Life insurance can offer peace of mind and financial protection, but it's essential to understand its purpose and limitations. This guide helps you determine when it is appropriate to purchase life insurance —and when it may not be.

What are the Reasons to buy Life Insurance?

Good Reasons to Buy Life Insurance

- **Final Expenses**
  Covers burial costs, funeral services, and other death-related expenses. Helpful if there are no other available funds to cover the costs.
- **Support for Dependents**
  Provides income for children, a spouse, or others who rely on the insured for financial support.
- **Business Protection**
  Helps cover financial obligations in the event of a key person's death in a business. Lenders sometimes require these "key person" policies to cover the repayment of outstanding loans in the event that a key business leader passes away.

Less Appropriate Reason to Buy Life Insurance

- **As an Investment or Savings Tool**
  Life insurance is generally a poor substitute for traditional investment vehicles. Many policies offer low returns and high fees compared to investing independently. Life insurance companies pay commissions to sales representatives who sell policies, which reduces the benefits for policyholders.

What are the Different Types of Life Insurance?

There are three types of Life insurance: Term Insurance, whole life insurance, and universal life insurance.

Term Life Insurance

Features:
- Provides coverage for a specific period, typically one year.
- A medical examination may be required.
- Premiums and insurability may be dependent on health, age, sex, and smoking status (smoker or nonsmoker).
- No cash value if the insured outlives the policy.

Benefits:
- Pays out a "death benefit" if death occurs during the term.
- Relatively inexpensive, based on age, health, and lifestyle.

Pros: Affordable, straightforward
Cons: No long-term cash value

Whole Life Insurance

Features:

- The policy period is for the insured's entire lifetime
- The premium remains constant throughout the policy term.
- The policy can be designed so that premiums are paid for a specific number of years, such as 10, 20, or 30 years, or until the insured reaches a certain age, typically 65. Under these circumstances, the policy is referred to as a limited-pay whole life policy.

Benefits: death benefit or cash surrender value

- Provides a death benefit if the death occurs during the policy period, provided premiums have been paid. (like term insurance)
- Also features a "savings" component, whereby the insurance company takes a portion of the premium and invests it in the financial markets (Stocks and Bonds), which results in a "cash surrender value."
- The cash surrender value can be withdrawn or converted into an annuity by the insured.

Pros:

- Option for individuals who do not know about investments
- Savings mechanism for individuals who lack the discipline to invest routinely and systematically.

Cons:

- Often marketed to "build wealth," but many policyholders are disappointed when they learn, years later, of the actual cash surrender value.
- Insurance companies act as a middleman regarding the "investment" portion.
- The insurance company pays significant commissions to agents who sell the policies**.**
- Three to four times more expensive than term insurance.

Tips: Before buying, compare:

- Total cost of a whole life policy vs. a term policy over 10 years
- The projected cash surrender value after 10 years
  The difference can be eye-opening. (see example at end of handout)

Universal Life Insurance

A Universal Life Insurance policy is similar to a Whole Life Policy, except that the premium can vary from year to year, the death benefit can fluctuate, and the cash surrender value is based on the investment experience.

The life insurance company has offered to pay the cash surrender benefit as an annuity. What does that mean?

An annuity is a contract that provides a stream of income payments.

It works by exchanging a lump sum or a series of payments for a guaranteed income stream, either for a fixed period or for the annuitant's lifetime.

If the insurance company is offering an annuity, it is doing so based on the insured not taking the cash surrender value and using that money to fund the income stream.

Can an Annuity be Created at Any Time?

Yes, it is possible to enter an annuity contract at any time, although some annuities have specific minimum and maximum age requirements.

A person would typically turn over a lump sum of cash to an insurance company, which would then guarantee a lifetime income stream, known as an annuity. The income paid out is based on the initial investment, the annuitant's age, sex, and health status. Essentially, the company offering the annuity has estimated the average lifetime of its clients based on the above factors. It has factored in that they will have sufficient funds to meet the payments and still generate a profit.

Are There Different Types of Annuities?

Yes – typically, annuities fall into two categories

- **FIXED ANNUITY** - Offers a guaranteed interest rate and a predictable payout, making it an ideal choice for those seeking a stable income stream.

- **VARIABLE ANNUITY**: Enables the client to invest in a portfolio of stocks, bonds, and other investments, and links the payout to the performance of a market index.

Furthermore:

- Annuities can begin providing income immediately after purchase or can be structured to start payments at a later, deferred date.
- They can be designed to provide income for a single lifetime, ceasing upon the individual's death, or for joint lifetimes, continuing payments to the surviving person after the first passes.

Are Insurance Proceeds Tax Free to the Recipient?

- Death benefits paid as a lump sum to a named beneficiary are not subject to federal income tax.

However:

- **Interest earned**: If the insurance company holds the proceeds and pays them out with interest over time (such as in an annuity or installment), the **interest portion is taxable** as income.
- **Estate inclusion**: If the policyholder owns the policy at the time of death, the **death** benefit may be included in their estate for estate tax purposes, which could result in estate taxes if the estate exceeds the federal or state exemption limits. If Estate Taxes are a concern, steps can be taken to avoid this issue. (See handout 9.06)
- **Tax treatment may differ** depending on whether the proceeds are taken directly as an annuity or used to purchase one after payout. The proceeds, if left with the insurance company, are taxable.

Summary

Life insurance can be a powerful tool to provide benefits on death.

It is a necessary item if others rely on the insured for financial support. However, stick to its core purpose: **financial protection**, not investment growth.

Always obtain multiple quotes and ask detailed questions before committing.

VOCABULARY

- Policy Owner
- Beneficiary
- Term
- Cash Value, Surrender Value
- Annuity

Comparison of Whole Life Insurance Cash Surrender Value vs Investor Controlled Investment after 20 years

Death benefit	1 million dollars
Insured	Woman, age 35, non smoker
Years Premium must be pai	20 Years

Assumes the cost of Term Insurances Increases 5% annually

Assumes that the Insured invests the premium difference in a stock and bond portfolio they control and earns an average of 4% interest annually

	Premium Term Insurance	Premium Whole Life Insurance	Premium Difference	Starting Investment (add premium savings current year)	Invest at	Earnings on Investment	Ending Value
1	$ 400	$ 15,000	$ 14,600	$ 14,600	4%	$ 584	$ 15,184
2	$ 420	$ 15,000	$ 14,580	$ 29,764	4%	$ 1,191	$ 30,955
3	$ 441	$ 15,000	$ 14,559	$ 45,514	4%	$ 1,821	$ 47,334
4	$ 463	$ 15,000	$ 14,537	$ 61,871	4%	$ 2,475	$ 64,346
5	$ 486	$ 15,000	$ 14,514	$ 78,860	4%	$ 3,154	$ 82,014
6	$ 511	$ 15,000	$ 14,489	$ 96,504	4%	$ 3,860	$ 100,364
7	$ 536	$ 15,000	$ 14,464	$ 114,828	4%	$ 4,593	$ 119,421
8	$ 563	$ 15,000	$ 14,437	$ 133,858	4%	$ 5,354	$ 139,212
9	$ 591	$ 15,000	$ 14,409	$ 153,621	4%	$ 6,145	$ 159,766
10	$ 621	$ 15,000	$ 14,379	$ 174,146	4%	$ 6,966	$ 181,111
11	$ 400	$ 15,000	$ 14,600	$ 195,711	4%	$ 7,828	$ 203,540
12	$ 420	$ 15,000	$ 14,580	$ 218,120	4%	$ 8,725	$ 226,845
13	$ 441	$ 15,000	$ 14,559	$ 241,404	4%	$ 9,656	$ 251,060
14	$ 463	$ 15,000	$ 14,537	$ 265,597	4%	$ 10,624	$ 276,221
15	$ 486	$ 15,000	$ 14,514	$ 290,734	4%	$ 11,629	$ 302,364
16	$ 511	$ 15,000	$ 14,489	$ 316,853	4%	$ 12,674	$ 329,527
17	$ 536	$ 15,000	$ 14,464	$ 343,991	4%	$ 13,760	$ 357,751
18	$ 563	$ 15,000	$ 14,437	$ 372,188	4%	$ 14,888	$ 387,076
19	$ 591	$ 15,000	$ 14,409	$ 401,485	4%	$ 16,059	$ 417,544
20	$ 621	$ 15,000	$ 14,379	$ 431,924	4%	$ 17,277	$ 449,201
	$ 10,062	$ 300,000	$ 289,938			$ 36,143	

$ 225,000

Cash Surrender Value
generally 75 % of premium paid

$ 449,201

Value at end of 20 years
Assumes invested in a
retirement account which grows tax free