TAX TALKS

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Life insurance is all about those you leave behind when you leave.

Life Insurance

Life insurance is easy to grasp. You are either alive or dead. Alive – you pay. Dead – they pay. But of course there is more to it. We asked Daniel Mikhail of Partners Wealth Group in Sydney for his insights.

Here is what we learned but please listen in as Daniel explains all this much better than we ever could.

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Terminal Illness or Death

Life insurance is not just about death. It can kick in while you are still alive. A terminal illness with a life expectancy of only 12 to 24 months (depending on your policy) can qualify for a life insurance payout.

No Link to Earnings

When you apply for life insurance, there is a review of your current income and your family's needs. Just to make sure that a casual employee on $50k a year doesn't take out a $10m policy and then heads to The Gap.

But once the insured amount is signed off, there is no link to your income. You might be unemployed or a pauper at the time of terminal illness or death. Your life insurance will cover the insured amount – no matter what.

Insured Amount

Within reason the insured amount can be any value. The higher the insured amount, the higher the premiums. You decide how much your family would need. Financial advisers often help. Tto work out how much your family would need, consider two things – debt and income.

1 Debt

Think of the mortgage on your family home, the loan on your car and the outstanding balances on your credit cards. If you suddenly died, all these debts would go into your estate for your family to deal with.

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If you are the main bread winner and you had no life insurance or savings to cover these debts – and of course you wouldn't have savings, because otherwise why would you have these debts – then your spouse would probably be unable to pay these debts. And as we all know the banks are all very friendly when you take out the mortgage or loan, but a lot less so when the payments stop coming in. So debt is the number one issue.

 # 2 Income

Think of money to live. If something happens to you and you are the main breadwinner, your family needs money to live. Income protection ends with death, so will no longer cover your family after your death.

If your children are little, your spouse would be unable to work or pay through the roof for childcare. Either way life would be very tough. So your life insurance needs to replace your income until your children are older and your spouse can work full-time again.

Stepped v Indexed

At the start your premiums cover a certain insured amount. But then you age. And with age the risk for the insurance provider increases. So something has to change. The premium. The cover. Or both.

For most industry funds the premium stays constant but the cover declines over time. So you pay the same premium for less cover as you age.

Most retail funds work the other way around. Your cover stays constant and your premiums increase. But then there is inflation and you can choose how to deal with inflation. You either ignore inflation and keep you cover at the current nominal value. Or you adjust your cover for inflation. Or you do both.

 # 1   Stepped Premium

You can choose to ignore inflation. You just keep the cover at the current nominal value. And then each year increase your premiums to cover the increased risk as you age. This is called a stepped premium.

The problem is that while the nominal value of your cover stays the same, the real value of your cover decreases with inflation. Ten years ago $1m bought a lot more than today. So your insured amount is worth a little bit less each year.

 # 2   Indexed Cover

You can choose to adjust your cover for inflation. This is called an indexed cover. You increase the insured amount each year by the CPI index.

Your premiums increase anyway to cover the increased risk as you age. But now your premiums will increase even more to cover the additional increase of the insured amount.

 # 3   Split Cover

You can choose to split your cover into two parts. Part of your insured amount is to cover debt. Your debt won't go up with inflation. So that part you cover with a stepped premium.

But the income your family needs to survive will go up with time due to inflation. So that part of the insured amount gets allocated an indexed cover.

Suicide

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Most life insurance policies cover suicide, but only after an exclusion period. This exclusion period is usually at least 13 months, but might be longer.

Industry v Retail

Differences between industry and retail funds tend to negligible when it comes to life insurance, because life insurance is very black and white. You are either dead or alive. Where you see big differences between industry and retails funds is around TPD and income protection, and especially the conditions you need to meet to qualify for TPD or income protection payouts.

Life and TPD

Life and TPD insurance often get linked to reduce premiums. Linking these two policies means that a TPD payout immediately cancels the life benefit. So as an example, if you received a payout under the TPD policy and then subsequently succumbed to your injuries, then your family wouldn't receive another payout under the life insurance.

Having two stand-alone policies usually means much higher premiums. But you can choose this option. It is called a re-instatement option. But it is rare that somebody chooses this option.

Inside or Outside of Super

When your children are little and you have a spouse, you can have the life insurance inside or outside of super. Inside of super means that you get a 15% tax deduction. Since you have tax dependents, any payout would go to your children and spouse tax-free.

But when your children are gown up and your spouse is gone, then you should move your life policy out of super. Any payouts to non-dependents will attract 30% tax.

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