TOPIC: LIFE INSURANCE

There are two primary uses of life insurance. The first is to provide a replacement source of income should a primary provider of income die. The second is to provide liquidity for the payment of estate taxes. Less common uses of life insurance include such functions as funding buy/sell agreements or other finite period requirements.

Income Replacement

The key characteristic of the use of life insurance for the replacement of income is that it generally covers a finite period and does not require permanent insurance. During the primary earning years of a person, two things should be occurring. One is that assets are being accumulated which could provide income in the future. The other is that the life expectancy of those who are dependent on that income is getting shorter and shorter. In most cases, there is a cross-over point where enough assets have been accumulated to satisfy the income needs for the remaining years of those dependent on the income. At that point, the person, couple or family is self-insured and no longer has a need for income replacement life insurance.

This type of requirement for a finite period is best served by the use of term life insurance. Term insurance is the least expensive form of life insurance and provides coverage for some limited period. Term insurance can now be obtained with a level premium for a period of years: 5, 10, 15, or even 20 years. The advantage of such a policy is that it is purchased based on the current health of the insured. The level premium is locked in for the extended period with no insurability requirement during the period. If health deteriorates during the period, there is no effect on the policy or the premiums.

The primary risk with such a policy is the insurability of the person at the end of the term. If the policy is maintained, the premiums will jump significantly at the end of the term of level premiums, generally enough to be prohibitive. When insurance is still required, the insured hopes to be re-insurable and starts another policy with a term of years that will hopefully cover the remaining number of years until self-insuring is possible. Because of this insurability issue, it is often wise to have multiple policies with staggered terms, each one taken out at a time when health is still good for the physical exam.

Permanent Insurance

The use of life insurance to provide liquidity to pay estate taxes is an entirely different function. It requires a policy which will exist for an unknown, extended period, until the death of the insured. The most efficient way to provide protection is with a permanent policy which never requires insurability in the future. The younger the person is and the better his/her health for the physical exam, the lower will be the premiums, which will be paid until death. This period might extend well beyond the normal life expectancy of the person, in which case a considerable sum will have been paid out in premiums.

Premiums for permanent insurance (often referred to as "whole life," "ordinary life," "variable," "universal," or "cash value" policies) are considerably higher than for term insurance. A "whole life" policy is the most conservative form of permanent insurance, with the highest premiums. It will tend to build cash value faster and has the highest probability of not having a funding problem in later years. A "variable" policy is one which has more upside to it but also more risk. Its funding depends on the investment performance of the stock market. It therefore has the potential of a higher payout at death, particularly if the policy remains in effect for a long period of time (in excess of 20 years). Conversely, if death is premature during a down period of the stock market, it could have a lower payout.

A "universal" policy is somewhat of a hybrid. It typically has lower premiums than a whole life policy and uses some of the cash build-up in the policy to pay future premiums. If too optimistic assumptions are used in initially setting the premiums, the policy might end up under-funded in the future and require an increase in premiums to prevent the policy from lapsing. This same danger exists for "single premium" life insurance, which is designed to be perpetuated with a single initial premium which, given the earnings record of the life insurance company, should be able to pay all future premiums out of the cash build-up within the policy. Not infrequently, such a policy ends up under-funded a long time in the future, and the policy owner must either resume premium payments or forfeit the policy.

An excellent form of life insurance for funding the estate taxes of a married couple is called "Second to Die" insurance. It insures the two lives jointly, which carries a lower premium than insuring two separate lives. It works well because the unlimited marital deduction allows avoidance of estate taxes at the first death, and the insurance policy assists in paying taxes at the second death. Care should be taken in purchasing the policy and determining the owner of the policy to assure that the proceeds will be received outside the insured's estate and not be subject to estate taxes.

The most common method is to set up an irrevocable life insurance trust which becomes the owner and beneficiary of the policy, but there are important pitfalls to avoid in doing that properly. An alternative method, in the right family situation, is to have the next generation be the owners and beneficiaries of the policy. Again, there are important guidelines to follow to do that properly. How premiums are paid - and by whom - is extremely important to assure that the death proceeds will not be subject to either income or estate taxes.

For company owners or high level executives, a popular form of permanent insurance is called Split-Dollar life insurance. It involves a single cash-value policy with joint ownership between the company and the insured. Basically, the company pays all or most of the premiums and maintains a right to be repaid the cumulative amount of those premiums out of the cash value or death proceeds at time of retirement or termination, death of the insured, or after some specified period of years. The employee pays income taxes on a portion of the premium amount. The arrangement is popular because it is generally easier for the company to provide the funds for the premiums.

In analyzing and choosing life insurance policies, it is extremely important to get objective advice, both on the appropriate type of insurance and particular policies, from someone who has no vested interest in selling a policy. The financial strength of the issuing company is also extremely important, because the insured is entering into a very long-term contract which will be useless if the insurance company does not continue to be financially strong.

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