Life Insurance:
Permanent and Term

Questioning which type is a smart financial strategy

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Historically, life insurance gets a bad rap—it's a policy with benefits and a purpose that doesn't truly shine, so many people skip this as part of their investment portfolio. Obviously, no one can predict the future, but having life insurance means you and your loved ones are better prepared when the unexpected happens. Even with a small policy, you may find yourself sleeping a little easier at night knowing that your family has protection in place should something happen to you.

For most of us, the belief that life insurance has one purpose: to provide a financial benefit in the event of your death, and if we've covered our final expenses with other products there really isn't a need to buy this coverage. But the reality is, life insurance can do much more for you while you're still among the living, you just need to ask the right questions.

Insurance is all the same right? Wrong.

Term Life Insurance

Term life insurance is a simple, straightforward insurance policy. The policyholder pays regular premiums. If they die while the policy is in effect, their beneficiary receives a death benefit. The defining factor when it comes to this type of insurance is the **"term"** - how long the policy is active. Term life policies expire after a set number of years. Additionally, term life insurance is relatively **inexpensive**, so young families looking to obtain coverage will find this option provides peace of mind while fitting within their budget.

Permanent Life Insurance

Permanent life insurance is designed to last from the time of purchase through the remainder of your life. It offers a death benefit to a beneficiary, as well as an investment component for the policyholder which accumulates a cash value. The cash value grows tax-deferred and the policyholder has the option to take loans without limitations. Permanent insurance policies are typically more **expensive** because they last from the time you buy into the policy until death, as long as you pay the required premiums.

Insurance Subcategories:

Term

Level: Insurance coverage at a fixed rate with premiums that don't change.

Return of Premium: Insurance policy that refunds the dollars you've paid into it if you live beyond the term of your policy.

Annually Renewable: Insurance that offers a guarantee of future insurability for a set period of years without taking a medical exam or reapplying.

Permanent

Whole: Insurance that is guaranteed to remain in force for the insured's entire lifetime, provided required premiums are paid.

Index Universal: Insurance that lets the policyholder decide how much cash value to assign to either a fixed account or an equity indexed account.

Guaranteed Universal: This policy offers fixed rates through the life of the policy, just like term insurance. GUL policies are also set to specific ages (usually 90, 95, 100, 105, 110, or 121), while term life insurance offers fixed rates for a specific number of years.

Universal: Insurance with an investment savings element and low premiums that are similar to those of term life insurance and also have differing premium options.

Current Assumption: Insurance where the cash value accumulates based on a declared interest rate by the insurance company and growth is based on current interest rates, as well as mortality and expense charges.

Variable Universal: Insurance with a flexible premium and a built-in savings component that allows for the investment of the cash value.

https://lifehappens.org/life-insurance-101/
https://www.investopedia.com/terms/l/lifeinsurance.asp

Q *I already have money invested in a tax-deferred product, so why should I consider purchasing life insurance as an asset?*

A **Tax-deferred growth:** You can only enjoy tax-deferred benefits from a few investments like IRAs and 401(k)s, but if you've maxed out your contributions, a permanent life insurance policy is another great option. In addition to having another tax-deferred asset in your portfolio, a permanent life insurance policy has no restrictions on how much you can put into this type of plan.

The bigger benefit for choosing this alternative income strategy is the loan option that differs from loan options from qualified investments like IRAs and 401(k)s. Taking a loan from life insurance is a tax-deferred alternative that gives you access to a penalty-free loan option by using the policy as collateral and taking a tax-free loan from the cash value. Additionally, the loan and interest aren't required to be repaid, rather the balance is just taken from the final death benefit. A permanent life insurance policy affords you the ability to use your money when you need it most during your lifetime.

Q *How can I ensure my life insurance will benefit my heirs without worrying that the dollar amount they receive will be reduced by taxes and fees?*

A **Beneficiaries actually do benefit:** Life insurance allows the death benefit to transfer income-tax-free to beneficiaries. This means no matter the amount, beneficiaries won't pay any income tax on the invested money they receive unlike other investments such as IRAs, annuities, and qualified retirement plans. However, income earned in the form of interest is almost always taxable at some point. Life insurance is no exception. This means when a beneficiary receives life insurance proceeds after a period of interest accumulation rather than immediately upon the policyholder's death, the beneficiary must pay taxes, not on the entire benefit, but on the interest[1].

If you're in the high net worth category, an irrevocable life insurance trust could allow for your heirs to not have to pay estate and income taxes on death benefits. If you're in a more modest income bracket, you and your heirs can benefit from cash gifting which will reduce your taxable estate and your beneficiaries won't have to worry about estate or income tax on the death benefit[2]. Note that with a properly designed policy, the transfer will bypass any potential probate.

Q *I have a special needs child and when I pass away, they'll continue to need care throughout their adult life, is term or permanent life a better choice?*

A **Coverage will probably last longer than you:** While many adults buy life insurance for coverage while their children are young, life insurance can help secure the future of a child with special needs through their adult years. In many situations, it is recommended to invest in term life insurance early on and purchase as much coverage as you can afford so, should the unfortunate happen, your child will have the financial benefits needed well into their adult years. Your term life insurance policy will end after a specified number of years, but the option to convert to a permanent policy does exist giving you peace of mind and your adult child the security they'll need.

Setting up the beneficiary correctly is crucial so that your child is not disqualified from any needed government assistance. People with disabilities generally can't have more than $2,000 of assets in their name or they risk losing essential health services. You can provide life insurance benefits for your child and still preserve eligibility for government programs by setting up a special needs trust. The trust holds assets for your child, and the trust document spells out how the money should be used. You appoint a trustee to manage the money on behalf of your child[3].

RIDER FOR LIVING BENEFITS

Chronic Illness | Critical Illness | Terminal Illness

To qualify for a chronic illness, the policyholder must be diagnosed with a qualifying condition and may need to meet certain long-term care requirements as determined by an insurance company. If you qualify you may be able to live more comfortably, afford better medical care, and get access to long-term care to offset the care costs of a severe impairment. This can help alleviate the financial stress on both the policyholder and their family.

Q *I have a family history of health issues and am concerned that I'll need cash to pay for expenses, how do I pay for those plus leave my heirs something later?*

A **Provisions for you and your heirs:** Life altering illnesses such as stroke, heart attack and certain cancers can decimate a family's savings. Government programs such as social security are fundamental retirement products that many people anticipate using to pay for living expenses but looking to the future these benefits could be in jeopardy thanks to the federal deficit. Creating an income stream from your permanent life insurance policy, may be a more stable choice when paying for retirement necessities.

One approach is to purchase s life insurance policy with an accelerated benefit rider. This provides the option to use a percentage of the death benefit in order to cover unexpected medical and living costs. The upside is that by taking the "accelerated benefits" now you can pay bills and enjoy your life with less worry. The downside is that your beneficiaries won't receive the full death benefit. Additionally, some policies have limitations regarding at what point they will distribute this benefit.

Another choice for the policyholder would be to take a low-interest loan against the cash value of their insurance policy. Borrowers can pay the loan back on their own schedule or choose to let the loan amount be pulled from the final death benefit amount. At the time of the policyholder's death, the loan amount, plus interest, will be subtracted from the death benefit[4].

According to **CMS.gov**, as many as one in two Americans have a pre-existing condition. Unfortunately, these conditions can also affect life insurance rates and approval for a policy. Having one of these conditions doesn't automatically mean you'll be denied coverage. However, depending on your insurer's underwriting process, it could mean higher rates.

Examples: *(Confirmation of coverage is required)*

- Stroke
- Heart attack
- Diabetes
- Multiple sclerosis
- Cancer
- Alzheimer's

More Information on choosing a rider can be found at: https://www.masonfinance.com/blog/chronic-illness-rider/

Q *A permanent life insurance policy is expensive, and I know there are better investment options so why should I consider adding this to my financial portfolio?*

A **You can borrow from "Peter to pay Paul":** Here's where investing in permanent life insurance really shines. Today's interest rates are so low that typical conservative assets (savings accounts, bank CDs, bonds...) are earning less than the rate of inflation and certainly not growing enough to cover rising medical costs. Further, these assets are taxable at ordinary income tax rates which means, without more risk, these investments are highly inefficient. A life insurance contract as an asset grows tax-deferred and allows you to access the cash value tax-free.

If you need money to make a purchase or even pay for college, you can borrow against the cash value of the policy and receive it free of taxes. If you borrow against the policy, you use the policy as collateral and take a tax-free loan from the cash value. Further, the interest rate for repayment is generally low compared to a personal loan or that of a credit card. Done properly, a tax-free loan on life insurance can offer investors a source of liquidity and tax-free income during retirement[5].

Conversely, if you put money in a tax-advantaged retirement plan like a 401(k) and want to take it out for a purpose other than retirement, you may be required to pay penalties.

Q *Life insurance makes sense as an alternative investment strategy and as a product to provides peace of mind, but how much do I need, what kind is right for me, and who offers the best policy for my situation?*

A **All great questions best answered elsewhere:** For a relatively low premium, insurance as an alternative investment strategy can help you pay for college, or illness, or take care of loved ones and is worth exploring as part of your portfolio. You'll need to discuss all your concerns with a licensed financial professional—from living benefit riders, to avoiding estate taxes, to final expenses—to obtain a properly written life insurance policy that can protect your life and legacy.

The variety of life insurance policies is vast and a need to add riders to your policy can add confusion to the decision-making process. Additionally, it's important to know that there will be price differences among different companies offering what appears to be identical coverage. When you're ready to apply, expect questions in detail regarding your lifestyle, future plans, your family health history, and your personal health history.

The process of choosing how to secure what's most important to you can be lengthy and deciding which life insurance policy is the right choice will depend on your reasons for setting up a policy. When you're ready, do your research ***(checklist for first-time buyers)****, take your time, and work closely with your financial professional.*

[1]George Depersio, August 20, 2020, “Do Beneficiaries Pay Taxes on Life Insurance?” [Online]. Available: https://www.investopedia.com/ask/answers/102015/do-beneficiaries-pay-taxes-life-insurance.asp

[2]George D Lambert, February 24, 2020, “Cut Your Tax Bill With Permanent Life Insurance”, [Online]. Available: https://www.investopedia.com/articles/pf/07/permanent_life_insurance_taxes.asp

[3]Barbara Marquand, May 22, 2015, “Life Insurance for Parents of Children with Special Needs”, [Online]. Available: https://www.nerdwallet.com/blog/insurance/life-insurance-parents-special-needs-children/

[4]Paying for Senior Care, April 14, 2009, “Life Insurance Accelerated Death Benefits as a Means to Pay for Care”, [Online]. Available: https://www.payingforseniorcare.com/financial-products/insurance

[5]Darla Mercado, CFP, August 19, 2018, “This source of tax-free cash can sweeten or ruin your retirement,” [Online]. Available: https://www.cnbc.com/2018/08/17/this-source-of-tax-free-cash-can-sweeten-or-ruin-your-retirement.html

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