How to Avoid Common Pitfalls When Buying Life Insurance
By Robert Mintz, JD

Life insurance can be a key element of an effective estate tax strategy. However, when devising estate plans with clients we often find their current policies accomplish little or nothing in terms of future tax savings. It is not uncommon to find that the actual benefits provided by their policies are not at all what the clients thought. Often, people do not review their policies until it's too late, only to find they may have misunderstood the terms or their insurance agent may have misrepresented or poorly communicated essential features.

Know What You Have

Recently, I was working with a client to develop a strategy to minimize his estate tax liability and preserve his business and savings for his children. We estimated that the total estate would likely grow to $10 million over the next 15 years. He planned to partially cover the potential estate taxes of $4 million with a $2 million "term" life insurance policy he had bought years earlier.

These popular policies are intended to pay at face value if the policy holder dies within the period of coverage. Premiums can be fixed for 10-20 years and sometimes can be renewed, with new premiums set by the company at that time. For example, a 20-year policy for $2 million might cost $10,000 per year at age 45. Depending on the policy, you may have the right to renew for another 10 or 15 years, but the premium will be reset by the insurer based on your new age. At 65 or 70, the annual premium might increase to several hundred thousand dollars per year.

Coming to "Terms" with Your Policy

Term policies have an important and specific purpose: to replace lost income from a premature death. If you should die before your anticipated retirement date, how much insurance would be necessary to replace for your spouse and children all or a portion of your lost income? If the answer is "a lot," you are probably a good candidate for term insurance—it's the best solution because it offers the most insurance for relatively low premiums.

What you probably won't get from term insurance is any actual money paid out. Remember, these are low-cost policies until you get older, at which point the premiums often skyrocket. Hardly anybody renews or keeps them in force for the rest of their life. It's too expensive to maintain a term policy as you reach age 65 and older. Term insurance effectively covers the risk of lost income for a set number of years, but it doesn't build wealth for the future. When we looked closely at my client's policy, we discovered that it had fixed premiums until age 70, at which point he could renew, but the increased annual premiums would make the policy effectively unaffordable. We could see that unless he died before age 70, there wasn't going to be any insurance to accomplish his goals. That was certainly not what he intended or understood when he bought the policy. He knew that his business would increase in value and he needed a source of funds to pay estate taxes without selling the business, so he had purchased the policy the agent recommended and didn't look too closely at the details.

Permanent Policies

Because your current term policy probably will be insufficient if you anticipate paying sizeable estate taxes or you want to leave money to your family, you'll need a "permanent" life insurance policy that lasts for your lifetime. There are many varieties of these policies, but they are often described as "Whole Life" or "Universal Life." In addition to paying the specified death benefit, these policies also work like savings accounts, building cash value that you can borrow against or redeem. They also get a big tax break because the earnings on the savings are not subject to income tax at any time.

Conclusion

Term policies and permanent policies meet important but different financial needs. Term life insurance efficiently and inexpensively protects against the risk of lost income for a specific number of years. Permanent policies are designed to last for a lifetime; they effectively guarantee that a specified amount of wealth is accumulated for whatever family, charitable, or estate tax needs you might consider. The caveat is that there are huge differences in benefits and costs among all of the available plans. We will cover some of these differences and dangers in future columns but for now, as always, we advise you to talk to your knowledgeable advisors about the real benefits and costs of any insurance plan you are considering.

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