Life Insurance as the Ultimate Hedge

Many people think of life insurance as a product for family protection. The life of one or two breadwinners is insured; in case of an untimely death, the insurance payout can help with raising children and maintaining the current lifestyle.

Once the children are able to live independently and a surviving spouse is financially secure, insurance coverage may be dropped. Such a strategy uses life insurance as a hedge against the risk of lost income when that cash flow is vital.

This type of planning is often necessary. That said, life insurance may serve other purposes, including some that are not readily apparent.

Final Expenses

When someone dies, funeral and burial expenses can be daunting. In addition, the decedent's debts might need to be paid off, perhaps including substantial end-of-life medical bills. Many insurers offer policies specifically for these and other post-death obligations, with death benefits commonly ranging from $10,000 to $50,000.

The beneficiary, typically a surviving spouse or child, can receive a cash inflow in a relatively short time. Generally, this payout won't be subject to income tax. The result might be less stress for beneficiaries during a difficult time and a reduced need to make immediate financial decisions in order to raise funds.

Investment Support

This year's stock market volatility has worried some investors, who may be tempted to turn to safer holdings, which have little or no long-term growth potential. Prudent use of life insurance might help to allay such fears.

Example 1: Jill Miller has $600,000 in her investment portfolio, where she has a sizable allocation to stocks. She is concerned that an economic downturn could drop her portfolio value to $500,000, $400,000, or less. Therefore, Jill buys a $250,000 policy on her life.

Now Jill knows that her children, the policy beneficiaries, will receive that $250,000 at her death, income-tax-free, in addition to any other assets she'll pass down. This gives her the confidence to continue holding stocks, which might deliver substantial gains for Jill and her children.

Balancing Acts

Life insurance also can help to treat heirs equally, if that is someone's intention, but circumstances create challenges.

Example 2: Charles Phillips, a widower, owns a successful business in which his older daughter Diane has become a key executive. Charles would like to leave the company to Diane, but that would exclude his younger daughter Eve, who has other interests.

Therefore, Charles buys a large insurance policy on his life, payable to Eve. This assured death benefit for Eve will help Charles structure his estate plan so that both of his daughters will be treated fairly. There is a potential downside to consider if Charles is wealthy enough to have an estate that is subject to the federal estate tax ($11.18 million in 2018). In this case, a large insurance policy will swell his gross estate, leading to a greater estate tax liability.

Life insurance may be especially helpful when one or both spouses has children from a previous marriage.

Example 3: Jim Devlin's estate plan calls for most of his assets to be left in trust for his second wife, Robin. At Robin's death, the trust assets will pass to Jim's children from his first marriage. Robin is younger than Jim, so it could be many years before his children receive a meaningful inheritance.

Again, life insurance can provide an answer. If Jim insures his life and names his children as beneficiaries, his children may get an ample amount without having a long wait.

Proceed Carefully

The life insurance marketplace ranges from straightforward term policies to so-called permanent policies (forms of variable, universal, or whole life) that have investment accounts with cash value. In some cases, policyholders can tap the cash value for tax-free funds while they're alive. Our office can help explain the tax aspects of a policy you're considering, but you should exercise caution when evaluating any possible purchase of life insurance. Find out what you'll be paying and what you'll be receiving in return.