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August 2001 - WHAT IS LIFE INSURANCE . . . AND DO I NEED IT? (Plus a Quick Note on Breaking Tax Law Changes)

Life insurance is one of the more important concepts in the financial world, as well as one of the least understood. In my last article, I said I would give an overview of the subject here, so that you will have a better idea if you need life insurance, as well as some pertinent questions for you to ask a financial professional before buying.

Quick Tax Rebate Update

Since my last article, you have probably heard that Congress approved and the President signed a major tax law revision. One single part of this new law has attracted all the attention, which is the tax rebate of up to $600 that many of you have heard you will be receiving in the next 3 months. The rebate is generating many questions, so a brief description and answers to the most common questions will be given here before proceeding to the material on life insurance.

The rebate itself is the result of the creation of a new lower tax bracket in the federal income tax code. For many years, the lowest bracket has been 15%. For single taxpayers, there is a new 10% bracket for the first $6,000 of taxable income. On this portion of income, the tax will be 5% less than before, or $300 for any single taxpayer with $6,000 or more of taxable income. For married taxpayers filing jointly, the new 10% bracket is for the first $12,000 of taxable income, which produces a $600 reduction for married taxpayers with $12,000 or more of taxable income.

That much seems to be pretty well understood, especially by merchants who are already trying to get you to spend the money with them before you have even received it. The intent of the President and Congress is to give the economy a boost now, and so this tax reduction is going to be mailed to most people who had taxable income on last year’s tax returns.

The confusion is coming from the letters that the IRS is mailing to over 90 million taxpayers on the subject. They have the enormous task of determining who gets these checks, explaining it to them, and getting the checks all mailed in a period of just a few months. In an attempt to do this quickly and at low cost, form letters are being used, rather than a personal explanation for each person.

The most common reason you may not get this tax rebate check is that you had enough child, earned income, or other credits last year that you did not pay income tax, and got a refund check for any income tax you had already paid in for last year. As already explained, this rebate results from a reduction in the percentage tax rate you pay, and so if you were already at zero, you will not get a credit below zero from this part of the tax law. (But you may very well get one from some other less publicized portions of the new tax law, when you file your 2001 tax return early next year.)

If your parents or some other person provided over 50% of your support last year, and claimed you as a dependent on their tax return, you also will not be receiving this rebate check. (However, you will get the benefit of the 5% tax cut when you file your 2001 return next year, if you have taxable income.)

The IRS form letters that tell some of us we will not be getting the rebate give both possible reasons without specifying which one applies in each individual case. This is what is causing the questions. If you know you paid no tax last year, then do not be surprised with your IRS letter saying you won’t be receiving the rebate, and do not be concerned with the statement in the letter that may make you think someone is claiming you as a dependent that you didn’t know about. That is for another recipient of the form letter, not you.

Life Insurance

Let's now switch to the actual subject of this article. Life insurance is a wonderful product that helps you make sure your financial obligations are met if you unexpectedly die before you can meet them yourself. The most notable example is a young parent who has the obligation to provide for a spouse and/or children until they are grown. This parent will want to carefully ponder how much it will take to replace his or her income for the years they might be gone. Children need both parents, and if one dies early, you will want to have enough money available that the remaining parent can care for the children without having to leave the home for a job every day.

Another important reason to have life insurance is to assure that the debts you have for a home, transportation, business, and other worthwhile purposes can be paid in full without a burden to grieving family members if you are no longer there to do so.

It is important to focus first on how much protection you need, and make sure you have that in place, before you move on to other uses of life insurance. A simple example to illustrate how this amount might be determined follows. Please note that actual circumstances, and even the assumptions used, will vary greatly with each individual case. Suppose that you wish to provide for 4 people, and that your monthly budget for food, transportation, medical/dental, clothing, utilities, home maintenance, property taxes, education, entertainment, and so forth is $2,500. Let's also assume that your debts, including mortgage and cars, total $150,000. You feel you need to provide the monthly income for 15 years and that any earnings on the life insurance proceeds during this 15 year period will be offset by inflation or used for income taxes. A statement has been received from Social Security showing that $1,200 per month will be paid for the first 6 years, $400 per month for another 4 years, and none the last 5 years. (Social Security often will pay a monthly income to children until they are 18 if one of their parents dies or becomes disabled, call 1-800-772-1213 to request a personal statement.) In this example, $93,600 is needed to provide $1,300 in monthly income for the first 6 years, $100,800 is needed to provide $2,100 in monthly income for the next 4 years, and $150,000 is needed to provide $2,500 in monthly income for 5 additional years. This totals $344,400 to cover the monthly income need. After adding $150,000 to pay debts, the total insurance need grows to $494,400. It is prudent to add at least another 20% of this total to cover contingencies such as funeral expense, final medical bills, and other additional expenses that will probably be faced by your survivors during the initial grieving period. Since this is not an exact science, after adding the 20%, round the total up to an even $600,000 in this example.

Life insurance in some cases can also be a useful tax planning or family savings tool, in addition to its financial protection purpose. Because of this, there are many different varieties of life insurance sold, including term, whole life, universal life, variable universal life, and combinations of these under many different additional names.

Term life insurance has the lowest premium in the early years of the policy. If you are struggling to make ends meet, you may be best off looking at term coverage first that covers the number of years until the children are grown or the mortgage is paid, just so you can make sure you can pay the premium for several hundred thousand dollars of coverage every month without fail. Take the time to explore fully how much coverage you need before looking at which type of policy you want, and do not settle for a policy that has a smaller coverage amount but has other benefits. If you can afford some of the additional benefits after getting the full amount of coverage, only then consider buying them.

Whole life insurance charges a fixed, higher premium for your "whole" life. Some of the difference between the whole life and term life premium go into a type of savings account, which you can draw on in years to come to offset increases in term life premiums or for family needs while you are still alive. Generally the savings balance earns a fixed interest rate of 4% to 5%, and with the benefits of compound interest over many years can become much larger than the original policy amount. With proper planning this cash balance can be tax deferred or even tax-free. Many people are glad in later years that they made the monthly sacrifice to have this money available when they need it.

Universal and variable life insurance products combine some of the features of term and whole life. They have cash balance features like whole life, but have a wider range of investment choices and can earn better returns, with sometimes accompanying higher risk. As with whole life policies, these features can be beneficial if you stay with them for many years.

This quick summary is designed to bring out a couple important points. One is to make sure that you have enough life insurance coverage to meet your financial obligations if you die early. The second point is to carefully consider the other optional benefits of life insurance (after assuring enough basic coverage) before buying a policy that includes these added benefits. There is no shame in buying a term policy first and then adding one of the other types later as a supplement to get some of other benefits after taking additional time to study them.

If you have a question you'd like to have answered in a future article, please contact me**.** Next month's article will explore the subject "Do I Need To Pay Estimated Tax?" and also look at some of the increased credits in this year's new tax law that may make it so you don't have to pay estimated taxes. I hope to have you with me again then.