KEATING
Wealth Management

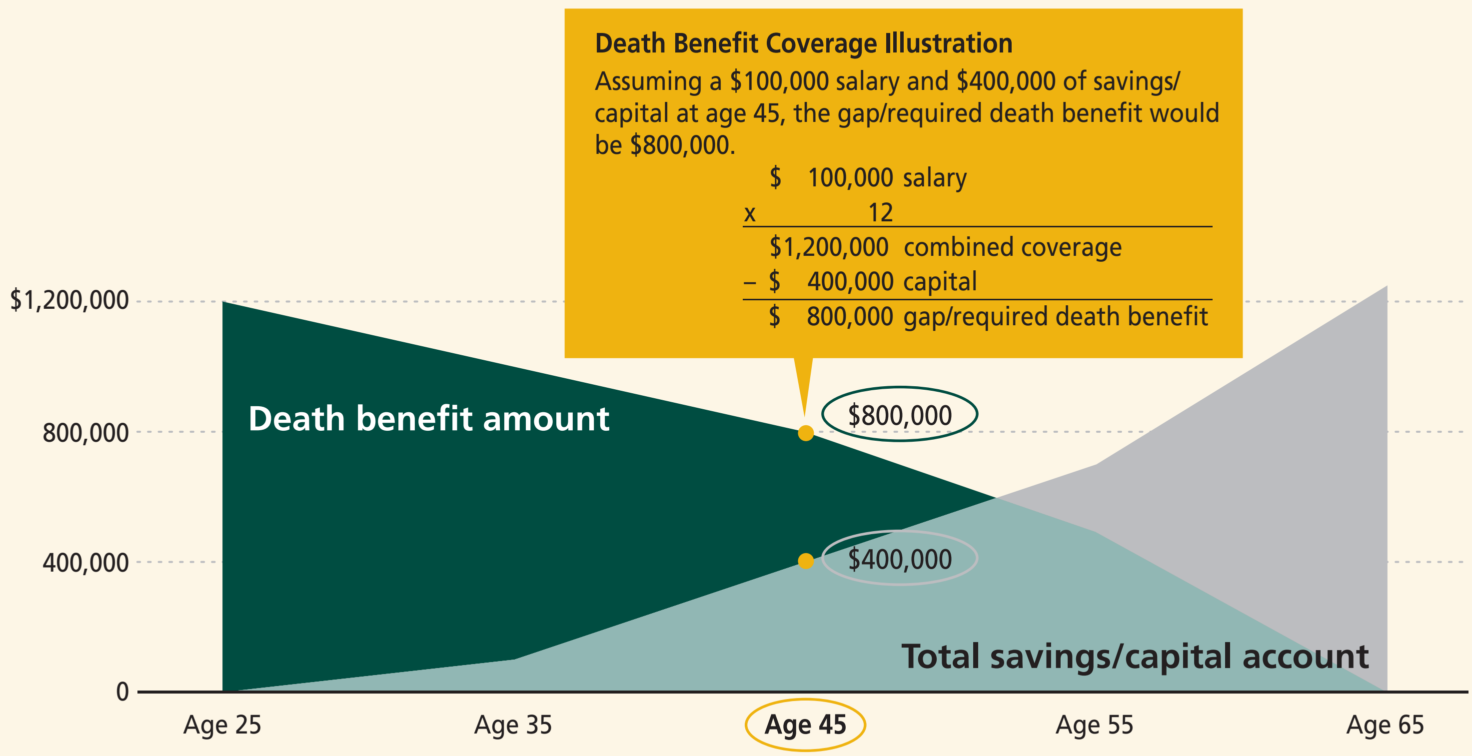
Life Insurance 101

Why have life insurance?

For many people, buying a life insurance policy is a smart move that ensures financial safety for family and loved ones. Life insurance provides a death benefit that can replace your earnings and also extinguish liabilities, such as a mortgage, and cover final expenses, such as burial costs. In short, the purpose of life insurance is to enable your dependents to continue living their lives and achieve their financial goals without interruption despite your death. According to Annuity.org, 44% of Americans would experience financial stress within six months of the death of the family's primary wage earner and 10% would feel the financial burden within one week.[1] Knowing that your family will be able to carry on in your absence offers substantial peace of mind.

How much insurance do I need?

Some 54% of Americans surveyed in 2022 said they hadn't purchased life insurance because they don't know what type to buy or how much they need.[2] The amount of life insurance you need varies based on personal and financial circumstances, but the death benefit should be enough to replace your income and cover your dependents' current and future expenses. When calculating the appropriate amount of life insurance, you will need to consider your age, the amount of income that needs to be replaced, other sources of income, and total assets and liabilities. With the aid of sophisticated financial planning software, and based on a series of assumptions and preferences, the ideal amount can be determined with precision. Here, we simply offer some basic rules of thumb to generate a ballpark estimate of the required death benefit. This can serve as a useful starting point for those without access to financial planning software.



[1] *Savannah Pittle, "Life Insurance Statistics and Industry Trends To Know in 2023," Annuity.org, September 5, 2023.*

[2] *Chauncey Crail, "Life Insurance Statistics, Data and Industry Trends 2023," Forbes Advisor, June 21, 2023.*

What type of insurance to buy

Always buy term life insurance. We explain why on page 3.

Rule of thumb: 12x income

A simple rule of thumb is that the value of your investment portfolio plus the death benefit of your life insurance policy should always total **12x your annual income**. This sum is called your capital account. As the value of your portfolio increases, the amount of life insurance coverage needed to maintain this ratio correspondingly declines. Conversely, if your portfolio value remains the same but your income increases, your required death benefit also increases.

Death benefit amount calculation

Here's a simple illustration using the 12x rule:

- You are a 35-year-old with a $100,000 annual income, and you have $200,000 in investments. Your target capital account value is $1,200,000 (12 x $100,000 income), so your required death benefit is $1,000,000 ($1,200,000 – $200,000 portfolio value).
- Fast forward 10 years to age 45. Assume your income has remained at $100,000 but your investment portfolio has grown to $400,000. Your target capital account value is still $1,200,000 (12 x $100,000), but the required death benefit has decreased to $800,000 ($1,200,000 – $400,000 new portfolio value).
- If your income rises to $150,000, your target capital account value would increase to $1,800,000 (12 x $150,000), so your required death benefit would increase to $1,400,000 ($1,800,000 – $400,000).

Critical implicit assumptions

The 12x rule of thumb is based on a series of critical implicit assumptions, which include:

- All debts are to be repaid and extinguished immediately upon the policyholder's death, especially any home mortgages.
- Apart from the spouse's employment income, there are no additional sources of income.
- There is no desire to adjust the family's lifestyle, basic living expenses, or financial goals.
- There are no other financial assets.

Types of insurance

There are two basic life insurance options: term and permanent. Both provide a death benefit. Term lasts for a specific, preset period. Permanent lasts a lifetime and typically comes in three varieties: whole life, universal life and variable life. **We strongly recommend purchasing term life insurance only.**

Term

Term insurance does not accumulate a cash value because it doesn't have a savings component. Your health and age will determine how much insurance you should buy and how long you'll want to have it. Your age, gender, health, lifestyle and occupation will also affect your insurance rates. Life insurance premiums increase with age, but ideally you'll need less coverage as you get older, because you will have more assets, less debt and fewer future obligations. Once you purchase life insurance, it is important to reassess your policy annually and ensure your coverage meets your specific needs.

Permanent

Permanent life insurance is designed to stay in place for your entire life. This type of policy offers a death benefit but can also be used as a savings or investment vehicle. Permanent coverage usually costs more than a term life insurance policy because it can build cash value. There are three main types of permanent insurance:

1. **Whole life** insurance offers fixed premiums for as long as the policy is in effect. As you pay your premiums, you can build up a cash value in the policy. Depending on the insurance company, you may be able to receive dividend payments from the policy.
2. **Universal life** insurance offers a little more flexibility than whole life coverage. The policy is attached to an interest-bearing account, and you can change your death benefit or premiums within certain limits. Generally, you can withdraw or borrow against funds held in the account as long as your premiums are covered. Just keep in mind that any unpaid loans will reduce the amount of the death benefit payable.
3. **Variable life** insurance policies offer a broader range of investment choices. Variable life insurance may prove a better choice for those more comfortable taking on a higher degree of risk. The value of the policy is tied to market performance. This means your benefits and premiums may decrease or increase over time. You can also borrow against this type of policy, but outstanding loans will diminish your death benefit.

Why term is always the best choice

The primary purpose of life insurance is to replace income when the insured dies. Term life insurance does that and nothing more. It is simple, easy to understand and affordable.

Permanent life insurance, by contrast, is extraordinarily complex because it combines a death benefit with a savings plan, called the cash value. Because of the large sales commissions embedded in the cost of permanent life insurance, the products are expensive and not consumer-friendly.

The extra premiums you'd pay for one of these plans should earn more if invested separately in an index fund, even if the permanent life insurance plan offers an index investment option. This is because a significant portion of the higher premiums for permanent life insurance end up in the pockets of the insurance agent and company, not in your investment vehicle. Not only does term life insurance offer the opportunity to accumulate more savings independently, but if you need to withdraw money from your separate index fund investment, it won't affect the death benefit on your term life policy. The one potential benefit of having a permanent life insurance policy is the ability to make tax-free withdrawals.

Who doesn't need insurance?

Some people really don't need life insurance. Here are a few examples:

1. **Retirees.** Many retirees have no future obligations that need to be funded, or any obligations they do have can be adequately funded from existing financial assets.
2. **Self-insured.** Those who have sufficient financial assets may not need life insurance.
3. **Young singles.** If you're single and don't have children, you likely don't need any life insurance. But you still might want to be prepared in case your status changes, since premiums are lower for young, healthy people.

Caution: If your employer provides **group coverage** as part of your benefits package or offers subsidized coverage through a group life insurance plan, you might think you don't need to buy your own individual policy. However, the coverage provided by your employer might not meet your needs, as coverage is usually capped at a low amount, such as one or two times your annual salary.[3] Also, group life insurance is usually active only as long as you stay with the original employer.[4] So it's best to consider group coverage a nice bonus rather than a substitute for personal life insurance.

[3] *Georgia Rose, "Pros and Cons of Group Life Insurance Through Work," Nerdwallet, April 26, 2023.*

[4] *Crail, "Life Insurance Statistics."*

Tax treatment of life insurance death benefits

Do beneficiaries pay taxes on death benefits?

Typically, no. In most cases, when the beneficiary of a life insurance policy receives the death benefit, this money is not counted as taxable income, so the beneficiary does not have to pay taxes on it. As always, consult with your tax adviser to determine the tax treatment for your specific circumstances.

Estate and inheritance taxes

In some cases, life insurance proceeds are paid to the estate of the deceased. This often happens when the policy's beneficiary dies before the policyholder and no contingent beneficiary has been named. The death benefit adds to the value of the estate, which may be subject to estate taxes or inheritance taxes. The easiest way to avoid this situation is to name primary and contingent beneficiaries for your life insurance policy.

High net worth estates

For 2023, the federal estate and gift tax exemption is $12.92 million per individual. This means an individual can leave $12.92 million to heirs without the estate having to pay any federal estate or gift tax. For a married couple, this amount is doubled ($25.84 million). If no further tax legislation is enacted, the current exemption will be reduced by approximately 50% at the end of 2025 to an estimated $6.2 million per individual and $12.4 million per married couple.[5]

An irrevocable life insurance trust, or ILIT, is a type of living trust that's specifically set up to own a life insurance policy, and one that is often used as an estate planning tool for high net worth estates. Death benefits are deposited into the ILIT when the insured dies, and the money is held in trust for the benefit of the individuals named in the trust documents. Determining the insurance planning needs of high net worth estates is a highly specialized field and far beyond the scope of this briefing. Individuals or couples whose estates fall into this category should always work with qualified experts and estate planning advisers to determine what's best for their specific situations.

---

[5] *Katherine L. Keating, "Increased Gift and Estate Tax Exemption Amounts for 2023," Foley & Lardner LLP, February 13, 2023.*

Important Legal Disclaimer: *We are not an insurance agency and are neither licensed nor qualified to render insurance recommendations or advice of any kind. Moreover, insurance is a specialty area that requires a subject matter expert to advise on the particulars of a given situation. The best course of action is to consult a qualified, licensed insurance expert in your state.*

September 2023

KEATING
WEALTH MANAGEMENT

www.keatingwealth.com
(720) 408-5250