Term Life Primer: Back to Basics

By Christine Potter

If, as stated by *LifeHealthPro.com*, "2014 was the year of heightened regulatory scrutiny," for the life insurance industry, 2015 may be the year of back to basics. Term life insurance, once thought of as the poor man's insurance, is poised to make a huge comeback in 2015. Industry-wide, the trend since 2013 has been to convert newer term universal life products back into traditional term life insurance. Were life insurers prescient, or just lucky when making that decision?

Following President Obama's State of the Union address on Wednesday, when the Commander-in-chief brought forth a broad domestic and corporate tax overhaul, the tax advantages of term life insurance cannot be overstated, especially for those in the uppermost tax brackets. No matter the make-up of someone's portfolio, however, term life insurance can have an important and potentially lucrative role to fill. From the young to the old, the middle-class to the upper class, term life insurance could stand between a death and financial hardship.

Term life sounds like it's one simple type of policy, but in fact it is the umbrella classification for a whole host of products. This allows term life policies to be almost tailor-made to each purchaser's needs. Term life is a fully different type of policy from that of universal life (indexed or not), or whole life insurance, but the basic idea is the same; the customer pays regular premiums to the insurer and should he die while the policy is in force, the insurer is obligated to pay his beneficiary or beneficiaries a pre-determined lump-sum amount. It used to be assumed among insurers that term life was best sold to younger customers, and that is still true, but in "the new normal," post Great Recession, it can play a role in everyone's financial plans.

What whole life and universal life (permanent insurance) offer are financial instruments that once paid remain in force for the entirety of someone's life. Their premiums are often lump-sum payments and significantly higher, especially early in, than that of a term life policy, but because once the investment has been made, it is made, they can be used as security for loans and leveraged in a variety of ways to free up liquid capital, and their cash value is tax deferred.

Term life rarely offers such liquidity because it is purchased for a specific period of time only, the term from which the product draws its name. The premiums are much lower and the credit requirements of the purchaser also less stringent because the customer is assuming a greater risk than with a whole life policy—that if they die it will be within the pre-specified term. If the customer does not die during the term, they receive no benefit from having purchased the policy.*

However, as author Tony Steuer states in his 2010 book, *Questions and Answers on Life Insurance*, "Term insurance is generally agreed to be an excellent short-term solution to a temporary need for life insurance coverage […]" The number of reasons someone might require or opt to purchase temporary life insurance are nearly as varied as the individuals themselves; from young people first asserting financial independence to entrepreneurs, from empty nesters with children in college, and a plethora of others, term life insurance may be just the ticket.

Learn the Terms.

There are a number of different options in term life insurance products. The traditional term life policy is one purchased for a pre-specified period (usually 1, 5, or 10 years) and the premium payments increase as the policy term advances. There is also a level term life product, which allows the premiums to stay at a fixed rate throughout the term.

An increasing term policy is one whose death benefit increases throughout the term, while the decreasing term policy does the opposite; its benefit starts higher and becomes less as the term progresses. Renewable term life or annual renewable term life (ART) allows for regular renewal of the policy until age 75, on average, and convertible term allows a customer to roll their term life policy into a whole or universal (permanent) policy after a specified period, usually with an up-front, lump-sum conversion premium prior to the commencement of regular annual premiums. A term life policy can also be added as a rider to an existing permanent insurance policy, for extra temporary coverage.

What Term Life Can Do.

The financial flexibility and benefits offered by term life insurance make it the go-to product for many. "Term insurance, especially at the younger [customer] ages, provides the greatest possible coverage for the lowest premium outlay," says industry analyst LifeHealthPro.com.

It can also be the perfect fit for those looking maximize their ability to invest in other high-yield, long term products like stocks, bonds, and real estate. In his best-selling book, *The Millionaire Next Door,* Thomas J. Stanley advises investors to spread their capital around with no more than 20% in any particular investment. For those just dipping their toe into the markets for the first time, or even those who need to have more liquidity to spread through their portfolios, term life provides death benefit coverage that does not tie up significant financial resources.

For decades, term life was thought to be a product for the younger set, and it still offers a unique opportunity to the youngest and presumed healthiest among us. Newlyweds, or singles purchasing their first homes, cars, and other long-term investments, can benefit by taking a term life policy whose dividend is large enough to cover the pay-off of a car loan and/or a mortgage or other large financial obligation. Young parents can provide the security of a college education for their young children by purchasing a policy large enough to fully fund their tuition saving accounts.

Term life can offer the same peace of mind to older parents whose children are in higher education already. A temporary policy can be taken to assure the funds are available for the children to finish school without hardship, should a parent die.

For those who work in corporate firms, are unemployed and seeking work, or who are the backbone of American business, entrepreneurs, term life can fill gaps in coverage that might not seem obvious. As companies seek ways to scale back benefits, a term life policy can supplement weak whole life coverage from an employer, or fill a similar gap to that of COBRA insurance should a person become unemployed or lose his benefits.

Corporations can also benefit from taking out term life policies on key team members during M&A shifts, as part of Buy-Sell agreements, or during the span of a special project. Entrepreneurs can take advantage of term life to make sure their venture maintains capital liquidity should they die, which can pay off debts, or keep the firm above water while a leadership transition takes place.

Term Life, Tax Buffer?

When the President begins prompting the government to "close tax loopholes," as he did in the State of the Union address, it behooves everyone to look to what instruments can be used to diffuse liability. In most cases, term life insurance is not subject to Federal income tax, state income tax, or estate/inheritance taxes, and because it lacks the whole cash value of a permanent policy is also generally not subject to capital gains tax.

Attaching a term life policy to an existing whole life product can specifically allow for it to pay the capital gains tax on the permanent insurance at benefit payout. Further, term life is not subject to probate, unless the estate is named as the beneficiary instead of an individual. This means that there is no public record made of the benefit amount paid, or the identity of the beneficiary.

According to a recent presentation by financial planning giant Ernst & Young, the global life insurance industry is focusing on three main issues in the coming year: Government oversight, macro-economic trends, and cyber risk (data security). It seems that President Obama proved the insurance industry prescient, again. The insurers seem to be a few steps ahead in the game, and if they see a return to traditional term life as an important shift, customers could do worse than to follow their lead.**

(SOURCES: The Statistics Portal, Questions and Answers on Life Insurance by Tony Steuer, *LifeHealthPro.com*, *The New York Times*, The State of the Union Address transcript, CNN, Ernst & Young , *The Millionaire Next Door* by Thomas J. Stanley*)*

*Most term life policies cannot be renewed after the age of 75, which greatly skews their pay-out statistics, but in a 1993 Penn State University study less than 1% of some 20,000 term life policies required the payment of benefits. Annual renewal term policies, (ARTs) can be used to replace a traditional term life policy after age 75 until age 100, but their premiums escalate each year and can become prohibitive for many.

**Between 2010 and 2013 the number of independent insurance firms decreased by nearly half, from more than 1,500 to just 843.