LIFE INSURANCE:
UNDERSTANDING YOUR COVERAGE OPTIONS

Most people will need some form of life insurance coverage during their lifetime. Life insurance can be used to replace lost income, establish retirement savings for a surviving spouse, fund other financial goals and create estate liquidity at death. Your life insurance goals are intertwined with your retirement, education and estate planning goals—making life insurance an important aspect of your financial life.

HOW MUCH COVERAGE IS APPROPRIATE?

Your need for life insurance will depend on several factors and the need will likely change over time. It is important to select a level of coverage that reflects family-specific circumstances without under or over-insuring. Some important factors to consider include:

- Debt Relief – What debt and other financial liabilities would you want to eliminate so your family is not burdened by these obligations? The decedent's student loans are not obligations that a surviving spouse will be responsible for. However, if the spouse also has student loans, you may wish to eliminate those to help improve the family's overall cash flow situation.
- Income Replacement – Once debt is eliminated, what portion of your current income would still be needed to provide for general family living expenses? If a surviving spouse would need to increase time spent working outside the home, consider the additional childcare expenses the family would incur as well.
- Retirement Savings – How much are you and your employer currently contributing to a retirement plan? Your spouse will likely not have the financial flexibility to increase his/her retirement savings to cover the loss of your contributions.
- Education – Would you like life insurance proceeds to fund your children's education in the event of your early demise? Often a surviving spouse is not financially capable of paying college expenses or making further 529 plan contributions.
- Succession Planning – Does your business need life insurance? Your business partners and employees might depend on you for their livelihoods. If you were to pass away, key person insurance and buy-sell agreements can help protect your business. Additionally, the value of your ownership in the business may decline after your passing. Consider life insurance to help support your family in the event they are unable to monetize the business.
- Other Financial Goals – Do you have additional financial goals such as: charitable contributions, helping your children with their first home purchase or caring for elderly parents? Consider securing additional life insurance coverage to help fund these goals.
- Estate Planning – Depending on your level of financial security and your remaining working years, you may not need life insurance for the above reasons. However, people who have amassed a sizeable estate may wish to consider life insurance as part of their strategic estate plan. Life insurance proceeds can be used to pay federal and state estate taxes, increase the inheritance for heirs, equalize the inheritance between heirs or fulfill charitable bequests.

Answering these questions will help you better determine the appropriate amount of life insurance coverage for each spouse. Most likely, you do not want your family to be forced to sell assets to cover basic living expenses or sacrifice educational opportunities due to a sudden change in the family's financial situation. Life insurance can help provide peace-of-mind for you and your entire family.

TYPES OF LIFE INSURANCE

The two basic types of life insurance are term life and permanent (cash value) life. **Term insurance** provides coverage for a specific amount of time (10 years, 20 years, to age 65, etc.) and is typically the least expensive type of coverage. Term insurance can be obtained individually or through a group policy provided by your employer. A medical evaluation is often required for individual policies but not for group coverage.

Convertible term insurance policies contain a provision that allows the owner to convert to a permanent policy at some point in the future. With this type of coverage, you select a payment period during which time you pay annual term insurance premiums. Once this period ends, you are able to convert the term policy to permanent coverage. The premium will likely increase based on the new type of coverage, but you are able to convert without having to provide evidence of insurability (no medical evaluation required).

If you do not have a convertible term policy but are considering a change from term to permanent insurance, we recommend exploring this option prior to age 60. It is much more difficult and more expensive to obtain permanent coverage as you age, have a medical issue or begin taking certain types of medications.

Permanent insurance remains in place for as long as the insured is alive and sufficient premiums are paid to keep the policy in force. A portion of each premium is credited to the cash value account, which grows tax deferred and can be borrowed against if necessary. Generally, permanent life insurance should not be relied upon to fund your retirement spending goals. There are often large up-front commissions and investment fees which can erode your return. If you want to invest for retirement, IRAs, 401(k)s or similar retirement plans are often more suitable retirement savings vehicles. Permanent insurance requires a medical evaluation and is generally more expensive than term policies. The following types of permanent insurance are available:

- Whole Life – Premiums are level throughout the insured's lifetime.
- Universal Life – Premiums can be paid at any time and in any amount, as long as the policy expenses and cost of insurance charges are met. This provides payment flexibility and the ability to increase or decrease the policy coverage amount through changes in premium payments.
- Variable Life - Premiums are level throughout the insured's lifetime and the cash value account is invested in sub-accounts, which include a variety of equity, fixed income and money market portfolios. This can result in increased or decreased coverage, depending on the investment performance of the sub-accounts.
- Variable Universal Life – Flexible premiums combined with the utilization of sub-accounts. Again, the coverage amount will change depending on the investment performance within the sub-accounts.

Evaluating your goals will help you determine the most appropriate type of life insurance coverage. If your insurance needs are focused on your working years (income replacement, retirement plan contributions and saving for education), term insurance is likely appropriate. If you have a need that continues beyond retirement (charitable bequest, inheritance equalization or payment of estate taxes) permanent insurance should be considered.

BENEFICIARY DESIGNATION

Life insurance proceeds will be paid to the beneficiary you have designated on the policy, regardless of what is stated in your will or trust. The beneficiary designation supersedes all other documents, so it is imperative that you review your beneficiary designations and update them as necessary. We recommend designating both primary and contingent beneficiaries. If your beneficiaries include minor children, consider naming a trust as the beneficiary so a minor child or his/her guardian does not receive the funds outright.

If there is no valid beneficiary at the time of death, policy proceeds will be paid to your estate and distributed as stated in your will or trust. While this may accomplish your wealth transfer goals, the insurance proceeds will be included in your probate estate and therefore will not be available to your heirs until the probate process is finished (generally 6-12 months).

ESTATE PLANNING WITH LIFE INSURANCE

Life insurance is often an important component of a strategic estate plan. If you are projected to have a taxable estate at death, life insurance can be used to pay the tax liability which preserves other assets for your heirs. Families with a large real estate holding or illiquid family business would otherwise be forced to sell a portion of these assets in order to pay the estate tax liability.

The Tax Cuts and Jobs Act of 2017 effectively doubled the federal gift and estate tax exemption beginning in 2018. For 2022, the federal gift and estate tax exemption is $12.06 million per person (increased from $11.7 million in 2021). However, the law provides that the increased exemption will only be applicable through December 31, 2025. Beginning in 2026, the federal gift and estate exemption is scheduled to automatically revert to the 2017 level ($5.49 million, indexed for inflation). As such, it is important to keep in mind that the increased exemption may be short lived. Many states, including Oregon, also have estate tax exclusions that are set at a much lower level.

Other estate planning strategies involving life insurance include estate equalization and the maximization of wealth transfer. If a large portion of your estate is concentrated in one asset, such as a business or family farm, life insurance can be used to help equalize inheritance to other heirs. For example, one child may be involved in the family business and will receive full ownership upon your death and the other child could receive life insurance proceeds of an equal value. Life insurance can also be used to leverage up the amount left to heirs or to charity.

IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

If you are utilizing life insurance as part of your estate plan, it may make sense to have the policies owned by an Irrevocable Life Insurance Trust (ILIT). Individually owned life insurance is includable in your gross estate. However, a properly drafted and executed ILIT will remove this asset from your estate and allow you to transfer additional wealth to your heirs or to charity.

Existing policies can be gifted to an ILIT or a new policy can be purchased by the trust. If the grantor gifts an existing policy, they must live for at least three years to remove the death benefits from their gross estate. Alternatively, if the grantor transfers cash to purchase a new policy, the three-year rule does not apply since the grantor will not have incidents of ownership in the policy. The number of trust beneficiaries and the number of insured lives (single individual or joint life policy) will determine the amount of the annual premium that can be paid annually free of gift tax or the size of an existing policy that can be gifted to the trust tax free. If you are interested in exploring this strategy, we would be happy to discuss and evaluate your unique situation.

REVIEWING OR CHANGING COVERAGE

If you are concerned about your risk or have existing coverage and want to determine if it is appropriate, we can facilitate an evaluation. Aldrich Wealth does not sell insurance; we simply guide you through the evaluation and education process. We do, however, have relationships with credible insurance brokers in our geographic markets. Brokers are able to place policies with many different companies, allowing them to find the most suitable insurance company and product for your specific needs. Aldrich Wealth does not receive any payment, commission or revenue sharing for the policies sold by these brokers. If you do not already have a trusted insurance agent or broker, we would be happy to introduce you to a local professional.