The five-year review

An insurance audit every five years, or more often, should be conducted to ensure a client’s affairs are up to date.

As every plan should be monitored and reassessed on a regular basis to ensure it remains relevant and conducive to achieving its objectives, so should your life insurance. Usually based on a financial or estate plan, once it is set up, rarely is it looked at and adjusted for changing facts, needs, wants or industry developments.

An individual’s life insurance portfolio should be audited on a periodic basis to determine if the:

- amount of coverage is appropriate based on current needs and wants;
- the type of coverage remains appropriate (e.g., temporary versus permanent coverage);
- the life or lives insured continues to be appropriate i.e., husband, wife, partner, parent, joint first-to-die and/or joint last-to-die;
- cost of the coverage is reasonable based on current market prices and client circumstances;
- cash value necessary for prefunding of future insurance costs is still sufficient given the last bear market;
- ownership is appropriate based on changing circumstances or corporate structure evolution; and
- beneficiary designations remain appropriate.

An insurance audit is an objective and thorough review of a client’s situation, taking into account his/her current state of affairs and objectives. Through the careful integration of structure and client needs, an audit leads to optimal efficiencies in the portfolio.

Appropriate amount

Life insurance is typically used to create capital that can be invested to replace earned income lost by the premature death of a spouse or parent. It can also be used to create liquid capital to pay income taxes triggered on death. Another popular use is to create an inheritance or to balance inheritances among children involved in
a family business and those not involved. A fourth use is to fund a charitable bequest without diminishing the overall value of the estate and the rights of other beneficiaries. There are many more needs fulfilled by life insurance than those listed and that would be more specific to unique family issues and objectives.

An insurance audit reviews the client situation for current life insurance needs and compares this to the amount of coverage in the insurance portfolio.

In addition, life insurance fulfills an equally wide variety of wants. A want is different from a need in that some families do not need additional capital or liquidity, but they view life insurance as an alternative form of investment. They measure the premiums as an investment that produces a return. Generally speaking, life insurance produces a positive rate of return. In addition, life insurance creates several tax planning opportunities that can enhance the overall after-tax rate of return to the client.

**Appropriate type**

Reasons for purchasing life insurance coverage will vary — some may be temporary in nature while others are more permanent. Assessing the nature of the circumstances is a valuable guide when selecting the appropriate type of policy. Foresight is required as today’s temporary need (e.g., policy designed to re-pay mortgage upon first death) may be replaced by a future temporary need (e.g., desire to fund the children’s university costs upon death) or a newly determined permanent need. As such, permanent life insurance coverage may in fact be appropriate to fund today’s perceived temporary need.

An insurance audit reviews needs and explores the benefits of adjusting the insurance portfolio. It bears mentioning that some term policies can be converted into permanent policies and some permanent policies can be increased at the policyholder’s option without a medical assessment.

**Selection of insured person**

A life insurance policy can be designed to pay on a single life, on the last death of two or more individuals, or on the first death of two or more individuals. The needs and budget of the client dictate which type of coverage is appropriate. First-to-die life insurance would be appropriate where there is a need for capital or liquidity upon the death of one individual in a group. A married couple might consider such coverage to provide an inheritance to children upon the first death in a second marriage situation. Business partners might consider this type of coverage to fund a buy/sell upon the first death.

**Competitively priced and appropriate cost**

Cost — cost of premiums versus amount of coverage — is a critical consideration. Typically, term insurance is designed with renewal periods, and the cost escalates with each renewal. Why? Renewal premiums reflect that an individual’s health is unknown at the time of renewal and the insurance company does not have the opportunity to reunderwrite. A cost-conscious, healthy individual could apply for new coverage for lower premiums. However, new coverage requires a new application and new underwriting. If replacement of the coverage is warranted for economic reasons, the process would be to put the new coverage in place before cancelling the old plan so there is no gap in coverage.

Sometimes life insurance policies are issued with ratings on medical or other issues that may improve through time (i.e., smoker to nonsmoker status); these ratings should be reviewed with the objective of removal. While ratings for health or lifestyle concerns increase the price of coverage, at the opposite end of the spectrum is a preferred pricing model. The insurance industry offers enhanced pricing to those individuals that have a significantly more-than-average healthy lifestyle. Both rating removal and enhanced pricing may lower the overall cost of the coverage to the client. While such a cost savings opportunity appears obvious, it is a rare client that thinks to press the advising agent or insurance company to invoke the change.

A difference can arise between insurance carriers in the application of ratings and health-style discounts on new insurance policies, ultimately affecting the total cost of insurance over the long term. For example, a male, age 45, nonsmoker, regular classification with $1 million of coverage would pay between $1,100 and $1,200 annually for 10-year term insurance. If this individual were to benefit from the top preferred discount for a healthy lifestyle, the premium drops substantially to $700 to $800 annually. Therefore, if one company underwrites the case at regular classification but another company is willing to underwrite it reflecting a more favourable lifestyle, the difference is fairly substantial.

Audits will uncover inefficiencies within an insurance portfolio or can identify value in an older policy that on the surface may appear inefficient.

**Sufficient cash value**

The cash value inside a life insurance policy can be used to smooth and prepay the cost of a life insurance policy over its term. This means that the level of cash value is critical in order for the client to achieve desired results.

A universal life contract is considered an unbundled contract that allows the policy owner to view the underlying components. The investment component of a universal life contract will offer a wide variety of investment choices for the policyholder to manage the cash value of the contract over the long term. A whole-life contract on the other hand bundles the components and credits the policy with an annual return called a dividend. The policyholder of a whole-life contract can only manage the cash value component by adding more money. If the level of cash value is materially eroded because of

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poor investment performance, either additional premiums are required or coverage must be scaled back. A quick acid test that compares the ratio of cash value and mortality charges to life expectancy will identify the magnitude of any deficiency, which can then be addressed prior to the point of irrevocable damage. It is valuable to undertake this test periodically with any cash value policy to ensure appropriate long-term funding.

Beneficiary designation
It is the last named beneficiary that is entitled to the policy proceeds, so evaluating any changes including date and methodology is important to ensure validity of the current designation. Each new designation cancels the previous one, assuming the appropriate steps are followed. A designation in a will is considered dated at the time the will is signed and can override a policy designation if the will is dated later.

If a client feels the beneficiary requires assistance in managing the capital or wants to separate income and capital beneficiaries, insurance proceeds can be paid directly into a testamentary trust. Understanding of the testator’s objectives and careful planning will ensure the plan does not go offside and inadvertently result in an inter vivos trust or evolve into a new trust without the testator’s customized provisions.

Where a corporation is the owner of a policy and names a shareholder’s spouse or upstream company as beneficiary, a taxable benefit may arise equal to the value of the benefit received. If the corporation is the owner and names itself or a downstream company as the beneficiary, there is no taxable shareholder benefit realized on the payment of premiums. An insurance audit will uncover problematic situations providing the opportunity to proactively correct.

An insurance audit would review the client’s plans with respect to his/her testamentary dispositions and ensure that the beneficiary designations remain appropriate.

Beneficiary designation alerts
- Naming the estate as beneficiary may sound simple because the will can deal with distribution of the funds, but it exposes the proceeds to creditors, probate, delays and possibly fees.
- In some provinces, an ex-spouse is entitled to the life-insurance proceeds as a named beneficiary even if a divorce has long since been completed.
- Naming an individual in the protected class will enhance creditor protection of the cash value within the insurance contract.
- An irrevocable beneficiary designation must be filed with the insurance company.
- A contingent beneficiary ensures that the insurance money flows outside of the estate to an alternative beneficiary should the primary beneficiary predecease the testator.

Ownership considerations
The policy owner has the responsibility of paying the premium/deposits as they become due, as well as the right to make beneficiary changes in most cases. Changing ownership is relatively simple through the completion of an absolute assignment form provided by the carrier. However, this is considered a disposition of the contract and the vendor may realize an income gain. To the extent the transfer is between parties not at arm’s-length, the transfer is deemed to have occurred at the cash surrender value of the policy regardless of the actual proceeds of disposition. If the transfer is between parties at arm’s-length, then the actual proceeds are considered the proceeds of disposition in calculating the vendor’s income gain and the buyer’s starting adjusted cost basis.

Conclusion
Inefficiencies either in cost or structure are apparent in almost all portfolios, particularly when a business situation is part of the scenario. An insurance audit should be a required analysis every five years or more often if there is a significant change in the client’s situation. The client benefits from an insurance audit by ensuring that his or her affairs are in order and properly aligned to his or her estate plan, are cost effective and current and future tax planning opportunities are being maximized.

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