LIFE INSURANCE

10 Things You Should Know About Life Insurance

There's more to life insurance than just a big check after you check out.

(Image credit: Getty Images)

The COVID-19 crisis was a stark reminder of how fragile life can be. As people worried about their mortality, it led to a surge in demand for life insurance. In 2021, life insurance sales increased by the largest amount since 1983.

Despite this growth, Chuck Czajka, CEO of Macro Money Concepts, a retirement planning firm in Stuart, Fla., thinks retirees still underutilize life insurance. "During seminars, I'll ask how many people let their life insurance go because the kids have grown up? The hands go up." After he explains the possible uses of life insurance as both a retirement and legacy planning tool, he finds attendees often regret this decision.

If you don't have coverage or you let your former policy lapse, coverage still could be an option. The industry has made it easier to qualify for life insurance even with health conditions.

With that being said, life insurance can be a sizable investment, especially since costs go up as you get older. It's fair to question whether insurance premiums are the best use of your retirement budget. If you're wondering whether life insurance still makes sense for your financial plan, here's what to know.

1. There Are Different Types

Life insurance policies all follow the same general approach: You pay a premium and then, if you pass away while covered, your heirs receive the listed death benefit.

Term policies have a set expiration date. You may be able to renew, but the premiums get substantially more expensive each time and the insurer could set an age limit for renewals. Permanent life insurance does not expire provided you keep paying the premiums. Premiums start out much higher than for term policies but then do not go up as quickly as you get older. Many permanent policies charge the same premium the entire time. It is also possible to buy a permanent policy with a single, large premium.

There are different types of permanent life insurance with different features. Whole life insurance charges the same premium each year. Universal life lets you adjust annual premiums, provided they add up to be enough to cover the ongoing insurance costs. Variable life combines investment products with life insurance, and your premium and death benefit depend on the investment performance. There are also products that combine multiple features, like variable universal life.

For retirement insurance needs like covering final expenses and leaving an inheritance, Czajka thinks permanent policies make more sense. “Term is useful when you’re young, can’t afford permanent and have temporary needs,” he says. Because the years of coverage are limited, “roughly 98% of term life policies don’t pay a death claim, so there’s usually nothing for your family.”

2. Life Insurance Can Build Savings

Permanent life insurance policies can build cash value from your premiums. This is money you could take out while alive, either as a withdrawal or as a loan that can be paid back.

The cash value earns a return, based on the type of permanent policy. Whole life insurance grows by a fixed interest rate. Insurers have since created more complex, market-based insurance policies. “Today’s products are not your grandfather’s insurance solutions,” says Derek Miser, president of Miser Wealth, a family office advisory firm in Knoxville, Tenn. For example, indexed universal life insurance policies earn a return based on a market index, like the S&P 500, with a floor to protect your balance against losses.

While these newer products can potentially earn more than simpler policies like whole life, it depends on how well your investments perform. Annual fees are higher too. If you cancel within a decade or even longer of buying, these policies could charge a penalty against your cash balance.

3. Tax Laws are Favorable for Growth

As long as you keep the cash value in your life insurance policy, you delay taxes on your gains. If you withdraw your cash value, you owe income tax on your gains. Alternatively, if you take money out as a loan, you don’t owe income tax. As long as you have an outstanding loan, the insurer charges interest and adds that to your outstanding loan balance. The outstanding loan could reduce your cash value growth because you have less money in the policy, though this depends on the insurer. Taking money out of your policy via withdrawal or loan reduces the death benefit for your heirs.

Miser points out that you don't have to pay loans back during your lifetime; loans can be paid off from the death benefit. "This stream of nontaxable income can help you avoid IRMAA surcharges on Medicare or taxes on Social Security," which you pay when your taxable income for the year is above thresholds set by the IRS.

4. Investment Fees Can Be High

Fees are a drawback to saving through life insurance cash value, especially on market-based variable products. Not only do you pay for life insurance premiums, but the insurer could also deduct annual fees up to 3% a year for the underlying investments. Similar mutual funds would charge 1% at the high end and often much less.

If you can still contribute to a 401(k), 403(b) or IRA, that likely would be the better long-term investment given those accounts also have tax benefits. Compared to a brokerage account where you owe taxes each year though, cash value life insurance can be more competitive, especially if you also want the insurance coverage.

5. You Can Combine Life Insurance with Long-Term Care Coverage

Some life insurance policies allow you to spend part or all the death benefit on long-term care. "With this setup, you either receive the money for long-term care or your heirs receive the death benefit," says Paul LaPiana, head of product for MassMutual. "It's use-it-or-use-it versus the use-it-or-lose-it set up of long-term care insurance," which won't pay anything if you pass away without needing care. Caveat: If you need prolonged care, however, traditional long-term care insurance likely would pay out more.

NYSUT NOTE: Combining life insurance with long-term care coverage is a great way to add financial protection for you and your loved ones. NYSUT members now can do so through the NYSUT Member Benefits Trust-endorsed Universal Life Insurance with Convalescent Care Benefit, provided by Trustmark. This new program combines Convalescent care benefits that can be used to help pay for long-term care services; a life insurance benefit to help secure your family's financial future; and caregiving tools provided by YourCare360® that offer guidance to manage your long-term care needs. For more information on this new program and how to get started, visit the website.

6. Insurance Can Make it Easier to Budget Your Other Savings

Miser of Miser Wealth finds that retirees are often scared to spend their savings in retirement, especially if they're married and don't want their spouse to run out of money. He suggests using part of your retirement income or assets to set up a policy, with the idea that when you pass away, it replenishes your spouse's savings. That way you can spend the rest of your money a little more freely.

7. It's a More Effective Inheritance Than Other Assets

When your heirs inherit pre-tax money in a retirement account, like a 401(k) or traditional IRA, they'll owe income tax when they take the money out. Most non-spouse heirs must withdraw everything within 10 years of the inheritance.

As an alternative, LaPiana suggests using some of your retirement assets or income to fund a life insurance policy. "Your heirs receive the death benefit income and capital gains tax-free." While estate taxes could apply, they kick in at the federal level only if you pass along more than

$12.92 million in total assets in 2023 (though 17 states and the District of Columbia charge these taxes at a lower level).

LaPiana says that by listing a beneficiary on your policy, you can speed up the inheritance versus other assets, like real estate, which must go through a court process called probate first. “The money goes straight to the beneficiaries with no court costs or uncertainty.” He says to make sure your beneficiary listings remain up to date because they take precedent over anything written in your will.

8. You Need to Qualify Based on Health, But it’s Gotten Easier

Most policies require you to pass medical underwriting before you can buy. Based on your current health and medical history, the insurer decides if you qualify and at what price. “With modern medicine, people who had serious issues in years past, like heart problems or cancer, can still qualify assuming the conditions are managed the right way,” says LaPiana.

If you cannot qualify or want to skip underwriting, there are policies that do not check health records. Be warned though: They tend to be much more expensive and have very limited benefits, such as they won’t pay out if you pass away within three years of signing up.

9. Not Every Insurer Delivers the Same Quality

LaPiana believes not every insurer offers the same quality with their product offerings and price competitiveness with their rates. Consider collecting quotes from a few insurers to compare their offers.

You should also check the financial rating of an insurer. “You want to know they’ve got the financial strength to deliver the promised payment years down the road.” Since 2013, one or two insurers per year have been taken over by state insurance departments due to financial issues. While state guaranty associations do cover losses if an insurer goes bankrupt, there are limits, so your heirs might not receive the full amount promised by your policy. Most states provide coverage for at least $300,000 in life insurance death benefits. You can check the website of your state’s guaranty association for the specifics of your state. Find your state association at the National Organization of Life and Health Insurance Guaranty Associations.

10. Policies are Usually Sold With a Juicy Commission

Since many insurance agents earn commissions, and the larger the sale the more they can earn, the incentives do not always line up. To get unbiased advice, Czajka recommends using an insurance rep who works as a fiduciary. A fiduciary must put your interest ahead of his or her own when recommending products, even if it means forgoing a larger commission. Says Czajka: “They consider whether life insurance makes sense as part of your entire financial plan. Or not.”

NYSUT NOTE: NYSUT members have access to a number of quality, competitive insurance programs that are endorsed by The NYSUT Member Benefits Trust. From life insurance, home & auto, and long-term care to dental plans and pet insurance, NYSUT Member Benefits has you covered. Visit the website for more information about the programs currently available to you and your loved ones.