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The pros of a permanent life insurance policy

In most cases you're going to want to purchase a permanent life insurance policy. Here's why.

For the last two weeks I've been talking about life insurance and its role in tax and estate planning. There are basically two types of life insurance policies: Temporary, and permanent. Today, let's focus on permanent life insurance.

In most cases you're going to want to purchase a permanent life insurance policy. Why? Because temporary, or term, insurance can't be renewed after about age 80, so if you die after that age, the policy won't help at all. Sure, if the purpose of the life insurance is to provide for a temporary need (such as covering loan amounts owing or providing for minor children), then term insurance will often fit the bill, but many of the reasons you might buy life insurance will require permanent insurance.

Permanent life insurance comes in three general types: Term-to-100 (which I spoke about last week), whole life, and universal life insurance. Permanent insurance will continue in force until your death, regardless of what age that might be, as long as you pay your premiums.

One of the interesting things about whole life and universal life insurance is that you can accumulate investments inside the policy. Now, there's a limit to how much you can accumulate inside the policy. This is called the Maximum Tax Actuarial Reserve (MTAR limit - now there's a piece of information that will make you the life of the party at that barbeque this weekend). But the limit is generous. As a general guideline, for every one dollar in mortality charges (the portion of the premium that covers the pure cost of insuring your life) you can add about three to four dollars to the accumulating fund (the investment component of the policy).

The investments grow on a tax-sheltered basis inside the policy, and can be paid out, along with the face value of the policy, on a tax-free basis when you pass away.

WHOLE LIFE

Now, with a whole life insurance policy, each dollar of premiums is split into parts: One part covers the mortality charge, one part covers administrative expenses, and one part goes into the investment component of the policy - the accumulating fund.

Whole life policies offer level premiums (the same each year) for the rest of your life. It's also possible to have limited pay periods where, for example, you pay the premiums for a period of five or ten years, then no more premiums will be required after that. As the owner of a "participating" whole life policy, you'll be entitled to dividends from the insurance company. "Participating" simply means that you may participate in the profits of the insurance company.

You can also purchase non-participating policies, but this is less common. You see, the participating whole life policies that our clients have looked at in recent years have provided incredibly steady rates of return. No, you're not going to shoot the lights out with the returns, but there's a lot to be said for lower volatility. Last year, for example, it was not uncommon to find participating whole life policies paying a dividend of 7 to 8 per cent. Not bad in a year when most portfolios took a beating.

UNIVERSAL LIFE

Universal life insurance policies are much like whole life policies, except that the three key components of the policy are separated: Mortality charges, administrative expenses, and the investment component. Under a whole life contract you have no say in how the money in the policy is invested. Not so with a universal policy, where you will actually have to choose the specific investment products you want to acquire under the policy.

My experience has been that most people do a terrible job at choosing these investments. These investments should be factored into your overall asset allocation when designing your investment strategy. Further, to the extent you are going to hold fixed income investments in your portfolio, holding them in your insurance policy (and your RRSP) makes sense to shelter from tax the interest income that would otherwise be highly taxed.

A universal insurance policy also offers the flexibility of changing your premium payments periodically. As a minimum you'll have to pay the mortality charge, but then you can deposit any amount over and above that to build up assets in the accumulating fund (up to the MTAR limit).

I wouldn't generally purchase a universal policy if you don't intend to build up the investments in the policy, because it may be cheaper to buy a Term-to-100 policy instead - but check this with your insurance adviser.

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