

## Why should I buy life insurance?

Many financial experts consider life insurance to be the cornerstone of sound financial planning. It can be an important tool in the following situations:

1. **Replace income for dependents**

If people depend on your income, life insurance can replace that income for them if you die. The most commonly recognized case of this is parents with young children. However, it can also apply to couples in which the survivor would be financially stricken by the income lost through the death of a partner, and to dependent adults, such as parents, siblings or adult children who continue to rely on you financially. Insurance to replace your income can be especially useful if the government- or employer-sponsored benefits of your surviving spouse or domestic partner will be reduced after your death.

2. **Pay final expenses**

Life insurance can pay your funeral and burial costs, probate and other estate administration costs, debts and medical expenses not covered by health insurance.

3. **Create an inheritance for your heirs**

Even if you have no other assets to pass to your heirs, you can create an inheritance by buying a life insurance policy and naming them as beneficiaries.

4. **Pay federal “death” taxes and state “death” taxes**

Life insurance benefits can pay estate taxes so that your heirs will not have to liquidate other assets or take a smaller inheritance. Changes in the federal “death” tax rules between now and January 1, 2011 will likely lessen the impact of this tax on some people, but some states are offsetting those federal decreases with increases in their state-level “death” taxes.

5. **Make significant charitable contributions**

By making a charity the beneficiary of your life insurance, you can make a much larger contribution than if you donated the cash equivalent of the policy’s premiums.

6. **Create a source of savings**

Some types of life insurance create a cash value that, if not paid out as a death benefit, can be borrowed or withdrawn on the owner’s request. Since most people make paying their life insurance policy premiums a high priority, buying a cash-value type policy can create a kind of “forced” savings plan. Furthermore, the interest credited is tax deferred (and tax exempt if the money is paid as a death claim).

## How much life insurance do I need?

In most cases, if you have no dependents and have enough money to pay your final expenses, you don't need any life insurance.

However, if you want to create an inheritance or make a charitable contribution, you should buy enough life insurance to achieve those goals.

If you have dependents, you should buy enough life insurance so that, when combined with other sources of income, it will replace the income you now generate for them, plus enough to offset any additional expenses they will incur replacing services you currently provide (for example, if you do the taxes for your family, the survivors might have to hire a professional tax preparer). Also, your family might need extra money to make some changes after you die. For example, they may want to relocate, or your spouse may need to go back to school to be in a better position to help support the family.

Most families have some sources of post-death income besides life insurance. The most common source is [Social Security survivors' benefits](#). Many also have life insurance through an employer plan, and some from other affiliations, such as an association they belong to or a credit card. Although these sources might provide a significant income, it is rarely enough.

### A multiple of salary?

Many pundits recommend buying life insurance equal to a multiple of your salary. For example, one advice columnist recommends buying insurance equal to 20 times your salary before taxes. She chose 20 because, if the benefit is invested in bonds that pay 5 percent interest, it would produce an amount equal to your salary at death, so the survivors could live off the interest and wouldn't have to "invade" the principal.

However, this simplistic formula implicitly assumes no inflation and that one could assemble a bond portfolio that, after expenses, would provide a 5 percent interest stream every year. But assuming inflation is 3 percent per year, the purchasing power of a gross income of \$50,000 would drop to about \$38,300 in the 10th year. To avoid this income drop-off, the survivors would have to tap into the principal each year. And if they did, they'd run out of money in the 16th year.

The "multiple of salary" approach also ignores other sources of income, such as Social Security survivors' benefits. These benefits can be substantial. For example, for a person who had been earning a \$36,000 salary at death (\$3000 a month), maximum Social Security survivors' monthly income benefits for a spouse and two children under age 18 could be about \$2,300 per month, and this amount would increase each year to match inflation. (It drops when there is only a spouse and one child under 18, and stops completely when there are no children under 18 remaining in the household. Also, the surviving spouse's benefit would be reduced if the spouse earns income over a certain limit.)

In this example, the survivors would need life insurance to replace only \$700

per month (adjusted for inflation) of lost income; Social Security would provide the rest. These survivors would need life insurance to replace about \$1,150 per month (adjusted for inflation) once the nonworking surviving spouse has only one child under 18 in her care, and the surviving nonworking spouse would have to replace the entire \$3,000 (adjusted for inflation) when the youngest child turns 18.

## **What are the principal types of life insurance?**

There are two major types of life insurance—term and whole life. Whole life is sometimes called permanent life insurance, and it encompasses several subcategories, including traditional whole life, universal life, variable life and variable universal life. In 2003, about 6.4 million individual life insurance policies bought were term and about 7.1 million were whole life.

Life insurance products for groups are different from life insurance sold to individuals. The information below focuses on life insurance sold to individuals.

### **Term**

Term Insurance is the simplest form of life insurance. It pays only if death occurs during the term of the policy, which is usually from one to 30 years. Most term policies have no other benefit provisions.

There are two basic types of term life insurance policies—level term and decreasing term.

- Level term means that the death benefit stays the same throughout the duration of the policy.
- Decreasing term means that the death benefit drops, usually in one-year increments, over the course of the policy's term.

In 2003, virtually all (97 percent) of the term life insurance bought was level term.

### **Whole Life/Permanent**

Whole life or permanent insurance pays a death benefit whenever you die—even if you live to 100! There are three major types of whole life or permanent life insurance—traditional whole life, universal life, and variable universal life, and there are variations within each type.

In the case of traditional whole life, both the death benefit and the premium are designed to stay the same (level) throughout the life of the policy. The cost per \$1,000 of benefit increases as the insured person ages, and it obviously gets very high when the insured lives to 80 and beyond. The insurance company could charge a premium that increases each year, but that would make it very hard for most people to afford life insurance at advanced ages. So they keep the premium level by charging a premium that, in the early years, is higher than what's needed to pay claims, investing that money, and then using it to supplement the level premium to help pay the cost of life insurance for older people.

By law, when these “overpayments” reach a certain amount, they must be available to the policyowner as a cash value if he or she decides not to continue with the original plan. The cash value is an alternative, not an additional, benefit under the policy.

In the 1970s and 1980s, life insurance companies introduced two variations on the traditional whole life product—universal life insurance and variable universal life insurance.

### **What is a beneficiary?**

A beneficiary is the person or entity you name in a life insurance policy to receive the death benefit. You can name:

- One person
- Two or more people
- The trustee of a trust you've set up
- A charity
- Your estate

If you don't name a beneficiary, the death benefit will be paid to your estate.

### **Two “levels” of beneficiaries**

Your life insurance policy should have both “primary” and “contingent” beneficiaries. The primary beneficiary gets the death benefits if he or she can be found after your death. Contingent beneficiaries get the death benefits if the primary beneficiary can't be found. If no primary or contingent beneficiaries can be found, the death benefit will be paid to your estate.

As part of naming beneficiaries, you should identify them as clearly as possible and include their social security numbers. This will make it easier for the life insurance company to find them, and it will make it less likely that disputes will arise regarding the death benefits. For example, if you write "wife [or husband] of the insured" without using a specific name, an ex-spouse could claim the death benefit. On the other hand, if you have named specific children, any later-born or adopted children will not receive the death benefit—unless you change the beneficiary designation to include them.

Besides naming beneficiaries, you should specify how the benefits are to be handled if one or more beneficiaries can't be found. For example, suppose you have two children and you name each one to receive half of the death benefit. If one of the children dies before you do, do you want the other child to get the entire death benefit, or the deceased child's heirs to get his or her share?

If the death benefit goes to your estate, probate proceedings could delay distributing the money, and the cost of probate could diminish the amount available to your heirs.

Choosing beneficiaries, and keeping those choices up-to-date, is an important part of owning life insurance. The birth or adoption of a child, marriage or divorce can affect your initial choice. Review your beneficiary designation as new situations arise in order to make sure your choice is still appropriate.