Term Life vs. Permanent Life Insurance

Should I Buy Term or Permanent?

A widow doesn't ask "What kind of insurance was it - Whole Life, Universal Life or Term?" She asks "How much do I have to raise my family?"

If you're shopping for life insurance, chances are you've been faced with the dilemma of buying term or permanent insurance. Some advisors have compared the decision to deciding whether to buy or rent your house, or lease a car. Both avenues have their advantages and disadvantages; perhaps you might decide a combination of the two is best.

Sometimes people get themselves mired in the nuances of the different policies and plans and end up losing sight of their original purpose for purchasing the insurance. Instead of analyzing which type to buy, first you must determine what should be done about the risk of premature death. The first question shouldn't be "What kind of insurance should I purchase?", but rather "How much insurance do I need?"

Often the answer to how much you need will determine what kind of insurance you are able to purchase. If the amount of insurance need is substantial, term insurance may be the only option available because of the costs and investment commitment involved in permanent. Let's look at how the different types compare.

TERM
Term is pure insurance. There is no cash value or equity. If you die during the term, your loved ones receive the insurance benefit. If you outlive your term, the policy lapses and you get nothing other than the peace of mind that your loved ones were protected.

THE GAMBLE
95% of all term policies go unpaid. In other words, if you took a random sample of 100 people who purchased term insurance, 95 of them would outlive their terms. The insurance companies know this. That is how they can afford to offer a 45 year old male $250,000 worth of coverage for a 20-year term for only $375 per year. They've crunched the numbers and are willing to bet that you and a whole lot of other people are going to outlive their policies. Because term is inexpensive, there is much less commitment. When you want out, simply stop paying the premium; no surrender or tax hits to worry about.

PERMANENT
With permanent insurance, there is no gamble, as long as you keep the policy in force – your loved ones will receive a death benefit. The downside is the companies must charge more because they know at some point they will have to pay out. Let's take our 45 year old male from the example above who wants $250,000 of coverage, only this time, for life. Permanent plans can be structured to deposit excess cash into the equity portion of the policy, but in our example we will show putting a minimal amount into the equity or "cash value", just enough to keep it in force until age 100. It would cost him $1,600 per year if he continued to pay his premium the remainder of his life.

Permanent policies can be structured in numerous ways. You can pay them all at once (single premium), over 10, 20, 30 years, or you can deposit a lot in the beginning and let the cash value grow tax-deferred and then take money out for retirement.

Again, it depends on how much you need, and how much you can afford. For some, like a young family with very little excess cash, but need a lot of insurance in case of a breadwinner's premature death, a term policy is the perfect choice. While others who want to guarantee a legacy to their estate might need permanent.

You should start by asking questions like:
- How much insurance will need when I'm 65? 75? 80?
- Will my other investments become large enough when I am 65 so that my loved ones will no longer need my life insurance?
- How do my investment alternatives stack up to my life insurance?
- Do the tax advantages of permanent insurance make it the best option?

Let's look at how they compare:

TERM ADVANTAGES
- Cheap – "Buy a lot for a little" – Term can cost up to 5 times less than permanent insurance depending on your age and term length.
- Low commitment – when you want out of term, you just simply stop paying the premium. Whereas with permanent you might incur surrender and tax penalties for withdrawing.
- Disclosure – What you see is what you get. There are no hard to understand charges or expenses, you don't have to worry about your interest rate or market returns. With term, you simply pay the premiums and get the coverage.
- Flexibility – you can purchase a cheap term policy now and convert it into a permanent policy later.
- Lots of options – you could take the money you saved by buying term and invest it into any investment vehicle of your choice.

TERM DISADVANTAGES

- Outliving it – Hopefully you'll live a long prosperous life and never see a dime from your term policy.
- No equity – With term, you are just paying for coverage. Other than the coverage it provides, it really has no value.
- Costly to renew – You should plan on not needing any insurance at age 70 plus, because term prices increase dramatically with age and deteriorating health status.

We generally recommend if our clients seek life insurance protection longer than 30 years then they should choose the permanent route. There is no telling what your health condition will be like when it comes time to renew your term policy.

Purchasing a permanent plan while you're young and healthy can often save you money over the long run. For example, take our 45 year old. He paid $375 for his 20 year term. Next he wants to renew it at age 65 for another 20 years – but now he has high blood pressure and cholesterol, costing him $4,162. He might live past 85 and get nothing after the policy has expired. In this example he would have been better off paying the $1,600 for permanent from the beginning.

PERMANENT ADVANTAGES

- Tax Advantages – the cash value in permanent insurance accumulates tax deferred. Unlike a mutual fund, there is no distribution, dividend or capital gains tax due each year. To earn a net return on investments that do not share the tax advantage enjoyed by life insurance, the gross rate of return on the alternative investment must be higher than that available under the life contract.

- Tax Free Withdrawal – As long as the policy remains in force, you can withdraw the money from a permanent policy without being taxed. The only other vehicle that both accumulates tax-deferred ***and*** allows tax-free withdrawals is a Roth IRA, which has individual contribution limits and is subject to a person's aggregate gross income.

Often permanent insurance is the perfect choice for high net-worth individuals who are seeking tax-sheltered investments and income levels are too high for other tax-advantaged vehicles. Unlike contributions to IRA's, permanent insurance has no restrictions for income or contribution amount as long as the MEC corridor is not exceeded.

- Liquidity – There are also no restrictions or tax-penalties for withdrawing the money early. You don't have to wait until age 59½. You could take out money after the first year without any penalty, as long as you have enough cash to keep the contract in force.

- Convertibility – You can convert the cash in the policy into another permanent policy or into an annuity.

- Forced Savings – Many people lack the self-discipline to save. Once a policy is taken out, people usually pay the premiums rather than deprive their family of the protection the policy provides. Paying the premiums means making regular contributions to the savings element of the contract.

PERMANENT DISADVANTAGES

- Commitment – "Until death do you part." Like marriage, the permanent insurance is designed to be a life long commitment. You can always cancel or surrender the policy, but most contracts have hefty surrender penalties if you decide to get out before the surrender period expires, which is usually more than 10 years and less than 20. In addition, at the time the policy is surrendered, the excess of the cash surrender value over the premiums paid is taxable as ordinary income.

- Charges & Fees – Since you are also buying life insurance, it is reasonable to assume a good chunk of the cash deposited in a permanent plan will go towards the cost of the insurance. Permanent plan charges can be steep, but most have guaranteed maximum charges that are required by law to be illustrated to the consumer before purchase. These charges can include: mortality, administrative expenses, surrender charge, policy fees, state premium tax, premium fees, and withdraw charges. Variable Universal Life also has management charges for the investment portfolios.

- Limited Investment Choices – Term life is pure insurance and is initially much less expensive than permanent insurance. You could take the savings provided by purchasing term and invest it in any vehicle you like. Permanent plans, on the other hand, require you to invest in the investment vehicles provided in the contract.

- Tracking and Disclosure – While the unbundled features of universal and variable life have helped disclose the breakdown of where the money is going, it can still be very difficult to track the investment performance, especially with variable life. Unlike stocks or mutual funds, tracking sub-account and overall investment performance is quite complicated because one must consider all of the charges, which are changing constantly.

The following are some guidelines we use to help determine what type of insurance you should buy:

YOU SHOULD BUY TERM IF YOU:

- only need coverage for a specific period of time, - like a house mortgage or until your children are independent.
- need a lot of coverage and can’t afford permanent.
- have low cash flow – if you’re living paycheck to paycheck and don’t think you can keep up with the permanent payments, triggering surrender charges.
- have other investments and are committed and self-disciplined enough to make regular deposits.
- don’t want the commitment required from permanent insurance.

YOU SHOULD BUY PERMANENT INSURANCE IF YOU:

- have a high net worth and are seeking a tax-advantaged investment
- don’t want to risk outliving your term and have nothing to show for it
- understand that permanent insurance is a long term commitment
- need insurance for estate planning purposes
- want forced savings
- want guaranteed life insurance for life

As you have probably concluded there are many variables to consider when deciding which type of insurance is best for you. Please call us at any time if you would like to discuss your particular situation!