A Matter of Life and Death

Life insurance is one of the most significant assets you will ever own. Here's what you need to know about how much to buy, and how to choose and purchase these policies.

BY JOHN ALLEVATO

More often than not, I find my clients don't have enough life insurance or don't own life insurance the right way. I don't sell insurance or benefit from my clients' insurance purchases, but I am convinced of the importance of life insurance in the estate and wealth preservation planning of physicians. Let's examine the phenomenon of this asset and set out what you should know to make decisions concerning its purchase and ownership.

The first thing is to remove some of the mystery surrounding life insurance. Insurance agents talk in terms of whole life, term, and cash surrender value. We're going to talk in terms of need: determining how much life insurance to purchase. Then we'll look at some of the major differences in policies so you can follow some of the lingo which will be thrown at you. Do you need life insurance? If others depend on you for their support, then there is probably a need for life insurance. You obviously have a need if you have children, but other situations may also dictate a need—if you take care of elderly parents or another family member, for example.

Other circumstances which may necessitate life insurance might be to ensure repayment of debt or to generate funds for the payment of estate taxes in larger estates. In this article, I will focus on life insurance needs to support family members.

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How much to buy?

There is no magic formula to determine how much life insurance you need. Those selling insurance will often recommend a multiple of income, say 10 times your annual income, as a way of determining how much insurance you need. A multiple of earnings is one way of making the determination, but it's not usually that simple.

The best approach is to first analyze the sources of the need. If you are the breadwinner in your household and your spouse is taking care of your children or contributing a smaller portion of the household income, then the need for life insurance be-

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comes one of "income replacement." In other words, you should have an amount of insurance on your life that replaces your lost income. That way, if you're gone, your family can maintain their accustomed standard of living.

Another factor in that mix is your level of indebtedness and large expected outlays of cash in the future, such as for the college education of your children, if this is not otherwise funded. If you don't factor in these amounts, then your survivors could find their insurance fund rapidly depleted by paying off a mortgage or other debts, or for the education of your children. Is that a disaster? Not necessarily, since the surviving spouse could start working or work longer hours. But that's an issue you have to resolve in discussions with your spouse.

Even if your spouse is working and contributing to the household income, determine how much insurance is needed to "supplement" that spouse's income for your family to maintain their standard of living if you're gone. You'll want to figure in some additional expenses that may be necessitated by your demise—such as child-care expenses.

Let's look at an example to quantify this determination. Say you make $150,000 per year in your practice, and your spouse works outside the home and makes $50,000. You have two young children, ages 4 and 8. Your medical school debt is around $75,000, and you just bought a home with a $300,000 mortgage.

Is $1,000,000 of life insurance on you enough? First, determine the reasons for the insurance. In this example, it would primarily be income replacement, as you contribute 75 percent of the household income. But there's also a hefty $375,000 of debt to factor in, as well as the college needs of your two children. In deciding how much to buy, all these factors are important.

Specifically, in order to replace your income, assess whether your family needs $150,000 in addition to your husband's $50,000 annual income. Can they maintain their lifestyle with $100,000 additional income from the insurance proceeds? Or maybe just $75,000 additional income? Will expenses decrease in the family as the result of your death, or will child-care expenses increase?

Or maybe your husband will first take $375,000 from the insurance proceeds, pay off all the major debts, and then put away funds for the children's college education. By doing that, there should be less of a need to replace the entire amount of your income, as there is now no income needed to service the debt.

So how much is enough in this example? $1,000,000 of life insurance might be enough if the debt is first paid off, funds are reserved for education, and the family's monthly needs are reduced as a result of your death. But that leaves only about $500,000 to replace your income. That might not be enough while the children are at home. Possible solution: Consider a 20-year term life insurance policy of $1,000,000, and maybe a 30-year permanent policy of $500,000 (we'll discuss these forms of insurance later). What does this do? It provides more insurance dollars during the period of the greatest need (while the children are at home or in college), and provides funds to retire the indebtedness and replace a substantial portion of your income, but does not jeopardize the your family's ability to continue their lifestyle.

One other significant factor has to be analyzed: How much income can be earned on the insurance proceeds remaining after debt repayment to generate the income to replace your lost income? When interest rates are low, as they are now, it takes more of a fund to earn a predetermined amount. For example, if you've determined that it is important that at least $50,000 of your salary is to be replaced by insurance, a determination has to be made how much insurance proceeds are needed to generate that amount of income. It may mean $1,000,000 of insurance in times of low interest rates, versus only $750,000 of insurance in times when interest rates are higher.

It's hard to play the interest rate game on a short term basis. It's best to do the safe thing and buy the larger amount of insurance. An additional factor your insurance professional won't let you forget about: Buy the insurance while you're able, meaning when you are insurable at a lower cost, which is usually when you are younger. Of course, the dilemma is that is the time when you may have the least funds with which to purchase life insurance.

Now, what kind of insurance to buy

A good insurance professional can assist you with everything that has been discussed so far. If not, get another insurance professional. Nevertheless, let's examine the types of life insurance out there. There are many different products at very many different prices. You need to know your options to understand the alternatives that will be thrown at you.

The difference in costs can be substantial. For example, I shopped the Internet for insurance for the hypothetical physician from the example above. Rates for a 20-year term life insurance policy with a death benefit of $1,000,000 for a 38-year-old female ranged in cost from $48 per month to $76 per month. A permanent policy for that same benefit amount could cost hundreds of dollars a month

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or more. And the difference in the attributes of the policies is significant.

How to know which type of policy to buy? First, based on your need, using some of the advice set out above, determine the period of time you need the coverage. Life insurance can be sold to be in force for as short as 10-year periods or as long as your lifetime.

The lowest cost policy would, in almost all cases, be a "term" life insurance policy. Generally, that is life insurance coverage for a specified period of time. The policy can be sold for periods such as 10, 15, or 20 years. The premium in these policies is fixed at the outset, usually after a medical exam and exploration of your medical history.

Term policies, while being the lowest cost, offer you nothing more than insurance protection. If you are still living at the end of the policy, you have nothing for the money you have paid in premiums over the years. It is pure life insurance protection.

The other type of policy is known as "permanent" or "cash value" life insurance. These policies offer insurance protection plus an investment feature. Why an investment feature? One of the advantages given life insurance in the tax code is that amounts can build up inside insurance policies on a tax-deferred basis. That means a policy can provide you with insurance coverage and the ability to grow an investment fund without paying income taxes on that investment. When you remove from the policy more than you've paid in premiums, you pay income tax on the excess over your premium payments. So these policies give you insurance and a tax-deferred return on your investment.

The drawback is these policies are much more expensive than term life insurance. So why would anyone buy them? Lots of reasons. First, after 8 or 10 years, most permanent policies will make available to the policyholder a "cash surrender value" which is about equal to the premiums paid to date. In essence, you've got the insurance coverage and your money back. Caveat—policy terms vary wildly, and these returns are not guaranteed. Plus, the cost of these types of policies is as much as six or eight times higher—and comes when you're younger and your budget is the tightest.

Another reason to buy this type of policy is that, for many physicians, this can be a "forced" savings account. This is controversial, but I'm being a realist here. More people than will admit it spend all their income—plus some. I've had success advising a lot of my clients to save through an insurance policy—otherwise, the money will be spent. (Another way to do this is to take out a 15-year mortgage rather than a 30-year mortgage.)

If you are financially disciplined and prudent, you are probably better off to "buy term, invest the difference." That is, buy a lower-cost term life insurance policy and force yourself to invest with your financial adviser the difference between the cost of the permanent insurance and the term policy. If you can do this, your return will be somewhat better. But if you need to be forced into saving, look into some permanent policies. Or, as noted above in the example, explore a mix of the two. Perhaps a 20-year term policy for the time when the kids are growing up and expect to be in college, and a smaller permanent policy for an underlying amount of permanent insurance.

How do I go about all this?

Rarely should you go it alone when buying insurance. There are plenty of opportunities to buy your own life insurance policies on the Internet. But a life insurance policy is only part of a well thought out, coordinated estate and wealth-preservation plan. A good, experienced, knowledgeable life insurance adviser should almost always be involved. At least consult with someone who can work with you to determine your life insurance needs and provide sound advice on how to proceed.

The main advantage of a seasoned insurance professional is his ability to find the best deals for you by shopping around—not only for price, but for the best coverage. For example, if you previously smoked, are now a smoker, fly, or have other health issues, then the life insurance options available to you will drop dramatically. That's where a good agent can make the difference. So find the right agent to be on your side and be your advocate when shopping for life insurance. You'll be much better off in the long run.

Additionally, it's a good idea to have another member of your estate-planning team who is comfortable with advising you about life insurance. For example, when I am working with my clients and their insurance advisers, I will review any recommendations for insurance policies. That way, an objective third party review is injected into the process. Although I don't benefit directly from the sale of the insurance, I have the satisfaction and peace of mind knowing that another part of my client's estate and wealth preservation plan has been accomplished. ■

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