TD Wealth

The Role of Life Insurance in Protecting Your Assets - Maximizing Your Estate

Common objectives in estate planning are to create, preserve, or maximize the value of the estate left to one's beneficiaries. The challenge is that a number of expenses incurred at death, such as income tax and probate fees, can erode the value of an estate. The strategic use of life insurance can help you meet expenses that may arise upon death and give peace of mind to you and your family.

Life Insurance as an Estate Planning Tool

Life insurance can play an important role in estate planning and typically includes two aspects:

- Estate Preservation or Maximization: Life insurance proceeds can provide liquidity to pay for expenses and liabilities that arise on death. Using tax-free insurance proceeds to pay for funeral expenses, debts, legal fees and tax liabilities will allow the estate itself to be left fully intact for beneficiaries.
- Estate Creation: Tax-free insurance proceeds can be used to create an instant estate for your family or beneficiaries.

Estate Preservation or Maximization: Funding to settle expenses on death

The use of life insurance can help provide liquidity to pay for final expenses and provide peace of mind to you and your family. Life insurance can also provide liquidity so that an estate's assets, such as business interests, a vacation property, or a family farm, do not have to be sold (particularly under unfavourable conditions) to pay debt liabilities, taxes or fees.

The following are a few of the most common expenses that Canadians encounter upon death:

Income taxes: For many Canadians, the greatest impact on estate value may be income taxes. In addition to any income earned up to the date of death, a decedent is also generally deemed to have disposed of any capital property (such as an investment portfolio, business and real estate holdings) that he or she owned, giving rise to potentially significant capital gains taxes. Any registered plans, such as a registered Retirement Savings Plan (RSP) or registered Retirement Income Fund (RIF), owned by the decedent are also typically deemed to be de-registered and included in taxable income. In situations where capital property and registered plans are inherited by the surviving partner, the tax liability can be deferred.

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The proceeds from an insurance policy used to manage income taxes arising on death can be particularly important where beneficiaries wish to retain the property for either sentimental reasons or where market conditions are unfavorable. Where property is first transferred to a surviving Partner, a joint and last survivor policy will provide funds to offset the eventual tax liability with proceeds payable on the death of the last partner.

Legal, Probate and other estate costs: Legal costs associated with the administration of an estate can also erode an estate's value. In addition, if a Will requires probate certification, additional fees may be incurred. Probate fees vary by province, but can be as high as 1.4% (in British Columbia) and 1.5% (in Ontario) of the value of the assets distributed through a Will. Other estate costs may include funeral and burial/cremation expenses along with executors' fees, valuator or appraiser fees, and legal and accounting fees.

Estate taxes in other jurisdictions: If you own assets in other jurisdictions, your estate may be subject to any estate tax imposed by those jurisdictions. For example, if you own U.S. situs assets, such as U.S. stocks or a vacation home in the United States, you may be subject to U.S. estate tax if your U.S. situs assets and worldwide assets exceed certain thresholds ($60,000 and $5,450,000 respectively for 2016). The U.S. federal estate tax can be as high as 40% for 2016.

Estate Creation: Capital replacement

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

Here are a few illustrations of how this works:

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

Note: New measures, which take effect in January 2017, will impact the level of tax-deferred growth permitted within exempt life insurance policies. However, these changes will not apply to policies issued before 2017 where certain conditions are met.

Facilitating charitable donations: Individuals can use life insurance as part of their charitable giving goals. Charitable donations can be achieved by donating the life insurance proceeds through a Will or naming a charity as the beneficiary under a life insurance policy.

Donations of life insurance proceeds made by Will or direct beneficiary designation under a life insurance policy are no longer deemed to be made immediately before death. Instead, charitable donations made as a consequence of a donor's death are considered to be made by the individual's estate at the time the property is transferred to a charity, provided the transfer occurs within 36 months after death. This provides an estate trustee the flexibility to allocate the available donation in the tax year the donation is made, an earlier tax year or the last two tax years of the individual.

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

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

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

Structuring your affairs to minimize tax and maximize your estate can be quite complicated. Your TD Wealth Advisor can put you in touch with our experienced Estate and Trust Specialists to find the solutions that work best for you and your family.

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Revised 29/04/2016