What Is Life Insurance?

A life insurance policy is a contract with an insurance company. In exchange for premium payments, the insurance company provides a lump-sum payment, known as a death benefit, to beneficiaries upon the insured's death.

Typically, life insurance is chosen based on the needs and goals of the owner. Term life insurance generally provides protection for a set period of time, while permanent insurance, such as whole and universal life, provides lifetime coverage. It's important to note that death benefits from all types of life insurance are generally income tax free.

There are many varieties of life insurance. Some of the more common types are discussed below.

Term life insurance

Term life insurance is designed to provide financial protection for a specific period of time, such as 10 or 20 years. With traditional term insurance, the premium payment amount stays the same for the coverage period you select. After that period, policies may offer continued coverage, usually at a substantially higher premium payment rate. Term life insurance is generally less expensive than permanent life insurance.

It's important to note that, although term life can be used to replace lost potential income, life insurance benefits are paid at one time in a lump sum, not in regular payments like paychecks.

Term life insurance proceeds can be used to replace lost potential income during working years. This can provide a safety net for your beneficiaries and can also help ensure the family's financial goals will still be met — goals like paying off a mortgage, keeping a business running and paying for college.

Universal life insurance

Universal life insurance is a type of permanent life insurance designed to provide lifetime coverage. Unlike whole life insurance, universal life insurance policies are flexible and may allow you to raise or lower your premium payment or coverage amounts throughout your lifetime. Additionally, due to its lifetime coverage, universal life typically has higher premium payments than term.

Universal life insurance is most often used as part of a flexible estate planning strategy to help preserve wealth to be transferred to beneficiaries. Another common use is long-term income replacement, where the need extends beyond working years. Some universal life insurance product designs focus on providing both death benefit coverage and building cash value while others focus on providing guaranteed death benefit coverage.

Whole life insurance

Whole life insurance is a type of permanent life insurance designed to provide lifetime coverage. Because of the lifetime coverage period, whole life usually has higher premium payments than term life. Policy premium payments are typically fixed, and, unlike term, whole life has a cash value, which functions as a savings component and may accumulate tax-deferred over time.

Whole life can be used as an estate planning tool to help preserve the wealth you plan to transfer to your beneficiaries.

Comparing types of life insurance

	Term Life Insurance	Universal Life Insurance	Whole Life Insurance
Needs it helps meet	Income replacement during working years	Wealth transfer, income protection and some designs focus on tax-deferred wealth accumulation	Wealth transfer, preservation and tax-deferred wealth accumulation
Protection period	Designed for a specific period (usually a number of years)	Flexible; generally for a lifetime	For a lifetime
Cost differences	Typically less expensive than permanent	Generally more expensive than term	Generally more expensive than term
Premiums	Typically fixed	Flexible	
Proceeds paid to beneficiaries	Yes, generally income tax free	Yes, generally income tax free	Yes, generally income tax free
Investment options	No	No	
May help build equity	No	Yes	Yes

How life insurance policies are issued

Policies are either simplified issue or fully underwritten. Simplified issue policies only require that you answer questions about your health when completing the insurance application. These policies may cost more since the insurance company has less proof about your health. Fully underwritten policies require that you take a medical exam and complete lab work. You usually get a lower premium with these policies if your results show good health.

Factors that determine your premium rate

A general rule of thumb with life insurance is that the younger and healthier you are, the less you will pay. Age is typically the most important factor in calculating your premium rate. Other factors include:

- Gender — females typically get lower rates because of longer life expectancy
- Answers to health questions on the policy application
- Results from medical exam and lab work
- Family medical history
- Marital status
- Location
- Lifestyle — smoker/nonsmoker, alcohol consumption, risky hobbies like skydiving

Are life insurance proceeds taxable?

Life insurance proceeds, aka the death benefit, aren't taxable as long as they go to a beneficiary in the form of one lump payment. That being said, if your policy is set up so your death benefit is paid out in installments, the beneficiary is likely to have to pay tax on the interest for the outstanding balance. It's also common for the death benefit to be taxed if your designated beneficiary is your estate.

If the value of your estate exceeds the IRS's threshold limits — federal and state exemptions — the difference will be hit with estate and possibly inheritance taxes. Estates valued in the millions could be taxed up to 40%. Certain states also have inheritance taxes for multimillion-dollar estates, with rates as high as 20% in some areas.

The federal estate tax threshold, as of 2019, is $11.4 million. If the value of your entire estate, including your life insurance payout, exceeds this limit, only the remaining balance will be taxed. So, if your life insurance policy is $5 million and your estate is worth $7 million, the $0.6 million difference will be subject to taxes. However, certain states have much lower threshold limits for their state estate taxes.

Can estate taxes be avoided?

Setting up an irrevocable life insurance trust (“ILIT”) is a way to potentially avoid estate taxes. This action can’t be undone — hence the “irrevocable” part. Basically, you’re transferring ownership of the life insurance policy to the trust and you can’t name yourself as the trustee, or the person in charge of it.

The trustee will carry out the rules of the trust that you establish, such as paying out a certain amount of your benefit to your kids annually or donating the entire sum to your alma mater — it’s up to you. You might choose to make your trustee a member of your family, like your spouse or a grown child, but you could also assign that role to a bank, your attorney, a trusted friend or anyone else.

The death benefit paid to the trust is not counted in your estate’s gross value when you pass away. This is what makes an ILIT ideal for those with estates exceeding the $11.4 million threshold. Setting up an ILIT for at least the difference in your estate’s value from the federal threshold can help a lot more of your money go where you want it to — instead of back into the IRS’s pocket.