



Will Power

Craig R. Hersch *Florida Bar, Board Certified, Wills, Trusts & Estates Attorney; CPA*

HOW MUCH LIFE INSURANCE IS NECESSARY?

Many clients ask me how much life insurance they should carry. This is a loaded question because life insurance can be used for so many different purposes, far too many for me to address in this one column. Today I'm focusing on families raising children, as I commonly find these families to be underinsured.

Suppose "Todd" age 42 - and "Nancy" age 39 - have three children, ages 13, 10 and 8. Both Todd and Nancy work, earning a combined \$150,000 annually. Assume for purposes of this discussion that Todd earns \$85,000 annually and that Nancy earns \$65,000. Todd and Nancy intend for all three children to attend college. Their nice home has a mortgage balance of \$300,000 requiring monthly payments including taxes and insurance of \$3,750.

Todd is insured for \$500,000 and Nancy is insured for \$250,000. Is this enough? I would suggest to you that it is not nearly enough life insurance. Let's back into our numbers to see how much life insurance Todd and Nancy really need.

If Todd were to die, the family cannot think of his life insurance as capital that will be spent down. His family has very significant expenses on the horizon. Have you ever seen the grocery bills for a family with teenagers? Not to mention the looming college expenses, and the fact that his young wife, Nancy, will need income for many years to come.

Instead, it is proper to think of the life insurance payment as the base on which the family will use to generate the income. If you think of it this way, it is not unreasonable for the family to purchase \$2 million of life insurance on Todd's life. I arrive at this figure by asking this question - "How much insurance would be necessary to allow a sum to grow at 3% annually (to keep up with inflation) and in addition to that, yield 5% income annually to replace Todd's current income?"

If Nancy received a lump sum of \$1.5 million and if it earned 5% annually it would gross \$75,000 before taxes. While the receipt of the life insurance is generally not a taxable event, the income and dividends that it earns would be subject to income taxes. So before taxes the \$1.5 million is not going to be enough to fully replace Todd's income, and at that amount of insurance there is no room for inflation, educational

expenses for the children, or other economic "surprises" likely to challenge the family.

Similarly, if Nancy were to die, Todd may have roughly the same need to replace her income. If the family wasn't reliant on Nancy's income should her life still be insured? Consider that in some families one spouse stays at home and doesn't work. If this were the case with Nancy, I maintain that there would still be a need for insurance, as Todd would have to replace all the things that she does for the family with hired help, and therefore there would be the need to generate the income to replace her loss.

I am not suggesting that an economic analysis is the sole means to determine how much someone is "worth" to family. I am merely trying to point out a means to determine how much might be needed to maintain a certain economic lifestyle. No amount of money can replace a father and husband, or a mother and wife. But when a young family is confronted with the question of how much insurance to carry, this economic analysis is a good starting point.

Moreover, there are different types of life insurance - whole life - variable - term - term that will convert to whole or variable products - to consider. The family should meet with a reputable life insurance representative to review their options that will meet their budgetary constraints. The family should not be in a position where the life insurance premiums inhibit their necessary day-to-day living and retirement savings strategies.

Their estate planning attorney should be involved to ensure that the life insurance is properly designated into a trust that would avoid estate taxes and ensure that the insurance is used for its intended purposes. The life insurance might be the largest asset in the event of someone's death, and it only makes sense to construct a proper estate plan around this asset.

The typical family doesn't want to deal with these issues. Nevertheless, these are important matters that every responsible parent should confront sooner rather than later.

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