How much life insurance do you need?

Here's how to calculate how much coverage will protect your family

Most people know they need some sort of life insurance, but since COVID-19, the ideas of risk and income loss seem much more real for many.

In a recent online Angus Reid Forum poll of more than 1,500 Canadians, nearly one-quarter said they're now considering life insurance, and among them, two-thirds admit their concern is related to the pandemic. The industry has responded to the increased demand by making it easier to apply for coverage, with many insurers offering digital application options and temporarily easing requirements for the collection of fluids on some policies.

But, pandemic or not, it can be hard to know just how much insurance to buy. The main reason to purchase a policy is for income replacement—if you pass away and can no longer provide for your family, then a lump sum of money can help your loved ones maintain their standard of living for a certain period of time.

Still, coming up with a number is more complicated than just covering off a few years of your salary or leaving enough to pay off a mortgage. Sorting out how much life insurance coverage you need is more like creating a budget, but for your family's future. Here's how to do it.

Determine your living expenses

Track your current spending on both needs (food, rent/condo fees/property taxes, clothing, utilities, transportation, home/car maintenance, retirement savings, etc.) and wants (travel, entertainment, gifts, etc.). Perhaps your short-term budget looks different because of COVID-19, but go with what you normally spend. This will give you a sense of how much money it would take for your family to maintain the same standard of living if your income is lost. There are a number of online personal finance apps that can help you see how much you're spending.

Take this monthly budget and multiply by the number of years left until your spouse reaches retirement age—don't worry about their income or their retirement income just yet, as you'll calculate that later.

Mortgage and other debt

Next, add any outstanding mortgage balances on your home, cottage, or income properties, as well as other debt you're carrying, such as car loans or lines of credit. Include the interest costs of those loans. You may want to leave enough insurance to pay everything off.

Child care and/or education costs

Since child care is for a limited period of time, it's easier to add this amount as a separate item by calculating the total amount of child care (including camps) you expect to pay per child until they turn 18. Similarly, add in how much of children's post-secondary education that you, as a parent, expect to pay.

To estimate this figure, work with your existing child care costs if you have younger kids. Don't forget that teens might still attend summer camp, including overnight camp, which can cost around $1,000 a week, while university tuition and living expenses cost anywhere from a few thousand dollars to hundreds of thousands of dollars per year.

Funeral costs and estate fees

Many people use insurance to cover funeral costs, which can be expensive. A funeral in Canada can run up to $20,000, though the average cost is about half that much. You'll also want to add the costs of settling your estate, which can cost a few hundred dollars or a percentage of the total estate.

Potential taxes

It's a good idea to talk to an accountant about potential tax liabilities, but depending on your marital situation, your estate may have to pay capital gains taxes on investments and second properties. If you're an entrepreneur, you may have to pay some business-related taxes, too.

Many people use life insurance specifically to pay taxes, so that their kids can keep more money from the estate for themselves.

Subtract sources of income and savings

If you add up all the above, you'll end up with a generous number in the millions. But that's not the amount of coverage you need.

Get the real number by first subtracting the total amount of net income your spouse expects to earn before retiring. The same goes for any other (after-tax) earnings, such as rental income on an investment property. If you have life insurance through your workplace, deduct the tax-free death benefit it would pay out. Finally, subtract any non-retirement savings and investments, such as those held in a Registered Education Savings Plan, which could help reduce the amount of coverage you'd need to, say, pay for a child's university education.

Work with what you have

Now, you've got a number to work with. However, this is an ideal amount that could provide generously for your family. You can opt for less coverage if the resulting premiums will stretch your budget too far. You don't want to risk defaulting on your premiums and letting your policy lapse.

It's all about balancing your life needs now with your potential risk later. Run the numbers so you can make an informed choice and look for a life insurance expert to help you find the right balance to ensure that your loved ones are taken care of.