PRIVATE CAPITAL MANAGEMENT

PCM Insights: Life Insurance

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LIFE INSURANCE – AN IMPORTANT PIECE OF YOUR FINANCIAL PLAN

Life insurance can play an important role in the risk management component of your financial plan. Life insurance and its cousin, disability insurance, protect your most important asset – you.

Previously, we discussed property and casualty insurance and its role in protecting your possessions and assets.[1] Continuing the thread of risk management, we will discuss the purpose of life insurance and the primary types of insurance available today. An in-depth conversation with your advisor, along with an understanding of your entire financial picture will allow for an analysis to determine the amount and type of life insurance that would be appropriate for your family's situation.

WHY MIGHT I NEED LIFE INSURANCE?

There are several reasons that life insurance may be needed as part of your financial plan. The following are some of the most often cited situations:

1. **Replace income for dependents** – If your family depends more on one individual income, replacing that income can be an important consideration of insurance. A common example is families with small children, a stay-at-home parent, or spouses with disparate incomes. Life insurance is an option to replace the missing income that would have been used to provide retirement savings, fund college savings, pay large debts, as well as fund living expenses in the transition period. Another example is when pension or social security payments will decrease significantly at the death of one partner.
2. **Pay final expenses** – Life insurance is distributed directly to the named beneficiaries via the contract and is received tax free. Other assets may become frozen at death and await probate. Because of this, life insurance is a good option to have for paying funeral expenses, probate and estate administration costs, medical expenses, or other immediate cash needs.
3. **Tax efficient inheritance strategy –** Life insurance can be used as part of an overall estate plan to provide a tax-exempt inheritance to heirs. Other less tax friendly assets can then be used for charitable goals or passed to heirs with a lower tax liability. Trusts can also be used in conjunction with life insurance to protect the interests of heirs.
4. **Pay estate taxes –** Although the estate tax exclusion amount is currently very high, this has not been historically the case. Life insurance could be particularly beneficial for people who may have an estate tax liability at either the state or federal level due to the valuation of a closely held business or property that would present a burden to sell if there is an estate tax or final tax liability for the deceased. Having a life insurance policy can allow the heirs time to thoughtfully consider the disposition of any harder to liquidate assets. An Irrevocable Life Insurance Trust (ILIT), can be used to ensure estate needs are met in addition to estate taxes.
5. **Use in business situations –** Life insurance policies are often used in a business with partners to fund a buy/sell agreement, or as a key person policy. If a partner in the business dies, the life policy would maintain continuity by providing the business with funds to ensure that heirs who may not want to step into the business are financially secure and fairly compensated. Key person insurance, often life but sometimes disability, insures founders, owners, or important executives in a business. The funds typically are used to supplement the business until a replacement can be hired or in extreme circumstances, pay severance to other employees, pay investors, and fund the closing of the business.

[1] PCM Insights: P&C Insurance - https://www.pcm-inc.com/_/kcms-doc/174/70304/2022-March-1-Insights-FINAL-v2.pdf

WHAT TYPES OF LIFE INSURANCE ARE THERE?

There are two major types of life insurance: ***Term*** and ***Permanent***.

1. **Term Life –** A simple type of insurance in which a contract is in force for a specified amount of time and will pay the policy amount if death occurs during the term of the insurance. The cost, amount, and availability are dependent on the insured's age and health, and often affordable for most even for larger policy amounts. This type of policy is often recommended during the earning and saving years and would usually lapse when financial independence is achieved or converted to a permanent policy if allowed and needed for other purposes.

2. **Whole Life/Permanent Life –** Permanent or Whole Life insurance is meant to stay in effect for the entirety of an insured's life. Because a whole life policy will eventually pay the death benefit, these policies are more expensive than term policies. They typically have a level premium amount that is based on the amount of death benefit, age, and health of the insured. To keep the premiums level, the premiums in early years are greater than what is required to pay the claim, this makes up for the higher amount that is needed at old age. The excess, once at a certain amount, are what becomes available to the policy holder as cash value. It is important to understand that cash value is an alternative to the death benefit, not an additional benefit under the policy. Although part of a life policy, any interest or dividends do not receive tax exempt status unless paid as part of a death benefit. There are subcategories of permanent insurance called universal life and variable universal life, and there are also countless contract variations within each subcategory.

    a. **Universal Life –** This is an adjustable type of permanent policy, with greater flexibility than traditional whole life policies. These types of policies, in general, split your premium between the insurance cost and a separate savings vehicle (called a cash value account). This account earns a money market rate of interest and can be used to cover a portion of premiums thereby allowing for alteration of premiums and death benefit.

    b. **Variable Life –** These policies combine the death benefit option with the savings vehicle of universal policies but allow the savings account to be invested in securities (bonds, stocks, mutual funds). The value of the policy has the potential to grow more quickly, though taking on the risk of the market which could cause the death benefit to decrease along with the cash value account. Depending on the contract details, some may prevent the death benefit from dropping below a minimum level or may cap the maximum loss/return. Other combinations have the investment characteristics of variable policies with the flexibility to adjust premiums and death benefit.

Beneficiary Considerations – Once you determine the reasons and types of insurance that would be appropriate to include in your financial plan, you'll want to be certain that primary and contingent beneficiaries are identified for each policy. Because insurance is paid to the beneficiary with no restrictions, you will want to ensure that the person receiving the proceeds is also the person who is responsible for paying expenses. Beneficiaries should be reviewed as part of your overall financial plan to account for any changes in personal circumstances as well as any changes to estate and tax law.

Final Thoughts - Life insurance, though regulated by state insurance agencies, is sold as a contract. As with any contract, the terms can be incredibly complex. At PCM we recommend working together with your financial advisor and an insurance professional to determine the insurance that is appropriate for your needs and goals.

Sincerely,
The Private Capital Management Team