spouse* and *Assigning a policy to a child*). Usually this means the cash surrender value less any outstanding policy loans.

The person who acquires the policy acquires it with an ACB equal to this same amount. This keeps the policyholder from avoiding a policy gain by giving the policy away, or selling it to someone else at a discount to its true value.

EXAMPLE

Robert owned a UL policy on the life of his wife, Joanna, naming himself as the beneficiary. Robert is terminally ill and, in anticipation of his death, he assigned ownership of the policy to his brother, Jim. At the time of the assignment, the policy had an ACB of $34,000 and a CSV of $61,000. As a result of this disposition, Robert realized a policy gain of $27,000.

Policy gain = $61,000 – $34,000 = $27,000

Jim acquired the policy with an ACB of $61,000.

7.8.3 Assigning a policy to a spouse

The *Income Tax Act* allows property to rollover from one spouse to another, meaning that it can be transferred without triggering a taxable disposition. This rollover applies to all types of property, including life insurance. So, if a policyholder assigns ownership of a life insurance policy to his spouse, he is deemed to have acquired proceeds equal to his ACB, and his spouse is deemed to have received the policy with the same ACB. This applies even if the recipient spouse paid the transferor spouse for the policy.

EXAMPLE

Noah recently assigned a life insurance policy with a CSV of $85,000 and an ACB of $32,000 to his wife, Eve. Noah is deemed to have received proceeds of $32,000, which will result in a policy gain of $0.

Policy gain = $32,000 – $32,000 = $0

Eve is deemed to have acquired the policy with an ACB of $32,000.

7.8.3.1 Opting out of the spousal rollover

The spousal rollover is automatic. However, the transferring spouse can choose to opt out of the rollover by filing a special election with his tax return. A policyholder might want to opt out of the rollover if he has a lower marginal tax rate than his spouse, or if he has income losses that he can use to absorb the resulting policy gain (e.g., rental or partnership losses).[19] By opting out of the rollover, the ACB for the recipient spouse will be higher, which in turn will reduce the policy gain when the recipient spouse later disposes of the policy.

19. This excludes capital losses, because capital losses can generally only be applied against taxable capital gains.

EXAMPLE (CONT.)

Noah has a rental loss of $70,000 and no other taxable income. If he opts out of the automatic rollover, the policy assignment will result in a policy gain of $53,000.

Policy gain = $85,000 – $32,000 = $53,000

However, this will be more than offset by his rental loss, so it will not result in him having to pay tax. Furthermore, by opting out of the rollover, Eve's ACB for the policy becomes $85,000.

7.8.3.2 Income attribution rules

When a taxpayer gives or sells property to his spouse, any property income (e.g., interest income, dividends or rents) or capital gains she earns on that property is generally[20] subject to income attribution as long as the taxpayer is still alive. This means that the income will be taxable to the transferor spouse even if it is earned and legally belongs to the recipient spouse. Once the transferor spouse dies, the income attribution rules cease to apply.

EXAMPLE (CONT.)

Suppose that Noah did not opt out of the automatic rollover, and that Eve later surrendered the policy when its CSV was $94,000. As a result of the income attribution rules, Noah would have to report the resulting policy gain of $62,000.

Policy gain = $94,000 – $32,000 = $62,000

This happens even though Eve is the one who would have actually received the money. If Eve waited until Noah died to surrender the policy, she would have to report the policy gain as part of her own income.

7.8.4 Assigning a policy to a child

The *Income Tax Act* also allows a policyholder to rollover an insurance policy to a child, if all of the following conditions apply:

- The transfer is done for no consideration (i.e., the child didn't pay the policyholder for the policy);
- The life insured by the policy is the child, or that child's child. The rollover will not apply if the policyholder is transferring a policy to his child and the policyholder is the life insured under that policy.

20. Income attribution will not apply if the recipient spouse pays fair market value for the policy and the transferor spouse opts out of the automatic rollover.

EXAMPLE

Rhonda owned a UL policy with an ACB of $16,000 and a CSV of $29,500 on the life of her daughter, Jolene, who is 19 years old. Rhonda gave the policy to Jolene for her 19th birthday. Because of the automatic rollover, Rhonda is deemed to have received proceeds equal to her ACB of $16,000, so no policy gain is triggered at the time of the gift. Jolene is deemed to receive the policy with an ACB of $16,000.

Any policy gain that is subsequently triggered when the transferee child disposes of the policy will be taxable to that child, as long as the child is at least 18 years old by the end of the year. If the child is under 18, the income attribution rules will apply and the policy gain will be taxable to the original policyholder.

EXAMPLE (CONT.)

Jolene surrendered the policy shortly after receiving ownership of it. She realized a policy gain of $13,500.

Policy gain = $29,500 – $16,000 = $13,500

Because she is over 18 years of age, the policy gain will be taxable in her hands.

Ownership of a policy cannot be transferred to a child until that child is at least old enough to enter into a contract (generally age 16, but this may vary by province).

7.8.4.1 Defining “child”

For the purpose of this rollover provision, a “child” of the policyholder includes the policyholder’s child, grandchild or great-grandchild, regardless of whether that relationship is by blood or adoption. It also includes any other person who, at any time prior to reaching the age of 19, was in the care and custody of the policyholder and was wholly dependent on the policyholder for support (e.g., a niece who is under the policyholder’s guardianship after the death of her parents).

7.8.4.2 Direct transfers only

The rollover to a child can only occur if the policy is transferred directly to the child. If the policy is transferred to a trust that benefits the child, the rollover will not apply.

7.8.4.3 Education funding or other intergenerational transfers

The rollover of an insurance policy to a child provides some interesting opportunities for intergenerational wealth transfer. For example, a policyholder could acquire a UL policy on the life of a child, and maximum fund it to build up the CSV as quickly as possible. He could then give the policy to that child, and the rollover would apply.

Once the child is 18 years of age, the child could surrender the policy, and the policy gain would be taxable in that child's hands, often when the child has little or no other taxable income. However, if the child surrenders the policy prior to age 18, income attribution rules would apply, meaning that the original policyholder would have to report the policy gain as income.

EXAMPLE

Dorothy is in the top marginal tax bracket, such that any interest income she earns personally is taxed at 44%. Dorothy bought a UL policy on the life of her daughter Madelyn, with the intention of eventually giving the policy to Madelyn's daughter Jackie (i.e., Dorothy's granddaughter), to help with her education expenses. By the time Jackie was 18, the policy had a cash surrender value (CSV) of $54,000 and an adjusted cost basis (ACB) of $18,000. Dorothy gave the policy to Jackie for her 18th birthday. The policy qualified for a rollover, so Jackie acquired the policy with an ACB of $18,000.

Jackie immediately withdrew $15,000 to pay for her first year of university. The prorated ACB for her withdrawal is $5,000.

Prorated ACB = ($15,000 ÷ $54,000) × $18,000

Her withdrawal will result in a policy gain of $10,000.

Policy gain = $15,000 – $5,000 = $10,000

She has no other sources of taxable income, so this will be fully sheltered by her basic personal exemption,[21] and she will not have to pay any tax. If her grandmother, Dorothy, had retained ownership of the policy and made the same withdrawal, Dorothy would have had to pay tax of $4,400.

Amount of tax Dorothy would have paid = $10,000 × 44%

21. Each taxpayer gets a basic personal exemption, which is a fixed amount of income that is not subject to tax. For 2022, the federal basic personal exemption is $14,398, and the provincial basic personal exemption ranges from $8,481 to $19,369 depending on the province. For more information on current rates (federal and provincial) consult: https://www.taxtips.ca/nrcredits/tax-credits-2022-base.htm [Consulted May 2, 2022].

Note that this tax strategy tends to be more effective when the transfer skips a generation, and when the life insured is not a minor. This is because the amount of money that can be accumulated within an exempt policy is partially a function of the age of the life insured and the face amount. The younger the life insured and the lower the face amount, the lower the MTAR line on the exempt test policy.

7.9 Death of the policyholder

If the policyholder dies and he is not the life insured by that policy, then generally he is deemed to have disposed of that policy immediately prior to death. For tax purposes, death is treated much like an absolute assignment. Under the default rules, the deemed disposition upon death will result in a policy gain on the policyholder's final tax return, equal to the policy's CSV minus its ACB.

EXAMPLE

At the time of his death, John owned a $300,000 whole life insurance policy on the life of his wife, Jacinta. His will left all of his property to his estate. The policy had a CSV of $73,000 and an ACB of $20,400. This resulted in a policy gain of $52,600.

Policy gain = $73,000 – $20,400 = $52,600

This amount was reported on his final tax return and taxed at his marginal tax rate.

7.9.1 Rollover to spouse

The rollover discussed in the Section *Assigning a policy to a spouse* also applies to policy transfers upon death.

EXAMPLE (CONT.)

If John had left the policy to his wife, Jacinta, his deemed proceeds would have been equal to the policy's ACB of $20,400, and no policy gain would have been triggered by his death. Jacinta would have acquired the policy with an ACB of $20,400.

7.9.2 Contingent policyholder

A policyholder is allowed to designate a contingent or successor policyholder on his life insurance policy, who will automatically receive ownership of the policy upon his death. This not only makes it clear who is to receive the policy, it allows the policy to bypass the estate, so the transfer is done quickly and is not subject to probate fees.

However, designating a contingent policyholder will not allow the policyholder to avoid the deemed disposition rules upon death, unless a rollover applies.

EXAMPLE (CONT.)

If John had designated his brother, Maxwell, as the successor owner of the policy, the policy would have automatically been transferred to Maxwell upon John's death, bypassing his estate. However, the policy gain of $52,600 would still have to be reported on John's final tax return.

7.9.2.1 Rollover to a child

As noted earlier in the Section *Assigning a policy to a child*, a policy can also roll over to the policyholder's child (provided that the life insured by the policy is that child or the child's child) but only if the transfer is made directly; the transfer cannot be done via a trust or estate.

If the policyholder wants to take advantage of the child rollover provision upon death, he should name the child as the successor owner. As successor owner, the child will automatically receive ownership of the policy upon the policyholder's death.

7.10 Taxation of life insurance strategies

The previous sections have examined how life insurance is taxed from a product perspective. This Section explores the tax implications of various strategies that can be implemented using insurance, including:

- Using the policy for collateral, including borrowing for business use;
- Annuitizing the cash surrender value to create a steady income;
- Leveraging a life insurance policy to create a retirement income;
- Charitable giving.

7.10.1 Using the policy as collateral

Rather than taking out a policy loan, a policyholder may also be able to use the policy's cash value as collateral for a loan from a third party. Basically, the policyholder assigns the rights to the policy's cash values and death benefit to the lender, which is called a collateral assignment. If the policyholder defaults on the debt, the lender can surrender the policy and use the cash surrender value to cover the debt. If the policyholder dies before repaying the loan, the lender can recover the debt either from the death benefit (if the policyholder was the life insured) or by surrendering the policy (if the policyholder was not the life insured).

The main advantages of taking a third-party loan secured by a collateral assignment of life insurance, as opposed to a policy loan, are:

- Unlike an absolute assignment, a collateral assignment is not a deemed disposition for tax purposes, so it will not trigger a policy gain;
- The full cash value stays in the policy, where it can continue to grow on a tax-sheltered basis.

7.10.1.1 Borrowing for business use

When borrowing money for business purposes, the lender may require security in the form of a collateral assignment of life insurance. This could apply to term or permanent insurance.

7.10.1.2 Deducting premiums

If the business loan is secured by a collateral assignment, some or all of the premiums will be deductible, as long as the following conditions are met:

- The loan is from an authorized lender;
- The lender requires a collateral assignment of an existing or new policy to secure the loan.

The amount that is deductible is limited to the lesser of the net cost of pure insurance (NCPI) and the premiums actually paid.

If the coverage exceeds the amount of the loan, the premium deduction is prorated accordingly.

EXAMPLE

Heloise borrowed $200,000 from a financial institution to expand her business. The lender required the collateral assignment of her $500,000 universal life policy, which had an adjusted cost basis (ACB) of $160,000 and a cash surrender value (CSV) of $250,000. Heloise paid premiums of $12,000 annually, with a NCPI of $3,200.

Because Heloise's policy is for $500,000 but the loan is only for $200,000, she can only deduct 40% of the NCPI.

Percentage of NCPI deductible = $200,000 ÷ $500,000 = 40%

So, she can deduct $1,280 as a business expense.

Deduction = 40% × $3,200 = $1,280

7.10.2 Annuitizing the cash surrender value (CSV)

A policyholder can create an income stream by annuitizing the CSV of his policy, which means using the CSV to buy an annuity that will provide an ongoing series of income payments, either for life, or for a fixed period of time. By annuitizing the CSV, he is essentially cancelling the contract and surrendering the policy. As a result, he will generally realize a policy gain to the extent that the policy's CSV exceeds its ACB.

EXAMPLE

George has a $500,000 life insurance policy with a CSV of $430,000 and an ACB of $290,000. He originally bought the policy to ensure that his family would be cared for if he died. His children are now grown up and his wife has died, and he feels he does not need life insurance any longer. He decided to use the $430,000 to buy a life annuity to enhance his income during retirement. As a result, he will have a policy gain of $140,000 which will be taxable at his marginal tax rate:

Policy gain = $430,000 – $290,000 = $140,000

7.10.2.1 If the policyholder is disabled

Some tax relief is provided if the policyholder is totally and permanently disabled at the time he annuitizes the CSV. If this is the case, the policy gain will be spread out over the life of the annuity. This will ease the burden on the policyholder's cash flow for the year of annuitization, and may also result in the policy gain being taxed at a lower rate because his marginal tax rate over the annuitization period will likely be lower.

7.10.2.2 Partial surrender

Policyholders in retirement may realize that they no longer need as much life insurance as they did when they were younger, but they do not want to give up their life insurance protection entirely. They may choose to decrease their coverage, and annuitize only a portion of a policy's CSV. This will be treated as a partial surrender for tax purposes, with a prorated policy gain as discussed earlier in this Chapter.

7.10.3 Leveraging a life insurance policy

Retired policyholders looking for a tax-free source of retirement income may be able to leverage their existing life insurance policy, in what is often called an insured retirement strategy.

7.10.3.1 Collateralizing the cash surrender value (CSV)

Recall that a policyholder may be able to use the CSV of his life insurance policy as collateral for a loan, and that doing so does not trigger a deemed disposition.

Under an insured retirement strategy, the policyholder negotiates a series of annual loans, where each loan is secured by the policy's CSV. When the life insured dies, the lender recovers the amount of the cumulative loans from the death benefit, with the remainder going to the beneficiaries. This is called collateralizing the CSV.

The policyholder gets a tax-free payment from the lender, which can be particularly important to those in retirement who are trying to minimize their net income to avoid claw backs of Old Age Security (OAS) benefits.

The cash value remains in the policy where it can continue to grow on a tax-sheltered basis. This growth in the accumulating fund will help extend the duration of the income stream, because the lender will not let the cumulative loans exceed a certain percentage of the CSV.

EXAMPLE

Doris owns a UL policy with a CSV of $380,000. She made an arrangement to receive a loan of $20,000 each year, secured by her insurance policy. She receives the $20,000 at the beginning of each year, and does not need to report it as taxable income.

7.10.3.2 Interest paid or capitalized

Depending on the lender, the policyholder may have to pay the interest on the loans annually, or the lender may allow the interest to be capitalized, meaning it will be added to the cumulative loan balance outstanding, which is payable at death.

Both methods have their drawbacks. Interest that has to be paid annually will reduce the policyholder's retirement cash flow. Interest that is capitalized will reduce the policy's estate value.

7.10.4 Charitable giving

There are a number of ways that a person can use life insurance to help meet his philanthropic goals, including:

- Assigning a new life insurance policy to a charity;
- Assigning an existing life insurance policy to a charity; or
- Naming a charity as the beneficiary of a new or existing life insurance policy.

Each of these methods has the potential to result in a charitable donations tax credit. The following sections explain how the charitable donations tax credit works, and how it applies when using life insurance for a charitable purpose.

7.10.4.1 Charitable donations tax credit

A person who makes one or more donations to a registered charity can claim non-refundable federal and provincial charitable donations tax credits for the amount of those donations. The tax credit rates are stepped; for most taxpayers, a federal credit rate of 15% is applied to the first $200 of donations claimed during the year, and a federal credit rate of 29% is applied to donations over $200.[22] The provincial credit rates vary by jurisdiction.

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22. For the 2016 and subsequent taxation years, the federal donation tax credit rate for donations over $200 is 33% to the extent that the donor has taxable income that is taxed federally at 33% (for 2022, this would mean taxable income over $221,708). Some provinces also have enhanced credit rates for high income earners. However, the details are beyond the scope of this Module.

EXAMPLE

Mahmoud lives in New Brunswick, where the provincial tax credit on charitable donations is 9.4% on the first $200, and 17.95% on amounts over $200. Last year he donated $2,000 to his favourite registered charity. It was his only donation, and his taxable income was $150,000. He was able to claim a total of $893.90 as a charitable donations tax credit, calculated as follows:

Federal tax credit on first $200	= $200 × 15%[23]	=	$30.00
Federal tax credit on balance	= ($2,000 – $200) × 29%[24]	=	$522.00
Provincial tax credit on first $200	= $200 × 9.4%	=	$18.80
Provincial tax credit on balance	= ($2,000 – $200) × 17.95%	=	$323.10
Total federal and provincial tax credits		**=**	**$893.90**

Mahmoud can deduct this from the total income tax he would otherwise have to pay.

Spouses can choose to report their combined donations on one tax return, to avoid doubling up on the lower tax credit rate.

The tax credit is non-refundable, which means that the donator can only use the tax credit to offset his income tax otherwise owing, but he cannot use it to generate a refund. However, he can carry unused credits forward for up to five years, and use it to reduce his tax liability in one or more of those years. In addition to the fact that the charitable donations tax credit is non-refundable, there is a limit on the amount of donations that can be claimed for the year. This limit is normally set at 75% of net income. Net income includes all forms of taxable income, minus deductions for things such as registered retirement savings plan (RRSP) contributions, child care and moving expenses.

EXAMPLE

Ned wants to donate $200,000 to his favourite charity as soon as possible. However, his net income for the current tax year is $140,000. If he makes the full donation this year as planned, he will only be able to claim the charitable donations tax credit on the first $105,000.

Amount eligible for tax credit = $140,000 × 75% = $105,000

He will have to carry forward the remaining $95,000 to claim it in one or more of the next five years.

23. 15% is the federal credit rate that applies on the first $200.
24. 29% is the federal credit rate that applies on amounts over $200. He is not eligible for the 33% rate because his income is less than the threshold for the top marginal federal tax bracket of 33%.

When the donor dies, the limit is increased to 100% of net income for the year of death, and the immediately preceding year, because there is no opportunity to carry any unclaimed amounts to future years. This limit is an important consideration when making a large donation using life insurance.

7.10.4.2 Assigning a new insurance policy to a charity

A policyholder can acquire new life insurance coverage, on his own life or on someone else's, and then give or assign that new policy to a registered charity, provided the charity is willing and able to take over ownership of the policy.

Because a new life insurance policy does not yet have a cash surrender value, the assignment of the policy is not considered to be an immediate charitable donation, and the charity cannot issue a tax credit to the donor.

EXAMPLE

Thorsten bought a new $500,000 whole life insurance policy, and then immediately assigned that policy to his favourite registered charity. At this point, the policy does not have any value to the charity; if they surrender the policy, they will not receive anything. Furthermore, unless someone pays the premiums, the policy will lapse and be worthless.

However, if the policyholder continues to pay the premiums on a life insurance policy after assigning it to the charity, the amount of those premiums would be eligible for the charitable donations tax credit. This applies regardless of whether the policy is for term or permanent life insurance.

EXAMPLE (CONT.)

Each year, Thorsten pays a premium of $3,500 on the assigned policy. He can claim a charitable donations tax credit on the full $3,500.

7.10.4.3 Assigning an existing insurance policy to a charity

A policyholder can also assign an existing insurance policy to a charity, provided the charity is willing and able to take over ownership of the policy.

If the existing policy is a permanent insurance policy, the charity will issue a tax receipt to the policyholder equal to the CSV or the fair market value of the policy at the time of the assignment. This is because once the charity takes ownership, it can choose to surrender the policy, and will receive the CSV in cash.

EXAMPLE

Samuel assigned a $200,000 life insurance policy with a CSV of $36,000 to his favourite charity. He received a tax receipt for $36,000. He lives in Manitoba, which provides a charitable donations tax credit of 10.8% on the first $200 of donations and 17.4% on donations over $200. His taxable income is less than $200,000. As a result of assigning the policy, he was able to claim total federal and provincial charitable donations tax credits of $16,662.80.

$$\text{Total tax credits} = (\$200 \times (15\%^{25} + 10.8\%)) + ((\$36{,}000 - \$200) \times (29\%^{26} + 17.4)) = \$16{,}662.80$$

Because term life insurance policies do not build up a cash surrender value, the assignment of an existing term policy to a charity will not result in a tax receipt.

An absolute policy assignment is a deemed disposition for tax purposes, even when it takes the form of a charitable gift. As a result, assigning an existing life insurance policy will result in a policy gain to the extent that the policy's CSV exceeds its ACB at the time of the assignment. This policy gain will be taxable at the donor's marginal tax rate.

EXAMPLE (CONT.)

Suppose that Samuel's combined federal and provincial marginal tax rate is 44%, and that the policy's ACB is $10,000. By assigning the policy, Samuel will have a policy gain of $26,000.

$$\text{Policy gain} = \$36{,}000 - \$10{,}000 = \$26{,}000$$

This will result in a tax of $11,440.

$$\text{Tax payable} = \$26{,}000 \times 44\%$$

This will be more than covered by the charitable donations tax credit of $16,662.80 that he can claim because of the assignment.

Regardless of whether the policyholder is assigning a new policy or an existing policy to a charity, if he continues to pay the premiums for that policy after the assignment, he will be able to claim the charitable donations tax credit on those premiums.

25. 15% is the federal credit rate that applies on the first $200.
26. 29% is the federal credit rate that applies on amounts over $200. He is not eligible for the 33% rate because his income Is less than the threshold for the top marginal federal tax bracket of 33%.

7.10.4.4 Naming a charity as the beneficiary

A policyholder can also name a charity as the beneficiary of a policy. The policyholder will not get a tax receipt at the time he names the charity as the beneficiary, nor will he get a tax receipt for the premiums he pays, because:

- The charity does not get ownership or control of the policy, and they cannot surrender the policy to receive the cash surrender value;
- There is no guarantee that the policyholder will not change the beneficiary at a later date (unless the beneficiary designation is made irrevocable);
- There is no guarantee that the policyholder will continue to pay the premiums and keep the policy in force; if he lets the policy lapse, the charity will not receive anything upon his death.

Instead, the charity will issue a tax receipt to the policyholder for the amount of the death benefit paid out upon the death of the life insured. If the policyholder is also the life insured, the executor of the policyholder's estate (or liquidator of the succession) can allocate the available donation on the basis of the estate taxation year when the donation was made, a taxation year prior to the estate settlement and the policyholder's last two taxation years to obtain a tax credit.

Managing taxes upon death

Life insurance is often used to manage or pay for the taxes that become due as a result of death. While life insurance cannot help the policyholder or life insured avoid these taxes, it can provide the funds to pay them, and thereby preserve the estate for the intended beneficiaries. The four primary taxes or fees that can burden an estate include:

- Tax on capital gains;
- Tax resulting from the collapsing of registered plans (RRSP, RRIF, etc.);
- Taxes payable by the estate;
- Probate fees.

Agents must estimate these liabilities with sufficient accuracy to determine if the estate will be large enough to cover them, or if insurance is required. Candidates are reminded to review the Booklet entitled *Life insurance taxation principles* to ensure they are familiar with these tax principles.

CHAPTER 8
BUSINESS LIFE INSURANCE

Competency components

- Analyze the available products that meet the client's needs;
- Assess the client's needs and situation.

Competency sub-components

- Analyze the types of contracts that meet the client's needs;
- Articulate the client's needs based on the risks that could affect his financial situation.

8
BUSINESS LIFE INSURANCE

Businesses may use life insurance to accomplish a number of different objectives, such as:

- Protecting the business from the death of a key employee or shareholder;
- Funding a buy-sell agreement;
- Providing additional compensation for highly valued employees.

8.1 Potential impacts of death on a business

While death is most often thought of as a personal or family tragedy, the fact is that death can have a significant impact on some businesses, particularly in the case of small businesses or start-up companies.

The agent must understand the structure of his client's business in order to advise him from an insurance perspective. A business may have to face a number of issues when a death occurs:

- Loss of skills;
- Creditor demands;
- Family interference;
- Equality for family members;
- Capital gains tax.

8.1.1 Loss of skills

Some companies have one single person, or a handful of people, who are integral to the success of the business. These are people who are integral to the business and who are not easily replaced. Such a person is referred to as a "key person" or "key employee."

EXAMPLE

A "key person" can be one of the following:

- A highly skilled craftsman;
- An entrepreneurial genius;
- An influential vice-president;
- A charismatic salesperson;
- An engineer with a particular expertise for the running of a factory.

If a key person dies, the business loses skills that are vital to the continued viability of the company. This may result in lower production or decreased quality of goods or services, higher expenses and reduced profit margins, reduced consumer confidence and lower revenues.

EXAMPLE

Monica is a talented architect who works for a company specialized in the design of professional offices for lawyers and surgical specialists. The owners of the firm believe that about 30% of their business is due to the clients that specifically seek out Monica's talents. Monica's death would have a significant impact on the company's revenue.

8.1.2 Creditor demands

Many business loans take the form of demand loans, which have no fixed term or set duration of repayment as long as interest is paid. The borrower can also repay a demand loan in full at any time without penalty. However, the lender can generally recall the loan, demanding repayment in full, as long as any notice requirements specified in the loan agreement are met.

If a business has significant debt and a key person dies, creditors can become nervous and may recall demand loans or refuse to extend additional credit if the company needs it.

EXAMPLE

Cooper was the senior sales director for an advertising firm and he has just died. Before his death, he was responsible for bringing in about 50% of the firm's new business. The company recently took out a $500,000 demand loan to completely revamp their IT infrastructure to allow them to develop new holographic ads. They were relying on Cooper to drive the sales needed to pay back the loan. However, when the bank heard about Cooper's death and saw the company's latest sales figures, they recalled the loan and demanded repayment in full.

8.1.3 Family member interference

When a business has multiple owners and one of them dies, problems may arise if the deceased left his interest in the business to his surviving spouse or children. Often, the beneficiary is not capable or is incompatible with the surviving business owners. Even where the beneficiary is willing to sell his share in the business to the surviving owners, he could demand an unreasonable price for that share.

EXAMPLE

Jason, Ivan and Conner were the joint owners of Restful Solutions, a funeral home that caters to the upper class of society. Jason died without a will and he was survived only by Mason, his 24-year-old son. Mason is a troubled young adult with a history of petty theft and drug use.

Mason inherited Jason's ownership interest in Restful Solutions. He showed up drunk at the funeral home shortly after his father's death and loudly announced his intention to take over his father's role in the business. When Ivan and Conner tried to tell him that it was not a suitable role for him, he demanded $1,200,000 for his share in the business.

This problem, and how it can be addressed, is discussed in more detail in the Section *Buy-sell agreements*.

8.1.4 Equality for family members

Parents desire to treat their children equally, however, they must remind themselves that "equally" means "fairly," which is different from "exactly the same." This applies to many aspects of life, but is especially important when doing succession planning for a family business. In many cases, one child may have the interest and aptitude for taking over the family business, but another child may have completely different talents and aspirations. The parents will have to be creative in their estate planning to treat both children fairly.

EXAMPLE

Christina is the sole owner of a very successful garden centre, Hibiscus, which is an incorporated company worth about $1.5 million. Christina has two children who are in their twenties; Harry shares his mother's passion for gardening and has worked at the garden centre since the age of 10. Nancy is a doctor and has never had any interest in the business.

Christina would love for Harry to carry on the business if she dies, but she worries about treating Nancy fairly. Christina's other assets are limited to about $400,000, and she feels it would be unfair to leave the business to Harry while only leaving $400,000 to Nancy.

8.1.5 Capital gains tax

When a Canadian taxpayer dies, he is deemed to have disposed of all of his property for its fair market value immediately prior to death (unless a spousal rollover applies). In the case of shares in an active and prosperous business, this can result in a significant taxable capital gain if the shares are left to anyone other than his surviving spouse. If there is not enough money in his estate to pay this tax, it can force the executor[27] to sell some of the shares just to pay the tax.

EXAMPLE

Lori owns a 20% interest in a business corporation that she wants to pass on to her daughter, Olivia, when she dies. The shares currently have an adjusted cost base (ACB) of $100,000 and a fair market value (FMV) of $600,000, so if she dies today, this would result in a taxable capital gain of $250,000, calculated as (($600,000 – $100,000) × 50%).

If her marginal tax rate is 50%, this would result in an income tax liability of $125,000. If her estate cannot pay that income tax, and her daughter cannot either, then her executor would be forced to sell some of the shares to pay the tax bill.

This will be explored further in the Section *Corporations*.

8.2 Business types

The challenges faced by a business upon the death of the owner or a key employee depend in part on whether the business is structured as a sole proprietorship, partnership or corporation. The types of business are addressed below:

- Sole proprietorship;
- Partnerships;
- Corporations.

27. In Québec, executor can also be called liquidator.

8.2.1 Sole proprietorship

A sole proprietorship is an unincorporated business that is owned by a single person. A sole proprietorship is usually operated by the sole proprietor, so obviously the death of the sole proprietor could have a catastrophic impact on the business. As with any business, a sole proprietorship could also have one or more employees who are key to the success of the business, such that their death could be detrimental to the business.

From a tax and legal perspective, there is no legal separation between the business and the owner; they are considered to be the same entity. A sole proprietor reports the net income of the business on his personal tax return, and he is personally responsible for any business debts or other obligations.

The business is not a separate entity that can be bought or sold, or bequeathed to another person upon death, and the business itself does not have an adjusted cost base. However, the assets of the business, including inventory, buildings, etc., would form part of the sole proprietor's estate and would be subject to the deemed disposition rules upon death.

8.2.2 Partnerships

A partnership is a business that is owned by two or more people who have the common purpose of earning a profit. In many cases, the partners are actively involved in the business and their death could be detrimental to the business. However, a partner can also be a passive or silent partner, meaning that he contributed capital to the partnership and shares in the earnings, but he does not take an active role in the business.

From a tax perspective, each partner must report his share of the net partnership income on his personal tax return. Each partner is also jointly and severally liable for all of the debts or obligations of the business, unless the partnership is a limited partnership. A limited partner is entitled to share in the partnership's profits, but is not personally responsible for the business's debts or other obligations. A limited partnership must always have at least one general partner, who is personally liable for the business's debts and obligations.

Unlike a sole proprietorship, a partnership interest can be bought, sold or bequeathed upon death. It has an adjusted cost base, and a capital gain or loss can be triggered upon the sale or the deemed disposition upon death. The resulting tax liability can be significant and can potentially destroy the business if it is not carefully planned for.

8.2.3 Corporations

A corporation is a legal entity that is separate and distinct from its owners also called shareholders. The shareholders are not personally liable for the business's debts or obligations, unless they personally guaranteed those debts. If they are directors of the corporation, they can be held personally responsible for the company's income taxes and any amounts they deduct at source from payroll (e.g., employee income tax withholdings, Canada Pension Plan (CPP) and Employment Insurance (EI) contributions).

The corporation's shareholders do not report the company's net income directly on their personal tax returns; instead, that net income is taxed in the corporation. After-tax profits either increase the corporation's share value or are paid out to the shareholders in the form of dividends. Shares in the corporation have an adjusted cost base, and the sale or deemed disposition upon death can result in capital gains or losses. As with a partnership, the resulting tax liability can be significant and can potentially destroy the business if it is not carefully planned for.

8.2.3.1 Public vs. private corporations

There are some significant differences in the tax rules that apply to public and certain private corporations. A public corporation is generally any incorporated company that is listed on a public stock exchange, while the shares of a private corporation are not traded publicly.

There is a subset of private corporations, known as Canadian-Controlled Private Corporations (CCPC). A CCPC is a corporation that has the following characteristics:

- It is not listed on a public stock exchange;
- It is resident in Canada;
- It is not controlled, directly or indirectly, by one or more non-resident persons;
- It is not controlled, directly or indirectly, by one or more public corporations.

8.2.3.2 Capital gains exemption

For the purpose of this Module, the most important tax attribute of a CCPC is that, upon actual or deemed disposition, the shares may[28] be eligible for the lifetime capital gains exemption (LCGE). The LCGE for a CCPC is $913,630 for 2022 and is indexed annually for inflation. A taxpayer can use the LCGE to eliminate or offset capital gains realized upon the disposition of qualified shares in a CCPC, a family farm or a family fishing business.[29]

28. To be eligible for the LCGE, a CCPC must meet certain additional requirements regarding the use of its assets in an active business and the length of time the shares were owned, but these rules are beyond the scope of this Module.
29. The LCGE for family farms and fishing businesses is currently set at a fixed amount of $1 million.

EXAMPLE

Gene was the sole shareholder of his sportswear manufacturing company, Kiliman, which is a CCPC. When he died, the business had a fair market value (FMV) of $2,400,000 and an adjusted cost base (ACB) of $200,000. He left the business to his daughter, Yvonne.

This deemed disposition resulted in a capital gain of $2,200,000.

Capital gain = $2,400,000 – $200,000 = $2,200,000

Gene has never made use of the LCGE, so $913,630 (in 2022) of this capital gain is exempt from tax, leaving his estate with a taxable capital gain of $643,185.

Taxable capital gain = ($2,200,000 – $913,630) × 50% = $643,185

If Gene's marginal tax rate for the year of death was 45%, this would result in a tax liability of $289,433.

Tax liability with LCGE = $643,185 × 45% = $289,433

However, if he had not been able to take advantage of the LCGE, the tax liability would have been $495,000.

Tax liability without LCGE = $2,200,000 × 50% × 45% = $495,000

8.3 "Key person" life insurance

If a business owner or employee is important to the success of the business, the business may want to buy key person life insurance on that individual. If the key person dies, the company would receive the death benefit tax-free and could use it to help the business survive by:

- Recruiting and training a replacement;
- Making up for lost revenue;
- Covering overhead expenses until the company gets back on its feet.

8.3.1 Split-dollar arrangements

A split-dollar life insurance arrangement is a method of sharing the attributes and costs of a permanent life insurance policy amongst two or more parties. It is typically used when more than one party requires the benefits that can be provided by a life insurance policy. For example, it might be used where one party needs life insurance protection, and the other party is looking for a tax-deferred investment vehicle.

In common uses, a life insurance policy could be jointly owned by a key employee and the corporation he works for. The split-dollar arrangement can be structured in several ways. For example, the employee could own the death benefit, and the corporation could own and control the policy's cash value or vice-versa. If it is a universal life (UL) policy with a death benefit equal to the face amount plus account value or cumulative premiums, usually the employee is only entitled to control the portion of the death benefit equal to the original face amount, which would be paid to a beneficiary of his choosing upon his death. The corporation would receive the account value portion of the death benefit upon the employee's death.

Alternatively, the corporation could own the death benefit up to the original face amount, while the employee owns the policy's cash value and any death benefit in excess of the original face amount. This is the most common arrangement for key person insurance, where the corporation needs the face amount to compensate for the impact that the key person's death would have on the business. The key employee benefits by getting access to a tax-deferred investment vehicle.

The employee and the corporation would split the premiums in a way that recognizes their separate economic interests in the policy. In the latter case, where the corporation owns the death benefit up to the face amount, its share of the premiums would be tied to the reasonable costs for comparable term insurance coverage, and the employee would pay the balance of the premiums.

8.3.1.1 Taxation of key person split-dollar arrangements

The *Income Tax Act* does not contain specific rules dealing with the taxation of split-dollar insurance arrangements. However, the Canada Revenue Agency's (CRA) administrative view appears to be that the premium allocation between the employee and the corporation should reflect the fair market value of their respective interests in the insurance contract.[30] For the cost of a death benefit equal to the initial face amount, this can be interpreted as the premiums for comparable term coverage. For UL policies, it can be the cost of yearly renewable term (YRT) coverage or even the net cost of pure insurance (NCPI).

Upon retirement or termination of employment, the corporation would no longer need the key person coverage and the ownership interest in the death benefit could be transferred to the departing employee. Depending on the fair market value (FMV) of the policy, the transfer might result in a taxable benefit for the employee. If the policy is surrendered, the employee would have to report a policy gain for the difference between the cash surrender value (CSV) and the employee's adjusted cost base (ACB) in the policy.

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30. Manulife Financial. *Split dollar life insurance*. [online]. Revised August 2021. [Consulted May 9, 2022]. https://www.manulife.ca/advisors/insurance/tax-retirement-and-estate-planning/technical-planning-support/split-dollar-life-insurance.html

8.3.2 As a requirement for borrowing

If the success of a business depends on the involvement of a key person, a financial institution extending a loan to that business may require the assignment of a life insurance policy on that key person. If the key person dies, the lender would receive that portion of the death benefit required to extinguish the debt.

If the business acquires insurance on a key person because the lender requires it, then the business can deduct the premiums (or the net cost of pure insurance in the case of a permanent insurance policy) from its business income. If the death benefit exceeds the outstanding loan, then the deduction for premiums would be prorated accordingly.

8.4 Buy-sell agreements

Many businesses that have more than one owner, such as partnerships and private corporations, implement a buy-sell agreement to control what happens if one of the owners dies. A buy-sell agreement usually specifies:

- Who has the option or the obligation of buying an owner's interest in the business upon his death;
- The price that will be paid for that ownership interest, either as a fixed dollar amount or as a formula or method to calculate the purchase price;
- How the purchase will be funded.

Buy-sell agreements can also specify how a buyout will be structured if an owner wants to leave the business, retires or becomes disabled. This Module, however, only considers how buy-sell agreements might be used upon death.

There are several ways that buy-sell agreements can be structured, as discussed below.

8.4.1 Cross-purchase agreements

With a cross-purchase buy-sell agreement, the other owners agree to buy the interest of a deceased owner. For a corporation, this means that the total number of shares outstanding and the value of those shares remain the same, but each surviving shareholder now owns a greater number of shares.

EXAMPLE

Bob, Calvin and Dylan are the three shareholders of a small incorporated business specializing in recycling paper. They each own 100 shares, which are currently worth $10,000 per share. They recently entered into a buy-sell agreement which says that, if any one of them dies, the survivors will buy his shares for their current share value as determined by the company's financial statements.

If Bob dies today, this means that Calvin and Dylan will each buy 50 shares from his estate at a price of $10,000 per share. Bob's estate will receive a total of $1,000,000, and Calvin and Dylan will now each own 150 shares. The total number of shares outstanding is still 300, but Calvin and Dylan now have a 50% interest, instead of the 33.33% ownership interest that they had before Bob's death.

With a share redemption plan, the corporation redeems the shares of the deceased shareholder. This reduces the number of shares outstanding, but the survivors' ownership interests increase.

EXAMPLE

Emily, Fatima and Gloria are the three shareholders of a small incorporated business specializing in health products called Forest Air. They each own 100 shares, which are currently worth $10,000 per share. They recently entered into a buy-sell agreement in the form of a share redemption plan with the company which says that, if any one of them dies, the company will redeem her shares for their current value as determined by the company's financial statements and will cancel shares redeemed by the company of which the total will be 200.

If Emily dies today, this means that the company will pay $1,000,000 to her estate. Fatima and Gloria will still own 100 shares each, but because the number of outstanding shares will drop to just 200, they will now each have a 50% interest in the company, instead of the 33.33% ownership interest that they had before Emily's death.

8.4.2 Why buy-sell agreements are important

Buy-sell agreements are important whenever two or more people own a business together. If one of the business owners dies, a properly funded buy-sell agreement protects the surviving business owners, the business itself, and the surviving family or other beneficiaries of the deceased owner.

8.4.2.1 Guaranteed buyer

One of the problems with small business units or shares is that often they are not very liquid (i.e., they can be hard to sell because there are a limited number of potential buyers). A surviving spouse who inherited small business units or shares from his deceased spouse may find it hard to sell those units or shares unless a buy-sell agreement is in place. Most buy-sell agreements usually specify that the surviving owners or the business must buy the units or shares of a deceased owner. This gives owners the certainty that there will be a buyer for their units or shares upon death.

8.4.2.2 Guaranteed value

Along with guaranteeing a buyer, most buy-sell agreements also specify the sale price, or the method by which the sale price will be calculated. This ensures that the surviving spouse or other beneficiary receives fair compensation for the ownership interest, rather than having to sell it at a deep discount to its true value.

8.4.2.3 Mandatory sale

A buy-sell agreement means that the surviving owners do not have to worry about some unknown person becoming a joint owner in the business. Without a buy-sell agreement in place, an owner could leave his ownership interest to any person of his choosing upon death. This could include his spouse, child or some other person, who may not be capable of running the business or may be incompatible with the surviving owners. With a buy-sell agreement in place, the estate must sell the units or shares to the company itself (in a share redemption plan) or to the surviving owners (in a cross-purchase agreement).

8.4.2.4 Guaranteed funding through life insurance

Perhaps the most important provision of a buy-sell agreement is establishing how the transaction will be funded, because there is no point in mandating a sale at a specific price if the buyer does not have the funds to complete the transaction.

The most secure way of funding a buy-sell agreement is through life insurance, as discussed in the Sections *Criss-cross insurance* and *Business-owned insurance*. Note that the taxation of these arrangements can be quite complex, and agents should refer business owners to a tax or estate planning specialist to determine the structure most appropriate for them.

8.4.3 Criss-cross insurance

Criss-cross insurance is often used to fund cross-purchase buy-sell agreements. In this arrangement, each party to the buy-sell agreement buys life insurance on the other parties to the agreement, in an amount sufficient to cover their purchase obligation upon that party's death.

EXAMPLE

Recall the earlier example where Bob, Calvin and Dylan each own 100 shares, which are currently worth $10,000 per share. They recently executed a buy-sell agreement which says that, if any one of them dies, the survivors will buy his shares for their current share value as determined by the company's financial statements. The agreement specifies that each associate will purchase life insurance on the lives of the other parties.

So Bob would buy $500,000 of life insurance on Calvin and Dylan, which would be sufficient to buy 50 shares at the current value of $10,000 per share.

Because the insurance is not being used to secure a loan for business or investment purposes, the premiums are not deductible to either the associates or the business. However, the death benefit is tax-free.

One of the disadvantages of criss-cross insurance is that there may be significant differences in the premiums for the coverage required on each party, depending on their age and health.

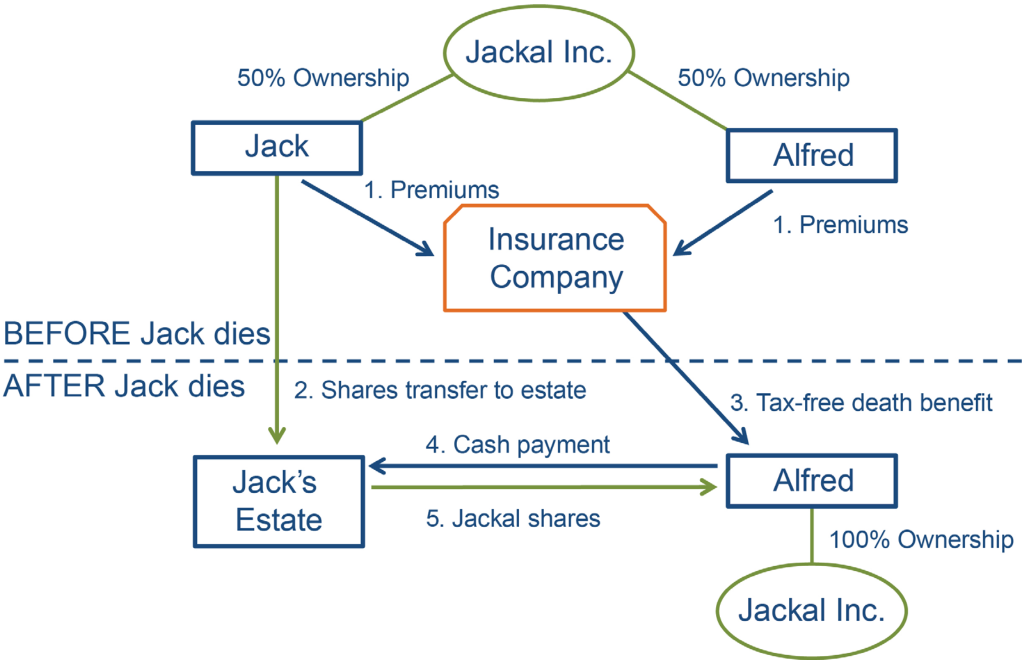
EXAMPLE (CONT.)

Bob is the youngest of the three owners. He is only 32 years old and in excellent health. Dylan, however, is 54 years old, overweight and a smoker, with a history of hypertension. Bob will pay much more for $500,000 of coverage on Dylan's life than Dylan will pay for $500,000 of coverage on Bob's life. Bob doesn't think this is fair, considering the fact that the death benefit is the same for both of them. Dylan, however, maintains that it is fair because Bob is far more likely to collect on the insurance than he is.

From a tax perspective, the deceased owner is deemed to have disposed of his business interest for its fair market value (FMV) just prior to death. This will trigger a capital gain on the deceased's final tax return, unless he can shelter some or all of the capital gain with the lifetime capital gains exemption (LCGE) available for qualifying small business shares. The LCGE for 2022 is $913,630. The surviving associate(s) use the tax-free death benefit they received when the owner died in order to acquire the units or shares from his estate.

EXAMPLE

Jack and Alfred each own 50% of the 200 shares of Jackal Inc., a frozen dessert company. They implemented a buy-sell agreement funded with criss-cross insurance. Jack died shortly thereafter. The overall process would look like this:



1. Jack and Alfred pay the premiums for life insurance on each other.
2. Jack dies, and his 100 shares transfer to his estate.
3. The insurance company pays a tax-free death benefit to Alfred.
4. Alfred pays Jack's estate for his 100 shares.
5. Jack's estate transfers the 100 shares to Alfred, who now owns all 200 shares, or 100% of the company.

8.4.4 Business-owned insurance

Another option for funding the buy-sell agreement is having the business buy the insurance coverage on the business owners. This has several potential advantages over policies purchased by the individual owners:

- If the cost of insuring each associate varies significantly due to age and health factors, a business-owned option will ensure that the costs are shared equally;
- Because the associates have access to the company's financial statements, they can assure themselves that the premiums for the insurance are actually being paid. If the policies are owned individually, it may be harder to obtain this proof;

- Because premiums are generally not tax-deductible and are paid with after-tax dollars, it will be cheaper for a corporation to buy the insurance if its tax rate is lower than the personal tax rates of the associates;
- If there are more than two associates, it will generally be more efficient and more cost-effective for the business to own policies on each associate, compared to each owner buying individual policies on each of the other associate;
- If the buy-sell agreement will be funded by business-owned insurance and there are only two shareholders, a joint first-to-die policy may be appropriate.

Business-owned insurance can be used to fund both cross-purchase buy-sell agreements and share redemption plans, as discussed shortly. However, first it is necessary to understand how a capital dividend account works.

8.4.4.1 Role of the capital dividend account (CDA)

A private corporation uses its capital dividend account (CDA) to record various amounts that it receives on a tax-free basis, such as the tax-free 50% of capital gains and some or all of the death benefits received from a life insurance policy. It can then pass those tax-free amounts on to shareholders on the same tax-free basis as a capital dividend.[31]

The CDA is only a notional account, which means it does not actually hold funds; it just keeps track of them for tax purposes. It keeps a running balance of the amounts that a private corporation can pay to its shareholders tax-free. A private corporation can elect to designate a payment to its shareholders as a tax-free capital dividend when it has a positive CDA balance and sufficient cash to do so. When the corporation pays out a capital dividend, the CDA balance is reduced by the same amount.

Note that only the portion of the death benefit that exceeds the policy's ACB is credited to the CDA, and ultimately paid out as a tax-free capital dividend. The remainder (i.e., an amount equal to the policy's ACB) is taxable to the corporation.

In the case of a term policy, the ACB is zero, which means that the full death benefit can be credited to the CDA. However, for whole life or UL policies, a portion of the death benefit equal to the policy's ACB is in fact taxable to the corporation.

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31. Manulife Financial. *Capital dividend account and life insurance*. [online]. Revised March 2019. [Consulted May 9, 2022]. https://www.manulife.ca/advisors/insurance/tax-retirement-and-estate-planning/technical-planning-support/capital-dividend-account-and-life-insurance.html

Recall from Section *G2 and G3 policies* that the ACB of G3 policies tends to grow faster than for G2 policies in the early years, and it takes longer for that ACB to reduce to zero. This ACB pattern is beneficial for individual policyholders who surrender their policies prior to death of the life insured because it reduces their policy gain. However, it is less favourable for corporate-owned policies because a greater portion of the death benefit ends up being taxable.

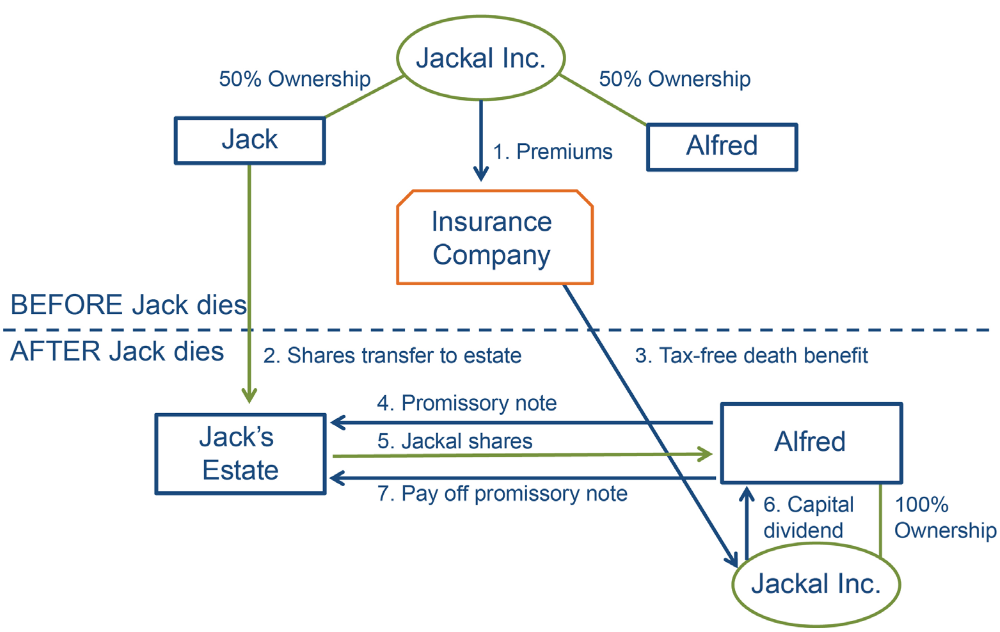
For simplicity, for the remainder of this Chapter, we will assume that the corporate-owned insurance is term insurance with an ACB of zero, so the full death benefit can be credited to the corporation's CDA.

8.4.4.2 Funding cross-purchase buy-sell agreements

If a cross-purchase agreement is funded by corporate-owned insurance, usually the corporation is named as the beneficiary of the policy. When one of the shareholders dies, the surviving owner(s) purchase the shares from his estate, often using a promissory note. The insurance company will pay the death benefit to the corporation, which will credit the amount to its capital dividend account. The surviving shareholder(s) will then direct the corporation to pay them a capital dividend, which they will use to pay off the promissory note.

EXAMPLE (CONT.)

Suppose Jack and Alfred's cross-purchase agreement is instead funded by insurance owned by Jackal Inc. When Jack died shortly thereafter, the overall process would look like this:



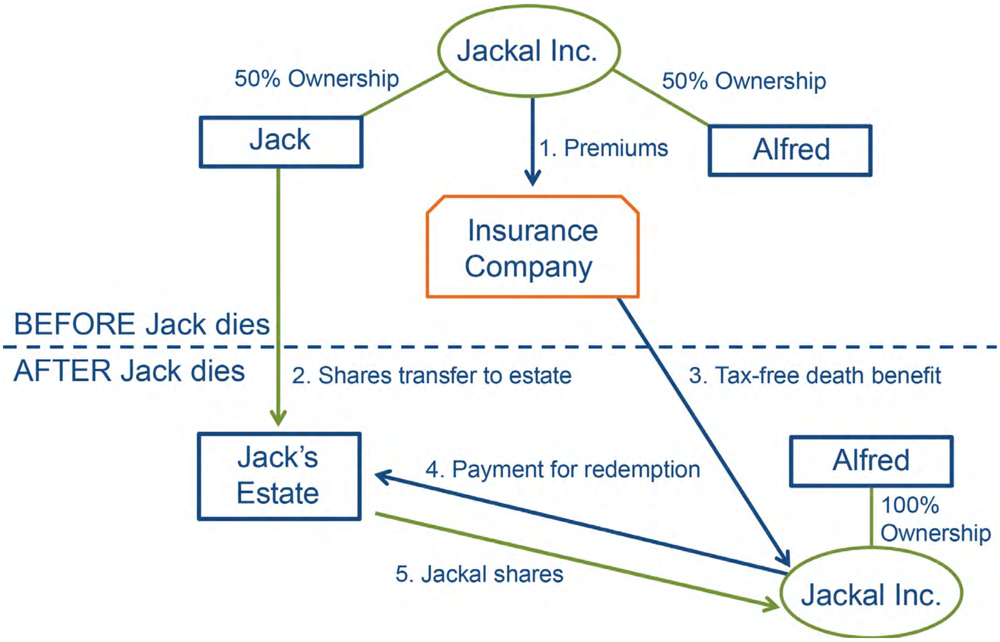
1. Jackal Inc. pays the premiums for insurance on both Jack and Alfred.
2. Jack dies, and his 100 shares transfer to his estate.
3. The insurance company pays the tax-free death benefit to Jackal Inc., which is credited to its CDA.
4. Alfred pays Jack's estate for his 100 shares with a promissory note.
5. Jack's estate transfers the 100 shares to Alfred, who now owns all 200 shares, or 100% of Jackal Inc.
6. Alfred instructs Jackal Inc. to pay him a tax-free capital dividend.
7. Alfred uses these funds to pay off the promissory note.

8.4.4.3 Funding share-redemption buy-sell agreements

In the case of a share redemption plan, the company and the shareholders are all parties to the buy-sell agreement. The company buys life insurance on all of the shareholders, naming itself as the beneficiary. When one of the owners dies, the company uses the death benefit to redeem the shares from the deceased shareholder's estate.

EXAMPLE (CONT.)

Suppose that Jack and Alfred instead entered into a buy-sell agreement with Jackal Inc., structured as a share redemption plan, funded by insurance owned by Jackal Inc. When Jack died shortly thereafter, the overall process would look like this:



1. Jackal Inc. pays the premiums for insurance on both Jack and Alfred.
2. Jack dies, and his shares transfer to his estate.
3. The insurance company pays the tax-free death benefit to Jackal Inc., which is credited to its CDA.
4. Jackal Inc. uses the funds to redeem the shares from Jack's estate, cancelling the said shares, reducing the number of shares outstanding to 100.
5. Alfred still owns the remaining 100 shares, which represents 100% of the company.

CHAPTER 9

APPLICATION AND UNDERWRITING

Competency component

- Implement a recommendation adapted to the client's needs and situation.

Competency sub-components

- Consider the impact of underwriting criteria as they apply to the client's situation;
- Confirm the requirements that must be met to implement the recommendation.

9

APPLICATION AND UNDERWRITING

When a life insurance company issues an insurance policy, it is entering into a contract; it agrees to undertake the risk of having to pay out a death benefit, in exchange for the certainty of receiving a premium. Before the insurance company can decide whether this is a reasonable risk to take, and what compensation (premium) is warranted, it must first assess this risk through its underwriting process. This Chapter discusses the underwriting process, from the initial application through policy issue and delivery.

The life insurance industry has historically been slow to change, but the application and underwriting process has been undergoing a modernization process over the past five or so years, making better use of technology and artificial intelligence (AI). Many insurers accelerated these changes in response to the global COVID-19 pandemic that started in 2020, and practices and processes continue to evolve.

Depending on the insurance company, the amount of the coverage being applied for and the age of the life insured, many of these steps may now be automated and may happen electronically or virtually.

9.1 Process overview

This Section provides an overview of the traditional application and underwriting process; the specifics are covered in more detail later in this Chapter, along with modernization and automation changes.

9.1.1 Agent's role

A life insurance agent is not responsible for personally assessing the risk presented by the applicant; that is the job of the insurance company's underwriter. The agent's role in the underwriting process is to help collect the information that the insurance company needs to perform its risk assessment. His role is a critical one, because he is often the only insurance company representative who actually sees the applicant (or the life insured, if different from the applicant) in person. In fact, it is often said that the agent is the "eyes" of the life insurance company, although today that contact may be virtual instead of face-to-face.

9.1.2 Completing the application

In an agent-client engagement, the first step in the underwriting process consists of the agent working with the applicant to complete a detailed application for insurance, as well as any related or supplementary forms. The agent must:

- Ensure that the information recorded on the application is complete and accurate;
- Ensure that the applicant understands the consequences of providing incomplete or false information;
- Confirm the identities of the applicant and the life insured (if different) by examining their identification (e.g., driver's licence, passport);
- Witness their signatures on the application.

With recent modernizations, many applications can now be submitted electronically, with or without the assistance of any agent. Meetings often now happen virtually using teleconferencing applications. Rules have also been relaxed to allow electronic signatures and electronic policy delivery.

9.1.3 Underwriting

The agent forwards the completed and signed application to the insurance company's underwriting department. Underwriting is the process an insurance company uses to assess the risk presented by the life insured.

The underwriter starts by assigning the life insured a baseline score, such as 100, which represents the mortality risk posed by the average or standard person. Then, for a long list of medical, financial and lifestyle criteria, the underwriter assesses the risk that the life insured presents and compares it to that of a standard person. If the life insured presents a lower mortality risk for specific criteria, then the score is reduced, while a higher mortality risk means the score is increased.

The cumulative result over all of the criteria is used to assign the life insured to a risk class, discussed in more detail in the Section *Risk classes and their impact on premiums*.

If the life insured's medical and non-medical evaluation and the amount of insurance being applied for fall within the insurance company's parameters for a standard policy, the application is usually underwritten quickly, and the policy may be issued in as little as a few days. However, if these details fall outside the standard parameters, the underwriter will seek and evaluate additional information before making his decision.

Some insurance companies now use algorithms and artificial intelligence (AI) to assist in the underwriting process, discussed in the Section *Accelerated underwriting*.

9.1.4 Issuing and delivering the policy

After the life insurance company issues the policy, the agent must deliver it to the applicant. This is considered to be a continuation of the underwriting process, because the agent must ensure that the medical, personal or financial situation of the applicant (and the life insured, if different) has not changed since the application date. The agent can only complete delivery if he is satisfied that nothing has changed. This is discussed in more detail in the Section *Issuing the policy*.

9.2 Application

The application is critical to the underwriting of a new insurance policy, and in fact the agent's role in helping the client to complete the application is sometimes referred to as field underwriting. The agent assists the applicant either by providing guidance or by actually asking the questions verbally and then recording the responses.

Depending on the insurance company and the type of policy being applied for, the application can range from 5 to 50 pages or even more.

9.2.1 Policy details

The application usually first gathers some basic information about the characteristics of the coverage the applicant is seeking. These details will define the terms of the policy.

9.2.1.1 Applicant/policyholder

The applicant is the person who wants to buy the policy and who will become the policyholder if the policy is issued.

The application form will record the applicant's legal name, address and contact information. If the applicant is not the life insured, the application will also ask for a contingent owner or successor owner, which is someone who will receive ownership of the policy if the original applicant/policyholder dies.

9.2.1.2 Life insured

The applicant must identify a specific person as the life insured. Throughout this Chapter, we make a distinction between the applicant (who will ultimately become the policyholder if a policy is issued) and the life insured. While in many cases the applicant will be the same person as the life insured, we have maintained the distinction of these roles throughout this Chapter for clarity.

For a joint-life policy, the applicant will name two people and must specify whether the death benefit is to be paid upon the first death to occur (i.e., joint first-to-die coverage) or upon the death of the second life insured (i.e., joint last-to-die coverage).

9.2.1.3 Beneficiary

The applicant must specify who will receive the death benefit if the life insured dies. The beneficiary can include one or more people, or legal entities such as trusts or business corporations. He can also specify a contingent beneficiary, who will receive the death benefit if the original beneficiary is no longer alive.

If no beneficiary is entered, the default is the estate of the policyowner. If the applicant is not the life insured, he can also name himself as the beneficiary. If he is the life insured, he can name his estate as the beneficiary.

Note that once the policy is issued, the policyholder can usually change the beneficiary designation, unless the policy is irrevocable. An irrevocable beneficiary designation is sometimes required to comply with a court order for child or spousal support and is sometimes used for tax planning purposes.

9.2.1.4 Type of policy

Many insurance companies use a single application for a number of different life insurance products. If this is the case, there will be a spot on the application for the applicant to choose the type of life insurance policy he is applying for (e.g., term, participating or non-participating, universal life).

For universal life (UL) policies, the applicant may also have to choose how the mortality deductions will be calculated (e.g., yearly renewable term or level cost of insurance) and how the death benefit is calculated (e.g., level death benefit plus account value or level death benefit plus cumulative premiums).

For UL and whole life policies, most insurance companies require the agent to submit an illustration of the policy along with the application. By signing the application with the illustration attached, the applicant is confirming that he has been shown how the policy works.

9.2.1.5 Riders and supplementary benefits

Similarly, if the insurance company allows policyholders to customize their coverage through a variety of riders and supplementary benefits, such as a guaranteed insurability benefit (GIB) or family coverage rider, there will be a spot on the application for the applicant to select these riders and benefits.

In many cases, the applicant can only add these riders and supplementary benefits at the time of policy issue, although sometimes they can be added to an existing contract.

9.2.1.6 Premium options

If the insurance company provides various options for paying premiums (e.g., annually, quarterly, monthly through pre-authorized chequing), the applicant can indicate his choice on the application.

9.2.1.7 Dividend options

For participating whole life policies, the applicant must choose a dividend payment option (e.g., premium reduction, paid-up additions, term insurance) when completing the application.

9.2.2 About the applicant

When underwriting an insurance application, the insurance company will be taking a close look at the applicant, even if he is not the life insured. The application will seek information that will help the underwriter assess his:

- Financial ability;
- Insurable interest;
- Justification for the amount of coverage; and
- Insurance application history.

9.2.2.1 Financial ability

One of the first things the underwriter will consider is whether or not the applicant has the financial means to afford policy premiums. To this end, the application may ask for details such as the applicant's:

- Occupation (or prior occupation if retired);
- Employer;
- Employment income;
- Additional sources of income;
- Net worth.

If the applicant is dependent on someone else for financial support (e.g., a spouse), the underwriter may enquire about the financial means of the supporting person.

9.2.2.2 Insurable interest

If the applicant is not the life insured, the applicant will be asked to specify his relationship to the life insured. The applicant must have an insurable interest in the life insured at the time of policy issue. Generally, this means that the applicant must expect to suffer a financial loss or fail to make a financial gain if the life insured dies. It is typically accepted that a person has an insurable interest in his own life, as well as in the life of:

- His child or grandchild;
- His spouse;
- Any person upon whom he is wholly or partially dependent for support or education;
- His employee;
- Any person in the duration of whose life he has a pecuniary interest.

If an insurable interest does not exist at the time of policy issue, the contract is generally considered to be void. However, the insurable interest only has to exist at the time of policy issue. If the relationship between the policyholder and the life insured changes, such that an insurable interest no longer exists, the contract is still considered to be valid.

EXAMPLE

When Isabelle and her husband Justin had their first child, Justin bought a $500,000 20-year term life insurance policy on Isabelle's life. Isabelle and Justin divorced a few years later and Isabelle has since remarried. Justin no longer has an insurable interest in Isabelle's life; the existing policy remains valid, but Justin would likely not be able to buy any additional coverage on Isabelle's life.

An exception to the insurable interest requirement applies if the life insured consents in writing to insurance being placed on his life. Usually the life insured is required to confirm his consent by signing the insurance application.

EXAMPLE

Justin's next door neighbour, Caleb, is an adventurous person who has a passion for extreme sports and travel. When Justin heard that Caleb was planning to go on a solo snowmobile expedition to the North Pole, Justin joked that he should buy life insurance on Caleb's life. However, Justin does not have an insurable interest in Caleb's life, so the only way he could buy insurance on his life would be to obtain Caleb's written consent.

9.2.2.3 Justification of amount of coverage

In addition to determining if the applicant has an insurable interest in the life insured, the underwriters will consider whether the amount of coverage is reasonable in the circumstances. The purpose of life insurance is to protect the policyholder (or the beneficiary, if different from the policyholder) from the financial loss that results from the death of the life insured, by restoring him to approximately the same financial position he enjoyed before that death. Insurance is not intended to provide a way of profiting from that death.

EXAMPLE

Frank and Susan are both 30 years old, and they have 3 children, all under the age of 5 years old. Susan stays home to care for the children, while Frank earns a salary of $250,000 per year. They have a $350,000 mortgage with a 20-year amortization.

Another couple, Jack and Jolene, are 46 and 42 years old, and they do not have children. Jack earns $40,000 and Jolene earns $25,000. They rent their home and have no major debts.

Susan and Jolene both applied for $7.5 million of life insurance coverage on their husbands. In all likelihood, the underwriters would consider $7.5 million of coverage on Jack's life to be excessive, and they would refuse to issue a policy for that amount. However, they would likely agree that the amount is reasonable in Susan's case, considering Frank's income and young age, Susan's lack of income, their mortgage debt and the fact that they have three young children who require ongoing support.

9.2.2.4 Insurance application history

The applicant will be asked about any existing life insurance policies he owns on the life insured, as well as any other applications that are in progress. This is to ensure that the total amount of insurance the applicant has or will have on the life insured is kept to a reasonable amount.

9.2.3 About the life insured

The risk to the insurance company stems from the health of the life insured, as well as any activities that might result in death. As a result, the insurance application is designed to gather as much information about the life insured as possible.

9.2.3.1 Personal information

The application will seek personal information about the life insured, such as his:

- Current name and any former names;
- Date of birth;
- Current address;
- Social insurance number;
- Country of birth;
- Current nationality or residence status;
- Employer and occupation;
- Bankruptcy history.

The application will also include questions about the life insured's lifestyle, such as:

- His avocations, which are activities that he engages in outside his employment, such as participation in extreme sports, adventure travel or dangerous hobbies;
- His past travel experiences and future travel plans;
- Current or past smoking habits, including tobacco, cigars or cigarillos, marijuana or hashish, or use of tobacco substitutes or smoking cessation products;
- Alcohol consumption;
- Narcotic or other recreational drug use;
- Driving history, including any charges for motor vehicle or traffic violations (e.g., speeding, illegal lane changes), careless or dangerous driving, or driving while impaired;
- Criminal history.

9.2.3.2 Medical information

A significant part of the application will be devoted to the health of the life insured. Questions usually cover the following:

- Height and weight, including any recent changes;
- Name of personal physician;
- Date of last medical consultation, reason for visit and outcome;
- Whether he had ever experienced, received treatment for or been investigated for a long list of medical conditions;
- Current medications;
- Other current treatments (e.g., physiotherapy, chiropractic care, psychologist);

- Whether his parents and/or siblings experienced any of a specified list of health problems (e.g., cancer, diabetes, multiple sclerosis, high blood pressure) and details about any positive responses;
- For female applicants, their pregnancy history.

Many of these questions require a “Yes” or “No” answer and, if the applicant answers “Yes” to any question that is looking for a “No” response, he is asked to provide additional details.

EXAMPLE

When Rebekah was filling out her life insurance application, she answered “Yes” to the question that asked “Have you ever had or been investigated or treated for conditions involving your heart or blood vessels?” because she had once visited the emergency room complaining of chest pain and shortness of breath. Later in the application, she was asked to provide details about the incident, including the name of the hospital and attending doctor, the types of tests he performed and the diagnosis.

9.2.4 Incomplete or erroneous information

Agents should encourage applicants to fill out the application completely and honestly and warn them of the possible consequences for failing to do so, which could include voiding the contract.

There are three main situations involving the application that can lead to problems, including:

- Mistake;
- Fraudulent misrepresentation;
- Incomplete information.

9.2.4.1 Mistake

Sometimes an applicant makes an honest mistake or inadvertent error when filling out his application, without any intention to deceive the insurance company. It could be as simple as forgetting a surgery he had 30 years ago as a child, misunderstanding a previous diagnosis or entering his weight in kilograms when the application asked for his weight in pounds.

A fact is considered to be a material fact if, had it been disclosed properly, it would have affected the underwriting of the policy. In other words, if the underwriter had known the truth, he may have declined the application or assessed a higher premium.

EXAMPLE

Christina recently filled out a life insurance application. The application accidentally listed her birth year as 1954 instead of 1945. This mistake is material, because risk of death increases significantly as the life insured ages.

When it asked her to specify her most recent visit to a physician, she listed her annual checkup that occurred nine months ago. She forgot to mention that she met with her physician three months ago to get a flu shot. This mistake is not material because getting a flu shot is unlikely to impact the underwriter's evaluation.

If a mistake is material in nature, and the insurance company discovers it within the first two years after the policy was issued or reinstated, it can void the insurance contract. However, once those two years have passed, the policy becomes incontestable and the insurance company cannot void the contract unless it can prove fraudulent misrepresentation.

9.2.4.2 Fraudulent misrepresentation

In general, underwriters assume that the information provided by an applicant is the truth, and they use this information to determine whether or not to issue the policy and what premiums to charge.

Fraudulent misrepresentation occurs if the applicant intentionally provides the insurance company with false information or fails to disclose important information, to purposely mislead the insurance company in the hopes that the company will issue a policy and/or lower its premiums.

EXAMPLE

When Eric was travelling in Peru several years ago, he contracted a parasite that left him seriously ill. After spending several days being treated in hospital, he was discharged with a prescription for more antibiotics and was told that he should follow up with his family doctor when he returned home because there could be long-term complications, including organ damage. Eric recovered quickly and he never bothered to see his family doctor.

When he later filled out a life insurance application, he knew he had some health issues that might concern the insurance company and that could result in higher premiums. He purposely neglected to disclose the incident in Peru; he decided that because it happened outside the country and he paid for it out of pocket, there was no way the insurance company could find out about it.

Three years later, Eric suffered sudden liver failure and died during surgery. The liver damage was eventually linked to his experience with the parasite in Peru. Because Eric made a fraudulent material misrepresentation, the insurance company was able to void the policy even though the two-year contestability period had passed, and they did not pay the death benefit.

One question that applicants are often tempted to answer fraudulently relates to smoking status. If the applicant says that he (or the life insured, if different) is a non-smoker, when in fact he is a smoker, this is fraudulent misrepresentation. If the life insurance company discovers this fact while the life insured is still alive, it can void the policy and return the premiums paid to date, or adjust either the premiums or the amount of the death benefit to reflect the true smoking status. If it discovers the fraud upon death of the life insured, it can deny the claim.

Agents should therefore caution applicants about the importance of being completely honest when completing the section of the application dealing with smoking.

9.2.4.3 Incomplete information

Sometimes the applicant fails to complete all of the questions on the application, either by oversight or perhaps because he was not sure about how to answer a particular question. If the agent submits such an application to the insurance company, the underwriter will return the application and require the agent to obtain the missing information. This delay will leave the policyholder unprotected until the matter is rectified.

9.2.5 Agent's comments

The application usually includes space for the agent to make comments on anything he noticed during the application process or that he otherwise knows about the applicant or life insured that might impact the underwriter's assessment. For example, he might record:

- His knowledge about the stability of the applicant's employment;
- His own observations regarding the health or smoking status of the life insured, particularly if they contradict the answers recorded by the applicant;
- His opinion on the truth or accuracy of the applicant's responses.

9.3 Temporary insurance agreement (TIA)

It can take several weeks or even months for the underwriter to completely process a life insurance application, particularly if additional information or a medical examination is required. An applicant typically submits an application because he has identified a need for the coverage, so he may not be pleased to learn it could take a few months before a policy is issued. For this reason, the agent typically has the authority to issue a temporary insurance agreement (TIA), which will provide some temporary coverage during the underwriting process.

9.3.1 Requirements for coverage

To obtain coverage under a TIA, the applicant must submit a completed life insurance application along with at least one month's premium.

Most insurance companies will only issue a TIA if the applicant completes a separate TIA application form and is able to answer "No" to a short list of health-related questions about the life insured. These questions can be very broad, such as:

- "In the past 60 days, have you consulted a doctor or other health practitioner and been told to have further examination, diagnostic test or surgery which has not been performed or for which the results are not known?"
- "Have you ever been treated for or had any indication of heart or circulatory disease, heart attack, high blood pressure, chest pain, abnormal ECG, stroke, transient ischemic attacks, diabetes, chronic kidney, liver or lung disease, cancer or tumour, multiple sclerosis, paralysis, motor neuron disease, Alzheimer's disease, Huntington's disease, Parkinson's disease, AIDS, ARC or HIV infection, loss of speech, blindness or deafness?"

If the answer to any of the questions on the TIA application is "Yes," then a TIA is automatically denied.

In addition, the life insured generally must meet certain age restrictions (e.g., between a minimum of 15 days old and a maximum of 70 years old).

9.3.2 Coverage limits

In most cases TIA coverage is limited to the lesser of:

- A fixed amount, such as $250,000 or $500,000; and
- The amount of coverage the applicant is requesting.

TIA coverage is subject to the same terms and conditions as the policy being applied for. In particular, this means that the suicide exclusion provision will apply, so the TIA's death benefit will not be paid if the life insured dies by suicide.

9.3.3 Coverage duration

Depending on the insurance company, TIA coverage may begin as soon as the application and premium have been submitted, or it may not start until all medical evidence has been submitted.

The TIA remains in effect until the earliest of:

- Its expiry date (usually 60 or 90 days);
- The date the policy becomes effective; and
- The date the insurance company notifies the applicant that his application has been denied and returns the premium.

If the underwriter who is processing the application decides that additional information is required, he may also revoke the TIA by advising the applicant in writing and returning the premium.

9.3.4 Agent's responsibilities

The issuance of a TIA is not an automatic or guaranteed part of the application process. The agent should only issue a TIA if:

- He has no concerns about the application or the likelihood that the underwriter will issue the requested policy; and
- The applicant submitted the first premium with the application.

EXAMPLE

Richard is a life agent and he has just helped Arlene complete an application for life insurance. Arlene is diabetic and has high blood pressure. She admitted that she smokes regularly and Richard noticed that she had a persistent cough, which he duly noted in the Agent's Comments section of the application. Given the concerns about Arlene's health, Richard should not issue a temporary insurance agreement.

9.4 Underwriting by the insurance company

Once the insurance company receives a completed application, its underwriter begins the task of evaluating the risks posed by the life insured. This Section first discusses the traditional underwriting process, before examining accelerated underwriting.

9.4.1 Underwriting guidelines

Each insurance company typically has internal underwriting guidelines that provide an explanation of the underwriting requirements for each product. While the guidelines are specific to each company, they might cover:

- A description of each condition or factor being evaluated;
- Key elements that must be considered when evaluating that condition;
- A list or description of the additional information that must be gathered before a decision can be made (e.g., policies for less than $100,000 of coverage may only require a blood test, while policies for over $1,000,000 may require a medical by a licensed physician, plus a stress test and specified bloodwork);
- The most probable underwriting decision, or a range of possible outcomes;
- Height and weight tables for standard risks.

The insurance company may have separate guidelines for medical, non-medical and financial underwriting.

While agents are not expected to underwrite the policies themselves, they may find it helpful to review these guidelines, so they can help their clients set realistic expectations about the probable outcome of their application.

EXAMPLE

Chandra is a life insurance agent and he recently helped his client, Jeannine, complete an application for life insurance. He noticed that she reported a family history of diabetes and that she had recently lost a substantial amount of weight. Because he was familiar with the insurance company's underwriting guidelines, he was able to tell her that it was highly likely that the underwriters would request more information and require her to submit to a medical exam. He also warned her that she might not qualify for standard rates and that there was even a possibility that the underwriters would reject her application.

9.4.2 Attending physician's statement (APS)

If the application indicates that the life insured has experienced a specified medical issue, the underwriter may request an attending physician's statement (APS). Normally the application includes an acknowledgement that gives the insurance company permission to contact the doctor directly. The insurance company pays any fees the doctor charges for preparing the APS, and the doctor sends the APS directly to the underwriter.

The APS usually provides:

- A summary of the life insured's medical history;
- A description of his current health, medications or other treatments;
- A prognosis from the doctor for any ongoing issues.

9.4.3 Medical exam

If the underwriter still has concerns about the health of the life insured after receiving an attending physician's statement, he may ask the life insured to undergo a medical exam. Sometimes the underwriter will request the medical exam without first obtaining an APS, either because he has significant concerns about the health of the life insured or because the insurance company simply has a policy of requiring a medical exam for policies over a certain face amount, or when the life insured is of a certain age. This medical exam could include more than just a visit to the doctor; it could include blood, urine or saliva tests, electro-cardiograms (ECGs) and more.

Usually the medical exam is performed by a health practitioner who works for an independent paramedical company. For high-value policies or complex medical concerns, the underwriter may require the exam to be performed by a licensed physician or may order special tests (e.g., a cardiac stress test). Regardless of who performs the exam or the extent of the tests required, the insurance company pays any related fees.

Some insurance companies have temporarily relaxed their requirements for in-person medical exams during the COVID-19 pandemic because of physical distancing requirements. If the application does not show any significant health concerns and the life insured falls within set age and coverage parameters, the policy may be underwritten without a medical exam or the collection of blood or urine. Many insurance companies increased the amount of coverage available without a medical exam to as much as $2,000,000, depending on the age of the life insured.

For clients who are beyond the age or threshold amounts but without any significant issues identified in their application, the insurer may still be willing to underwrite the policy if the life insured can provide a doctor's report or medical records. Some companies also use an online or telephone interview to help determine if the application can be underwritten without an in-person medical exam or the collection of blood or urine.

9.4.4 Medical Information Bureau (MIB)

Most life insurance companies in Canada and the United States choose to be a member of the Medical Information Bureau (MIB), by paying an annual fee. The MIB is a membership organization that facilitates an exchange of medical information about applicants between member insurance companies.

When someone applies for life insurance at a MIB-member company, they must be informed about the nature of the MIB. They must also sign a release that authorizes the insurance company to search for information about them on the MIB database and to share any applicable details of their current application with the MIB.

When the underwriter at a MIB-member company processes an application, he is required to report significant underwriting issues to the MIB. The MIB compiles this information in coded reports that represent different medical conditions and non-medical conditions (typically hazardous hobbies and adverse driving records) that could affect the insurability of the applicant. The next time the applicant applies for life insurance at an MIB-member company, his MIB report will alert the underwriter to possible errors, omissions and misrepresentations that he made in the application process.

If the MIB report is inconsistent with the information provided by the applicant, the underwriter must investigate further to obtain more information about the reported medical history or condition, prior to making an underwriting decision. In other words, the underwriter cannot use the MIB report itself as a basis for declining or rating an application; he must first verify that the problem actually exists.

EXAMPLE

Ernie was living in Ontario when he applied for life insurance with ABC Insurance Co. last year. On his application, he indicated that he had previously experienced a heart attack and had two related surgeries. He was also a heavy smoker and overweight. His application was declined.

This year Ernie moved to Alberta and again applied for life insurance with XYZ Insurance Co. This time, he decided not to mention any of his heart problems, thinking that his health records would not be transferred between provinces. Also, he claimed to smoke only socially, a few cigarettes a month. He had also lost all of his excess weight, so he felt much more confident that his application would be approved.

When Ernie had applied for insurance with ABC Insurance Co., they reported his heart problems to the Medical Information Bureau (MIB). When the underwriter at XYZ Insurance Co. started working on his application, he searched the MIB database for any previous applications by Ernie. The MIB alerted him to the fact that another insurance company had reported that Ernie had heart problems and was a heavy smoker. While XYZ Insurance Co.'s underwriter could not use this as a basis for denying Ernie's application, it did prompt him to request a copy of Ernie's past medical records and he also required Ernie to undergo a full medical exam, including various heart-related tests. Based on those results, the underwriter declined his application.

9.4.5 Motor vehicle record (MVR)

If the application fails to provide the requested details about driving history, or when the amount of coverage requested is above a certain level, the underwriter may request a copy of the life insured's motor vehicle record (MVR) from the provincial motor vehicle and licensing authority. This report provides a synopsis of the life insured's driving history over a specific period (3 to 10 years, depending on the jurisdiction). The MVR includes a record of the life insured's:

- Speeding or other moving violations;
- Chargeable accidents;
- Driving under the influence (DUI) charges;
- License suspensions or revocations;
- Accumulation of points.

It may seem strange that a life insurance underwriter would request a motor vehicle report, because the application is not for automobile insurance. However, statistics have shown that a person's driving record directly influences his risk of death. In fact, infractions such as failing to use a seat belt, using an electronic device while driving, running a red light or speeding will often cause the policy to be rated, resulting in much higher premiums. Rated policies are discussed in the Section *Risk classes and their impact on premiums*.

9.4.6 Inspection report

If the underwriter still has concerns about the application, he may hire a service company to investigate the life insured and then prepare an inspection report. The majority of inspections are completed via telephone, but for large coverage amounts a personal visit may be required.

An inspection report usually focuses on non-medical issues and could include questions about the life insured's:

- Habits — E.g., smoking/tobacco use, alcohol consumption.
- Finances — E.g., income, estimated net worth.
- Occupation — E.g., confirmation of employment, nature of duties.
- Driving record — E.g., history of speeding tickets, careless driving.
- Avocation — E.g., participation in extreme sports or hazardous travel.

9.4.7 Requests for clarification or more information

If the application is not filled out completely or if the answers are vague, the underwriter may contact the applicant to ask for clarification or for more information. This can slow down the underwriting process, so it is important for the applicant to be as thorough as possible when completing the application.

9.4.8 Financial underwriting

Financial underwriting involves assessing the applicant's financial situation and the reason for obtaining life insurance, to determine if:

- The amount of coverage is reasonable based on his need; and
- He can afford the premiums.

The company's financial underwriting guidelines will usually specify what the maximum coverage can be, based on the intended purpose and the age of the life insured. For example:

- If the policy is intended to provide income replacement if the life insured dies, then the maximum coverage may be set at 30 times earned income if the life insured is between 16 and 30 years of age, down to 10 times earned income if he is between 60 and 69 years of age;

- If the policy is intended for estate preservation, the maximum coverage might be tied to the net worth of the life insured;
- If the policy is on the life of a university student, the maximum coverage may be tied to the intended occupation.

9.4.9 People who are not Canadian citizens

Life insurance companies may have different underwriting requirements for people who are not Canadian citizens. This Section discusses how some of those special situations might be handled, but remember that each life insurance company may have its own methods and procedures.

9.4.9.1 Permanent residents

A non-citizen who has been granted permanent residency status is generally eligible for the same coverage as a Canadian citizen. However, some additional underwriting may be required, which could include:

- Confirmation of permanent resident status;
- If he has lived in Canada for less than one year, detailed bloodwork and a medical exam may be required;
- If he makes frequent or extended trips back to his country of origin or other countries, he may be rated as substandard risk (which would result in higher premiums), or the policy may include an exclusion for death occurring in the specified country.

9.4.9.2 Awaiting permanent residency

A non-citizen who is currently living in Canada and who has applied for, but has not yet achieved permanent residency status, may or may not be eligible to apply for life insurance, depending on his unique situation and the individual insurance company's underwriting guidelines. Some insurance companies set maximum coverage amounts based on skill levels. For example, the underwriting guidelines of one insurance company specify that:

- Those with a highly skilled or managerial occupation (e.g., doctors, nurses, pharmacists, engineers, lawyers) might qualify for up to $10,000,000 in coverage;
- Those who pursue a trade-level occupation (e.g., electricians, plumbers, medical technologists, butchers) might qualify for up to $2,000,000 in coverage;
- Live-in caregivers (e.g., nannies, personal support workers) might qualify for up to only $250,000 in coverage;
- Dependent spouses or children of the life insured might qualify for a percentage of the coverage on the life insured (e.g., 50%).

Underwriters may require noncitizens awaiting permanent residency status who have lived in Canada for less than a year to undergo additional medical screening. They may also be asked to provide a copy of their work permit, proof that they have applied for permanent residency status, and proof of a pattern of earned income (unless they are a spouse or child of the life insured).

9.4.9.3 International students

International students (i.e., students from another country who come to study in Canada) are typically not eligible to purchase life insurance in Canada, unless they also fall into one of the newly landed immigrant categories discussed previously.

9.4.10 Frequent travellers

If the life insured is a frequent traveller, the insurance company may request further details about past travels and future plans, including the countries visited, and the frequency and duration of visits. As a result, the issued policy may have a substandard risk rating (which would result in higher premiums), or it may specify an exclusion for travel to specified countries.

9.4.11 Avocations

Avocations are hobbies or activities that the life insured pursues outside his regular employment. Underwriters will be concerned about any activities or hobbies that expose the life insured to above-average risk of death. For example:

- Parasailing;
- Back-country snowboarding;
- Mountain climbing;
- Scuba diving;
- Race car driving;
- Travel to countries prone to conflict;
- Piloting a private aircraft.

If the life insured participates in such activities, the underwriter will likely collect additional information, such as:

- How often the life insured engages in that activity;
- When and where he carries out that activity;
- His experience or certification in that activity;
- History of accidents or certification violations.

9.4.12 Accelerated Underwriting

Even before the COVID-19 pandemic, some insurance companies were moving towards accelerated underwriting for some applications, up to maximum ages and coverage amounts. Accelerated underwriting leverages technology, existing data, computer algorithms and artificial intelligence (AI) to evaluate applications.

Insurers access data about the applicant's medical history through the Medical Information Bureau (MIB), driving habits through motor vehicle records, credit history and any other available data. Algorithms combine all data points to quickly determine eligibility and cost of coverage.

Note that accelerated underwriting and simplified issue are not the same thing. A simplified issue underwriting process makes use of a short application and instantly available evidence to quickly make an "accept" or "reject" decision, without any human underwriting or detailed medical underwriting. Simplified issue underwriting does not provide the for the possibility of preferred rates for those in good health, or rated policies for those with an increased risk of death due to their medical conditions. Premiums for these "no-exam" policies tend to be higher than policies that are fully underwritten.

In contrast, accelerated underwriting is a fully underwritten process that makes use of data, tools and modeling techniques to assess applications without gathering the more traditional underwriting evidence such as medical exams and laboratory testing. Unlike simplified issue underwriting, accelerated underwriting can result in policies issued at or close to fully underwritten retail rates, including preferred and rated classes.

9.5 Risk classes and their impact on premiums

Recall that when evaluating the risk of the life insured, the underwriter starts with a baseline (e.g., 100) and then adds to or subtracts from this amount after evaluating each risk factor, based on how the life insured compares to the standard person of the same age. When this evaluation is complete, the underwriter can assign the life insured to a risk class. Each insurance company will have their own class system and number of classes, but general categories are discussed below.

9.5.1 Standard

Every insurance company will have a standard or normal risk category, which represents the average person. If the life insured falls within the standard risk category, the premiums will be set at the standard rate.

9.5.2 Preferred

Insurance companies usually have one or more preferred categories, for people who present an exceptionally low risk. To qualify for a preferred risk category, the life insured usually has to go through some additional medical screening. People who fall into this category are eligible for preferred lower rates.

9.5.3 Rated

If the life insured is in a rated risk class, it means that he represents an above-average, but still acceptable, level of risk. Premiums in a rated class will be higher than standard rates, sometimes by a substantial amount, depending on the risk involved.

9.5.4 Exclusions

Sometimes the life insured would have qualified for coverage if it were not for one specific factor that concerned the insurance company. The insurance company may issue a policy for the appropriate risk class, but specify an exclusion to the policy, which means that they will not pay the death benefit if death is a case covered by the exclusion.

EXAMPLE

Michael immigrated to Canada from Lebanon 35 years ago, and he is a Canadian citizen. He recently applied for life insurance, and the underwriter noted that Michael was in exceptional good health and would normally be eligible for preferred rates. However, he also noted that Michael returns to Lebanon every other year to visit his parents and siblings, who still live in that country, which often experiences periods of armed conflict. Rather than declining Michael's application, the insurance company issued a policy at preferred rates with an exclusion for travel to Lebanon. This means that if Michael dies while in Lebanon, the death benefit will not be paid.

9.5.5 Upgrading risk class

Once the insurance company issues a policy, it cannot decide to reassess the life insured at a later date or add a rating and charge a higher premium if his health has declined. In other words, the insurance company cannot downgrade his risk rating after the policy is issued.

However, if a policy is issued on a rated basis and the reason for that rating no longer exists, the policyholder may be able to ask the insurance company to remove or decrease the rating, with an appropriate decrease in premiums.

EXAMPLE

When Bill first applied for life insurance, he was a commercial fisherman, which is one of the most dangerous occupations in terms of risk of death. While he was able to obtain insurance, the policy was rated and came with a hefty premium. Once his daughter was born, Bill left the fishing industry and he now works as a janitor for the local school board. Bill should ask his insurance company if the hazardous occupation rating can be removed from his policy, with a corresponding reduction in premiums.

The reason an insurance company would consider such a request is competition; if the rating is not removed, the policyholder may be tempted to cancel the policy and apply for a new, unrated policy at another insurance company.

9.5.6 Declined

If the life insured falls in the declined risk category, it means he represents an uninsurable risk and coverage is declined. The decline may be temporary or permanent, depending on the findings of the underwriter. If the decline is temporary, the underwriter will usually specify when reapplication is possible. A permanent decline means that no further reconsideration will be granted, regardless of the passage of time.

9.6 Client factors that may affect premiums

One of the components that affect life insurance premiums is the net cost of pure insurance (NCPI), which in turn is based upon the risk that the life insured will die during the period of coverage. This risk is evaluated during the underwriting process that was just discussed. There are many risk factors that are common to all people. This Section examines those risk factors and their impact on the policy's premiums.

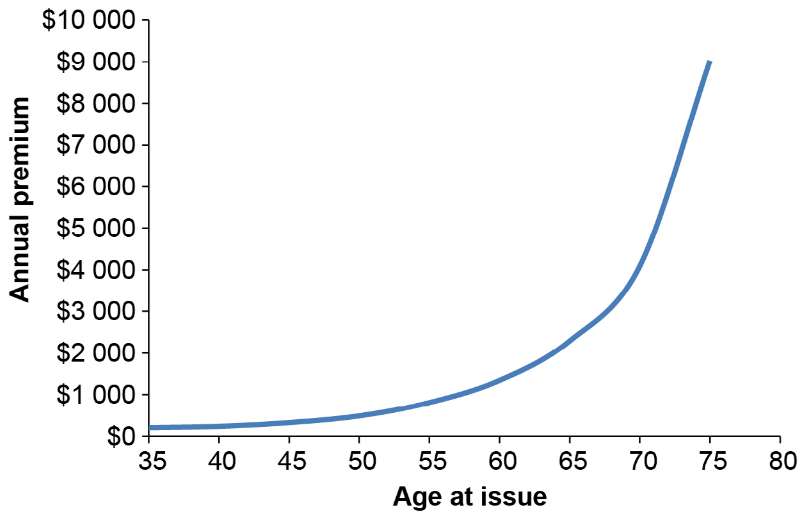
9.6.1 Age

Age is one of the key factors used to determine insurance premiums. In general, a person's risk of death during any specific year increases as he gets older. As a result, policy premiums at the time of issue increase as the age at issue increases.

Diagram 9.1 shows the annual premiums for a $250,000 10-year renewable term insurance policy for a male in the standard or normal risk class, based on his age at issue. Notice how the increase in premiums is not linear. This is because a person's risk of death increases somewhat exponentially as they age, particularly after age 60 or 65.

DIAGRAM 9.1

Impact of age at issue on premiums[32]



9.6.1.1 Attained age

The premiums at issue or upon renewal are based on the attained age of the life insured at that time. Depending on the insurance company, attained age might refer to his:

- Age on his last birthday;
- Age on his next birthday;
- Age on his closest birthday.

9.6.2 Gender

Statistics show that women tend to outlive men. This means that, all other things being equal, a man's risk of death at a specific point in time is greater than a woman's risk. As a result, policy premiums for a male are generally higher than for a female of the same age.

Diagram 9.2 shows the annual premiums for a $250,000 10-year renewable term insurance policy for both a male and a female in the standard or normal risk class.

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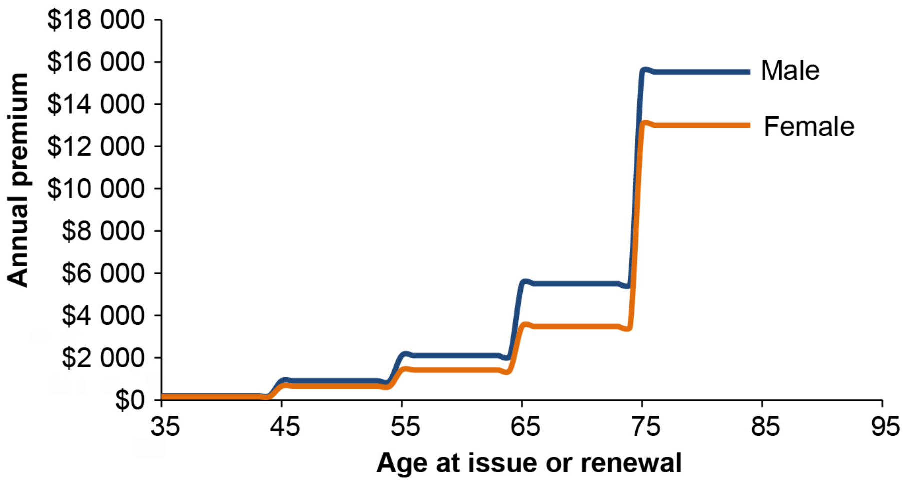
32. Based on rates provided by Canada Life for the first 10-year term of a $250,000 10-year renewable term life insurance policy for a male with a standard health profile.

DIAGRAM 9.2

Impact of gender on premiums[33]



Because men and women have different mortality rates, the premiums paid will depend on gender, and this raises the question of how premiums are determined for transgender or non-binary individuals. In the past, this has been quite complicated but, as the world moves forward, insurers are working to keep up.

Underwriting is based on statistics and large amounts of historical data. Up until recently, the collected data focused only on the cisgender identities of male and female. As shown much earlier in Table 1.1, statistics have clearly shown that the probability of death at any given age can be quite different between men and women, particularly between ages 30 to 60.

However, the nonbinary and transgender population is small and has only gained significant visibility in the last few years, so actuaries simply do not yet have the same amount of data to assess their risk of death. This has resulted in a variety of underwriting approaches, depending on the insurance company.

Many insurers will underwrite the policy based on preferred gender, although some insurers still use the gender assigned at birth. Others will only underwrite based on preferred gender if the life insured has undergone transition surgery or is taking hormone therapy. Previous gender confirmation surgery should not disqualify the applicant from obtaining life insurance; however, applicants who are planning to undergo gender confirmation surgery should be aware that the insurer will likely postpone the application until after surgery.

Some insurers may only recognize the gender that listed on the life insured's official documents, such as driver's license or passport. And some insurers are taking a middle ground approach by using unisex (blended male/female) rates.

Because of these various underwriting approaches, someone who Is transgender or identifies as non-binary should consider shopping around to ensure they are getting the best rates.

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33. Based on rates provided by Canada Life for a $250,000 10-year renewable term life insurance policy for a male and female with a standard health profile.

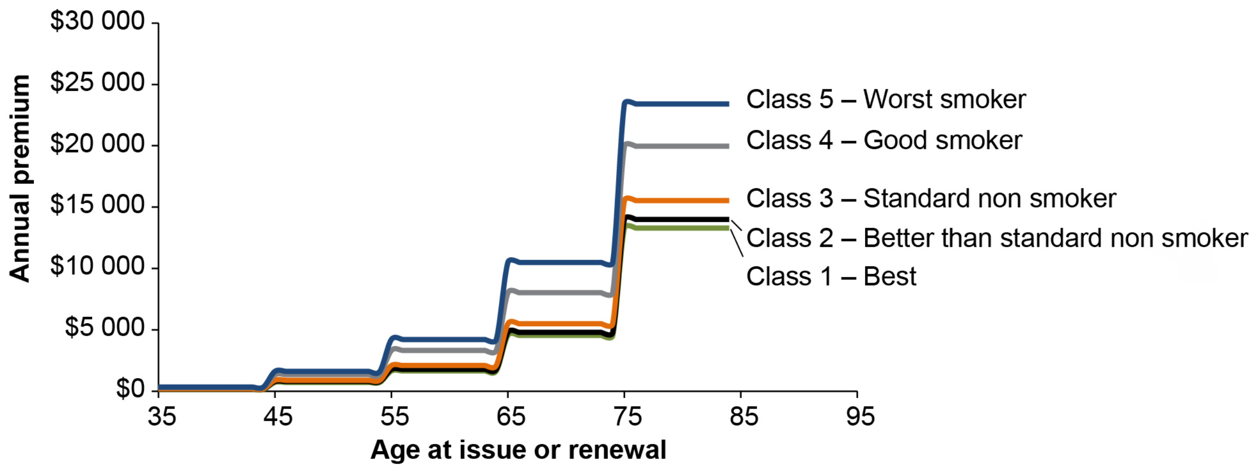
9.6.3 Health status or risk class

As discussed in the Section *Risk classes and their impact on premiums*, each insurance company will have its own system for classifying risk, but they generally have three to five health classes, including standard, below-standard and above-standard risk classes.

Diagram 9.3 shows the annual premiums for a $250,000 10-year renewable term insurance policy for a male in various risk classes.

DIAGRAM 9.3

Impact of health class on premiums[34]



Below-standard policies carry higher than normal premiums, while above-standard policies may have preferred pricing. Smoking status is usually reflected by a below-standard rating.

9.6.4 Hazardous occupation

If the life insured has a hazardous occupation, his risk class will likely be further adjusted by a rating based on that occupation, resulting in higher premiums.

9.6.5 Hazardous lifestyle

If the life insured has a hazardous avocation or hobby, in most cases this will be addressed by an exclusion in the policy for that activity. However, depending on the insurance company, the hobby and how frequently the life insured engages in that activity, it may also result in a rating of the policy, resulting in higher premiums, or the application may even be denied.

34. Based on rates provided by Canada Life for a $250,000 10-year renewable term life insurance policy for a male in various health classes.

9.7 Company factors that may affect premiums

The insurance company may adjust premiums on new policies to address changes to its mortality costs, administration costs and investment returns.

9.7.1 Mortality costs

Recall that an insurance company's mortality costs are the amounts the insurance company actually pays out in death benefits. If the company experiences higher mortality costs than it originally anticipated, it may increase premiums on new policies to compensate.

9.7.2 Administration costs and expenses

A life insurance company is a business, and it incurs many business-related expenses, including:

- The costs of selling the policy (e.g., marketing, salaries or commissions to agents);
- Underwriting the policy (e.g., processing applications, undertaking medical exams);
- Issuing and administering the policy documents;
- Investigating claims;
- Processing claims.

To the extent possible, the insurance company offsets these expenses through investment returns and annual policy fees. However, a portion of these costs may also be covered by the premium. Increasing expenses can put upward pressure on premiums for new policies.

9.7.3 Investment returns

The insurance company invests policy reserves for the purpose of earning investment income that can offset mortality costs and expenses. When current or expected investment returns decrease, the premiums for new policies generally increase to compensate for the lost revenue.

9.8 Reinsurance

Insurance companies place an upper limit on the amount of coverage on any one individual that they are willing to assume responsibility for. This protects them financially from having to make a payment that could seriously undermine their finances.

This upper limit is called the retention limit. An insurance company may still accept life insurance applications for amounts in excess of its retention limit, but it will only underwrite that policy if it can pass some of that risk on to one or more reinsurance companies. In essence, the insurance company insures its risk of having to pay a death benefit that exceeds its retention limit.

EXAMPLE

John applied for $15 million in life insurance coverage with Insure4life Co. Insure4life's retention limit is $10 million, but they were still interested in placing the policy. They contacted Resure Co., a reinsurance company, to underwrite the additional $5 million of coverage, and Resure agreed. Insure4life issued a $15 million policy to John, and he pays the full premium directly to them. Insure4life in turn pays a premium to Resure. If John dies, Insure4life will pay the full-death benefit of $15 million, but then it will receive a death benefit of $5 million from Resure.

9.9 Issuing the policy

The underwriting process does not stop with the issuing of the policy; it continues right up until delivery and acceptance of the policy.

9.9.1 Delivery

In the past, the agent was required to deliver the policy directly to the applicant in person. The thought was that by having a face-to-face meeting with the applicant, the agent could ensure that nothing important has changed that would affect the insurability of the life insured. However, policies can now be delivered electronically via email or a user portal on the insurance company's website. For policies that undergo accelerated underwriting, the client and the life agent may even get text messages saying that the policy has been accepted, and that it will be delivered electronically within the next few days.

For policies that do not undergo accelerated underwriting, prior to delivery, the agent should review the contract in detail with the client and verify that the coverage is what the client applied for. The agent should also explain the major provisions of the contract, including:

- Grace period;
- Incontestability;
- Suicide exclusion provisions.

These provisions are discussed in more detail in the Module *Ethics and professional practice*.

For policies that do not undergo accelerated underwriting and that are not automatically delivered electronically, before final delivery, the agent should obtain verbal and written confirmation that a change in insurability has not occurred, which might be the case if the life insured:

- Has experienced a change in health;
- Changed his occupation;

- Changed his recreational activities;
- Has experienced a change in financial status.

Once the applicant confirms that there has been no material change (and pays any outstanding premiums, if applicable), then the agent can deliver the policy.

However, if the applicant cannot confirm this or fails to remit the proper payment, or if the agent has reason to suspect that there has been a material change despite the applicant's assurance that all is fine, the agent must not complete the delivery. Instead, he should contact the underwriter for further consideration, and advise the client that the contract is not yet in force.

9.10 Acceptance

The final step in the activation of the policy is getting the policyholder to sign and date an acknowledgment stating that he has received and accepted the policy. This confirmation can be done electronically.

After accepting the policy, the policyholder must be given a minimum of 10 days to review the policy. During this time, he can choose to return it to the insurance company for cancellation and a full refund of all premiums paid. This is the client's right of rescission, also known as the "10-day free-look provision."

Rescission is the right of all parties to a contract to back out of the contract, within the legal parameters to do so. An insurer can exercise this right during the two-year contestability period, or any time in the case of fraudulent misrepresentation, or if the contract has a cancellable clause.

9.11 Group life insurance

The application and underwriting process discussed thus far in this Chapter applies to individual life insurance. One of the big benefits for members of a group life insurance plan is that they are covered for the base amount offered by the plan regardless of their health, because underwriting is not done on an individual basis. However, a group plan still goes through an underwriting process.

9.11.1 Basic group life insurance

When underwriting the basic life insurance provided by a group insurance plan, the underwriter looks at the demographics of the group as a whole, including the mix of ages, genders and occupations. He then uses the insurance company's experience with similar groups to determine the average risk per person and to calculate the premium.

Premiums are typically quoted as a rate for every $1,000 of coverage. If the group plan provides different benefit levels for different classes of employees, the rate will be calculated separately for each class. These same rates will apply to every person in the group or class, regardless of that person's age, gender, smoking status or health status.

The insurance company will usually recalculate the premium every year, to reflect changes in the group's demographics over time. For example, if the group's average age increases, the premiums per member will likely increase as well to reflect the greater risk of death.

9.11.2 Additional coverage

Some group life insurance plans give members the option of buying additional life insurance coverage, on top of the base coverage that all members receive. A member who wishes to buy the additional coverage is usually required to provide evidence of insurability, and the underwriter will assess the member on an individual basis.

Unlike the premiums for the base coverage, premiums for the additional coverage are usually based on the member's age and smoking status.

9.11.3 Creditor life insurance

While creditor life insurance is a type of group life insurance, in most cases the life insured must provide at least basic evidence of insurability to obtain coverage. Often this means just answering a few health questions on the application.

A "Yes" response to a question that requires a "No" answer (or vice versa) will usually prompt a medical underwriting, which could include a more detailed questionnaire, blood or urine tests, or even a medical exam. However, if all the responses are correct, then the application may be automatically approved.

When creditor insurance is offered through a financial institution, the applicant must complete the application without help from the bank employee, because that employee is not an insurance agent.

Some companies limit the amount of creditor insurance that they are willing to offer without more comprehensive medical underwriting (e.g., $250,000 or $500,000).

Depending on the program, the creditor insurance premiums may be set at:

- A fixed monthly rate per $1,000 of outstanding balance (commonly used for credit cards); or
- A fixed monthly rate per $1,000 of original balance (commonly used for mortgages).

In both cases, a different rate will apply to different age groups (e.g., 18 to 25, 26 to 30, 31 to 35).

9.11.3.1 Post-claim underwriting

One of the drawbacks of group creditor insurance is that a claim may be denied as a result of post-claim underwriting. This is the practice of issuing the policy with little or no underwriting (i.e., just a couple of yes/no health questions) and then doing a more thorough underwriting only after the life insured has died. Sometimes this post-claim underwriting determines that the life insured did not actually qualify for insurance, and the claim is denied.

There is no way to determine ahead of time if post-claim underwriting will result in the claim being denied, so this raises concerns about the surety of coverage. Because the coverage is only denied upon the death of the life insured, obviously there is no opportunity to go back and seek other coverage.

CHAPTER 10
ASSESSING THE CLIENT'S SITUATION

Competency component

- Assess the client's needs and situation.

Competency sub-components

- Determine the client's situation;
- Assess the appropriateness of the client's existing coverage in regard to his or her situation.

10
ASSESSING THE CLIENT'S SITUATION

The Chapter *Application and underwriting* described how a life insurance company assesses the life insured (and the applicant, if different) to determine the probability of having to pay out a death claim while the policy is in force, and to determine the appropriate premiums for that policy.

This Chapter and the Chapter *Recommending an insurance policy* cover the general approach that a life agent should take when assessing new clients, in order to determine the best type and amount of life insurance for their situation. This Chapter provides an overview of the issues or needs that should be considered, while the Chapter *Recommending an insurance policy* describes how to quantify those needs in an insurance needs analysis.

The concepts will be illustrated in both Chapters using a case study focused on Derek and Becky's family, introduced below.

DEREK AND BECKY'S FAMILY CASE STUDY

Derek and Becky are 47 and 38 years old respectively and they have been married for two years. Derek and his previous wife, Susan (age 44), divorced four years ago, and they share joint custody of a son, Jordan (age 8).

Prior to marrying Derek, Becky was a single mother to Anya (age 4). Derek formally adopted Anya when they got married. Derek and Becky have just had a child together; Robbie is two months old.

Derek and Becky are concerned about securing their financial future in the event that Derek dies, and they have approached a licensed life insurance agent to help them assess their insurance needs.

10.1 Assess the family dynamics

Many people use life insurance to provide financial support for their families upon their death. Agents need to understand their clients' family dynamics before being able to advise how to best provide that support.

10.1.1 Current spouse

If the life insured is married, or in a common-law relationship, he will often want his spouse to receive some type of financial assistance upon his death. The amount and frequency of that support may depend on the nature of their relationship and the surviving spouse's own financial capacity, as discussed below.

10.1.1.1 Dependent vs. self-sufficient

In single-income households, the spouse of the life insured may be financially supported entirely by his earned income. In this case, the death of the life insured and the resulting loss of income would be devastating to the surviving spouse. If the surviving spouse has never worked and has no training, her prospects for earning her own income may be limited and she may need financial support until government benefits such as OAS and CPP begin. If she is the caregiver for the family's children, her return to work would also result in additional child care expenses.

In dual-income households, the spouse of the life insured may earn enough income to be partially or fully self-sufficient if the life insured dies.

CASE STUDY

Derek is employed full-time as the Vice President of Industrial Design for a manufacturing company, with take-home pay (i.e., income after taxes and deductions) of $8,400 per month. Becky currently stays home caring for Jordan, Anya and Robbie, but she intends to return to work as a human resources manager once Robbie is in school full-time, about six years from now. She anticipates that her take-home pay will be around $4,500 per month. However, Derek feels that, if he dies, he would prefer that Becky would not have to return to work until Robbie is 18, if at all possible.

If Derek were to die today, the family would obviously suffer from the loss of his income and, even if Becky could return to work immediately upon his death, her income would be insufficient to maintain the family's current standard of living.

10.1.2 Support obligations to ex-spouse(s)

If the life insured has an ex-spouse, he may have a legal or moral obligation to provide financial support to that spouse.

CASE STUDY

Derek and Susan used a mediator to develop their spousal support agreement, which specifies that Derek must pay spousal support of $500 per month until Susan reaches age 65 or she remarries, whichever occurs first.

10.1.2.1 Court-ordered insurance

Court-ordered spousal support may stipulate that the support obligation continues even upon death. If the court order is silent on how this support is to be funded, the ex-spouse may have a claim against the deceased spouse's estate. However, sometimes the court order will state that the supporting spouse must obtain sufficient life insurance to cover the support obligation, naming the ex-spouse as the beneficiary.

CASE STUDY

While their support agreement was not court-ordered, Derek told his life agent that he wants to ensure that the $500 in spousal support is paid monthly to Susan even if he dies.

10.1.3 Minor children

If the life insured has minor children who are financially dependent on him, he will want them to be well cared for if he dies. Usually this means ensuring that they will be able to maintain the same standard of living until they reach adulthood. Some parents may feel this means providing financial support until age 18, while others want that support to be continued through any post-secondary education.

CASE STUDY

Derek wants to ensure that Becky has the financial resources she will need to raise their children if he dies prematurely. In addition to their living expenses, he would also like to ensure that all three children will have enough money to pay for post-secondary education.

10.1.3.1 Current care arrangements

For single-income families, the insurance needs analysis should consider more than the loss of income that would result from the death of the working spouse. The death of a stay-at-home parent can also have a huge financial impact on the family, particularly when the children are young enough to require full-time care.

CASE STUDY

Becky is not currently earning an income, but her role as the stay-at-home parent is vital to the family. If she died, Derek would have to pay for someone else to take care of Jordan, Anya and Robbie so that he could continue to work. In addition, the family would not benefit from the income Becky hopes to earn when she returns to work in six years.

10.1.3.2 Child support to ex-spouse

If the life insured has one or more children from a prior relationship and his ex-spouse has full or partial custody, in most cases he will have a legal obligation to provide financial support for those children.

10.1.3.3 Court-ordered insurance

If the life insured has been ordered to pay child support as part of a court-ordered divorce or separation settlement, in many cases that same court order will require him to obtain sufficient life insurance to ensure that this child support can continue even if he dies. If the court order is silent on the matter, the surviving spouse may still have a claim against his estate, on behalf of the children.

CASE STUDY

As part of their mediated divorce agreement, Derek agreed to pay child support to Susan for Jordan, in the amount of $1,000 per month, until Jordan is 19 years old. While it was not specifically addressed in their agreement, Derek wants to ensure that Jordan continues to benefit from this support even if he dies.

10.1.4 Other dependents

Depending on the life insured's unique situation, he may be providing support to other family members who would suffer financially if he dies.

10.1.4.1 Disabled family members

If the life insured's family includes someone who is disabled and who will need care until the end of his life, it can present an enormous financial burden on the family and have a significant impact on estate planning needs.

CASE STUDY

Derek and Becky are fortunate that all of their children appear to be healthy and they expect the children to eventually become financially self-sufficient. Derek's older brother, Peter, and his wife Janine are not as fortunate; their eight-year-old son, Chase, has a severe developmental disability and he will never be able to live independently. However, Chase has a normal life expectancy, so Peter and Janine need to consider how to provide for him over a time frame that could extend 50 years or even more.

10.1.4.2 Aging parents

As Canada's population continues to age, an increasing number of adult children are caring for their elderly parents. Depending on the parent's own financial situation, this care could be both physical and/or financial. If the life insured has assumed financial responsibility for parental care, this should be considered when doing the insurance needs analysis.

10.2 Assess the employment situation

Loss of income is often one of the biggest financial risks associated with death, so the life agent should gain a clear understanding of this income stream, whether the life insured is an employee, a business owner or retired.

10.2.1 Employee

There are a number of different factors that should be considered if the life insured and/or his spouse earn income as an employee.

10.2.1.1 Current income

The first consideration is, of course, the amount of income the life insured earns on a regular basis. A life insurance needs analysis is normally based on the take-home pay, or the amount that the life insured receives after all deductions (i.e., income tax, CPP and EI contributions, union dues), from now until normal retirement age. This represents the amount of spending power that the surviving family will lose if the life insured dies.

The income of the surviving spouse is also important, because it represents a source of funds that can likely continue after the death of the life insured.

10.2.1.2 Future income potential

If the objective of the life insured is to allow his family to maintain the same standard of living they could expect to enjoy if he lives into the future, the insurance needs analysis should also take into account his expected future income, including increases for inflation if appropriate.

CASE STUDY

Derek is a Vice President with take-home pay (i.e., pay after all tax and other deductions) of $8,400 per month. He expects to be promoted to Chief Operating Officer (COO) within the next two years, which would increase his take-home pay to $9,500 per month, with the potential for larger bonuses as well. This might suggest that he would want the flexibility to increase his insurance coverage in the future.

10.2.1.3 Job stability

The insurance needs analysis should consider the job stability of both the life insured and his spouse. If the life insured's job is at risk, this may mean that he could have trouble paying life insurance premiums in the future, and he might benefit from an insurance product that allows him to decrease premiums for a period of time, without reducing coverage.

If the spouse's job is at risk, it may mean that the life insured should plan for greater financial dependency when completing the life insurance needs analysis.

CASE STUDY

While Becky plans to return to work once Robbie is in school full-time, she is worried that her time away from the workforce and her outdated technology skills may make finding a new job difficult. She may even have to spend time updating her training before she is employable. This makes the replacement of Derek's employment income even more important if he dies.

10.2.1.4 Group benefits

The loss of employment income may not be the only financial loss resulting from the death of an income earner. Group benefits, such as medical, dental and life insurance benefits, will cease when the employee dies. If the group benefits include life insurance, the resulting death benefit should be factored in the life insurance needs analysis, as discussed in the Section *Assess existing life insurance*.

CASE STUDY

With three young children, Derek and Becky expect to have many dental and medical bills over the next 15 or 20 years. Becky already suffers from some arthritis; as a result, she wears custom orthotics and sees a physiotherapist regularly. All of these expenses are currently covered by Derek's plan, but that coverage would cease upon his death, increasing the strain on the surviving family's cash flow.

10.2.2 Business owner

If the life insured runs a business, such that he is self-employed, the life agent will need to gain a better understanding of how that business is structured, because it may impact the amount and type of life insurance required. The Chapter *Business life insurance* discussed the basic business types (sole proprietorships, partnerships and corporations), including the flow of income to the business owner, and the taxation of the business interest upon disposition, including the deemed disposition at death, but they are reviewed briefly in this Section.

CASE STUDY

While neither Derek nor Becky is self-employed, Derek has three siblings (Peter, Mark and Kimberly) who all own their own businesses. The examples in this Section will focus on their businesses.

10.2.2.1 Sole proprietorship

If the life insured is a sole proprietor, he has to report the net income of the business on his personal tax return. In most cases, if a sole proprietor dies, the business ceases to exist. The deemed disposition rules that apply upon death apply to the assets of the sole proprietorship, not the business itself.

CASE STUDY

Derek's brother Peter offers strategic management consulting services as a sole proprietor. His business income fluctuates from year to year, but on average he receives consulting income of $120,000 and he has related business expenses of $15,000 per year. He reports the net business income of $105,000 on his personal tax return. If Peter dies, his family will no longer benefit from this self-employment income.

His business-related assets are minimal and include some home office furniture and computer technology, all of which have depreciated in value since purchase. If Peter dies, he will be deemed to have disposed of all of his business assets for their fair market value prior to death. Because they have decreased in value, this will not result in a capital gain.

10.2.2.2 Corporation

If the life insured owns a private corporation, he may receive employment income if he is actively involved in the business, and this is recorded as an expense for the business. He may also receive taxable dividends, which are paid with the corporation's after-tax profits.

If the life insured dies, he is deemed to have disposed of his shares in the business for their fair market value, which could potentially trigger a large capital gain upon death. If the company is a qualified small business corporation (QSBC), some or all of that gain may be sheltered by the lifetime capital gains exemption (LCGE) of up to $913,630 in 2022. The LCGE is indexed annually to inflation.

However, unlike a sole proprietorship, the corporation can continue beyond his death. As long as the business remains viable without his participation, dividends could still be paid to the beneficiary of his business shares.

CASE STUDY

Derek's sister, Kimberly, is one of two equal shareholders in Intersavvy Inc., a successful Internet research company structured as a Canadian controlled private corporation (CCPC). She receives an annual salary of $180,000 per year, as well as dividend income averaging $50,000 per year. The company has 12 other employees, and Kimberly is confident that the business will survive even if she dies.

However, she is worried about the tax implications of the deemed disposition of her corporate shares upon her death. Even after using the LCGE of $913,630, she expects that the unsheltered taxable capital gain upon death will be in the order of $500,000. She is also worried about how her family will manage if she dies and they can no longer benefit from her annual salary of $180,000.

10.2.2.3 Partnership

If the life insured owns an interest in a partnership, he will have to report his share of partnership income on his personal tax return. If he dies, he is deemed to have disposed of his partnership interest for its fair market value, which could potentially trigger a large capital gain upon death.

CASE STUDY

Derek's brother, Mark, owns and manages several apartment building complexes in partnership with his two adult children, Aaron and Penny. Mark owns 50% of the partnership, while Aaron and Penny each own 25%. Mark's share of profits last year was $140,000. His will leaves his partnership interest to Aaron and Penny. Because this business is structured as a partnership, it does not qualify for the LCGE and Mark is worried that the anticipated taxable capital gain of $400,000 upon his death will erode the rest of his estate, which he plans to leave to his wife, Michelle.

10.2.2.4 Existing buy-sell agreement

If the life insured is one of the owners of a partnership or a corporation, what happens to his business interest upon death may be governed by a buy-sell agreement.

As discussed in the Chapter *Business life insurance*, if a buy-sell agreement is in place, the owner cannot choose to leave his business interest to someone in his will, such as a spouse or children. Buy-sell agreements typically specify that either the corporation (in a share redemption plan) or the other shareholders or partners (in a cross-purchase agreement) will buy an owner's business interest if he dies. This purchase is done either at a fixed price, or at a price determined by a formula specified in the agreement. An accountant is usually retained to determine the appropriate values.

CASE STUDY

Derek's sister, Kimberly, and Janet (who is the co-owner of Intersavvy Inc.) are in the process of implementing a buy-sell agreement. This agreement specifies that if Janet dies, Kimberly will buy Janet's shares from her estate for $2 million, and vice versa. In accordance with their agreement, Kimberly must acquire a $2 million life insurance policy on Janet's life, to ensure she has the funds to comply with the agreement if Janet dies.

10.2.2.5 Business income stability and amounts

Similar to the stability of employment income discussed earlier in the Section *Employee*, the insurance needs analysis should consider the stability of the business income, and the business itself. If the life insured is a business owner and his income from the business fluctuates from year to year, or is at risk because of potential failure of the business, this may mean that he could have trouble paying life insurance premiums in the future, or could benefit from a life insurance product with flexible premiums. If the spouse of the insured owns a business with fluctuating revenues, this must be taken into account when assessing the family's life insurance needs, to ensure there is enough income if the spouse dies.

If the objective of the insurance needs analysis is to replace the business owner's income, remember that this usually refers to the after-tax or take-home pay, after all deductions, because this represents the loss of spending power that would result from the business owner's death. If the objective of the life insured is to allow his family to maintain the same standard of living they expect to enjoy if he lives into the future, the insurance needs analysis should also take into account any expected increases in income earned via the business.

10.2.3 Retirement

Retirement does not mean that the need for life insurance ends; however, the need to replace employment income may end.

10.2.3.1 Time to retirement

If the life insured is still actively working, the life agent should determine when he expects to retire. This is particularly important if the life insured wants to replace his income until retirement if he dies.

CASE STUDY

Derek plans to retire at age 65, and he would like to ensure that he has enough life insurance to replace his income for the next 18 years, if he dies prematurely.

10.2.3.2 Retirement income sources

There are several potential sources of retirement income that should be considered during a life insurance needs analysis, particularly if the life insured is nearing or at retirement.

If the life insured is a member of a defined benefit pension plan (DBPP), the life agent should determine the survivor benefits provided by that plan. Pension legislation generally requires that the pension plan must provide a 60% to 66% (varies by province) survivor's pension to the surviving spouse. If the life insured used money from a defined contribution pension plan (DCPP) to buy a life annuity, survivor's benefits may or may not be payable, depending on the type of annuity purchased.

If the life insured is entitled to CPP or OAS pension benefits, his surviving spouse may be eligible for ongoing survivors' benefits upon his death. Also, if the life insured's spouse is entitled to her own employer pension, or her own CPP or OAS benefits, this may reduce her dependency needs if the life insured dies. CPP and OAS benefits payable upon death are covered in more detail in the Section *Government benefits*.

10.3 Assess current financial situation

The life agent needs to get a clear picture of the life insured's existing financial situation, to determine:

- Assets that are already available to address his estate needs;
- Debts that may need to be paid upon his death;
- The amount of income the household currently receives, and how this is likely to change upon his death;
- How much of that income is spent to meet current needs or is directed towards savings;
- How much cash flow is available for insurance premiums?

10.3.1 Assets

A life insurance needs analysis should consider all property owned by the life insured that could:

- Be used to address his estate objectives;
- Have a corresponding liability (e.g., a mortgage) that must be paid by his estate;
- Result in a tax liability for his estate as a result of the deemed disposition upon death.

A distinction should be made between those assets the family would be willing to sell to meet estate needs (e.g., investment assets), and those they would prefer to keep intact (e.g., the family cottage or beloved family heirlooms). It is also important to record the adjusted cost base (ACB) where applicable, and the designated beneficiary, to determine if a taxable capital gain could arise upon death.

10.3.1.1 Liquid assets

Liquid assets include any items that are easy to sell or convert into cash without any loss in value. Examples include cash, chequing account balances, money market funds, term deposits with a maturity of less than one year, or cashable guaranteed investment certificates. Liquid assets are useful because they can be used to:

- Replace the income of the deceased and maintain cash flow until the estate is settled;
- Pay for final expenses (e.g., funeral or burial costs);
- Pay taxes owing upon death;
- Pay off debts that become due upon death.

Without sufficient liquid assets, the executor of the estate may be forced to sell other estate assets to meet these expenses, including property the deceased had meant to go to certain beneficiaries. Furthermore, it may force the executor to sell these assets at an inopportune time, such as when markets are down, or at a price lower than true value just to complete the sale quickly (i.e., at "fire sale" prices).

CASE STUDY

Derek and Becky use their tax-free savings accounts (TFSAs) to hold their emergency fund. They each have $25,000 in their TFSAs, invested in a combination of money market funds and cashable guaranteed investment certificates (GICs). They also have $20,000 in their joint chequing account. They only invest in their TFSAs if Derek receives a year-end bonus.

10.3.1.2 Fixed assets

Fixed assets include tangible property that could be sold to generate cash. This includes real estate (e.g., homes, vacation properties), jewelry or antiques, vehicles or other valuable property.

CASE STUDY

Derek and Becky jointly own a house valued at $550,000 (ACB of $425,000). Derek has a new car worth $45,000, while Becky's used family van is worth $10,000. Derek also owns a cottage valued at $600,000 (ACB of $250,000) that he inherited from his father, which he hopes to pass on to Jordan, Anya and Robbie someday. He also owns 3 vintage cars that could easily be sold for a total of $72,000 (ACB $60,000), which he suspects Becky would sell upon his death.

10.3.1.3 Investment assets

Investment assets are those that are used to generate and store wealth for future use, including:

- Shares in public or private corporations;
- Debt instruments (i.e., bonds) issued by corporations or governments;
- Term deposits with a maturity of one year or more;
- Pooled investments such as mutual funds, exchange traded funds (ETFs) and segregated funds;
- Real estate held to generate rental income; and
- Partnership or corporate business interests.

Again, it is important to record the ACB and the fair market value (FMV) of investment assets, as well as the intended beneficiary, because the deemed disposition upon death could result in a significant tax liability if a rollover does not apply.

A distinction should also be made between unregistered and registered assets (e.g., those assets held in a registered retirement savings plan (RRSP) or a registered retirement income fund (RRIF), or their locked-in equivalents). While registered funds can roll over to a spouse, or sometimes to a child, if a rollover cannot be used, the full amount must be included in the deceased's income on his final tax return for the year of death.

CASE STUDY

Derek has a non-registered investment portfolio in a diverse mix of equities. The portfolio has a FMV of $280,000 and an ACB of $162,000. It generates after-tax income of $7,200 annually. He has $89,000 in his personal self-directed RRSP, and he has been contributing to a spousal RRSP for Becky. There is $36,000 in the spousal RRSP, and Becky has her own RRSP worth $24,000. They only contribute to the RRSPs in years Derek earns a bonus.

10.3.1.4 Pension entitlements

If the life insured or his spouse is a member of an employer-sponsored registered pension plan, the life insurance needs analysis should factor in his current entitlement under that plan, as well as the plan's provisions for survivor's benefits, both before and after retirement.

CASE STUDY

Derek is a member of his employer's DCPP. To date, his account is worth $180,000 (including his contributions, those of his employer, and accumulated investment income). Becky is the designated beneficiary of this account. If Derek dies before retirement, the funds will roll over into a locked-in retirement account, which Becky can access upon reaching age 55.

10.3.1.5 Case study summary of assets

The Chapter 11 *Recommending an insurance policy* will be using the information collected thus far about Derek's and Becky's assets, summarized in Table 10.1.

TABLE 10.1

Summary of assets of Derek and Becky's family

ASSETS	DEREK	BECKY	JOINT
Liquid assets			
TFSAs	$25,000	$25,000	
Chequing			$20,000
Fixed assets			
House			$550,000 (ACB $425,000)
Cottage	$600,000 (ACB $250,000)		
Vintage cars	$72,000 (ACB $60,000)		
Van		$10,000	
New car	$45,000		
Investment assets			
Non-reg. investments	$280,000 (ACB $162,000)		
Personal RRSPs	$89,000	$24,000	
Spousal RRSP		$36,000	
Pension entitlement			
DCPP	$180,000		
Total assets	**$1,291,000**	**$95,000**	**$570,000**

10.3.2 Debts

A life insurance needs analysis must consider the family's debts as well as their assets, because the payments can limit the cash flow available to fund estate objectives, and because creditors may demand payment upon the borrower's death. If insufficient cash is available, estate assets may have to be liquidated to satisfy the creditors' claims.

10.3.2.1 Mortgage

Many people who own a house have an outstanding mortgage. If the life insured is the sole owner and mortgagee, this mortgage will have to be discharged before the property can be passed on to its intended beneficiary. If the life insured and his spouse are co-owners and mortgagees, the lender may or may not be willing to extend that mortgage to the surviving spouse alone. In many cases, the life insured will specify that he would like to have sufficient life insurance to pay off this debt, to ease the financial demands on his surviving family.

CASE STUDY

Derek and Becky have a mortgage of $318,120 on their house, resulting in payments of $1,800 monthly over the remaining 18-year amortization period. Given Becky's current lack of income, Derek would like the mortgage to be paid off if he dies.

10.3.2.2 Credit cards and lines of credit

If both spouses share the same credit card account and one spouse dies, the lender may allow the account to remain open, but it may adjust the spending limit on the card to reflect the surviving spouse's income. Credit card debt can be very expensive because of the interest rates, so ideally it should be paid off as soon as possible upon death.

Similar to credit card debt, the lender may allow a line of credit (LOC) held jointly to remain open after the death of one spouse, if the line of credit is secured by assets that remain in the hands of the surviving spouse (e.g., a home equity line of credit). However, if the property securing the LOC is bequeathed to someone other than the surviving spouse, any balance on the line of credit will first have to be paid off.

CASE STUDY

Derek and Becky do not have a line of credit and, while they sometimes charge as much as $3,000 to their credit cards in one month, they usually pay the balance in full to avoid interest charges.

10.3.2.3 Other loans

Other major asset purchases, such as a car or a motor home, may be financed with a financial institution or dealer loan, and these loans generally become payable upon the death of the borrower.

CASE STUDY

Derek has a car loan with a balance of $41,000, with payments of $620 monthly for the next 72 months. He would like this loan to be paid off if he dies.

The life insured may also have an outstanding demand loan, which is a loan that allows the lender to demand repayment at any time. Demand loans typically have no predetermined repayment schedule and often only require the borrower to make interest payments. The borrower is also free to repay the loan in full at any time, without penalty for early repayment. Demand loans are often used by investors to leverage their investments.

10.3.2.4 Case study summary of liabilities

The Chapter 11 *Recommending an insurance policy* will be using the information collected thus far about Derek's and Becky's liabilities, summarized in Table 10.2.

TABLE 10.2

Summary of debts of Derek and Becky's family

DEBTS	DEREK	BECKY	JOINT
Mortgage on house			$318,120 ($1,800/m for 18 more years
Car loan	$41,000 ($620/m for 72 months)		
Credit card debt			$0 (paid off each month)
Total debt	**$41,000**		**$318,120**

10.3.3 Tax liability upon death

The insurance needs analysis should also recognize the potential tax liability that can arise upon death. This may result from the deemed disposition of capital assets or the deregistration of registered plans.

CASE STUDY

Derek has a number of assets that have the potential to result in a tax liability upon death, depending on who the designated beneficiary is. Any non-registered property transferred to Becky can roll over, without triggering a taxable capital gain. Similarly, registered plans such as Derek's TFSA, RRSPs and pension entitlement can transfer into registered plans for Becky if he designates her as the beneficiary.

Perhaps the biggest concern is the family cottage that he wants to pass on to the children. If he leaves the cottage to the children, either directly or through a trust, it could trigger a taxable capital gain of $175,000 based on its current value, calculated as:

(FMV of $600,000 – ACB of $250,000) × capital gains inclusion rate of 50%

If Becky decides to sell Derek's vintage car collection, this would also result in a taxable capital gain.

10.3.4 Current expenses

The life insurance needs analysis should consider the family's current expenses, including amounts paid for shelter, transportation, child care, food and clothing, allocations to savings, and discretionary expenses such as vacations, entertainment or dining out.

Some thought should also be given to how those expenses would change if the life insured dies.

CASE STUDY

A summary of Derek's and Becky's average monthly expenses is provided in the table below:

Summary of monthly expenses

Expense	Monthly amount
Spousal support for Susan	$500
Child support for Jordan (child)	$1,000
Mortgage (principal and interest)	$1,800
Car loan (principal and interest)	$620
Property tax (home)	$480
Home insurance and maintenance	$330
Property tax (cottage)	$370
Cottage insurance and maintenance	$400
Utilities, phone and Internet	$440
Car insurance	$340
Gasoline	$300
Food	$600
Derek's life insurance	$20
Clothing and personal care	$400
RESP contributions	$450
Dining out and entertainment	$150
Sports/fitness activities	$160
Vacation	$200
Total monthly expenses	**$8,560**

10.3.5 Available cash flow

Cash flow is the difference between net income coming in (i.e., income after taxes and deductions) and cash going out (i.e., expenses and savings commitments). A positive cash flow means that the family can afford to increase expenses (e.g., buying life insurance) and/or they can direct more towards saving for retirement, education or other goals.

A negative cash flow will result in increasing debt, and it means that the family will have to either increase income or decrease spending if they want to buy insurance.

CASE STUDY

With Derek's take-home pay of $8,400 per month, they appear to have a small shortfall of $160 per month. However, Derek has indicated that until he receives his anticipated raise in two years, he is willing to use the after-tax investment income from his non-registered investments ($7,200 per year or $600 per month) to cover the shortfall, as well as any required insurance premiums. While Becky and Derek both agree that it is important for her to remain home until Robbie is in school, they are looking forward to the day in about six years when she can return to work and bring in additional income.

10.4 Assess existing insurance

The next part of an insurance needs analysis requires the life agent to identify and assess any existing insurance in place.

10.4.1 Individual insurance

If the life insured already has one or more individual insurance policies in place, the life agent should note the following:[35]

- **Type of policy:**

  Is it term, term-100, participating whole life, non-participating whole life or universal life?

- **Face amount/death benefit:**

  What is the original face amount of the policy?

  For term policies, is the death benefit level, increasing or decreasing?

  For participating whole life policies, are dividends used for paid-up additions?

  For UL policies, is the death benefit level, increased by the cash account value or cumulative premiums, or indexed?

- **Cash surrender value (CSV):**

  For UL and whole life policies, what is the policy's current CSV and adjusted cost basis (ACB)?

  Will surrender charges apply?

  How do the current values compare to the initial policy illustration?

- **Policyholder:**

  Who owns the policy and can make decisions regarding it?

  Is it owned by an individual or a corporation or partnership?

35. A testamentary trust is a trust that is established upon death, to hold assets from the deceased's estate or the death benefit of a life insurance policy on his life. The terms and conditions of the trust can be set out in the deceased's will, or appended to the life insurance document.

- **Life/lives insured:**

  Is the life insured the same person as the policyholder?

  If there is more than one life insured, is it a joint first-to-die or joint last-to-die policy?

- **Term of coverage:**

  If it is a term life insurance policy, what is the term of coverage (e.g., 5-year, 10-year, 20-year)?

- **Renewability and convertibility:**

  If it is a term life insurance policy, is the coverage renewable upon expiry of the term?

  Can the policy be converted to whole life or universal?

  Until what age can the policy be renewed or converted?

- **Beneficiaries:**

  Who is the beneficiary of the policy? Is the beneficiary designation revocable or irrevocable?

  If the policy names multiple beneficiaries, does it state how the death benefit is to be split between them?

  If the beneficiary is a minor child, does it specify what should be done with the death benefit until the child reaches the age of majority?

  Is the beneficiary a testamentary trust?[34]

- **Riders and supplementary benefits:**

  What riders and supplementary benefits are included with the policy?

  For example, does the policy include a guaranteed insurability benefit (GIB) rider, which would allow the life insured to increase coverage in the future without providing proof of insurability?

  For whole life and UL policies, does the policy include a provision for paid-up additions (PUA)?

  What are the coverage limits under the GIB or PUA riders?

  Does the policy include dependant or family life insurance benefits and, if so, for what amount and who are the beneficiaries?

- **Premiums:**

  What are the premiums currently payable for the policy?

  For renewable term policies, what are the premiums upon renewal?

  For UL policies, what are the minimum and maximum deposits?

  Are the premiums payable for life or for a limited number of years?

  Are the mortality deductions based on yearly renewable term (YRT) rates or level cost of insurance (LCOI)?

- **Limitations or exclusions:**

  Does the policy exclude coverage for death resulting from certain causes or activities?

  Examples include death while travelling in a specific country, or death incurred while deep-sea diving. An accidental death policy may not cover death that results from illness or natural causes.

CASE STUDY

When Jordan was born, Derek (who was 39 at the time) bought a 10-year term policy with a $250,000 level death benefit. Originally the policy named Susan as the beneficiary, but when they divorced he made his estate the beneficiary. The policy has a double indemnity rider for accidental death and is renewable and convertible to age 70. It does not include any other riders. His current premiums are based on standard health rates and are $250 per year. The policy is due to renew in two years. The annual renewal rates at age 49, 59 and 69 are $1,125, $2,625 and $6,875 respectively.

10.4.2 Business insurance

If the life insured is a business owner or a key person in a business, his life may already be insured in connection with that business. However, that does not necessarily mean that the funds will be available to his family if he dies.

10.4.2.1 Relationship to buy-sell agreement

Life insurance is often used to fund a buy-sell agreement, as discussed in the Chapter 8 *Business life insurance*. In fact, the agreement often specifies that insurance must be purchased on each of the parties to ensure that money is available to fulfill the purchase obligations specified by the agreement. Depending on the nature of the agreement, the insurance may be purchased by the individual shareholders or partners, or by the business itself.

10.4.2.2 Type of policy

Is the policy a term policy, whole life policy or universal life policy?

If the policy is being used as collateral for a business loan, term insurance is normally sufficient. Policies intended to fund a buy-sell agreement may be term policies, to minimize costs, particularly if the insurance is held personally in a criss-cross arrangement. However, there may advantages to using permanent insurance, such as having the cash surrender value available to buy out the interest of a retiring owner, or having coverage that can remain in place for an indefinite period of time.

As discussed in the Chapter 8 *Business life insurance*, if the policy is intended to be an additional benefit for a key employee, it is more likely to be some form of permanent insurance, where the employee can benefit from its tax-deferral opportunities, discussed further below.

10.4.2.3 Ownership of policy and payment of premiums

Who owns the policy and who pays the premiums?

In most cases, life insurance used for business purposes is owned by the business itself; however, in the case of a cross-purchase buy-sell agreement, the business owners may buy insurance on the other owners personally, under a criss-cross arrangement.

If the life insured is a key employee and he and his employer co-own the policy under a split-dollar arrangement (discussed previously in the Chapter 8 *Business life insurance*), it is important to determine which portion of the death benefit belongs to him – the original face amount or the cash value in excess of the face amount? If the business wants to protect itself from the loss of a key employee while also offering him access to a tax-deferred investment vehicle, the business would own the face amount, and the employee would own the cash value. In this case, the business's share of the premiums would be tied to the reasonable costs for comparable term insurance coverage, and the employee would pay the balance of the premiums.

10.4.3 Group insurance

The life agent should also evaluate any group life insurance that is in place, including any policies where the life insured is the group member or any policies where the life insured is covered as a dependant of the group member (i.e., if he is covered under the family coverage under his spouse's group life insurance plan).

10.4.3.1 Face amount

Below are questions that the agent must ask himself:

- How much coverage does the group plan currently provide?
- Is it tied to salary, or is it a fixed amount?
- Is there an opportunity to increase the coverage amount and, if so, is there any limit on the time frame for taking advantage of this?
- Is the death benefit increased in the event of accidental death?

10.4.3.2 Policyholder and conditions of membership

It is important to note that the policyholder is NOT the group plan member, and that the member has limited rights under the policy, beyond naming the beneficiary and deciding whether to buy any optional coverage on himself or his family.

The agent must ask himself the following questions:

- If the policyholder is an employer, how stable is that employer?
- If the policyholder is an association (such as a university alumni association, or a professional association), what are the requirements for continued cover?
- What happens if the life insured terminates membership in the group?

10.4.3.3 End date and convertibility

The agent must ask himself the following questions:

- When does coverage under the group policy end?
- Does coverage extend beyond retirement?

In general, many group policies give the plan member the option of converting the coverage to individual coverage if the plan is terminated, or if the member leaves the plan or retires.

As discussed in the Chapter *Group life insurance*, guidelines set forth by the Canadian Life and Health Insurance Association[36] (CLHIA) suggest that the following provisions should apply for at least 31 days after a plan member leaves the group:

- On or before reaching age 65, a plan member should be able to convert up to $200,000 of the group-life coverage on his own life to individual insurance without providing proof of insurability; and
- At a minimum, he should have the option of choosing yearly renewable term or term-to-age 65.

However, these are suggested minimum requirements and are not legal requirements.[37]

The agent must also be sure of other elements by asking himself the following questions:

- Does the life insured's group coverage provide for greater or lesser conversion amounts?
- What about spousal or dependant coverage under the group plan, can it also be converted?
- What would the premiums be upon conversion?

36. Canadian Life and Health Insurance Association. *Guideline G3 - Group life and group health insurance*. [online]. Released June 12, 2013. [Consulted May 9, 2022]. https://www.clhia.ca/web/CLHIA_LP4W_LND_Webstation.nsf/page/13CD6FF39333FBBE8525784F0058BAC4/$file/G3.pdf
37. In Québec, the *Regulation under the Act respecting insurance* requires the insurer to offer participants aged 65 and up the option to convert their policy to an individual life insurance contract within 30 days of leaving the group. The participant has the right to convert the contract without having to provide evidence of insurability, and the amount of insurance must be at least $10,000 and may not exceed the lesser of the amount of all the life insurance protections that the participant held under the contract on the conversion date and $400,000.

CASE STUDY

Derek has group life insurance equal to one time his annual salary through his employer's group plan. It is convertible to the same amount of individual term coverage upon leaving the plan.

10.4.3.4 Vulnerabilities

When reviewing group life coverage with a client, the vulnerabilities associated with that coverage should be noted, such as:

- The amount of coverage is usually limited;
- The plan member does not have any control over the policy;
- The policyholder may decide to terminate the contract, or switch providers, without consulting with or getting the approval of the group members;
- The plan member generally must maintain membership in the group to maintain coverage at group rates;
- While coverage is usually convertible to an individual insurance policy, the premiums upon conversion are not guaranteed.

10.4.4 Government benefits

While the government benefits upon death are not usually sufficient to address all of an individual's insurance needs, they are still worth noting.

10.4.4.1 Canada Pension Plan (CPP) survivor benefits

If a person who has contributed to the Canada Pension Plan dies, CPP survivor benefits may be payable to his estate, surviving spouse or dependent children, provided that he meets certain eligibility requirements regarding the amount and duration of his contributions.

These survivor benefits may include a death benefit, a survivor's pension and a children's benefit. His estate, surviving spouse and children (or their guardians) must apply for these benefits; they are not paid automatically.

- **Death benefit:**

  This is a one-time lump-sum benefit of $2,500 payable to his estate or beneficiaries.

- **Survivor's pension:**

  The amount that his surviving spouse can receive as a CPP survivor's pension depends on whether or not she is also receiving a CPP disability or retirement pension, her age at the time of his death and his CPP contribution history. The maximum monthly survivor's pension is $674.79 if the surviving spouse is under age 65, and $752.15 if she is 65 or older (2022 amounts). If the spouse is over 65 and also receives her own CPP retirement pension, the maximum she can receive in combined benefits is the maximum monthly CPP retirement pension of $1,253.59 (2022 amount).

- **Children's benefit:**

  Children of a deceased eligible CPP contributor can receive a flat-rate monthly benefit of $264.53 (2022 amount). If both parents die and they were eligible CPP contributors, the child can receive two children's benefits. The child must be under 18 years of age, or between the ages of 18 and 25 and enrolled in school full-time to receive this benefit.

CASE STUDY

Derek has been making the maximum CPP contributions for about 20 years and meets the eligibility requirements for survivor benefits.

10.4.4.2 Québec Pension Plan benefits (QPP)

Survivor benefits under the QPP mimic those under the CPP with the following differences.

- The death benefit, which has a maximum of $2,500, is only paid to the extent of funeral expenses incurred with respect to the QPP contributor (i.e., if the services were provided for free, no death benefit will be paid);
- The maximums for survivors under 45 who have dependent children and/or who are disabled are different from the maximum CPP survivor's pension, as shown in Table 10.3.

TABLE 10.3

Summary of CPP and QPP survivor benefits in 2022

CPP SURVIVOR BENEFITS	MAXIMUM AMOUNT*(2022)
Death (one-time flat-rate payment)	$2,500.00
Survivor – younger than 65	$674.79
Survivor – 65 and older	$752.15
Survivor – 65 and older, combined with CPP retirement pension	$1,253.59
Children of deceased contributor	$264.53
QPP SURVIVOR BENEFITS	
Death (maximum one-time payment)	$2,500.00
Survivor – younger than 45 and:	
▪ not disabled, no dependent children	$602.86
▪ not disabled, with dependent children	$955.61
▪ disabled	$993.10
Survivor – age 45 to 64	$993.10
Survivor – 65 and older	$746.65
Survivor – 65 and older, combined with QPP retirement pension	$1,253.59
Children of deceased contributor (called orphan’s pension in Quebec)	$264.53

* All amounts are maximum monthly amounts, with the exception of the death benefit, which is paid as a one-time lump sum.

10.4.4.3 Old Age Security (OAS) allowance for surviving spouse

Canada’s Old Age Security (OAS) program provides for an allowance to be paid to a low-income surviving spouse of an OAS pensioner, provided that the surviving spouse is between the ages of 60 and 64.

The maximum allowance is $1,468.47 per month (April to June, 2022), but may be reduced based on other income, such that it is eliminated completely if the survivor has income of $24,496 (April to June, 2022). All OAS benefits and thresholds are indexed quarterly. Once the recipient reaches the maximum age for receiving the allowance, she will begin receiving her own OAS benefits.

10.4.4.4 Workers' Compensation benefits

Workers' Compensation (WC) programs protect employees from the financial hardships associated with work-related injuries and occupational diseases. Employers are required to pay premiums into the program, at rates based on their own risk and safety records, in comparison with provincial averages.

Each province has their own WC board, and the federal government has a separate WC board for federal employees. WC fatality and dependency benefits are paid if a covered employee dies from a work-related accident or illness. These benefits, paid to the surviving spouse or children, can vary widely from jurisdiction to jurisdiction, but typically include the following types of payments:

- Funeral costs, ranging from $4,000 to an unlimited amount;
- An immediate lump sum, ranging from $2,000 to over $100,000;
- Monthly pensions for the surviving spouse and/or children that range from as little as $400 per month for a child to 85% of the deceased's net earnings for a surviving spouse with children. Some jurisdictions factor in the surviving spouse's earnings, or earning capability, while others do not.

While the WC fatality and dependency benefits can appear to be quite generous in some jurisdictions, it is important to remember that these benefits are only payable if death is caused by a work-related accident or illness. Death resulting from an accident outside of work, or from an illness or disease that is not linked to work, will not result in WC benefits for the surviving family. Thus, WC benefits cannot be counted on to satisfy the family's life insurance needs.[38]

10.5 Identify client's priorities in the event of death

So far this Chapter has focused mainly on facts and numbers – how old the life insured is, how many children he has, his marital status, the amount of life insurance he already has, how much money he makes, how much his family spends, and so on. The agent must also understand that the qualitative questions are as important.

10.5.1 Family lifestyle

No one likes to think of leaving their family behind and nothing can replace the presence or love of a father or mother or sibling, but proper planning can ensure that the surviving family can maintain their lifestyle from a financial perspective. The life agent should determine the client's objectives with respect to the following:

38. The Association of Workers' Compensation Boards of Canada (AWCBC) provides a useful summary of WC fatality and dependency benefits by jurisdiction. Please click on Dependency benefits and fatalities at: http://awcbc.org/?page_id=75 [Consulted May 9, 2022].

- **Child care:**

  How long will the children need care, and what type of care?

  Will the surviving spouse have to go back to work right away after the life insured's death, or can she stay home and make caring for the children a priority?

  If they need additional care, will this occur at a subsidized daycare, or will a live-in nanny be hired?

- **Surviving spouse's dependency:**

  If the surviving spouse has always been a stay-at-home parent and depended on the life insured for financial support, will that financial dependency continue after his death and, if so, will it be until retirement age?

  Or can it reasonably be expected that the surviving spouse can become self-sufficient over time?

  Would additional training or education be required, and how would that be financed?

- **Family residence:**

  Does the life insured want the family to be able to continue to live in the same residence after his death?

  Does he want it to be mortgage-free?

  If the life insured was the primary person who performed care and maintenance of the home, will the surviving spouse be able to take over these duties after his death, or will additional expenses be incurred?

- **Cottage/vacation home or heirloom properties:**

  Are there certain properties that the life insured wants to pass on to his children intact, without the risk of having to sell that property just to pay the taxes or funeral expenses?

- **Family business:**

  Similarly, does he have a business that he hopes to pass on to his children, and will the income taxes due as a result of the deemed disposition upon death interfere?

CASE STUDY

Derek wants Becky to be able to carry through with their plans to have her stay at home until Robbie is in school full-time. At that time, he knows she will be ready to return to work, but her earnings will not be enough to maintain their current standard of living. Thus, he would like to ensure that she has enough money to replace his income for the next six years, plus enough to supplement her anticipated income to the same level, until retirement at age 60. He also wants all of their debts to be paid off if he dies.

Derek wants to fulfill his commitments for spousal and child support for Susan and Jordan and, while he believes Becky would honour his wishes, he would prefer not to have to involve her in these payments after his death.

Finally, Derek wants to ensure that the title to his cottage can pass on to his children, by having enough funds in his estate to pay the income tax that would result upon his death.

10.5.2 Final expenses

Funeral arrangements are a very personal choice and the agent needs to verify this with the client:

- What kind of funeral would the life insured like to have?
  - Small and simple, or large and lavish;
  - Burial in a mausoleum;
  - Cremation followed by scattering of ashes.

CASE STUDY

Derek does not want an extravagant funeral. He believes $20,000 will be more than adequate to cover his final expenses.

10.5.3 Plans for future

Many people want to look beyond maintaining the family's current lifestyle when determining their insurance needs, by planning for events they hope will happen in the future. This might include things such as:

- **Post-secondary education:**

  With post-secondary education costs continuing to increase at a pace exceeding inflation, many parents include some provision for paying, or helping to pay, for their children's post-secondary education.

- **Weddings for children:**

  Some parents feel it is important to ensure their children can have the wedding of their dreams.

- **Other family legacies:**

  Some parents want to go beyond providing for their children's post-secondary education, by planning to give them a lump sum (perhaps upon reaching a certain age) that can be used to help buy their first house or start a business.

- **Philanthropy:**

  Dependent vs. self-sufficient is often stated as an estate planning objective. Some people like to be able to give at death, what they could not afford to give during life. Some estate plans also incorporate charitable giving via insurance as a tax-planning strategy.

CASE STUDY

Derek and Becky believe it is their job to prepare the children for adulthood by helping them afford a quality post-secondary education, without necessarily covering the entire cost. Beyond that, they have no intention of providing the children with capital for a home or business. They already contribute to an RESP for each child, and as long as he can ensure that his income will be replaced if he dies, Becky can continue to make these contributions. He believes that another $10,000 for each child will be sufficient to cover their educational expenses.

If possible, Derek would also like to make a charitable donation of $100,000 to his local hospice if he dies, because this organization recently provided excellent end-of-life care to his father.

10.6 Next steps

This Chapter provided a general overview of the issues or needs that should be considered when doing a life insurance needs analysis. The family's Case study continues in the next Chapter, *Recommending an insurance policy*, which explains how to quantify those needs and recommend an appropriate type and amount of life insurance coverage for a specific client situation.

CHAPTER 11
RECOMMENDING AN INSURANCE POLICY

Competency components

- Assess the client's needs and situation;
- Implement a recommendation adapted to the client's situation.

Competency sub-components

- Articulate the client's needs based on the risks that could affect his financial situation;
- Propose a recommendation adapted to the client's needs and situation.

Important note:
For Québec readership, the calculations must be completed using the Québec Pension Plan (QPP) benefits and not the Canada Pension Plan (CPP).

11
RECOMMENDING AN INSURANCE POLICY

Chapter 10 *Assessing the client's situation* provided a general overview of the issues or needs that should be considered when doing a life insurance needs analysis. This Chapter explains how to quantify those needs and recommend an appropriate type and amount of life insurance coverage for a specific client situation. The concepts will be illustrated by continuing with Derek and Becky's family case study, which was introduced in the previous Chapter.

11.1 Evaluate the probability, severity and duration of risks

When doing any type of insurance needs analysis, whether it be for life, disability or critical illness insurance, it is important to first assess the probability, severity and duration of the risk, and ensure that the client understands what this means for them. This information can be summarized in a risk assessment matrix or table, such as the one shown in Table 11.1.

TABLE 11.1

Risk assessment matrix

SEVERITY OF RISK	PROBABILITY	FINANCIAL IMPACT
Death	Low	High
Disability	Medium/High	Medium
Critical illness	Medium	Medium/High
Incapacity requiring long-term care	Low/Medium	Medium
Medical or dental expenses	High	Low

Each person will have a different risk matrix and it will evolve over time. For example, a healthy 30-year-old male with a young family would have a low risk of death, but the financial impact of his death on the family would be high. In contrast, an 85-year old single female with no dependants would have a high risk of death, but the financial impact of her death would be low.

11.1.1 Probability of death

Most people avoid contemplating their own mortality, and prefer to assume that they are going to live well into old age. The agent should be able to convey the fact that the client's risk of death, although it may be slight at the current time, is still very real and needs to be addressed. The life agent should be able to explain that an individual's risk of death is based on a number of factors.

11.1.1.1 Current age and gender

The first factors are the individual's age and gender. Chapter 1 *Introduction to Life Insurance Module* provided some statistics about average Canadian life expectancy and probability of death, for both males and females. These same statistics are provided in a slightly different way in Table 11.2, which expresses the odds that a male or female of specific age will die during the year. This Table clearly shows that the odds of dying increase with age, for both males and females. However, aside from old age, females have lower odds of dying than their male counterparts.

TABLE 11.2

Odds of dying for males and females[39]

ODDS OF DYING BEFORE NEXT BIRTHDAY ARE 1 IN…

AGE	MALE	FEMALE
10	12,500	14,286
20	1,449	3,125
30	893	1,961
40	649	1,205
50	328	538
60	141	227
65	90	142
70	56	86
75	34	51
80	21	30
85	12	17
90	7	9
95	4	5
100	3	3

39. Based on Statistics Canada. *Life expectancy and other elements of the life table, Canada, all provinces except Prince Edward Island* (Table 13-10-0114-01, 2018 to 2020). [online]. [Consulted May 2, 2022]. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1310011401

Sometimes expressing the probability of death in terms of odds helps a client visualize how real the risk of death is. Odds are simply calculated by dividing 1 by the probability of death. For example, according to the general statistics for all Canadians, a man who just turned 30 has a probability of dying before his next birthday of 0.104%. To many people, that seems to be a very low number. However, when expressed as odds, this means that one out of every 962 men who have just turned 30 years old will die before their 31st birthday. If the life agent can compare this number to something relevant to the client (e.g., the number of students in the local high school, or the number of people working for his employer, or the number of seats at the local hockey rink), it can emphasize how real the risk of dying is.

CASE STUDY

Derek is currently 47 years old, while Becky is only 38. Based on the same data set that was used to produce Table 11.2 (i.e., an average for all Canadian males and females), Derek's probability of dying before his next birthday is 0.242%, which represents odds of 1 in 413. Becky's probability of dying before her next birthday is 0.067%, which represents odds of 1 in 1,389.

Another approach is to present the probability of death occurring before a certain age, such as age 65. Based on the data set from Statistics Canada that was used to produce Table 11.2 (i.e., an average for all Canadian males), the probability of a male who just turned 30 years of age dying before reaching age 65 is about 12%, which represents odds of about 1 in 8. The life agent in this situation can ask his 30-year-old client to envision eight friends of similar age, and then point out that the odds are that one of that group will die before age 65.

11.1.1.2 Personal and family health history

Another important contributing factor to the risk of death is that person's personal and family health history. If the person has a history of health problems, or if his ascendant relatives have experienced diseases or conditions that carry a genetic component, then his probability of death is likely higher than the average Canadian.

CASE STUDY

Derek's father and two of his uncles were diagnosed with Type 2 diabetes before the age of 50. His father is still living at age 72, but both uncles died in their early 60s. While Derek is fine so far and of average health, he knows that he is overweight and that he is predisposed to develop the same disease. This will increase his odds of dying before his next birthday.

11.1.1.3 Lifestyle risks

A person's lifestyle choices can also influence his probability of death, such as:

- Smoking;
- Having a stressful job;
- Drinking excessively;
- A history of driving infractions;
- Frequent travel, particularly to developing countries;
- Engaging in hazardous activities or hobbies.

If the life agent learns that the client is exposed to these or other lifestyle risks, he can advise the client that his odds of dying are likely higher than the average Canadian.

CASE STUDY

Derek admits that he started smoking six or seven years ago, and while he has cut back considerably, he still smokes ten cigarettes every day; this increases his risk of death. Becky does not smoke. They both drink occasionally at social events, and neither of them has risky jobs or dangerous hobbies.

11.1.2 Financial impacts of death

The agent should help the client understand what his death will mean for his family from a financial standpoint. The biggest financial impacts typically relate to:

- The loss of income, if the life insured is employed and supports his family;
- The cost of replacing a caregiver, if the life insured is the primary caregiver of the family's children;
- The need to repay debts, including a mortgage or a personal loan;
- Income taxes that result from the deemed disposition of capital property at death.

CASE STUDY

The biggest financial impact associated with Derek's death would be the loss of his employment income, which currently amounts to $8,400 per month after-tax. His death may also result in the calling of their $318,120 mortgage and his $41,000 car loan, meaning that payment would be required in full, and the passing of the cottage to his children may result in a tax liability of $175,000.

The biggest financial impact associated with Becky's death at this point in time would be the need for Derek to hire a caregiver for the children so he can continue to work full-time.

The Sections *Insurance needs analysis – Income replacement approach*, and *Capital needs approach* will explain how these financial impacts can be addressed with life insurance.

11.1.3 Duration of risk

The life agent also needs to determine how long the client's risk of death will be a concern from a financial standpoint. Obviously the risk of death will continue right up until the actual time of death, but the financial impacts associated with that death may only present a problem for a short or specific period of time.

CASE STUDY

Most of Derek's financial obligations have a limited duration:

- His spousal support obligation of $500 per month will continue until his ex-wife Susan reaches age 65, and she is currently 44 years old;
- His child support obligation for Jordan is $1,000 per month until Jordan reaches age 19, and he is currently 8 years old;
- Derek and Becky's mortgage has a balance of $318,120, with payments of $1,800 per month over the next 18 years;
- Derek's car loan will be paid off in 6 years.

However, the tax liability resulting from the cottage transfer will only arise upon his death, and because the timing of that death is unknown, the risk could continue to be a concern for 40 or 50 years or even longer. Furthermore, while the amount of the other financial risks related to supporting his family decrease over time, the tax liability is likely to increase over time as the cottage continues to appreciate.

11.1.4 Other risks

The agent should consider other risks to which the client may be exposed, other than the risk of death, particularly those that could be covered under a life insurance rider or that could interfere with the ability to pay the policy premiums.

11.1.4.1 Risk of illness or disability

The risk of becoming disabled for a period of three months or longer is significantly higher than the risk of death for all age groups. Disability can have as great an impact on family finances as death, if the disabled person is no longer able to earn an income. If the client does not have adequate disability coverage or a sizeable emergency fund, he may be interested in adding a waiver of premium benefit, or a dread disease rider, to his life insurance policy. These may help him keep the policy in force if he becomes ill and is unable to earn an income.

CASE STUDY

Derek has a generous occupation disability insurance policy through his employer, so he is not interested in these supplementary benefits.

11.1.4.2 Risk of unemployment

As noted in Chapter 10 *Assessing the client's situation*, the agent should try to ascertain the stability of the client's income, to ensure that he will have adequate cash flow to pay the required premiums. If his income fluctuates from year to year, he may benefit from a universal life (UL) policy that provides some flexibility in the policy's deposits.

11.2 Insurance needs analysis – Income replacement approach

From an insurance perspective, income replacement approach is reflected by the loss of employment income that would result from the death of an income earner. This approach strives to replace that lost income and it assumes that as long as this income can be replaced, the surviving family will not experience a reduction in their standard of living.

CASE STUDY

Derek is currently the sole income earner for the family. A life insurance needs analysis based on the income replacement approach would determine the value of the income that would be lost upon his death.

Where the life insured provides an essential but unpaid function, his contribution can be expressed in terms of what it would cost to replace that essential service, or income-in kind.

CASE STUDY

Becky currently stays home to care for Anya and Robbie, as well as Jordan when he is with Derek (recall that Derek and his ex-wife Susan share joint custody of Jordan). While Becky's death would not result in a loss of income, her role as caregiver still has economic value. A life insurance needs analysis based on the income replacement approach would determine the cost of replacing her duties as caregiver and homemaker.

11.2.1 Capitalization of lost income

Under the income replacement approach, the insurance need is determined by calculating the amount of capital that would have to be invested to generate the lost income, as follows:

Capitalized value = annual income ÷ rate of return

CASE STUDY

Derek currently takes home $8,400 per month. Assuming a rate of return of 5%, the capitalized value of his lost income would be $2,016,000, calculated as:

$2,016,000 = ($8,400/month × 12 months) ÷ 5%

This suggests that he should have about $2 million in life insurance.

The life insurance need calculated using this approach tends to be high, because it assumes that the principal itself (i.e., the death benefit) always remains intact. Preserving the capital in this manner is also sometimes referred to as capital retention. Only the income generated by investing the death benefit is used by the beneficiary. This ensures that the income stream can be replicated in perpetuity, regardless of how long the surviving family lives.

11.2.2 Impact of investment returns, inflation and income tax

The approach described so far is quite simplistic. First, it assumes that return earned on the invested death benefit will remain constant over time. To protect against changing investment returns, a conservative interest rate should be used, such as that available on guaranteed investment certificates or other term deposits.

In addition, the approach so far fails to consider the impact of income taxes or inflation on income, such additional refinements can be made, as discussed below.

11.2.2.1 Accounting for income taxes

While life insurance proceeds are not taxable when received, if the proceeds are invested, the resulting investment income is taxable.

When using an income replacement approach, lost income may be expressed either as a gross salary, or an after-tax amount, and the capitalization of income should be calculated on the same basis. This means that if the lost income is expressed as an after-tax amount, the interest rate used when calculating the capitalization of income should also be an after-tax amount, using an appropriate tax rate.

If the amount of income is small, relative to the recipient's other sources of income, the marginal rate tax rate should be used. However, if the amount is large, as is often the case when trying to replace lost employment income, an effective or average tax rate should be used.

CASE STUDY

Derek has after-tax income of $8,400 per month, or $100,800 per year. Therefore the investment income earned on the death benefit needs to be calculated on an after-tax basis.

The after-tax rate of return is calculated as follows:

$$\text{After-tax rate of return} = \text{rate of return} \times (1 - \text{tax rate})$$

If the investment return is 5% and average tax rate is 25%, the after-tax rate of return is 3.75%, calculated as:

$$3.75\% = 5\% \times (1 - 25\%)$$

This means that, using the replacement of income approach, adjusted for income taxes, Derek would need $2,688,000 in life insurance, calculated as:

$$\$2{,}688{,}000 = (\$8{,}400/\text{month} \times 12 \text{ months}) \div 3.75\%$$

11.2.2.2 Accounting for inflation

The model also assumes that the income being replaced would be fixed over time, when in reality an individual's employment income usually increases over time, at least at a rate to keep pace with inflation.

CASE STUDY

If Derek's employment income increases at a rate of just 2% a year, the $8,400 per month he takes home today will increase to $10,240 in 10 years, which is a significant difference.

This can be addressed by using an inflation-adjusted rate of return when calculating the capitalized value. The inflation-adjusted rate of return is calculated as follows:

$$\text{Inflation-adjusted rate of return} = \frac{(1 + \text{return})}{(1 + \text{inflation rate})} - 1$$

CASE STUDY

If the inflation rate is 2% per year and the investment return is 5% per year, the inflation-adjusted rate of return is 2.94%, calculated as:

$$\frac{(1 + 0.05)}{(1 + 0.02)} - 1 \quad = 0.0294$$

This means that using the replacement of income approach, adjusted for inflation, Derek would need $3,428,571 in life insurance, calculated as:

$3,428,571 = ($8,400/month × 12 months) ÷ 2.94%

11.2.2.3 Accounting for income taxes and inflation simultaneously

In reality, the amount of capital needed will be affected by both income taxes and inflation. To account for both factors, the after-tax, after-inflation rate of return should be used, which is calculated as follows:

$$\text{After-tax, after inflation rate of return} = \frac{(1 + \text{after-tax return})}{(1 + \text{inflation rate})} - 1$$

CASE STUDY

Previously it was determined that if the investment return is 5% per year and taxes are 25%, the after-tax rate of return is 3.75%. If the inflation rate is 2%, the after-tax, after-inflation rate of return is 1.71%, calculated as:

$$\frac{(1 + 0.0375)}{(1 + 0.02)} - 1 \quad = 0.0171$$

This means that using the capitalization of income approach, adjusted for income taxes and inflation, Derek would need $5,894,737 in life insurance, calculated as:

$5,894,737 = ($8,400 per month × 12 months) ÷ 1.71%

11.2.3 Weaknesses of the income replacement approach

The income replacement approach has the benefit of simplicity, but it fails to address what the survivors actually need, as well as how long the lost income would have been generated if the life insured had not died. Replacing 100% of lost income in perpetuity may be much more than the surviving family needs for day-to-day living, or it may not be enough. The income replacement approach also fails to address the life insured's desire to create or protect an estate.

11.3 Insurance needs analysis – Capital needs approach

It is usually more beneficial to take a capital needs approach, which identifies all of the income and capital needs arising as a result of death, and converts them to a capitalized amount at death.

This approach starts by listing the surviving family's sources of income, then comparing them with their expenses, to determine if a shortfall exists.

11.3.1 Income earned by survivors

Income earned by the surviving family could take the form of employment income, pension or investment income, or government benefits.

CASE STUDY

Becky does not currently work, and she does not expect to return to work for at least 6 years, at which time she believes that her take-home pay would be about $4,500 per month. However, Derek would feel better if he knew that she could manage the household financially without working until Robbie turns 18. Neither of them currently earns investment or pension income.

If Derek dies, Becky would be eligible for a Canada Pension Plan (CPP) survivor benefit of about $675 per month, and Anya and Robbie[40] would be eligible for a CPP benefit of about $265 per month as children of a deceased CPP contributor.

Derek wants to ignore any potential benefits his family could receive under his province's Workers' Compensation Board, because there is no guarantee that his death will be work-related.

Derek's non-registered investment portfolio currently produces after-tax income of $7,200 annually, but because these assets may be needed to meet estate expenses, this income is not being included at this point.

40. Derek shares joint custody of Jordan with his ex-wife, Susan. Therefore, Susan would be the one who would apply for and receive the CPP children's benefit on behalf of Jordan.

11.3.2 Ongoing expenses

The next step involves determining what the family's ongoing expenses are going to be after the death of the life insured. It is important to consider that certain expenses may:

▪ Increase	E.g., childcare.
▪ Decrease	E.g., food, clothing.
▪ Be unaffected	E.g., home heating.
▪ Be eliminated entirely	E.g., the life insured's golf membership, or mortgage payments if the mortgage is to be paid off with insurance monies.

CASE STUDY

Derek has indicated that he would like to see all of his debts paid in full upon his death, which means Becky will not have to worry about mortgage or car payments. Derek also wants to handle the support obligations separately, so they will not form part of Becky's budget if he dies. In addition, some of their expenses, such as gas, car insurance and food, will decrease slightly upon his death. The table below shows a modified version of summary of expenses that was provided in the Chapter *Assessing the client's situation*, showing both current expenses, and how they would likely change as a result of Derek's death.

Summary of the family's monthly expenses, current and after death

Expense	Monthly amount (Current)	Monthly amount (After Derek's death)
Spousal support for Susan	$500	$0
Child support for Jordan (child)	$1,000	$0
Mortgage (principal and interest)	$1,800	$0
Car loan (principal and interest)	$620	$0
Property tax (home)	$480	$480
Home insurance and maintenance	$330	$420
Property tax (cottage)	$370	$370
Cottage insurance and maintenance	$400	$400
Utilities, phone and internet	$440	$440
Car insurance	$340	$200
Gasoline	$300	$140
Food	$600	$500
Derek's life insurance	$20	$0
Clothing and personal care	$400	$300
RESP contributions	$450	$450
Dining out and entertainment	$150	$150
Sports/fitness activities	$160	$100
Vacation	$200	$200
Total monthly expenses	**$8,560**	**$4,150**

11.3.3 Income shortfall

If the income is less than the expenses, then an income shortfall exists, calculated as follows:

Income shortfall = expenses – income

CASE STUDY

Factoring in the CPP survivor benefits ($675 monthly for Becky and $265 monthly for each Anya and Robbie, if Derek dies, the family would experience a shortfall of $2,945 per month, calculated as:

$2,945 = $4,150 – ($675 + $265 + $265)

11.3.3.1 Capitalization of income shortfall

The next step is to determine the amount of capital that would be needed at death to fund this shortfall in income. There are two approaches that can be used.

If the intent is to preserve the capital (i.e., the capital retention method), then:

Capitalization of shortfall = annual shortfall ÷ investment return

Ideally, the investment return used in this formula should be the after-tax inflation adjusted rate of return.

CASE STUDY

Previously it was determined that if the inflation rate is 2% per year, the investment return is 5%, and the average tax rate is 25%, then the after-tax, after-inflation rate of return is 1.71%. Using the capital retention method, the capitalized value of Derek's family's income shortfall would be $2,066,667[41], calculated as:

$2,066,667 = ($2,945/month × 12 months) ÷ 1.71%

A more practical approach for those needs that have a limited duration is to simply multiply the annual shortfall by the number of years the shortfall is expected. This is sometimes called a "capital drawdown method."

CASE STUDY

Derek has indicated that he would prefer that Becky would not have to return to work until Robbie turns 18. At that time, she could find work and likely take home enough money to cover all of her expenses. Using the capital drawdown method, the capitalized value of the family's shortfall over 18 years would be $636,120, calculated as:

$636,120 = ($2,945/month × 12 months) × 18 years

Any other ongoing expenses, such as support obligations to a previous family, could be handled in a similar manner.

41. CPP survivor benefits are taxable to each recipient, but given their negligible incomes in this case, we will assume these are after-tax amounts.

CASE STUDY

Derek would like to ensure that his estate can provide spousal support to his ex-wife Susan of $500 per month for a maximum of 21 years (until Susan is age 65). Using the capital drawdown method, this results in a capitalized value of $126,000, calculated as:

$$\$126,000 = \$500/\text{month} \times 12 \text{ months} \times 21 \text{ years}$$

He also wants to ensure that his child support obligation of $1,000 per month can be met for 11 years (until Jordan is 19 years old). Using the drawdown method, the capitalized value of these support payments is $132,000, calculated as:

$$\$132,000 = \$1,000/\text{month} \times 12 \text{ months} \times 11 \text{ years}$$

11.3.4 Capital needs analysis

The next step is to identify all of the other lump sum needs that may arise as a result of death, to insure that the estate has enough liquidity to meet these needs.

11.3.4.1 Final expenses

Final expenses refer to the cost of providing burial, cremation, funeral or remembrance services. These expenses are generally payable a short time after death.

CASE STUDY

Derek has previously indicated that he believes that $20,000 will be sufficient to cover his final death expenses.

11.3.4.2 Tax liabilities

The deemed disposition of capital assets upon death and the deregistration of registered assets (unless a rollover is available) can result in a significant tax liability for the year of death. If the estate does not have sufficient liquidity to pay this tax bill, the executor ("liquidator" in Québec) may be forced to sell estate assets to provide the necessary funds.

CASE STUDY

Derek plans to leave all of his assets, with the exception of the cottage, to Becky upon his death. He would like to leave the cottage in trust to the children upon his death, and this will result in a deemed disposition for tax purposes.

The cottage currently has an ACB of $250,000 and FMV of $600,000, which would result in a taxable capital gain of $175,000 if Derek died today, calculated as:

(deemed proceeds – ACB) × capital gains inclusion rate
or
($600 000 – $250 000) × 50 %

If Derek's marginal tax rate for the year of death is 45%, the resulting tax liability would be $78,750.

Note that if the cottage continues to appreciate in value prior to Derek's death (which is quite probable given historical increases), this tax liability would be even higher.

11.3.4.3 Debt elimination

A common objective in a life insurance needs analysis is to ensure that the estate has sufficient liquidity to pay off all debts owing at the time of death.

CASE STUDY

Derek wants their mortgage of $318,120 and his car loan of $41,000 to be paid off if he dies.

11.3.4.4 Estate expenses

There are many expenses that could be incurred by an estate, such as:

- Probate fees, which can be as high as 1.5% of estate assets, depending on the jurisdiction;
- Compensation for the executor or estate trustee, often in the order of 1 to 3% of estate assets;
- Legal fees, dependent upon the estate's needs;
- Asset management fees, particularly if the estate consists of a large investment portfolio;
- Property maintenance fees, if the estate includes real estate.

Whether these are incurred as a one-time expense or on an ongoing basis, the estate will need sufficient cash to pay these amounts.

CASE STUDY

Derek feels that his estate is fairly straightforward, and his brother has agreed to act as his executor without compensation. As a result, no provision has been made for estate expenses.

11.3.4.5 Emergency fund

A common rule of thumb is that a family should have sufficient liquid assets in an emergency fund to cover three to six months of regular expenses, although many families fall far short of this goal. Even if the life insured has managed to accumulate such an emergency fund, it can be easily consumed upon death by final expenses, income taxes or other estate expenses, which could leave the surviving family without this safety net.

CASE STUDY

Derek and Becky currently each have $25,000 in their TFSAs, earmarked as their emergency fund, as well as $20,000 in their joint chequing account. Their monthly expenses are $8,560 (or $51,360 over 6 months), so their current emergency fund is adequate. However, they need to be careful that this does not get consumed by all of the expenses associated with Derek's death. Assuming that Becky's monthly expenses after Derek's death would be $4,150 (as shown in the Section *Ongoing expenses* in the Table, *Summary of the family's monthly expenses, current and after death*). Derek would like to ensure that 6 times this amount, or about $25,000, is maintained as an emergency fund.

11.3.4.6 Education fund

The capitalized value of anticipated education expenses is often included in the life insurance needs analysis.

CASE STUDY

As discussed in the Chapter 10 *Assessing the client's situation*, Derek feels that setting aside $10,000 for each of their 3 children, in addition to their RESP would be sufficient. So, he would like the capital needs analysis to include an education fund of $30,000.

11.3.4.7 Estate equalization

Most parents with multiple children try to treat them equally or fairly, and this treatment continues even at death. However, sometimes the assets to be shared among the children do not lend themselves to equal division. If this is the case, insurance can be used to help equalize the distribution, at least from a monetary standpoint.

CASE STUDY

Suppose that Derek had decided to leave the cottage to Jordan only, perhaps because Jordan is the one who will likely use or enjoy it, or because Derek knows that Jordan, Anya and Robbie would not be able to manage it jointly without fighting (while the children in this case study are currently too young for these issues to arise, it is a common situation in other families). How would Anya and Robbie feel about their brother receiving sole title to an asset worth $600,000? Derek could perhaps alleviate conflict between the siblings if he bought sufficient life insurance to give $600,000 each to Anya and Robbie, thereby equalizing their treatment.

11.3.4.8 Charitable bequests and legacies

The capital needs analysis could include many other amounts, reflecting the unique situation and desires of the life insured. Often the life insured wants to provide for a charitable bequest upon death, either as a tax strategy, or purely for philanthropic reasons. He might also want to provide a legacy, to set up a scholarship fund at his alma mater, or a lump sum to a child as down payment for a home.

CASE STUDY

Derek has indicated that he would like to be able to donate $100,000 to the local hospice centre upon his death.

11.3.4.9 Total capital needs

Once all of the capital needs have been identified, including the capitalized income shortfall, a total must be calculated.

CASE STUDY

Derek's total capital needs in the event of death are summarized in the table below:

Summary of capital needs upon death

Capital need	Amount
Capitalization of Becky's income shortfall	$636,120
Capitalization of spousal support for Susan	$126,000
Capitalization of child support for Jordan	$132,000
Final expenses	$20,000
Income tax on cottage transfer	$78,750
Mortgage	$318,120
Car loan	$41,000
Emergency fund	$25,000
Education fund (to supplement RESPs)	$30,000
Donation to hospice	$100,000
Total capital needs	**$1,506,990**

11.3.4.10 Assets available upon death

The next step is to identify all of the assets that would be available upon death to meet estate needs. This should only include those assets that are already in the form of cash or cash equivalents, or that the family is willing to sell to meet those estate needs.

CASE STUDY

A summary of the family's assets was developed in the Chapter *Assessing the client's situation*, and is repeated in the table below, but many of these assets are not available to meet estate needs.

Summary of current assets

ASSETS	Derek	Becky	Joint
Liquid assets			
TFSAs	$25,000	$25,000	
Chequing			$20,000
Fixed assets			
House			$550,000 (ACB $425,000)
Cottage	$600,000 (ACB $250,000)		
Vintage cars	$72,000 (ACB $60,000)		
Van		$10,000	
New car	$45,000		
Investment assets			
Non-reg. investments	$280,000 (ACB $162,000)		
Personal RRSPs	$89,000	$24,000	
Spousal RRSP		$36,000	
Pension entitlement			
DCPP	$180,000		
Total assets	**$1,291,000**	**$95,000**	**$570,000**

Becky is the beneficiary of Derek's registered retirement savings plan (RRSP) and his defined contribution pension plan (DCPP), and he believes they should be preserved for her own retirement. She will continue to live in the house, and the cottage is to be held in trust for their children. Presumably she will keep his newer car and sell her van. This leaves a much smaller asset base of $402,750, as summarized in the following table.

Assets available for estate needs

ASSETS	Current value	Income tax upon disposition (assuming MTR of 45%)	After-tax value
TFSAs (current emergency fund)	$50,000	$0	$50,000
Chequing account	$20,000	$0	$20,000
Vintage cars	$72,000 (ACB $60,000)	$2,700, calculated as (($72,000 – $60,000) × 50% × 45%)	$69,300
Becky's van	$10,000	$0	$10,000
Non-reg. investments	$280,000 (ACB $162,000)	$26,550, calculated as (($280,000 – $162,000) × 50% × 45%)	$253,450
		Total amount available for estate needs	**$402,750**

11.3.4.11 Existing insurance

A summary should also be made of existing insurance, its term, premiums, renewability and convertibility and, for permanent insurance, its cash surrender value and ACB.

CASE STUDY

Derek has an individual $250,000 10-year term life insurance policy that names his estate as the beneficiary. It is renewable and convertible until age 70. He is currently paying premiums of $240 per year, but the policy will renew in 2 years at age 49, with premiums of $1,125. Premiums at renewal at age 59 and 69 are $2,625 and $6,875 respectively.

He also has $100,000 of coverage through his employer's group life insurance plan.

11.3.4.12 Shortfall

The last step is to determine the shortfall in capital, which is calculated as:

Capital shortfall =
total capital needs at death – available assets – existing life insurance

This shortfall represents the amount of additional insurance that should be acquired. It is normally rounded up to the nearest $10,000 or $50,000 amount.

CASE STUDY

Using a capital needs approach with the capital drawdown method, Derek's capital shortfall is $754,240, calculated as:

$754,240 = $1,506,990 – $402,750 – $250,000 – $100,000

Derek should therefore consider acquiring an additional $760,000 in life insurance.

11.4 Bringing it all together

Now that most of the number crunching is done, the life agent should be in a good position to determine if life insurance is needed, and to evaluate options that might be suitable for the client. However, a few more factors are worthy of attention before a recommendation is made.

11.4.1 Duration of risk

One important consideration is the duration of each of the capital needs, because this helps determine whether permanent or term insurance is required, and if it is the latter, the duration of that term. Among cases where the capital needs may be suited to term insurance:

- Need to pay off the mortgage with the insurance; only for the duration of the mortgage, usually 25 years or less;
- Children's needs when most will eventually be financially independent, say within 20 or 25 years;
- Need to replace employment income; usually extends only until retirement age (around age 55 to age 65).

Examples of capital needs more suited to permanent insurance include:

- Special needs children who may never outgrow their need for financial support;
- Tax liability that only arises upon death; may not be realized for 30, 40 or even 50 years into the future, and it may also increase by that time;

CASE STUDY

Derek's capital needs may be term needs or permanent needs, as follows:

Term needs:

- He wants to ensure that his family's income shortfall is covered until Robbie turns 18. After that time, he assumes Becky can support herself.
- His support obligation to his ex-wife, Susan, could last as long as 21 years, unless she remarries prior to age 65.
- His support obligation for Jordan will last for 11 years.
- Their mortgage will be paid off in 18 years.

Permanent needs:

- He would like to be able to donate $100,000 to the local hospice centre upon his death, regardless of when that death occurs.
- The tax liability on the cottage inheritance will not arise until his death, which hopefully will not be for another 30, 40 or even 50 years.

11.4.2 Investment needs

If the client has maxed out his RRSP and TFSAs and is looking for additional tax deferral opportunities, or an opportunity to transfer wealth to the next generation, then a whole life or universal life insurance policy may be a reasonable option.

CASE STUDY

Derek and Becky are not maximizing their RRSPs, and they are only making contributions to their TFSAs in years when Derek has a bonus.

Their only current investment program involves their RESPs for the children. As a result, they do not appear to need additional investment opportunities.

11.4.3 Cash flow vs. premiums

Sometimes a trade-off will be needed between the ideal type or amount of insurance, and the cash flow available to pay the premiums. If cash flow is limited, it is unlikely that the client will be able to afford the premiums required for permanent insurance at this time. However, if income is expected to increase in the future, that client may want to ensure that his term insurance includes a conversion option, which will allow him to convert to permanent coverage at a later date.

If cash flow is generally adequate but fluctuates from time to time, a universal life policy that allows the policyholder to adjust premiums to some degree may be a good option.

CASE STUDY

Recall in the Chapter 10 *Assessing the client's situation*, it was determined that the family has current monthly expenses of $8,560, while Derek's take-home pay was $8,400 per month and his after-tax investment income was $600. As long as his non-registered investment portfolio continues to provide the same level of income, it appears that the family has about $440 per month to potentially spend for insurance purposes. Derek had also noted that his take-home pay might increase to $9,500 in 2 years, when he hopes to be promoted to chief operating officer. This would increase their cash flow in the future.

11.4.4 Coverage for spouse or dependents

If the rest of the family does not have sufficient life insurance coverage, there may be an opportunity to cover them under the same policy. For example:

- Some or all of the insurance could be done on a joint-first-to-die or joint-last-to-die basis on both spouses;
- The spouse and/or children could be covered under a family life rider.

CASE STUDY

Derek and Becky do not currently have any insurance on Becky's life, or any of the children. Ideally, he would like coverage of at least $150,000 on Becky's life to help pay for childcare until the children are all in school full-time, and $10,000 on each of the children.

11.5 Making the recommendation

Once the life agent has compiled all of this qualitative and quantitative information, he should be ready to assess various life insurance options and develop a recommendation.

11.5.1 Type of coverage

The first step is to determine the life or lives insured, the type of coverage (term, whole life or UL) and, for term insurance, the appropriate term.

CASE STUDY

Derek's risks can be roughly categorized into three categories:

- Those that will disappear in about 10 years (child support for Jordan, car loan);
- Those that will disappear in 20 to 25 years (mortgage, income shortfall for Becky, spousal support);
- The tax liability on the inheritance of the cottage, which will be a permanent concern;
- The donation to hospice, which will be a permanent concern.

From this, it would appear that Derek could use a combination of 20-year and/ or 10-year term insurance policies to cover all needs except the tax liability on the cottage and the donation to hospice. A cumulative cost comparison will be required to determine the most cost-effective option for him.

Whole life insurance would be more appropriate than universal life for the tax liability and the donation to hospice because at this point in time, Derek is not looking for additional investment opportunities and cash flow is limited.

Note that while a joint-last-to-die policy is often used to cover the tax liability on a family asset being left to the children, it is not appropriate in this case because the cottage is to be held in trust for the children if Derek dies; there is no opportunity to roll it over to Becky and defer the taxable capital gain until her death. Therefore, all of Derek's life insurance should be on a single life basis.

The coverage on Becky and children should be some form of term life insurance, and can be done via an individual policy on Becky with a child life rider, or as a family life rider on one of Derek's policies. Both options will be compared shortly.

11.5.2 Death benefits

If several types of policies are recommended, the next step is to determine the benefit for each policy.

CASE STUDY

It has been determined that Derek needs a total of $760,000 in additional life insurance. This could be broken down as follows:

- While the taxability on the cottage is estimated to be $78,750 based on its current value, Derek is concerned the tax liability could be much higher because he expects the cottage to continue to appreciate in value. As a result, an amount of $200,000 for the permanent insurance policy would be appropriate to cover the cottage tax liability plus the $100,000 hospice donation. Selecting the paid-up additions (PUA) option for any dividend payments would provide further protection against increasing cottage values.

- Of the other financial needs, 2 of them will end within the next 10 years ($132,000 in child support for Jordan and the car loan of $41,000). A $180,000 Term-10 policy should be used to cover these needs.
- The balance of $380,000 ($760,000 – $200,000 – $180,000) could be covered by either by a Term-20 policy, or a renewable Term-10 policy. A cost analysis should be performed to determine which would be most cost effective in the long run.

Term coverage lasting at least five years is also needed on Becky's life, plus $10,000 term coverage on each of the 3 children. Derek also wanted to consider whether he should replace his existing $250,000 Term-10 policy before it is up for renewal in 2 years.

11.5.3 Premiums

Once the amounts and types of insurance have been identified, it is time to provide premium quotes on the recommended coverage.

CASE STUDY

Based on Derek's current age, health and smoking status, the following monthly rates[42] would apply per $100,000 of coverage:

- Whole life with PUA, $325 for life.
- Term-10 renewable to age 85, $33 for first 10 years, $183 at age 57, $435 at age 67, $925 at age 77.
- Term-20 renewable to age 85, $60 for first 20 years, $540 at age 67.

Cost of new insurance needed on Derek

- For the cottage liability and hospice donation, the $200,000 of whole life insurance will cost $650 per month.
- Derek has total term insurance needs of $560,000 ($760,000 – $100,000 (cottage) – $100,000 (hospice donation):
  - $180,000 of coverage for his shorter term needs (i.e., child support and car loan will end within 10 years);

42. For ease of reading, the amounts have been rounded up.

- $380,000 ($760,000 – $200,000 – $180,000) in longer-term needs (i.e., spousal support, mortgage and Becky's income shortfall will end in about 20 years).

So should Derek use renewable 10-year term (T-10), 20-year term (T-20), or a combination of both to cover these term needs? Performing a cumulative cost analysis can help here, as shown in the following table.

At this point it is necessary to compare $560,000 of T-10 (Option A) or T-20 (Option B) renewable, dropping to $380,000 of coverage upon renewal, when his needs will have dropped. Remember, the premiums upon renewal will have already been set when he buys the policy. The cumulative cost analysis is provided below.

(A) Option A – All T-10 renewable: ($560,000 for first 10 years, dropping to $380,000 for next 10 years)

(B) Option B – All T-20 renewable: ($560,000 for first 10 years, dropping to $380,000 for next 10 years)

Year	Age	T-10 Face amount (A)	Monthly premium per $100,000 of T-10 (A)	Annual cost (A)	Cumulative cost (A)	T-20 Face amount (B)	Monthly premium per $100,000 of T-20 (B)	Annual cost (B)	Cumulative cost (B)
1	47	$560,000	$33	$2,218	$2,218	$560,000	$60	$4,032	$4,032
2	48	$560,000	$33	$2,218	$4,435	$560,000	$60	$4,032	$8,064
3	49	$560,000	$33	$2,218	$6,653	$560,000	$60	$4,032	$12,096
4	50	$560,000	$33	$2,218	$8,870	$560,000	$60	$4,032	$16,128
5	51	$560,000	$33	$2,218	$11,088	$560,000	$60	$4,032	$20,160
6	52	$560,000	$33	$2,218	$13,306	$560,000	$60	$4,032	$24,192
7	53	$560,000	$33	$2,218	$15,523	$560,000	$60	$4,032	$28,224
8	54	$560,000	$33	$2,218	$17,741	$560,000	$60	$4,032	$32,256
9	55	$560,000	$33	$2,218	$19,958	$560,000	$60	$4,032	$36,288
10	56	$560,000	$33	$2,218	**$22,176**	$560,000	$60	$4,032	**$40,320**
11	57	$380,000	$183	$8,345	$30,521	$380,000	$60	$2,736	$43,056
12	58	$380,000	$183	$8,345	$38,866	$380,000	$60	$2,736	$45,792
13	59	$380,000	$183	$8,345	$47,210	$380,000	$60	$2,736	$48,528
14	60	$380,000	$183	$8,345	$55,555	$380,000	$60	$2,736	$51,264
15	61	$380,000	$183	$8,345	$63,900	$380,000	$60	$2,736	$54,000
16	62	$380,000	$183	$8,345	$72,245	$380,000	$60	$2,736	$56,736
17	63	$380,000	$183	$8,345	$80,590	$380,000	$60	$2,736	$59,472
18	64	$380,000	$183	$8,345	$88,934	$380,000	$60	$2,736	$62,208
19	65	$380,000	$183	$8,345	$97,279	$380,000	$60	$2,736	$64,944
20	66	$380,000	$183	$8,345	**$105,624**	$380,000	$60	$2,736	**$67,680**

Clearly if only one policy is to be used, the T-20 policy (Option B) works out better than the T-10 policy (Option A) in the long run, with a cumulative cost of $67,680 over 20 years, compared to $105,624 for the T-10 policy. However, notice the cumulative costs for each policy after the first 10 years, before the coverage drops to $380,000. At 10 years, the T-10 policy is the clear winner, with a cumulative cost-to-date of $22,176, compared to $40,320 for the T-20 policy. This reversal suggests that a combination of policies may be in Derek's best interests.

At this point a cumulative cost comparison is useful between:

- Using a T-20 policy for the entire $560,000, dropping to $380,000 after 10 years (Option B as shown in the Table above); and
- Using a combination of a T-10 policy for the shorter term needs of $180,000, along with a T-20 policy of $380,000 to cover the longer term needs (Option C, shown below).

COMBINATION OF TWO POLICIES ($180,000 T-10 for first 10 years, plus $380,000 T-20 for 20 years)

Year	Age	T-10 Face amount	Monthly premium per $100,000 of T-10	Annual cost for T-10 policy	T-20 Face amount	Monthly premium per $100,000 of T-20	Annual cost for T-20 policy	Total annual cost (T-10 + T-20)	Total cumulative cost (T-10 + T-20)
1	47	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$3,449
2	48	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$6,898
3	49	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$10,347
4	50	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$13,796
5	51	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$17,245
6	52	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$20,694
7	53	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$24,143
8	54	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$27,592
9	55	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$31,041
10	56	$180,000	$33	$713	$380,000	$60	$2,736	$3,449	$34,490
11	57	$0	$183	$0	$380,000	$60	$2,736	$2,736	$37,226
12	58	$0	$183	$0	$380,000	$60	$2,736	$2,736	$39,962
13	59	$0	$183	$0	$380,000	$60	$2,736	$2,736	$42,698
14	60	$0	$183	$0	$380,000	$60	$2,736	$2,736	$45,434
15	61	$0	$183	$0	$380,000	$60	$2,736	$2,736	$48,170
16	62	$0	$183	$0	$380,000	$60	$2,736	$2,736	$50,906
17	63	$0	$183	$0	$380,000	$60	$2,736	$2,736	$53,642
18	64	$0	$183	$0	$380,000	$60	$2,736	$2,736	$56,378
19	65	$0	$183	$0	$380,000	$60	$2,736	$2,736	$59,114
20	66	$0	$183	$0	$380,000	$60	$2,736	$2,736	**$61,850**

The cumulative cost of this combination of policies over 20 years is only $61,850, compared to the $69,120 over 20 years for a single T-20 policy, or a savings of about 10%.

So given that Derek has 2 very distinct coverage periods (e.g., 10 years and 20 years) and is certain that some of his insurance needs are short term only, then a combination of T-10 and T-20 policies will be more cost effective in the long run. However, if he feels that his insurance needs may remain the same or even increase in the future, he may want to consider covering the entire amount with a single T-20 policy.

Note that while spreadsheets help illustrate the point, the cumulative cost comparisons can usually be done very simply using a calculator, as follows:

Option A

Single $560,000 renewable T-10 policy, dropping to $380,000 after 10 years

1st 10 years = $560,000 ÷ $100,000 × $33/month × 12 months × 10 years = $22,176

2nd 10 years = $380,000 ÷ $100,000 × $183/month × 12 months × 10 years = $83,448

Cumulative cost over 20 years = $22,176 $ + $83,448 $ = $105,624

Option B

Single $560,000 T-20 policy, dropping to $380,000 after 10 years

1st 10 years = $560,000 ÷ $100,000 × $60/month × 12 months × 10 years = $40,320

2nd 10 years = $380,000 ÷ $100,000 × $60/month × 12 months × 10 years = $27,360

Cumulative cost over 20 years = $40,320 + $27,360 = $67,680

Option C

$180,000 T-10 policy for 10 years, plus $380,000 T-20 policy for 20 years

T-10 policy = $180,000 ÷ $100,000 × $33/month × 12 months × 10 years = $7,128

T-20 policy = $380,000 ÷ $100,000 × $60/month × 12 months × 20 years = $54,720

Cumulative cost of 20 years = $7,128 + $69,120 = $61,848

Replace Derek's existing $250,000 policy?

Derek has an existing $250,000 Term-10 policy that is due to renew in 2 years. He was shocked to realize how much the premiums will increase upon renewal (from $250 per year to $1,125 per year). Derek heard that it is often cheaper to shop for a new policy, rather than renew the old one, so he asked his agent to determine the cost of replacing his old policy.

The results are provided in the table below, which shows that Derek would be better off keeping his existing policy. The reason the results were disappointing for Derek was that he became a smoker after the original policy was issued. The old policy will remain valid, even though Derek is a now a smoker. This is one of the reasons premiums jump so much upon renewal, because the life insured may no longer be in the fine health he was when the policy was first issued.

Cumulative cost comparison, existing and new $250,000 policies

Year	Age	CURRENT POLICY (Annual premium)	CURRENT POLICY (Cumulative cost)	NEW POLICY (Annual premium)	NEW POLICY (Cumulative cost)
1	47	$250	$250	$990	$990
2	48	$250	$500	$990	$1,980
3	49	$1,125	$1,625	$990	$2,970
4	50	$1,125	$2,750	$990	$3,960
5	51	$1,125	$3,875	$990	$4,950
6	52	$1,125	$5,000	$990	$5,940
7	53	$1,125	$6,125	$990	$6,930
8	54	$1,125	$7,250	$990	$7,920
9	55	$1,125	$8,375	$990	$8,910
10	56	$1,125	$9,500	$990	$9,900
11	57	$1,125	$10,625	$5,490	$15,390
12	58	$1,125	$11,750	$5,490	$20,880
13	59	$2,625	$14,375	$5,490	$26,370
14	60	$2,625	$17,000	$5,490	$31,860
15	61	$2,625	$19,625	$5,490	$37,350
16	62	$2,625	$22,250	$5,490	$42,840
17	63	$2,625	$24,875	$5,490	$48,330
18	64	$2,625	$27,500	$5,490	$53,820
19	65	$2,625	$30,125	$5,490	$59,310
20	66	$2,625	$32,750	$5,490	$64,800

Insurance for Becky and the children

Derek wants to obtain $150,000 of life insurance coverage on Becky's life, and $10,000 on each of the children. This can be accomplished in one of two ways:

- Buying a standalone $150,000 Term-10 insurance policy on Becky, with a $10,000 child-life rider, which would have a total monthly premium of $23.54;
- Adding a family life rider to his whole-life insurance policy, with $150,000 of Term-10 coverage on Becky and $10,000 each on the children, which would have a total monthly premium of $19.04.

The standalone policy is more expensive because it has a separate policy administration fee; this fee is not charged when the coverage is added as a rider to Derek's whole life policy.

Total costs

The total monthly cost of the recommended additional insurance is $956, as shown below.

Insurance coverage	Initial monthly premium
$200,000 whole life policy on Derek	$650
Family coverage rider of $150,000 on Becky and $10,000 on each child	$19
$180,000 Term-10 on Derek	$59
$380,000 Term-20 on Derek	$228
Total	**$956**

This exceeds the $440 the family currently has in available cash flow, so they will have some decisions to make. A few of the possibilities include:

- Reducing the amount of coverage, and accepting the fact that Becky may have to return to work before Robbie turns 18, and Derek will not be able to leave $100,000 to his favourite charity;
- Obtaining term insurance with a conversion option for the tax liability on the cottage and the hospice donation, which would allow Derek to convert to permanent insurance once cash flow permits;
- Scaling back on their other expenditures to increase the amount of cash flow they can devote to life insurance;
- Depending on the policy of their insurance company, Derek may be able to apply for a decrease in premiums if he is able to stop smoking for at least a year.

11.5.4 Beneficiaries

The agent may offer a recommendation on who should be named as beneficiary of the policy, based on his understanding of the client's unique situation and objectives.

11.5.4.1 Primary and contingent

The applicant is required to specify one or more primary beneficiaries on the insurance application. Primary beneficiaries will receive the death benefit as long as they survive the life insured. Some examples include:

- If the funds are to be used to pay income taxes due upon death, the estate may be an appropriate beneficiary;
- If the funds are to be used to provide a replacement source of income to the surviving family, then the spouse may be an appropriate beneficiary;
- If the funds are to be used to support minor children, then a trustee should be named to manage the funds until the children reach the age of majority.

Note that it is possible to name more than one primary beneficiary. If multiple primary beneficiaries are listed without additional instructions, then the death benefit will be divided equally among them. However, it is also possible to allocate different amounts to each beneficiary.

CASE STUDY

With his $180,000 term life insurance policy, Derek could name Becky the beneficiary of $50,000 in order to reimburse his car loan and a testamentary trust as the beneficiary of $130,000, to provide child support for Jordan, with any remaining amount to be paid to Becky when Jordan turns 18.

The agent should also encourage the applicant to specify one or more contingent beneficiaries. If the primary beneficiary does not survive the life insured, then the death benefit will pass to the contingent beneficiary. If no contingent beneficiary is named, then the death benefit will be paid to the policyholder, or if the policyholder is also the life insured, to his estate.

CASE STUDY

If Derek names Becky as his beneficiary, he may want to name a testamentary trust for the children as a contingent beneficiary. If he and Becky die simultaneously, this will keep the funds from being part of his estate and being subject to probate.

11.5.4.2 Revocable or irrevocable

In most Canadian jurisdictions, beneficiary designations are automatically revocable unless the application specifies otherwise. In Quebec, however, if the policyholder designates his spouse as the beneficiary, it is automatically irrevocable, unless the policyholder specifies that it is revocable when he first designates the spouse as his beneficiary.

There are only a few situations where the agent might recommend an irrevocable beneficiary designation, such as when:

- It is a requirement of a spousal or child support court order;
- There is a need to protect the insurance proceeds from creditors;
- It is being used to implement a tax strategy in connection with charitable giving.

11.5.4.3 Probate implications

Note that if the estate is named the beneficiary or if the estate becomes the beneficiary because the specified beneficiaries did not survive the life insured, then the death benefit will be subject to probate. In jurisdictions with high probate fees, it is usually desirable to name someone other than the estate as the beneficiary, but only if this is practical.

If the proceeds are to be used to pay income taxes or other amounts payable by the estate, then the estate may still be the appropriate beneficiary, despite the probate fees that will result. Remember that the highest probate fees are still only in the order of 1.5%. Therefore the desire to avoid probate should not be allowed to overtake good planning.

Note also that when an estate is subject to probate, the contents of the estate and the terms of the will become public knowledge. Therefore, naming the estate as the beneficiary of an insurance policy means that the death benefit becomes a matter of public record. This increases the chance that someone might contest the distribution of the death benefit to its intended beneficiary.

11.5.5 Highlighting important clauses

When reviewing a new policy, the life agent should ensure that the policyholder is aware of, and understands, certain key provisions. These are covered in more detail in the Module *Ethics and professional practice*.

11.5.5.1 Exclusions

If the policy was issued with a specific exclusion, the agent should ensure that the policyholder understands that if death occurs and is subject to that exclusion, the death benefit will not be paid. The life insured must then make a choice – either avoid partaking in the excluded activity, or accept the fact that the death benefit will not be paid if that activity results in death.

EXAMPLE

Anne-Marie is an avid photographer and frequent traveller. When the insurance company inquired about her travels, she had disclosed that her most recent places of travel included Ethiopia, India and South Africa. The policy was issued with an exclusion for death while travelling to Ethiopia, because of the perceived high incidence of disease and conflict at that time. The death benefit will be paid as long as her death does not occur in Ethiopia, and cannot be linked to an illness acquired from her travels there.

Suicide

All policies have a two-year exclusion period for deaths that occur as a result of suicide. This means that if the life insured dies by suicide within the first two years after the policy is issued or reinstated, the death benefit will not be paid.

11.5.5.2 Incontestability

For the first two years of a life insurance contract, the insurance company can re-evaluate its underwriting of the policy. If it discovers that a material mistake was made in the application for coverage, the insurance company has the option of adjusting the premiums, adding exclusions or voiding the policy. Thus, the policy is said to be contestable during the first two years. Reinstated policies are also contestable for the first two years following reinstatement.

Once this contestability period has expired, the policy is said to be incontestable. This means that the insurance company cannot cancel the policy for any reason other than missed premiums, or fraudulent misrepresentation.

11.5.5.3 Grace period

All policies provide a grace period for premium payments, usually 30 or 31 days after the date the premium is due. As long as the policy premium is received by the insurance company within the grace period, the policy will remain in force. However, if payment is still outstanding after expiry of the grace period, and the policy is not a permanent policy with an automatic premium loan feature, then the policy will lapse, and coverage will no longer be in force.

If the life insured dies during that grace period, the death benefit will still be paid, but it will be reduced by the amount of the outstanding premium.

The COVID-19 pandemic resulted in significant job loss throughout Canada and some policyholders were finding it impossible to pay their premiums. Many insurers responded empathetically by extending their grace periods to as long as 90 days, and providing the option to spread missed payments out over a year or more to ensure that policyholders did not lose their coverage as a result of the pandemic.

11.5.5.4 Reinstatement

If the policyholder does allow the policy to lapse, most life insurance contracts allow him to reinstate that policy within two years of that lapse, as long as he can provide proof of insurability and he pays all missed premiums, plus accrued interest.

While reinstatement requires proof of insurability, there may still be an advantage in choosing reinstatement and paying the missed premiums, instead of just applying for a new policy. This is because the premiums on the reinstated policy will be based on the age of the life insured when the policy was first issued or last renewed, while premiums for a new policy would be based on his age at the time the new policy is issued.

EXAMPLE

Barry bought a $250,000 20-year renewable term life insurance policy when he was 38 years old, and the policy premiums were $35 per month. When Barry was 50, he missed three monthly payments in a row and the policy lapsed 31 days after the first missed payment.

When he discovered his error, Barry considered buying a new life insurance policy. He was shocked to learn that the premiums on the new policy would be $150 per month, because the premiums would be based on his current attained age of 50. Fortunately for Barry, he was still in excellent health, and he was able to reinstate his old policy by paying the $105 in missed premiums, plus accrued interest.

Note that when a policy is reinstated, the two-year contestability and suicide exclusion periods apply from the date of the reinstatement.

11.5.5.5 Right of rescission

The agent should ensure that the policyholder understands his right of rescission once the policy is issued. This refers to the 10-day free-look period, which gives the policyholder 10 days to review the policy after receipt of a new policy. During this time, the policyholder can choose to return it to the insurance company and he will receive a full refund of all premiums paid.

11.5.5.6 Expiry

Term policies have an inherent expiry date, meaning that coverage will cease at the end of the term, unless the policy is renewable.

11.5.5.7 Surrender charges

For universal life insurance policies, the life agent should ensure that the policyholder understands any surrender charges that may be applied if the policy is cancelled or a partial withdrawal is made. Usually these surrender charges only apply during the early years of the universal life policies.

11.6 Using illustrations

Illustrations are commonly used to help the client understand the recommended policy, and they are often appended to the life insurance application so that the insurance company's underwriters have a clear picture of the coverage being applied for.

In the case of a term policy, the illustration just shows the premiums payable and the death benefit in each policy year. For permanent insurance policies, the illustrations are more complex, in that they also include projections of future policy dividends, mortality deductions, investment account values, and cash surrender values for each policy year. However, these projections are only intended to demonstrate how the policy works, and are not a prediction of guaranteed or expected performance.

Participating whole life and universal life policy outcomes are very sensitive to even small changes in investment performance, particularly over the long life of these policies. To highlight this sensitivity, most policy illustrations now include projections for at least two investment return scenarios. Agents must ensure that policyholders understand that the projections are not predictions of future performance. In fact, the policyholder is typically required to sign the illustration, acknowledging that he understands the limitations of the illustration.

In addition to the official policy illustrations generated by the insurance company's software, agents may find it useful to develop their own simple spreadsheets to compare products or insurance options, such as those provided earlier in the case study above.

CHAPTER 12
ONGOING SERVICE

Competency Component

- Provide customer service during the validity period of coverage.

Competency sub-components

- Validate the appropriateness of contract amendment, renewal and termination applications in regards to the client's situation;
- Inform the claimant of the claims process.

12
ONGOING SERVICE

Once a life insurance policy is issued, the life insurance agent still has a role to play, providing ongoing service.

12.1 Monitoring changing client needs

An individual's insurance needs are rarely static and, if possible, the agent should schedule periodic reviews with existing clients to determine if a change in coverage is warranted. Some of the life events that may impact insurance needs are discussed below:

- New dependants;
- Marriage;
- Divorce;
- Employment changes;
- New mortgage;
- Acquiring a business;
- Leaving Canada;
- Updated needs analysis and appropriate recommendations.

12.1.1 New dependants

When a new dependant, such as a new baby, enters the family of the life insured, the need for life insurance usually increases accordingly. The life insured will want to ensure his estate will be sufficient to provide for that dependant in the event of his death. Typically this is done by increasing the amount of coverage.

The policyholder may also want to acquire coverage on the life of the new dependant, either by acquiring a new life insurance policy on that life, or by adding a family rider to an existing policy. If the policy already has a family rider, usually it automatically covers a new baby 14 or 15 days following birth.

12.1.2 Marriage

Marriage can prompt a number of insurance-related changes. For example:

- A newly married policyholder may want to change the beneficiary designation of an existing policy in favour of his new spouse.

- If the new spouse is financially dependent on the policyholder, he may wish to acquire additional coverage to ensure this financial support can continue if he dies.
- Marriage often leads to the birth of a child, and life insurance can be used to ensure the child is financially supported if one of his parents dies.

12.1.3 Divorce

While divorce generally revokes an ex-spouse's entitlement under an existing will, in most jurisdictions it does not automatically revoke the beneficiary designation on a life insurance policy. However, The *Civil Code of Québec* states that a pre-divorce beneficiary designation on a life insurance policy is nullified upon divorce. Thus the policyholder should review life insurance beneficiary designations upon divorce, to ensure they reflect any changes in his wishes or intentions as a result of that divorce.

If the policyholder is required to pay spousal or child support according to a settlement agreement, often that agreement will specify that he must obtain life insurance to ensure the support will be provided even in the event of his death. To further protect the interests of the recipient spouse or child, the settlement agreement may also specify that the policyholder cannot allow the policy to lapse, and cannot change the beneficiary without consent (i.e., the beneficiary designation must be irrevocable).

12.1.4 Employment changes

When a client experiences a change in employment, insurance needs should be reviewed for a number of reasons, such as:

- The new employer may offer less group life insurance than the previous employer, so the client may need additional coverage;
- There may be an opportunity to convert the group life insurance at the previous employer to individual coverage, usually within 30 days after leaving the group plan;
- If the client's insurance needs are determined using a human capital approach, any increase in income resulting from the job change should be reflected in the amount of insurance coverage;
- A change in occupation may result in a better lifestyle rating, which generally may provide an opportunity to obtain life insurance at a lower rate.

12.1.5 New mortgage

If a client buys a house with a mortgage, or refinances an existing mortgage, the lender may require him to obtain life insurance to cover the debt. Even if the lender does not make this a requirement, many families opt to buy enough life insurance to pay off the mortgage upon death of the borrower, to lessen the financial burden on the surviving family.

12.1.6 Acquiring a business

Clients who become business owners may want to buy life insurance to:

- Fund a buy-sell agreement;
- Cover a key employee;
- Protect their wealth from creditors of that business;
- Secure a business loan.

12.1.7 Leaving Canada

If an existing policyholder plans to move to another country and he will cease to be a Canadian resident, it is important to review the terms and conditions of the existing life insurance policy. Some policies are only valid if the life insured is resident in Canada, or they include an exclusion if the death occurs in certain countries.

12.1.8 Updated needs analysis and recommendations

When meeting with an existing client with changing needs, ideally the life agent will review the previous life insurance needs analysis, and update it to reflect the changing needs. This ensures that any issues identified in the original needs analysis are carried forward and not forgotten.

The life agent will then be in a position to recommend changes to life insurance coverage if necessary, which could include things such as:

- Modifying the amount of coverage;
- Converting term insurance to permanent insurance (refer to the Section *Replacing an insurance policy* later in this Chapter);
- Changing the beneficiary designations on existing coverage;
- Adding a life insured to the policy, or adding a family coverage rider.

12.2 Amending a policy

There are two general categories of amendments or changes that may be possible on an existing life insurance contract – those that do not require additional underwriting (which are typically administrative in nature), and those that do.

12.2.1 Administrative changes

A policyholder can request most administrative changes by contacting the insurance company in writing, or by filling out the prescribed form. These administrative changes might include changing the:

- Legal name of the policyholder, life insured or beneficiaries, without actually changing the parties to the contract (e.g., changing last name as a result of marriage or divorce);
- Mailing address;
- Beneficiary designations;
- Premium amount (for universal life (UL) policies);
- Payment frequency;
- Fund choices.

When contacted by the policyholder about these types of changes, the life agent can often direct the policyholder to the insurance company's website to obtain the necessary forms. However, he may also be able to use these contact points as an opportunity to meet the client.

12.2.2 Changes requiring underwriting

The life agent can help with the more substantial changes that usually require additional underwriting, such as:

- Adding a life insured;
- Adding a rider or supplementary benefit;
- Increasing coverage;
- Changing smoking status;
- Changing health status or lifestyle category;
- Changing the dividend option on a par policy to paid-up additions;
- Changing the type of death benefit (e.g., from level death benefit, to level death benefit plus account value).

12.3 Renewing a policy

Renewable policies renew automatically at the end of the term, without requiring new evidence of insurability. The term upon renewal is the same as the original term. For example, if a 10-year renewable policy was issued at age 35, it would renew for another 10 years at age 45, and another 10 years at 55, until the maximum age specified by the policy.

The new premiums upon renewal will reflect the age of the life insured on the renewal date. Most policies provide a schedule of guaranteed renewal rates when the policy is first issued.

EXAMPLE

Kevin bought a $500,000 10-year renewable term insurance policy when he was 35 years old, and the initial premiums were $450 per year. The policy will automatically renew at age 45, 55, and 65, with annual premiums of $2,250, $5,250 and $13,700 respectively.

The guaranteed rates upon renewal may be significantly higher than the rates being offered on new policies with the same term, particularly if the life insured is in excellent health. This is because at the time of issue, the insurance company had no way of knowing what the health of the life insured would be upon renewal. Based on the phenomenon of adverse selection, those who have experienced a decline in health would be more likely to renew the policy than those in good health. As a result, while the rate for the initial term reflects the health of the life insured at policy issue, the guaranteed rate upon renewal tends to reflect the health of the average life insured.

Therefore, policyholders who are still in good health will often shop around for replacement coverage just prior to renewal, to determine if better rates are available. The policyholder must however take into account that a new policy will include incontestability and suicide clauses that last a period of two years.

EXAMPLE (CONT.)

Kevin is approaching the 10th anniversary of his policy and he decided to apply for a new $500,000, 10-year renewable term policy. He is still in good health, and was pleased to learn that the premiums would be only $770 per year, substantially less expensive than the guaranteed renewal rate of $2,250 on his existing policy. Once the new policy is in place, Kevin will cancel his existing policy.

12.4 Replacing a policy

Because the life agent earns a commission whenever he places a new policy, there is a potential conflict of interest whenever that new policy replaces an existing life insurance contract. The life agent's fiduciary duty requires that he only recommend replacing an existing life insurance contract with a new contract, when doing so is clearly in the best interests of the client.

12.4.1 Churning and twisting

A life agent fails this fiduciary duty if he deliberately uses misrepresentations, incomplete information or false statements to convince the policyholder to:

- Replace an existing life insurance policy with a new one;
- Withdraw the cash accumulated within an existing policy and use those proceeds to buy a new policy.

This deliberately deceitful practice is called "churning"; it takes place when the existing policy and the new policy are with the same insurance company. If the existing and new policies are with different insurance companies, the practice is called "twisting."

12.4.2 Disclosure requirements

To protect consumers from churning and twisting, most jurisdictions require the policyholder to receive and sign a life insurance replacement declaration (LIRD), as shown in Document 12.1.

DOCUMENT 12.1

Standard Life Insurance Replacement Declaration (LIRD)[43]

Life Insurance Replacement Declaration

Do not cancel your existing policy until the new policy is in force and you accept it.

Before you cancel your life insurance policy you should have answers to the questions below. Ask any insurance agent or broker, or an independent person, for help if you need it.

Questions about your present life insurance policy

1. Why do you want to replace your policy? Is the new policy better for you? How?
2. Should you just buy more insurance or change your policy? How much will these changes cost?
3. When should you cancel your present policy? When is your next annual dividend paid? Will the timing affect your cancellation charges?
4. Will you pay more income tax if you cancel your present policy?

Questions on the advantages and disadvantages of a new life insurance policy

1. Do you understand the type of insurance policy you are buying? Is it a *term life, whole life,* or *universal life* insurance policy? You should know the differences.
2. Are there times when the new policy will not pay all the benefits that your present policy does? Examples are suicide and contestable periods and contractual exclusions.
3. Will the new policy pay as much as your present policy? Examples are death benefits, cash values, and dividends.
4. Does the new policy have the same extra, or optional, benefits as your present policy? Examples are waiver of premium, guaranteed insurability, accidental death, and family member riders.
5. Are there cancellation charges on the new policy?
6. What guarantees apply to your present and proposed policies? Which policy has the best guarantees?
7. Will either of the policy premiums (payments) go up? For how long will the premiums stay the same? How much will they increase?

***Important*: Please ensure that the agent or broker provides you with copies of the written explanation of the advantages and disadvantages of replacing your life insurance policy with a new policy.**

I confirm that I have received this Life Insurance Replacement Declaration.

_________________________ _______________________

Client's signature Date

I have given the client this document and a written explanation of the advantages and disadvantages of replacing their life insurance policy, before starting the application for a new policy.

_________________________ ________________________

Agent or broker's signature Date

Note: Your agent or broker should deliver and review the new policy with you. If the policy is not satisfactory for any reason, you may have a right to reject it and receive a full refund of premiums, under provincial or territorial law or under contract. Check the policy and the law for the right of rejection and the time limit for rejection.

43. Canadian Council of Insurance Regulators. Life Insurance Replacement Declaration. [online]. Revised 2010. [Consulted May 9, 2022]. https://www.ccir-ccrra.org/Documents/View/2652 (English version) or https://www.ccir-ccrra.org/Documents/View/3066 (French version)

The LIRD must be accompanied by a written explanation that specifies:

- Why the policy is being replaced;
- How the new policy benefits the policyholder;
- Any situations where benefits under the new policy may not be paid.

The Canadian Life and Health Insurance Association (CLHIA) published a useful guide in August 2014, called *A guide to preparing the written explanation required for the life insurance replacement declaration*,[44] which includes several useful samples for replacing different policy types.

In Québec, the life agent must provide the client with a form called *Notice of Replacement of Insurance of Persons Contract*,[45] which acts much like the LIRD required in other jurisdictions.

12.4.3 Cancelling the contract being replaced

It is absolutely imperative that the policyholder keep the existing policy in force until after the new policy has been issued, delivered and accepted. If he cancels the existing policy before the new policy is in force, he runs the risk of being without life insurance if the new policy is not issued.

12.5 Cancelling a policy

A policyholder may decide to cancel an existing life insurance policy for a number of reasons, such as:

- He no longer needs the protection;
- He needs a different type of policy (e.g., whole-life coverage instead of term);
- He could obtain a better rate with a new policy, compared to renewing the existing policy;
- He can no longer afford the premiums.

Theoretically, a policyholder can cancel a term insurance policy by simply stopping to pay the premiums and letting the policy lapse. Stopping the premiums on a whole life or universal life policy may not have the same effect, if the policy has a cash value or an accumulating fund that the insurance company can withdraw premiums from.

Regardless of the type of policy, it is better for the policyholder to cancel the policy in writing, either on a form supplied by the insurance company, or in a letter. The letter should specify the policy

44. For more information, consult: http://omfinancial.com/wp-content/uploads/2018/06/Replacement-Disclosure.pdf or https://www.clhia.ca/web/clhia_lp4w_lnd_webstation.nsf/page/37FDDA06D06C2F168525811D0068C93E [Consulted May 9, 2022].
45. For more information, consult: https://lautorite.qc.ca/fileadmin/lautorite/formulaires/professionnels/assureurs/preavis-remplacement-contrat-assurance-personnes_an.pdf [Consulted May 9, 2022].

number, the policyholder's name, the name of the life insured if different, and the date he wants coverage to stop.

If the policy is cancelled between policy anniversaries, the insurance company will generally refund a prorated portion of the premiums paid.

12.6 Surrendering a policy

When the policyholder of a whole life or universal life insurance policy cancels the insurance contract, it is more commonly referred to as fully surrendering the policy. When the policyholder fully surrenders a policy, he is giving up all rights under the contract. No death benefit will be paid once he surrenders the policy.

He can also partially surrender the policy by making a withdrawal from the policy's cash value. In this case, the contractual rights under the policy continue, which means that a death benefit will be paid if the life insured dies after that withdrawal.

Note that fully or partially surrendering a policy can result in taxable income for the policyholder, as discussed in Chapter 7 *Taxation of life insurance and tax strategies*.

12.7 Policy assignments

A policyholder can choose to assign some or all of his rights under an insurance policy to another party.

12.7.1 Absolute policy assignment

Under an absolute assignment, the policyholder transfers the legal title of the contract, including all rights and obligations, to the assignee or recipient. Once the transaction is completed, the original policyholder has no further control or financial interest in the policy.

The requirements to complete an absolute assignment are often contained within the policy itself. For example, the policy may specify that:

- The assignment is not binding unless the prescribed assignment form is signed and filed at the insurance company's head office;
- The insurance company assumes no obligation as to the effect, sufficiency or validity of the assignment;
- The assignment is subject to any indebtedness to the insurance company on that policy.

Recall from Chapter 7 *Taxation of life insurance and tax strategies*, that an absolute assignment is a deemed disposition for tax purposes and could result in taxable income for the transferor.

12.7.2 Partial policy assignment

In all parts of Canada other than Québec, the use of a life insurance policy as security for a loan requires the policyholder to execute a collateral assignment. This normally takes the form of a partial assignment where, as the assignee, the lender does not become the owner of the policy, and the policyholder still owns the policy. However, the assignment allows the lender to prevent the policyholder from undertaking any action that would diminish the lender's security, such as making a policy withdrawal, or failing to remit premiums.

If the loan is still outstanding when the life insured dies, then the lender has first rights on the death benefit, up to the amount of the loan outstanding. If the policyholder defaults on the loan while the life insured is alive, the lender can force a surrender of the policy, in order to recover the unpaid loan balance.

In Québec, a moveable hypothec is required to use a life insurance policy as collateral. Like a collateral assignment, the moveable hypothec does not involve the transfer of policy ownership. However, it provides security for the loan by giving the lender rights in the policy to the extent of the loan balance.

A moveable hypothec can only be used by corporations (including holding companies and operating companies) and non-incorporated business owners when the debt is for the purpose of their business. The policyholder must complete a "Notice of hypothecation of a right resulting from the insurance contract" and submit it to the insurance company.

12.8 Claims process

Once the life insured dies, the beneficiary, or the estate if there is no other beneficiary, becomes the claimant. This Section discusses the steps that need to be done before the life insurance company will pay the death benefit.

12.8.1 Agent's role

The life agent's role is to facilitate the claims process in a timely and sensitive manner, from providing and filling out forms, to choosing settlement options.

If the agent becomes aware of the death of the life insured, perhaps through his personal connections, his business network or a death notification in the newspaper, he can proactively contact the claimant. However, it is also possible that the claimant will contact the agent or the life insurance company directly.

The agent should be careful not to give the claimant the impression that he is the one who decides whether the claim will be paid, or that payment is guaranteed.

12.8.2 Completed claim form

The agent can supply the claimant with all of the forms that the insurance company requires, and help the claimant complete those forms if necessary. He then submits the forms, along with any other required documentation, to the claims examiner at the life insurance company that issued the policy.

12.8.3 Policy status

Sometimes a claimant will have a copy of an insurance policy document that he believes is current, but this is not necessarily true. One of the first things the claims examiner will do is confirm that the policy was in force at the time of death.

The policy may not be in force in one of the following cases:

- The policyholder allowed the policy to lapse, as a result of failing to pay the premiums;
- The policyholder had surrendered the policy prior to death;
- The policy has expired because the term was limited.

12.8.4 Proof of death

Part of the supporting documentation is an official certification of death, usually in the form of a provincial death certificate, funeral director's certificate, or a coroner's report. The claims examiner uses this to confirm that the person who died is in fact the person who was the life insured under the policy.

12.8.5 Letters probate

If the estate is named beneficiary of the policy, the claims examiner may request a copy of the life insured's probated will. Through the probate process, the court will issue "letters probate," which verifies the authority of the executor[46] to act on behalf of the estate, including signing off on the receipt of life insurance proceeds. If the life insured dies without a will, then the court will have to appoint an administrator, and it confirms his authority by issuing "letters of administration." The cost of obtaining these documents is born by the estate.

In Québec, a will executed before a notary is deemed an authentic act. The claims adjuster will request a copy of the notarial will and the will search certificates establishing that this is the last will and testament. However, if the will is handwritten or made in the presence of witnesses, it must be probated by a notary or by the Superior Court of Québec, who, upon conclusion of the probate proceeding, will deliver a certified copy of the will and court decision or probate transcripts, as applicable.

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46. In Québec, the executor is called a liquidator.

If the insured has died intestate (without a will), the legal heirs are the liquidators of the succession. The claims adjustor will request a notarial declaration of heirship and/or the appointment of liquidators, as the case may be, which must be obtained from the court or a notary. The costs of obtaining these documents are borne by the succession.

12.8.6 Attending physician's statement (APS)

For large claims, the insurance company may also request an Attending physician's statement (APS), to certify the cause of death and to verify the medical information that was used to underwrite the policy.

If the APS reports that the life insured died by suicide and the policy is still within the suicide exclusion period (i.e., within two years from the time of issue or reinstatement), then the claim will be denied. Likewise, if the APS reports that death resulted from an activity or cause that was excluded from coverage, then the claim will be denied.

12.8.7 Proof of age and gender

The claims examiner will want to verify the age and the gender of the life insured, and usually requests documentation such as a birth certificate. If the actual age or gender of the life insured is different than what was recorded when the policy was issued, the death benefit may be adjusted. This is discussed further in the Section *Factors that could vary the payment upon death.*

12.8.8 Confirmation of beneficiary

The claims examiner will need to confirm that the claimant is the beneficiary named in the policy, as on record at the insurance company, or as directed in the will of the life insured.

If the primary beneficiary predeceased the life insured, the insurance company will require his proof of death as well, before paying the proceeds to the contingent beneficiary, or to the estate if a contingent beneficiary was not specified.

If the policyholder named a class of people (e.g., "all my children") as beneficiaries, payment may be delayed while the insurance company completes an investigation to ensure that all people in that class have been properly identified. This is why the policyholder should be as specific as possible when making the beneficiary designation.

EXAMPLE

Instead of saying "my children" in his policy, Hugh wrote "all of my children, including those not yet born, from my marriage to Jane Doe."

He could also have written "my children Anne, Bob, Cathy and any other child born from my marriage to Jane Doe."

12.9 Group life insurance claims

Group life insurance claims are processed in much the same way; only the plan's administrator, rather than a life agent, will facilitate the claims process.

In the case of an employer-sponsored group plan, the claims examiner will confirm that the deceased person was in fact covered under the plan. He may not be covered if he had yet not satisfied the plan's waiting period, or if he had terminated employment prior to death.

As discussed in the Chapter 9 *Applications and underwriting*, group creditor insurance may be subject to post-claim underwriting.

12.10 Factors that could vary the payment upon death

The amount paid upon death could be more or less than the policy's face amount, depending on a number of factors.

12.10.1 Participating whole life policies

Depending on which payment option the policyholder chose when setting up the policy, participating policy dividends may affect the amount paid out at death. For example:

- The paid-up additions option will permanently increase the death benefit every time policy dividends are issued;
- The accumulation option may increase the death benefit, if the policyholder does not withdraw all of the funds in the accumulation account;
- The term insurance option will temporarily increase the death benefit, for the duration of the one-year term only.

12.10.2 Adjustable whole life policies

In the case of an adjustable whole life insurance policy, the insurance company usually guarantees the death benefit and premiums for a certain period of time, such as five years. At the end of that period, the insurance company may increase, decrease or maintain the death benefit, depending on its experience.

12.10.3 Universal life policies

Universal life insurance policies have several death benefit options, including a:

- Level death benefit;
- Death benefit plus account value;

- Death benefit plus cumulative premiums;
- Indexed death benefit.

Depending on the option the policyholder chose when buying the policy, the deposits made to the policy and the investment returns earned within the cash account, the amount paid upon death can exceed the original face amount.

12.10.4 Misstatement of age

If the insurance company determines, at the time of the claim, that the life insured had misstated his age on the application, it can void the policy and deny the claim, but only if it can prove that the misstatement was fraudulent. Note that this applies even if the policy's two-year contestability period has expired.

If the misstatement was not fraudulent, then the insurance company will pay the death benefit. However, it will adjust the amount to reflect the coverage that the premiums paid would have purchased, had the correct age been known.

EXAMPLE

When Paul was 45 years old, he bought a $100,000 10-year term life insurance policy, with an annual premium of $230. Paul died four years later, at age 49. When processing his death claim, the insurance company noticed that there was a mistake on Paul's application, which had led them to believe he was only 40 years old at the time of issue. However the annual premium for someone aged 45 at the time of issue was $324.

Ignoring any annual policy fees included in the premium, this means that the insurance company would pay a death benefit of $70,988, calculated as:

$$\$70,988 = (\$230 \div \$324) \times \$100,000$$

This is the amount of coverage that Paul's premiums of $230 would have purchased if the insurance company had known he was 45.

This illustrates why it is important for the agent to double-check the life insured's date of birth as listed on the life insurance policy, prior to completing delivery.

In Québec, a misstatement of age does not make the policy void. The insured amount is simply adjusted according to the ratio of the premium received and the amount that should have been received.[47]

12.10.5 Misstatement of gender

Similarly, if the insurance company determines, at the time of the claim, that the life insured had misstated his gender on the application, it can void the policy and deny the claim, but only if it can prove that the misstatement was fraudulent.

If the misstatement was not fraudulent, then the insurance company will pay the death benefit. However, it will adjust the amount to reflect the coverage that the premiums it actually received would have purchased, had the correct gender been known. In Québec, this adjustment is not allowed.

EXAMPLE

When Leslie was 35 years old, he bought a $100,000 10-year term life insurance policy with an annual premium of $62. When he died three years later, the insurance company discovered that his gender had been entered as female when the policy was issued, so the annual premium he was paying of $62 was lower than it should have been. Premiums for a 35-year-old male would have been $80.

Ignoring any annual policy fees included in the premium, this means that the insurance company would pay a death benefit of $77,500, calculated as:

$$(\$62 \div \$80) \times \$100{,}000$$

This is the amount of coverage that Leslie's premiums of $62 would have purchased if the insurance company had known at the time of issuing the policy that he was male.

This illustrates why it is important for the agent to double-check the life insured's gender as listed on the life insurance policy, prior to completing delivery.

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47. Note that the insurer could try to make the policy void if the age of the insured was, at the time of issue, outside the age boundary set by the insurer. If this is the case, the insurer has a period of three years following the issue of the policy to override it. This must however take place in the lifetime of the insured and within 60 days of discovering the error.

12.10.6 Policy assigned as collateral

If the policy was assigned as collateral to secure a loan, the insurance company will pay the outstanding balance of that loan to the creditor, and only pay the remaining portion of the death benefit to the designated beneficiary.

EXAMPLE

Zachary assigned his existing $500,000 life insurance policy to the bank, to secure a $300,000 business loan. His wife Deborah was listed as the beneficiary of the policy. When Zachary died a few years later, the outstanding balance on the business loan was still $230,000. The insurance company paid $230,000 to the bank to discharge that debt, and the remaining $270,000 to Deborah.

12.10.7 Outstanding policy loan

If the policyholder has taken out a policy loan against the cash surrender value of his whole life or universal life insurance policy, and a balance is still outstanding when the life insured dies, then the balance of the loan plus any accrued interest will be deducted from the death benefit.

EXAMPLE

Marva has a $500,000 whole life insurance policy, and three years ago she took a policy loan of $100,000 against the policy's cash surrender value, with interest at 4.5% compounded annually. She has not paid back the loan or paid any interest over the past three years. If she dies today, the death benefit will be reduced by $114,117, calculated as:

$$\$114{,}117 = \$100{,}000 \times 1.045 \text{ (Year 1)} \times 1.045 \text{ (Year 2)} \times 1.045 \text{ (Year 3)}$$

or

$$\$100{,}000 \times (1 + 0.045)^3$$

This is the original policy loan plus compound interest calculated as:

- Year 1: $100,000 + (4.5% × $100,000) = $104,500;
- Year 2: $104,500 + (4.5% × $104,500) = $109,202.50;
- Year 3: $109,202.50 + (4.5% × $109,202.50) = $114,116.61.

As a result, her beneficiary would receive $385,883 calculated as:

$$\$500{,}000 - \$114{,}117$$

12.10.8 Unpaid premiums

If the policyholder dies after missing a premium payment, the death benefit will still be paid as long as death occurred during the policy's grace period. However, the death benefit will be reduced by the amount of the unpaid premium.

EXAMPLE

Joshua had a $250,000 term life insurance policy, with annual premiums of $3,300. He has been hospitalized for the last two weeks after suffering a serious heart attack, and as a result, he forgot to pay the premium when it came due last week. If Joshua dies today, the insurance company will still pay the death benefit, but the amount will be reduced to $246,700, calculated as:

$246,700 = $250,000 – $3,300

12.11 Settlement options

The claimant or the estate's executor may be unaware that there are alternatives to receiving the death benefit as a lump sum, such as using the proceeds to buy term certain or life annuities. A term certain annuity will provide monthly or annual payments for a fixed period of time, while a life annuity will provide payments for life. Annuities and their uses are discussed in more detail in the Module *Segregated funds and annuities*.

The life agent can provide assistance at the time of death by discussing these settlement options with the claimant and providing quotes if necessary.

12.12 Time requirements

There is no actual time requirement for filing a life insurance claim, and in fact sometimes life insurance policies are not discovered for years after the death of the life insured. As long as the claims examiner determines that the policy was valid at the time of death, the death benefit will be paid, including interest.

Once a claim has been filed, the insurance company could process the claim within days, or it may take several months, depending on the circumstances. For example, if the insurance company suspects that the life insured died by suicide and the policy falls within the two-year suicide exclusion period, it will want to investigate the cause of death more thoroughly, and this could take time.

Once the investigation has been completed and all the supporting documents have been received, the insurance company must pay the insured amount within 30 days.

12.13 Tax treatment of death benefits

As discussed in the Chapter 7 *Taxation of life insurance and tax strategies*, the death benefit from a personally-held life insurance policy is not considered to be taxable income for the deceased or the beneficiary. This holds true regardless of how long the policy has been in place, or how much the policyholder has paid in premiums.

The death benefit includes the entire amount paid out upon the death of the life insured, not just the original face amount. For example, if a universal life (UL) policy offers a level death benefit plus account value, the beneficiary will receive the original face amount plus the value of the investment account tax free.

Similarly, the death benefit paid under a group life insurance policy is also paid out tax-free, regardless of whether the life insured or his employer paid the premiums.

The death benefit from corporate-owned life insurance is received tax-free by the corporation. As discussed in the Chapter 8 *Business life insurance*, if that corporation is a Canadian private corporation, some or all of the death benefit will be credited to the corporation's capital dividend account (CDA). The Board of Directors can then direct the corporation to pay out a special tax-free dividend from the CDA to shareholders, thereby preserving the tax-free nature of the death benefit.

CONCLUSION

Life insurance is an important risk management and estate planning tool that can be used to mitigate the financial impact of death. While life insurance cannot replace the person who died, it can ensure that survivors are financially secure, a business can continue to operate, or that the deceased leaves behind a legacy. Life insurance can also be used to create and preserve wealth to be transferred to the next generation.

The wide range of life insurance products, riders and supplementary benefits available allows the life insurance agent to individualize an insurance solution for almost any situation, whether it is temporary or permanent, increasing or decreasing, intended for those on a strict budget, or for individuals looking for an additional investment opportunity.

The agent must gain a thorough understanding of his client's financial needs, resources and available cash flow to identify the most appropriate solution for him. As a field underwriter, the agent also plays a critical role in gathering the information that the insurance company's underwriters need to determine if the risk presented by a client is insurable, and what the premiums should be.

The agent must also ensure that the client understands the content of the contract being underwritten, including policy limitations or exclusions, its expiry or renewal terms, and any assumptions used in illustrations. He should review the client's insurance needs periodically to ensure that coverage continues to meet the client's needs as he moves through the life cycle.

Finally, the agent should remember that he is not just selling a product; he is bringing peace of mind to the policyholder, and financial security to those who survive the life insured.

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