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The Most Important Question To Ask When Buying Whole Life Insurance

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FULL BIO

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You may have heard the expression, “Buy ‘term’ and invest the difference.” While this axiom makes sense for many, there are times when whole life insurance is appropriate. It may sound odd, but a good question to ask is this: “Do I want to have life insurance when I die?” If you answer yes, then whole life insurance may be the better choice for you.

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There are certainly arguments that favor term life insurance. For young families with children and others who need a large amount of inexpensive death benefit, term life is a great way to get low-cost protection. But because of the temporary nature of term insurance, only a very small percentage of contracts actually pay benefits. This is due to the great number of policy holders who cancel their policies or outlive the agreed-upon term period. Therefore, if you want to be certain that your policy will be in force when you pass away, and if you don't know exactly when you are going to die, then permanent whole life is the solution.

There are several types of whole life policies. Selecting one depends on your unique situation and whether you want to accumulate cash inside your contract. Term insurance does not accumulate any cash or equity (it is akin to renting a home). Whole life, however, can accumulate cash on a tax-favored basis—if you pay more into the contract than is needed for pure death benefit protection.

Shopping for a permanent whole life contract that is primarily designed for maximum death benefit without the complication of adding cash value can be relatively simple, as it becomes a commodity type purchase. Based on your medical history, credit score, driving record, family history, and other factors, your premium will be a function of the perceived risk the insurer is taking. At that point, consider several strong insurance providers and compare policy costs. Depending on the carrier and the risk you present, there will be a range of prices within different policy types including:

- Traditional Whole Life
- Universal Life
- Variable Life

The good news is that if you aren't concerned about accumulating cash inside your contract and instead are focused on maximizing death benefit, your decision is less about policy type and more about the cost of your guaranteed death benefit. One note regarding any illustrated death benefit: be sure to look at the guaranteed death benefit column (otherwise an amount based on an estimated rate-of-return assumption may never fully materialize).

The decision becomes more complex if you want to accumulate cash inside your contract—which could be a smart idea if you want to accumulate cash on a tax-free basis. In this case, the policy type matters.

Traditional whole life insurance is fairly straightforward in its design. It invests your cash inside the contract into a fixed-return type of product. There will be a "guaranteed cash value" column on your policy illustration, and that is reliable—provided the insurer can honor its guarantee. This rate of return is set by the insurer, and while it can be reliable, it may or may not keep pace with market-based investments.

Universal life, in its basic form, has a guaranteed rate of cash accumulation. It can also offer a variable amount of cash accumulation through market-linked investments inside the policy.

Variable life, as the name implies, has a variety of investment options for your cash and hence has a wide range of potential returns. If you select this type of policy, you may see a wide range of returns on your cash.

One important distinction that plays into this equation is that with traditional whole life the premium is a fixed amount. But with universal and variable life the premium amount can be flexible. With a variety of carriers to pick from, a medley of policy types, flexible payment structures and various investment options, you have a complex decision. Then, the most important question to ask is this: "How much of my premium do I want allocated to the death benefit, and how much of my premium do I want allocated to accumulating cash inside my policy?"

If the goal is to maximize cash, design your policy to provide the least amount of death benefit your premium will buy. The main cost of an insurance contract is the death benefit. So if your goal is to maximize cash accumulation, it makes sense to have the least amount of cost—or least amount of death benefit—as a percentage of your premium. Yet many accumulation policies aren't structured this way.

This is important because if you miss a few payments or reduce the size of your payments, you may wind up only paying for the death benefit portion and not adding to your cash value. Eventually, your cash value will be less than projected, and you may get discouraged and cancel the policy. You may think it's the policy's fault, but it was more likely a lack of communication or understanding by the

agent, or a flawed policy design. In other words, commit only to a premium you feel comfortable maintaining throughout the life of the contract—if your goal is maximum cash accumulation inside the contract.

Remember to minimize the amount of death benefit you are purchasing while maximizing the amount of cash the IRS will allow into the contract. Yes, the IRS limits how much cash you can put into a life insurance policy, so be sure to talk with a knowledgeable, ethical insurance advisor when reviewing your options. Finally, make sure your premium amount is something you can commit to over the long term—otherwise you may only be paying for the death benefit when that was not your goal.

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Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publication . Securities and advisory services offered through Commonwealth Financial Network®, Member www.FINRA.org/www. SIPC.com, a Registered Investment Adviser. Fixed insurance products and services offered through Potomac Wealth Advisors, LLC or CES Insurance Agency. 15245 Shady Grove Rd., Suite 410, Rockville, MD 20850