Life insurance backs succession plan

A widow uses insurance products to assist her son and plan a legacy for her daughter

By Andrew Allentuck

A couple we'll call Martha, 60, and Max, 61, farmed in south central Manitoba for four decades. They grew an original 640 acres into 2,400 acres they own personally and through their corporation, and then added another 4,000 acres, which they rent. A son, Ernest, in his mid-30s, has been part of the operation for a decade and a half. A daughter, Mary, has a business far from the farm.

Max died last year. His wish was for Ernest to have the farm one day. In the administration of the will, Martha got half the farming corporation and Ernest got the rest. Ernest will get the remaining half of the operation and land when Martha passes away. All non-farm assets will go to Ernest's sister, Mary. To cover creditor claims, Max and the farming corporation had credit and mortgage insurance to cover the land and farm equipment loans. Loan balances were fully paid, but there was no money left for other creditors.

The insurance policies covered an outstanding obligation that the farming corporation incurred when it bought an additional 700 acres for $1.8 million through a mortgage. The corporation also upgraded farm machinery with a $500,000 bank loan. The issue was critical — would the farming operation also need more insurance coverage for predictable risks?

Farm Financial Planner asked Don Forbes, head of Forbes Wealth Management Ltd. in Carberry, Manitoba, to work with Martha to devise a plan to provide her with retirement income, to insure the farm against risks of illness or premature death of Martha and/or Ernest and to create liquidity for payment of taxes.

Crafting an insurance program for risk that can be anticipated, such as premature death and crop loss, public liability, etc. and creating a viable business plan is partly a matter of balancing what can happen with the cost of paying for it when it does not happen. Forbes created a scenario of insurance choices for possible losses.

INSURANCE CHOICES

Forbes suggested several insurance plans.

1. **Bank debt:** This insurance requires a variable premium monthly payment based on the outstanding value of the loan at the end of each month. On Martha's passing, the bank creditor insurance would only pay the outstanding loan balance. A plan to cover the current $2.3 million in bank debt was purchased and is in place.
2. ***Key person life:*** This is a $1 million policy to cover Ernest's life. This policy would add $1 million of cash to the company to help unwind operations in the event of Ernest's death, and not have to do it at fire sale prices. Cash left over would be allocated on a per share basis to remaining shareholders. The company's cost for the insurance would be a modest $50 per month for the next 10 years. This has already been issued and is in place.
3. ***Disability insurance:*** This is a business overhead disability policy of $5,000 per month on Ernest's life. The policy would cover costs resulting from any disability Ernest might suffer causing him to be unable to work. If Ernest became disabled, the policy would pay the farming corporation $5,000 per month to cover costs of coping with Ernest's absence. This policy would cost the company $68/month and would provide two years of cash flow. Or, Ernest could apply for a personal policy, which would pay him directly. The benefit would, however, be just two-thirds of his salary or $3,200 per month for the same premium. It is too much money for a modest risk, Forbes says.
4. ***Fire, liability, crop and hail insurance:*** These policies aren't part of the succession plan, but will be maintained.
5. ***Business life policy on Martha's life:*** This is a $1 million policy on Martha's life. Were she to die within the next decade, only the first $1 million of debt would be repaid. Ernest would inherit the remaining $1.3 million of bank debt and remaining shares of the farming corporation. This policy would cost the company $300/month for 10 years; the cost would rise the following year. If not paid, the policy would lapse. Its purpose is really a bridge to allow Ernest to take over the farm. He would be responsible to pay outstanding loans. This is in place in lieu of taking on insurance for the $2.3 million outstanding loans.
6. ***A term policy on Martha's life:*** A $500,000 term policy on Martha's life would supplement an existing $400,000 of off-farm investments. The concept would be to provide a $1 million legacy for Ernest's sister Mary (Martha's daughter). A $500,000 term to 100 life policy would cost $10,000 per year until Martha's passing. A $500,000 10-year level term policy would cost $1,500 per year for the next 10 years. By choosing the second option, a 10-year policy, the savings of $8,500 per year could go into Martha's investment accounts. At the end of the 10 years, assuming Mary is still alive, she would cancel the plan and should have saved $85,000 plus interest. This is the simplest and one of the least expensive ways of ensuring a legacy for Mary. Martha added this policy.

THE OUTCOME

How all these choices will turn out depends on investment return assumptions. If all investment assets earn six per cent before two per cent inflation, net four per cent, then: present financial assets of $409,000 and farm assets of $3 million (total $3,409,000); plus $10,000 a year to Martha's RRSP for the next five years to her age 65; adding $5,500 to the TFSA for every year; and investing $8,500 for the next 10 years (the difference in costs between the term to 100 and the 10-year level term policy); and in 10 years Martha would have $180,100 non-registered assets, $474,200 in her RRSP, $250,700 in her TFSA, and farmland with no additional investment but growth with inflation of $4.44 million.

Assuming Martha starts receiving: Canada Pension Plan benefits at age 65 at $10,519 per year; Old Age Security benefits at $7,040 per year in 2018 dollars; $36,000 from the farming corporation as a salary; $7,700 from non-registered assets; and $9,590 from the TFSA, she would have total annual income of $70,849. She would pay tax of about $19,250 for net after-tax income of $51,600.

The income would be roughly stable for the remainder of her life. Martha could easily cover her cost of living estimated at $36,000 per year. During her life, income from the farming operation would be adjustable to her needs, Forbes says.

We've assumed that Martha will stay on the homestead and that, at some point, she can consider crystallization of the value of farm assets and use the Farm Land Capital Gains exemption for transfer of ownership to Ernest. Provided that the farm's capital value grows as assumed, transfer of value to Ernst and cash to Mary should go as planned. The insurance program covers risks that can be anticipated at a reasonable cost, Forbes suggests. GN

Andrew Allentuck's book, "Cherished Fortune: Build Your Portfolio Like Your Own Business" (with co-author Benoit Poliquin), will be published in November, 2018.

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