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How Much Life Insurance Do You Need?

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If you are the primary breadwinner in your family, your untimely death would be a financial as well as an emotional burden on your survivors. Therefore, you probably need life insurance as long as you have dependents. Determining your insurance needs, though, can be a challenge. "Don't go by simplistic rules of thumb, such as so many times your income," says Marty Kelman, a financial planner in Memphis. "Ideally, you should do a fairly sophisticated analysis to calculate your life insurance needs."

For example, Mr. Kelman says, what would happen if you die tomorrow and your surviving spouse lives until age 95? "You should project ongoing living expenses, increasing at some rate of inflation," he says.

Mr. Kelman says that you will also need to anticipate some expenses, such as college bills, that eventually will decline. "After college, your kids can be expected to leave home, so child-related expenses will decline. Once you have all of those numbers, you should be able to calculate an amount that your family will need after your death."
For example, if you project an ongoing need for $100,000 a year while your family likely will have $30,000 in income, the $70,000 shortfall would have to come from the life insurance proceeds.

"I usually estimate that life insurance proceeds will generate 8 to 10 percent a year, invested in a diversified portfolio of stocks and bonds," says Craig Carnick, a financial planner in Colorado Springs. "Thus, a $1 million death benefit likely will generate at least $80,000 a year in investment income."

You can reduce the amount of insurance you will need by the assets you have already accumulated. That is, if you calculated that your family will need $2 million and you've already saved $500,000, the insurance need would be $1.5 million. "I generally recommend carrying enough life insurance to pay off your debts, including mortgage interest," says Mr. Kelman. In this example, if total debt is $300,000, then you would need $1.7 million worth of insurance. Mr. Carnick says that you probably should insure your spouse, too, whether

your spouse is a homemaker or brings home a paycheck. "If your spouse dies prematurely, you'll likely incur substantial child-care expenses," he says. "That's a risk that should be insured."

Although a life-insurance needs analysis usually focuses on a surviving spouse and dependent children, you may have to consider your aging parents as well. "Assuming you die tomorrow, who'll support your parents?" asks Mr. Carnick. "Who'll pay their nursing-home bills, if that becomes necessary? In fact, you might want to arrange long-term-care insurance for your parents so they won't be moving in with you."

Greg Galecki, a financial planner in Fort Wayne, Ind., concurs, pointing out that one of his clients is a physician whose 86-year-old widowed mother has a small amount of assets.

"She has indicated that she would like to live in a continuing-care community one day, where the likely up-front cost is around $75,000 and the monthly charges are about $2,000 a month. My client would have to co-sign any papers if she enters such a community, so his life insurance needs right now have to include the possibility that his mother will need care. In general, your projections should assume that everyone will live to age 90 or to five years older than any ancestor, whichever is longer," he says.

Clearly, life insurance needs will vary from one family to the next. "In my experience," says Mr. Kelman, "doctors with college-bound children generally need $1 million to $2 million worth of life insurance." Mr. Carnick, too, says that $1 million to $2 million in coverage is normal for physicians.

Generally, the insurance policy should be held in trust, so the proceeds will be sheltered from estate tax, and the beneficiaries won't be tempted to squander $1 million or $2 million worth of cash. "Most parents don't want their kids to be too rich," says Mr. Carnick. "Thus, instead of $1 million in insurance proceeds, the trust beneficiaries might have an income of around $80,000 a year while the principal is available in case of emergencies."

A trust holding life insurance proceeds might buy homes for the children to live in, according to Mr. Carnick. "In case a child is divorced," he says, "the house won't be included in the divorce negotiation because it's owned by the trust." At the end of the line, if the children die while there are still assets in the trust, those assets can go to the insured individual's grandchildren, or to charity.

Buying $2 million, or even $1 million, worth of life insurance is a major expense. To reduce the premiums, Mr. Kelman generally recommends term insurance, which is pure insurance. That is, you pay so much each year for insurance protection, and nothing else.

The alternative to term insurance is permanent insurance, which includes whole life, universal life and variable life insurance. These policies all include an investment account, called the "cash value," that accumulates over the years.

Permanent life insurance offers exceptional tax advantages. The buildup of cash value is untaxed and that account may be tapped, tax-free, via loans and withdrawals. Nevertheless, permanent life insurance requires much larger premiums than term insurance, in order to contribute to the investment account and to pay hefty sales commissions.

Thus, term insurance tends to be more affordable. "Recently," says Mr. Kelman, "I've seen some excellent prices on 20-year, level-premium term insurance."

Term-insurance rates are so reasonable, says Mr. Carnick, that a healthy 50-year-old likely can buy $1 million worth of 10- year term coverage for $2,000 to $2,500 a year. Buying $1 million worth of permanent insurance might cost $10,000, $20,000 or more per year.

"For most young and middle-aged professionals, 20 years is a good time period to carry insurance," says Mr. Kelman. "After the 20 years are up, the kids may be living independently and the insured individual may have accumulated enough wealth so that insurance isn't necessary any more." That is, if your kids are off on their own and you have $1 million in your retirement plan that your spouse can inherit, you might not need insurance for family protection.

Sometimes, says Mr. Kelman, he will advise splitting the insurance, so that clients buy half of the needed amount in 10-year term and the other half in 20-year term. That is, your insurance needs may be lower in 10 years than
they are now, so you can scale down the coverage, say, from $1 million to $500,000.

Another possibility is that your insurance needs will change rather than shrink. For example, you might not need life insurance for family protection any more, but you might need liquidity for paying estate tax. In that case, you will probably want a permanent rather than a term policy. "You might want to buy a term policy with a conversion feature, while your kids are still dependents," says Mr. Kelman. "Later, if your needs change, you can convert to a cash-value policy without having to take a physical exam."

"Some level-premium term policies have extension periods," says Mr. Carnick. "For example, seven years into a 10-year term policy you may be able to extend coverage out to 20 or 25 years, without taking a physical exam. The annual premiums will increase, though."

If you have a good idea of how much insurance you need and how long that need will continue, you can specify the policy you want to buy and select the one with the lowest price. Make sure that the company has been in business for a number of years so you can feel confident it will live up to its promise of paying death benefits

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