The life insurance industry is rife with high fees and lofty commissions. Agents and brokers often work to convince individuals that life insurance is necessary, when one can frequently accomplish many of the same objectives without incurring excessive fees. This does not mean, however, that one should always reject the idea of purchasing a life insurance policy. Understanding when and how to use life insurance is a crucial component in one's financial planning.

An Introduction to Basic Types of Life Insurance

Broadly, there are two types of life insurance policies: term policies and permanent policies. Term policies typically have the lowest annual premiums, as these policies expire after a specified "term" of years. After that term expires, the purchaser of the policy is no longer covered. In contrast, permanent policies such as whole, universal, or variable life policies can be more costly and complex. They provide lifelong coverage and come in an array of different structures. Whole life policies have a fixed annual premium and death benefit. Universal and Variable policies have the flexibility to adjust the death benefit and annual premiums over time. A variable policy's cash value grows based on the performance of an underlying investment portfolio while a universal policy's cash value grows based on an interest rate set by the insurance company. When looking into purchasing a life insurance policy, it is essential that one select the type of policy appropriate to meet their financial need.

With this introduction behind us, let's turn our attention to the appropriate uses of life insurance.

Reasons to Buy Life Insurance

1.) **Income Replacement** - Imagine a family with young children and an outstanding mortgage. Unexpectedly, the parent who provides the majority of the household income passes away. Along with having lost a loved one, the surviving spouse now finds him or herself in a financial dilemma: *How do I cover the family's living expenses including schooling and perhaps even college for the children?* In this scenario, a life insurance policy can provide the funds necessary to maintain the family's lifestyle while the family transitions to a more stable footing under the new circumstances. A low-cost term policy may be an ideal solution as it is temporary and cost-effective, providing the spouse and young family with protection in the event it is needed. Generally, we advise purchasing 5-10x the annual income received by the insured in order to adequately provide for a family upon the death of the breadwinner.

2.) **Estate Planning -** In 2020, the lifetime gift and estate tax exemption amount per person is $11.58 million (10mm by law but then adjusted for inflation) which is set to sunset back to $5 million in 2026. Any dollar within one's taxable estate over the exemption amount incurs an estate tax of 40% which is due within 9 months after death. One of the most important and common uses of a permanent, as opposed to term, life insurance policy is to pay the estate tax. Specifically, an estate that is primarily made up of illiquid assets such as real estate, a privately owned business, or farmland would likely be well served by a substantial life insurance policy to provide liquidity. Heirs could be forced to fire sale these illiquid assets at below market value to pay the estate tax, reducing the inherited value of the estate while also causing unnecessary stress.

Remember Miami's "Joe Robbie" football stadium from back in the 80's - 90's? Joe Robbie was the founder of the Miami Dolphins and worth over $115M at his passing in 1990. Unfortunately, the majority of his net worth was illiquid and due to the lack of financial planning, his family had to sell the team in order to pay the estate taxes. Now, it is the Hard Rock Stadium, which recently hosted the Super Bowl in February.

What if the estate contains mostly liquid assets like stocks and bonds? In this case, the calculation is a bit more complicated. After all, upon death, the heirs can simply liquidate a portion of the investments at market value to satisfy the estate tax. So the question is quite different. A potential purchaser of life insurance must now ask "will the cost of the policy while I am alive be lower than the 40% owed to Uncle Sam after death?" One must consider the amount paid in premiums, fees as well as the potential lost investment growth on these premiums and fees. Because annual premiums quoted for a policy vary based on the type of policy, age and health of the individual, each option must be thoroughly evaluated. Scenario-based analysis should be performed, likely with the help of a financial advisor, to evaluate if life insurance is really necessary.

3.) **Long-Term Care -** Stand-alone long-term care policies have become increasingly unpopular due to their high annual premiums and uncertainty of use. Will I ever need any services that are covered under long-term care such as nursing homes or assisted living? If I don't, what happens to all the contributions I've made to the policy? *Simply put, you use it or lose it.*

However, by including a "Long-Term care" rider within a life insurance policy, one can eliminate the risk of losing the contributions as the unused benefits transform into a death benefit. If a portion of the total benefit is used for medical costs, the remaining benefit amount is still paid out to your beneficiary at death.

4.) **As An Investment to Your Heirs -** Brokers like to pitch life insurance as an investment vehicle but more often than not, life insurance is a poor investment. Universal and Variable policies combine the premiums used to purchase the death benefit with an investment portfolio component which frequently contains hidden fees and options. Given the structure of a universal or variable policy, the insurance company can adjust the premiums if the investment component has poor performance. That said, there are times when, depending on the insureds' life expectancy, a life insurance policy can provide an attractive yield. Calculating whether it makes sense to add life insurance to an investment portfolio requires scenario analysis both with regards to life expectancy and to the foregone performance on assets used to pay the life insurance premiums. In our view, this analysis should be done with a financial advisor, someone with a detailed understanding of your investment portfolio and goals, rather than solely with an insurance broker.

What else do I need to know about owning a life insurance policy?

This is not an exhaustive list of considerations but hopefully it provides a reasonable grounding in the basics of life insurance. We also want to emphasize that simply buying a life insurance policy absent some additional estate planning is not sufficient. One must also take steps to ensure the policy is excluded from the insured's estate. Otherwise, the death benefit proceeds will incur the 40% estate tax effectively eliminating one of the primary purposes of purchasing the policy in the first place. By establishing and appointing an Irrevocable Life Insurance Trust (ILIT) as the owner and beneficiary of the policy, the policy is no longer considered part of the estate and the proceeds are then received estate tax free. The annual premiums would be paid from the ILIT which is funded through annual gifting by the insured. Keep in mind, changing the owner on a policy only takes effect after 3 years have passed from the date of the change. If you pass away before then, the proceeds will still be included within your estate. Thus, it is strongly advised, that the policy is owned by the ILIT when initially purchased.

Conclusion: Revisit Necessities

Although the life insurance industry has gained a bad reputation due to high fees and aggressive sales tactics, we still believe life insurance can be a useful, indeed often essential, part of an individual's financial plan. It is important to take a cautious approach when considering the purchase of a policy. One must analyze the decision across a range of probabilistic scenarios regarding life expectancy, asset appreciation and tax law. We recommend consulting with financial advisors in addition to insurance brokers when considering one's options. Financial advisors with financial planning expertise in house who not only have the experience and analytical capabilities to run the necessary scenario analysis but also have insight into your personal portfolio situation and financial goals can help you make an informed decision on the most appropriate policy for you and your family.

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