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What You Need To Know About Life Insurance – A Primer (part 1)

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"In this world nothing can be said to be certain, except death and taxes."—Benjamin Franklin

Life insurance holds out the promise of addressing the two inevitabilities of death and taxes. However, you need to be a careful consumer in order to get the best value from what can be a very complicated purchase. The goal of this article is to help you ask intelligent questions of your insurance agent to make sure the insurance you get achieves the best balance of costs and benefits for your overall financial plan.

The death benefit

The death benefit is the essential component of life insurance. This is a payment to the beneficiary of the policy after you die. Death benefits can be important if your family or business is depending on your being a productive earner. The amount of life insurance that you take out should, if affordable to you, be sufficient to meet your financial obligations. For individuals these might include: remaining mortgage payments, your survivors' living expenses for some years, and children's educational costs. Business uses for life insurance include protecting the business against the impact of the untimely death of a key person or to fund a buyout of the share of the business owned by a deceased partner by a surviving partner.

There are also potential income and estate tax benefits to some life insurance products. Life insurance premiums are paid with after-tax dollars (usually), so death benefits are generally not subject to income taxes. We will have more to say about estate tax benefits below, and about income tax benefits in part 2 of this article.

How much life insurance do you need?

There is no single answer to this question. Rather, the optimal amount of coverage depends on your particular situation. However, for those readers seeking death benefits to help their survivors meet financial obligations, here are some rules of thumb that provide a good place to start.

The simplest strategy is simply to purchase coverage amounting to ten times your annual income. A more refined estimate is to purchase the amount of coverage needed to replace your survivors' anticipated expenses for a set number of years. For example, you might purchase coverage to replace the income you would have earned until your youngest child graduates college. Or you could estimate how much you would like to contribute towards your children's college, add that to the remaining balance on your mortgage and other loans, and add that to the number of years' income you want to replace to get a total amount of coverage.

Note that the amount of coverage you might want today can be different from the amount of coverage you might need in ten years from now. If you expect to need less coverage in the future, you can purchase multiple term life insurance policies (defined in part 2) with the expectation that some of your coverage will lapse in the future when your insurance needs are lower. The link below to Nerd Wallet (www.nerdwallet.com) has an interactive calculator that can help you get started.

https://www.nerdwalletcom/blog/insurance/how-much-life-insurance-do-i-need/

Some little know life insurance facts:

1. 84% of Americans agree most people need life insurance but only 70% said they needed any.
2. 41% of Americans do not carry any life insurance.
   Of those who do, nearly 1/3 have just a basic group policy.
3. Almost ½ who owned no life insurance said they either don't need any or had enough already
4. 4 in 10 said they were under-insured, and the remainder didn't know either way.
5. 39% felt as though they wish their spouse or partner would buy more insurance, with 1 in 10 not even knowing how much they had.

*Source: bestliferates.org LLC May 2017

Life insurance to fund legacy bequests to your heirs

Suppose your survivors' foreseeable needs are already provided for, but you wish to be sure to leave an inheritance to them even if you die untimely young. You have three choices to use life insurance to achieve this goal:

1. Buy a policy where the proceeds will go into your estate to be bequeathed according to your will. If your estate is large enough so that the death benefit will be subject to estate tax then you should not pursue this option.
2. Have your heirs buy a policy and make a gift of the premiums to those heirs. If the premiums are less than $14,000 per year per beneficiary then no gift or estate tax will be due on either the premiums or the death benefit.
3. Set up an irrevocable life insurance trust to own the policy, then make a gift of premiums to the trust. If the premiums are less than $14,000 per year per beneficiary then no gift or estate tax will be due on either the premiums or the death benefit.

Note that bequests to spouses (who are U.S. citizens) are not subject to any estate tax. Therefore, the strategies that involve making a gift of insurance premiums to your heirs or to a trust will reduce estate taxes only when the intended beneficiaries have a different relationship to you (e.g.: non-spouses or spouses who are not U.S. citizens).

Life insurance trusts

The advantage of a life insurance trust is that the trustee has control of the funds used to pay the premiums and of the death benefit. This is helpful if the beneficiaries are minor children or if you are concerned about the financial prudence of your adult beneficiaries. The downside is that you need to have a trustee you can trust. You also have to bear the expense of hiring a lawyer to draft the trust. In my experience this can cost in the neighborhood of $2,000.

Lastly, there is a procedure for making a gift of the annual premiums to the life insurance trust which involves the trustee issuing a written notice to the beneficiaries informing them when a gift has been made to the trust. The
trustee must give the beneficiaries a window of opportunity (typically 30 days) to withdraw the gift instead of allowing the trust to use it to pay the life insurance premiums. (This is called a Crummey letter.)

Pay for life insurance or invest instead?

Let's suppose you have $14,000 each year to give to each of your intended heirs. Are those heirs likely to end up with more money if that gift is invested or if it is used to pay life insurance premiums? The answer depends on how long you live, of course, and also on future investment returns. If you are destined to live to age 100 then your heirs will probably be better off investing your gifts than waiting for a life insurance policy to pay off. Conversely, if you are destined to die younger than average, life insurance will end up being more profitable.

The first approach should be to purchase the least expensive coverage that will give you the desired death benefit. This is usually what is called a term life insurance policy. (We will discuss different types of life insurance in part 2.) If the premium on this policy is less than $14,000/year then the remaining gift can be invested. This gives you the best of both worlds: If you die early the death benefit provides for your heirs. If you live a long time then the compounded investment returns will represent the payoff.

Conclusion

Two of the main reasons to buy life insurance are to provide for your survivors' living expenses if you die during your earning years, and to provide a financial legacy to your survivors. The amount of insurance you should buy depends on your remaining financial obligations and on your ability to afford the premiums.

If your goal is to avoid estate taxes then you should not own a life insurance policy outright. Rather, either your heirs or a trust for their benefit should own the policy. Instead of paying the premiums yourself, you make a gift of the funds to pay the premiums to the policy holders (your heirs or a life insurance trust).

In the next installment we will review different types of life insurance policies that you can choose from. The costs and benefits of each vary widely.

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