

Life Insurance during Retirement: Basics You Need to Know

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Summary

Some people need life insurance in retirement, and some do not. If you need to buy new insurance, this paper will describe some of your principal options. If you already have life insurance, we describe different sets of choices, depending on whether you still need the death benefits.

Do you need life insurance when you retire?

This is not always an easy question to answer, and you may need to consult a professional advisor, or at least use good software, to help you decide. But here are the main reasons why many retirees do still need life insurance:

- If you or your partner would be left in serious financial jeopardy if the other died first. In many retiree households, income belongs mainly to one person, and there might not be enough left if that person dies first. Pensions, annuities, employment income, and Social Security can all work in that fashion (though sometimes they don't, which is one reason why this question is complicated). There may also be differences in expenses: one spouse is frugal, and the other isn't, or one has big medical bills. If there is a disparity in how financially well off the survivor will be, depending on which person dies first, life insurance can make up the difference.
- If there is the need or desire to leave someone a big bequest at death, or to cover taxes, debts, or other expenses at death, insurance can assure that these goals are met.
- If you have a child or other dependent with special needs, whom you want taken care of long after you are gone.
- If you have business interests or other situations that call for cash when someone dies.

Tax advantages of life insurance

When someone covered by life insurance dies, the proceeds usually go to the beneficiary free of federal income taxes. This means that all the increase in value, over and above the premiums that were paid, is tax-free income. The government does place some highly technical restrictions on life insurance policies to assure that this advantage is not abused, but most policies qualify for the tax break.

The tax advantages alone are usually not enough to justify purchasing new insurance at an advanced age, unless your intention is to leave money for someone else, and not use it yourself. The reason it is not a good bargain for your own use, usually, is that you are paying the cost for the insurance company to pay off a big extra amount if you happen to die prematurely. The cost for these death benefits gets higher as you get older, and it can easily offset, or more than offset, the tax advantages.

But if you need life insurance for other reasons, or if you have a policy that you acquired when you were younger, the tax-advantaged cash value growth of such policies can be a nice supplement to your income, or at least a good contingency fund for you. Whether an

old policy whose death benefit you no longer particularly need is worth keeping for its tax-advantaged cash value growth depends on what kind of insurance you have, what your alternative investment options are, and your own health and family situation. A professional advisor may be needed to work out the details in your case.

Options if you need new life insurance

- ***One life or two?*** Most life insurance policies pay off when a particular person dies. But you can get policies that insure two lives, and pay off only when the *second* one dies. These "second-to-die" (or "survivorship") policies can be good if you have a dependent whom either spouse could take care of, but would need funds when both are gone. (They are also, and more commonly, used for wealthy families facing large estate taxes.) You can also get "first-to-die" policies, covering two or more persons and paying off at the *first* death. These policies have high premiums and are mostly used in business situations, but if you are part of a married couple where your financial means would be cut almost exactly in half regardless of which person died first, and if half is not enough to live on, then a first-to-die policy could be a solution.
- ***Cash value or no cash value?*** Younger and middle-aged people often buy "term" insurance, which has no cash value. These policies pay off only if you die while you still own the insurance — apart from that, they cannot be cashed in or borrowed against. Furthermore, the premiums usually increase as you age, and once you get into your retirement years, the costs can get prohibitive. So this kind of insurance is usually best to cover needs that have only a limited time-span, which is why it is called "term" insurance, as opposed to "permanent" insurance. This is not usually a good choice for retirees, because if you are buying insurance at an older age, it is probably because you need it for the rest of your life, not just a certain number of years. Permanent insurance costs more than term insurance, but also builds up a cash value.
- ***Flexible premiums, or fixed premiums?*** Traditionally, insurance premiums on permanent insurance are level for life, though once you start building up cash value in the policy, premiums can often be reduced, or even eliminated eventually. But some policies are built with the idea that premiums can be flexible almost from the beginning: you can pay less in some years, or even skip a year here and there. If you anticipate that you might have cash flow problems in some years, you might want to obtain such a policy (most "universal life" policies are in this category).
- ***Results tied to the financial markets, or more guaranteed?*** You can buy "variable life" policies where the cash values are invested in stock, bond, and/or other funds, and so those values and the death benefits can vary from year to year as the market does well or not. If you are bullish on the financial markets, and if you are comfortable taking some risk in exchange for the opportunity to do better, a variable life policy could be for you. These policies also allow you to shift your policy cash values from fund to fund, or to split them in differing proportions, as the markets change, without paying taxes when you do so. But if your priority is for modest but guaranteed results, then a traditional product might be for you. Variable life products, being more complex and being tied to investment funds, also usually have more costs to

cover, and so there is a bit of a hurdle for them to get over before they can beat the performance of traditional insurance plans. "Universal life" policies often fall between these two: their year-to-year values can vary depending, usually, on interest rates (rather than stock or bond performance), so there is more variability built in than you get with traditional life insurance policies, but there is less chance of either exceptionally good or exceptionally bad performance than with variable life. You can also get "variable universal life" policies that combine the leading features of both these types.

These points only begin to describe the options you have. You can get policies that start out with low premiums that gradually increase over time, then level off ("graded premium life"). You can get policies with higher premiums that you pay for only a limited period of time (say ten or twenty years), but then the policies are paid up and they last the rest of your lifetime. If your policy pays dividends, you can take the dividends in cash, have them deposited back into the policy, or used to increase the death benefit. You can purchase various riders that add further benefits to a policy. Your insurance agent can discuss these and other choices with you.

Options if you already have insurance, and need to keep it.

If you have term life insurance, and it looks like your need for insurance is permanent, then you probably have the wrong kind of insurance. You can usually convert term insurance to permanent insurance. This means you need to start paying a higher premium, but generally the premium will not increase again after that, as it usually does with term policies. You might also consider canceling the term insurance and starting from scratch with a new policy. Your insurance advisor can quote you rates on new policies, to see if this would be a better deal. But never cancel the old policy until the new one is actually issued, just in case you don't get approved. The premiums on a new policy will also depend on your health, so you might end up paying more than you or the agent expects (this is usually not the case for policies converted from term to permanent). If your health is bad enough so that your life expectancy is pretty short, though, your best bet might be to just continue the term insurance, rather than bumping up your premiums to the higher level for a permanent policy.

If you have permanent life insurance, and if there is significant cash value, ask your agent for an illustration of how the policy might perform in the future. Generally, if your policy is not already paid up, and you continue paying premiums on it, your illustrated future cash values and death benefits will increase significantly. If you don't need that much growth, you may be able to reduce your premium payments (depending on the kind of insurance you have), or just stop them altogether, either immediately or at some point down the road. You may well have a continuing but *shrinking* need for death benefits as time goes on. For example, if you have insurance on your life to benefit your spouse, which you need because of (let us suppose) lower pension or Social Security payments coming into the household after your death, your spouse will have to live at least in part off of the insurance death benefit. If you die when you are 75, and your spouse lives another 20 years, that death benefit needs to be pretty big. But if you are already 95, then your spouse is very unlikely to survive you by long, so a smaller death benefit is needed.

You could then consider not only stopping premium payments, but actually withdrawing some money from the policy.

Options if you already have insurance, and but do not need the death benefit.

If you have term insurance, and you no longer need the coverage, you can simply cancel the policy. This can be a good idea, assuming you are still healthy, because if you live into old age, either the policy will simply expire (as most term policies do at some point), or else the premium payments will become prohibitive. If you are in poor health, however, especially if you are in very poor health and think you probably will not live more than a few years, it might be smart to keep the policy going so that your beneficiary can collect the death benefit when you are gone. Another possibility: you might be able to get a *life settlement* (described a little further on), whereby a third party takes over the premium payments and will collect the death benefit, and pays you cash now for having that opportunity – but not all term policies are eligible for this arrangement.

Keeping a cash value policy as an investment can make sense even if you no longer need the death benefit. As mentioned earlier, such policies have excellent tax advantages. There are two things you can do:

- First, if you are retired, you should probably have the policy converted to paid-up status, meaning the death benefit will be reduced to an amount that the current value of the policy can pay for without the need for any future premium payments. This will reduce the proportion of your cash value being used to support a future death benefit that you don't need, will eliminate the need for future premium payments, and therefore will turn the policy into a more efficient investment. However, if you can easily afford the premium payments and want to, in effect, increase your tax-advantaged savings, then keep the policy at its original amount and keep paying premiums – in fact, you might even want to pay extra premiums, if your policy permits this, as many do. (Note: if you have a variable life policy, switching from Option B, which provides for an increasing death benefit, to Option A, which provides for a level death benefit, is another way for you to keep cash values in the policy, rather than having them applied to higher death benefits you do not need.)
- You can withdraw (*surrender*) from the policy an amount equal to the total of premiums that have previously been paid into it. Such withdrawals are tax-free, because they are considered to be a return of your premiums, not income. If you wish to withdraw more than that amount, you can do it by borrowing against the policy. Since this is a loan, it is also not taxed. In theory, you do have to pay back the loan some day, with interest. But you can let that ride, and when you do eventually die, the loan will be repaid automatically from the tax-free death benefit of the policy. So neither you nor your beneficiary ever pays income taxes on the money you took out of the policy. This is one of those rare things that sounds too good to be true, but in fact is true (the government is trying to encourage people to buy life insurance, so that widows and orphans are provided for). The main catch is that if your policy expires at a certain age (say, 100) and you live past that time, or if you take out so much cash from your policy that it lapses, then the insurance contract ends, and you never do get that tax-free death benefit – so the year the policy ends, you will be taxed on anything

you took out of the policy over and above the total of what you paid in. So check with your agent about whether this could happen with your particular policy.

Surrendering the policy (turning it in for cash) could be your best bet if the cash value is not too much larger than the total of premiums you paid in. But any excess in cash value over and above that total of premiums paid will be taxable as ordinary income ó which means Uncle Sam could take a big bite out of it, especially if this transaction pushes you into a higher tax bracket. It is often better to spread a big surrender payment over several years, by using partial surrenders and policy loans, to minimize your tax burden.

Turn the policy into an annuity means ending the life insurance aspect of it, and using the cash value to provide a lifetime income for the person insured under the policy. This can be a good choice if the death benefit is no longer needed, and the insured person is healthy. The tax advantages are not as good as they are when you just keep the life insurance policy and withdraw money from it directly, but if you live a long time, such withdrawals probably will completely deplete the policy's value, and you also may run the risk of getting stuck with a big tax bill. If you convert the policy to an annuity, part of your monthly income might be tax-free, and the portion that is taxed (even if all of it is taxed) is still advantageous because it has been tax-deferred. The biggest advantage, though, is that payments will continue to be made no matter how long the recipient lives ó which is why this can be a good plan if you are healthy and expect a long life.

Receiving "accelerated benefits" may be an option if you have a severe medical condition and a very short life expectancy. Many policies explicitly permit you to, in effect, receive a portion of your death benefits early if you are gravely ill ó and even when the insurance contract does not specifically provide for this, life insurance companies often do it anyway, if you ask. This can be a godsend if you need funds to pay for a nursing home, at-home care, a hospice, or expensive medical treatments, and it is much better for you financially than surrendering all or part of the policy. In fact, the presence of a long-term care rider or the availability of accelerated benefits if you need them later could be a good enough reason by itself to keep a policy around until then.

A "life settlement" may be another option if your health is poor, if you are elderly, and perhaps even if neither of those is true. Under this arrangement, a third party will purchase your policy, and will name itself as beneficiary. The third party will pay any future premiums on the policy, and will collect the death benefit when you die. In the meantime, they will pay you a cash amount (a "settlement") up front, based on their estimate of what the policy will eventually be worth to them. Naturally, the sooner you are expected to die, and the sooner they get paid off, the more your policy is worth to them. The amount of the cash value and the amount of any premiums that still need to be paid also go into the equation. This may or may not be a good deal for you, but it is more likely to be a good deal if premiums are still due, and you can't afford them ó or if you need money right now. But on the other hand, if your policy has cash value, you can reduce or eliminate payments, as previously described, without selling the policy. And the money you receive in the life settlement, to the extent that it exceeds total premiums you have paid into the policy, will be taxable (unless you are terminally ill ó i.e., expected to

die within 24 months).^{*} So you should compare your options carefully before deciding on a life settlement. And shop around for a buyer ó there is no established pricing or open market for life settlements, so you might get widely different offers. Also be alert to any costs you are being charged for the transaction, and to any issues relating to your medical privacy. Life settlements are regulated in some states, though not consistently among them, and not at all in other states, so you have to take responsibility for making sure you really understand any agreement you enter into.

Let your kids take it over. Rather than selling your policy to someone else so that they can make a profit, perhaps you'd like to keep the money in the family. If one or more children would like to be named as beneficiary and is willing to start paying the insurance premiums, you can easily make those arrangements. You can withdraw or borrow some or all of the cash value first, if you need it. If you don't need it, it's a simple, tax-free way to pass an inheritance down the line without it having to go through probate court.

Give it away. If there is a cause that is dear to you, you might consider naming a charity as your beneficiary. Keeping the policy in force gives you access to its cash values in case you need them, and you could always change the beneficiary again later (say to a needy child or grandchild) if that became necessary. So you don't give up total control. But if it turns out that you don't need the insurance values after all, then you have already arranged for an important gift to be made upon your death. Another possibility on many policies is the little-used idea of changing the person insured. If you don't need the insurance, you might have a child or grandchild who does, and the insurance company might be happy to permit the switch.

How do you decide what to do?

Only an insurance agent licensed in your state can sell you new life insurance.

And it is almost always best to talk with an agent for your existing life insurance company about your options concerning insurance you already own. The agent can get you computer-generated illustrations of future premiums, cash values, and death benefits, and can show what these might look like under different options that you have. This information will be central to the decisions you make. Your agent may be able to help arrange a life settlement, but not all agents deal with them.

Most insurance agents do get paid by commission, and this may affect their advice about new products. Commissions on old policies you own, however, are usually small or non-existent, so an agent's advice on those policies is usually pretty *disinterested* (i.e., unbiased), but may also be *uninterested* (i.e., unenthusiastic) because you are probably not presenting an opportunity to make money. So, as always, you should listen to all advice carefully, but also watch out for yourself.

^{*} There are three levels of taxation on life settlements. There is no tax up to your *cost basis* ó which is the total amount you have paid into the policy minus any funds you have previously withdrawn or borrowed (and not repaid). The amount between your cost basis and the cash surrender value of your policy, had you surrendered it to your insurance company, is taxable as ordinary income. Any amount above the cash surrender value (or above the total of premiums paid, for term policies with no cash value) is taxable at capital gains rates.

An agent may suggest that you replace an old policy with a new one. Just because the agent will get a commission on the new sale does not mean that this is a bad idea. Some policies, especially ones that are more than, say, 20 years old, may be built upon assumptions that no longer make sense and that do not work to your benefit. As with all products, some work better than others, and even ones that work well might no longer be suited to your particular needs. Be skeptical about replacing old policies with new ones, but also be open to the possibility that this might be a good idea for you.

While you're at it...

Review with the agent all beneficiary and ownership arrangements on existing policies. Perhaps the original beneficiary is no longer alive, or is no longer the best person to receive the proceeds. If your estate is the beneficiary, it is usually better to designate a particular person or persons, or a trust.

If you have enough assets so that your estate, when you die, might be subject to federal estate taxes, it could be prudent to change the ownership of your insurance policies, perhaps transferring them to an irrevocable life insurance trust.

For More Information

- Many books have been written about life insurance, and life insurance basics are covered in many books about family financial planning. If you want additional general information, your local library or favorite bookstore can help. A good on-line source for basic explanatory information is the American Council of Life Insurance website, at: <http://www.acli.com/Consumers/Life%20Insurance/Pages/Default.aspx>. Your state insurance department probably can provide free information, either in a booklet, online, or both. For example, Alabama offers their very helpful "Consumer's Guide to Life Insurance" at <http://www.aldoi.gov/Consumers/LifeInsurance.aspx>; links to other state insurance departments are given at the ACLI site.
- Regarding life settlements, the National Association of Securities Dealers, a regulatory body, offers excellent information and advice on issues you should consider, at: http://www.nasd.com/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/SeniorsBewareWhatYouShouldKnowAboutLifeSettlements/NASDW_018469. For a rosier outlook from a company involved in arranging life settlements, you can go to <http://www.seniorsettlements.com/>, especially if you do not have an agent who can help you price a life settlement.
- Regarding life insurance trusts, some interesting points are made by Jon Gallo in "Transferring Life Insurance To and From ILITs," *Journal of Financial Planning*, August 2006.
- Regarding annuities, see the other paper in this series, "Annuities: Basics You Need to Know."
- Financial strength ratings for most life insurance companies can be found at: <http://www.thestreet.com/insurers/index.html>