



Underinsured and Overlooked

By: Tom Piro, CFP®, Enrolled Agent

July 2024

3 Common and Critical Coverage Gaps & How to Protect Yourself

Affluent individuals and families often possess significant assets, refined financial portfolios, and live seemingly comfortable and secure lives. But even with substantial wealth, they can still have their lives significantly impacted without proper insurance coverage in critical areas. There are three commonly underinsured and overlooked coverage gaps for affluent individuals.

The first two forms of insurance are more traditional types of coverage gaps. Frequently I see affluent individuals lack optimal coverage with **umbrella insurance** and **laddered, term life insurance**. Understanding the importance of these insurance types, which often are relatively inexpensive, can help affluent individuals ensure more comprehensive financial protection.

The third form of insurance coverage is what we call “**tax insurance**.” This is a unique concept, but it centers around the fact that the overwhelming majority of retirement accounts are pre-tax. If tax rates increase in the future, the amount of after-tax money that can be withdrawn (what really matters), could be significantly reduced.

The good news is that once individuals are aware of these critical and commonly overlooked forms of insurance, the solutions to resolve and protect yourself can be very straight forward.

1. Umbrella Insurance: Significant Protection at a Low Cost

Affluent individuals often have a higher risk of liability due to their lifestyle, where they live, and the assets they own. For instance, many affluent individuals own rental property. And do you know the most sued profession in the United States? If you guessed “landlord”, then you guessed correctly.

Despite this, umbrella insurance, which provides additional liability coverage beyond the limits of primary policies (such as home, rental properties, auto, boat insurance, etc.), is frequently overlooked entirely, or lacks a sufficient amount of coverage, despite its relatively low price. Besides those that own rental property, umbrella insurance is particularly important for affluent individuals that have teen drivers, frequently entertain guests on their property, or have swimming pools. While the probability of needing to utilize umbrella insurance is statistically very low, a wise man once said, “Throw statistics out the window if it happens to you.”

Why do many affluent individuals not have any, or insufficient, umbrella insurance? There are two primary reasons:

1.) A common belief is that their existing insurance policies provide adequate coverage. While homeowners and auto insurance policies offer *liability protection*, they often have *coverage limits* that may not suffice in the event of a significant liability claim or lawsuit.

For instance, let’s assume an affluent individual has a \$1MM auto liability policy, and a \$1MM umbrella policy. Then, let’s assume that individual is at fault in a fatal auto accident in an affluent neighborhood. If a



Underinsured and Overlooked

lawsuit were to follow, there is a strong probability the lawsuit would settle for in excess of \$2MM, meaning the at fault individual would be liable for the difference, and be at risk of losing significant personal assets. (We'll revisit this scenario in a moment).

Umbrella insurance fills this gap by providing additional coverage, typically in increments of millions of dollars, increasing the comprehensive protection against these types of unforeseen liabilities.



While this meme is intended to garner a laugh, it is a good reminder that simply having a \$1MM or \$2MM umbrella policy often isn't enough. An adequately sized umbrella policy can be crucial to protecting one's wealth.

2.) The second factor contributing to the underutilization of umbrella insurance among the affluent is the perception of cost-effectiveness. Some view the premiums for umbrella coverage as an unnecessary expense, especially when they already have robust insurance coverage in place. However, compared to the potential financial ramifications of a large liability claim or lawsuit, the cost of umbrella insurance is a prudent and nominal investment in protecting wealth and assets.

Peace of Mind and Low-Cost Protection: The benefits of having umbrella insurance for affluent individuals are manifold. Most notably, it provides peace of mind by offering an extra layer of multi-million dollar protection against unforeseen liabilities, and safeguarding all that one has worked for: personal assets, savings, and future income streams.

Revisiting the fatal auto accident scenario, let's now assume that the affluent individual had a \$5MM umbrella policy, instead of just \$1MM. In this scenario, there is a significantly higher likelihood the victim's family would settle for a \$6MM payment (as compared to a \$2MM payment), and the at fault driver's personal assets would no longer be at risk.

In this same scenario, it is important to recognize the priorities for insurance companies and the resources they put into a potential lawsuit. An insurance company is much more likely to defend a lawsuit where they risk losing a \$5MM lawsuit (via the larger umbrella policy), as compared to the initial scenario, where the insurance company is only at risk of losing \$1MM. The larger an umbrella policy, the more likely an insurance company will defend their client.

Given these benefits, umbrella insurance (especially when coupled with other insurance policies) is a fairly inexpensive form of insurance. A \$5MM umbrella insurance policy can often cost as little as \$500 annually. And while the probability of ever needing an umbrella policy may be low, it can save you from financial ruin.



Underinsured and Overlooked

2. Term Life Insurance: A Critical and Low-Cost Safety Net

Many affluent individuals believe that their wealth, investments, and assets provide sufficient security for their families in the event of their death. This belief is grounded in the idea that liquidating assets or drawing from savings will more than cover necessary expenses or future goals for the family. However, this approach has potential drawbacks and risks:

1. **Illiquidity of Assets:** High-net-worth individuals often have significant portions of their wealth tied up in illiquid assets such as real estate, businesses, or long-term investments. In the event of an unexpected death, converting these assets into cash quickly can be challenging and could result in significant financial losses and tax burdens.
2. **Underestimation of All Future Expenses and Goals:** There are many rules of thumb for how much life insurance an individual should carry, e.g. 5X your current income. The issue with this approach is that it is obviously not specific, and often a multiple of an individual's income (even for affluent individuals) falls short of critical goals, e.g. paying off a large mortgage, paying for a child's education, significant medical expenses or long-term care, etc.

Despite these misconceptions, term life insurance offers several advantages that make it a valuable source of protection for affluent individuals:

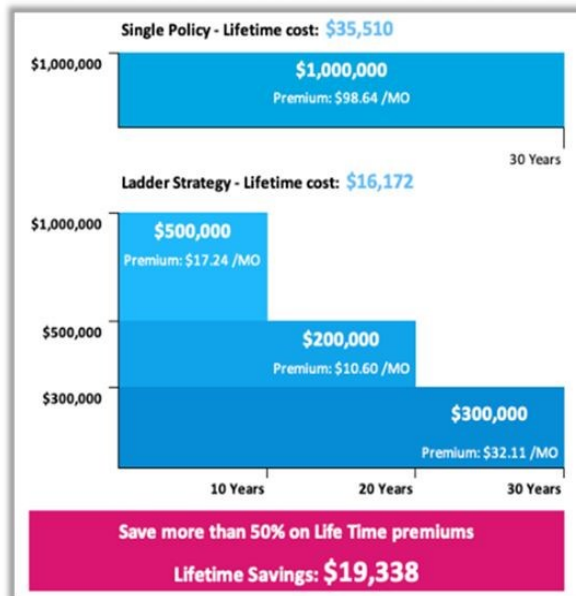
Relatively Low-Cost Way to Ensure Goals are Met: While every policy is priced differently, term life insurance can provide appropriate levels of coverage at an economical price. Whole life insurance policies and other alternatives are often more costly.

Based on my experience and the hundreds of financial plans I've structured (which include costs for future unpaid goals), affluent individuals rarely need term life insurance policies that stretch beyond 10 – 15 years. By not buying long term policies (e.g. 30 years, which increases risk to the insurer and increases the price you pay), it helps keep term life premiums low.

Additionally, I often recommend "laddering" term life insurance. This is a strategy that involves purchasing multiple term policies with varying expiration dates to match different financial obligations over time, ensuring that coverage decreases as financial responsibilities (such as a mortgage or children's education expenses) diminish. All of this helps keep the costs of term life insurance low.

Underinsured and Overlooked

High-level illustration of the laddering concept



Source: PolicyAdvisor

Affluent individuals often neglect life insurance due to misconceptions about their financial security. However, by integrating life insurance into their financial planning, affluent individuals can close a significant gap or risk for their families and their legacy.

3. Tax Insurance

Many affluent individuals have built substantial retirement accounts. The gap here lies in the fact that only 14.8% * of 401(k) retirement accounts in the United States have any type of post-tax contributions at all (meaning the overwhelming majority is pre-tax). So, if tax rates increase in the future, the amount of “after-tax” money investors can withdraw from their retirement accounts and spend on the things they enjoy and are important to them can be significantly reduced.

Roth IRAs are a very advantageous form of retirement savings not just for their potential to grow tax-free but also for their unique ability to provide what I call “tax insurance.” Especially in an era of growing government debts, which increase the risk of future tax hikes, the “tax insurance” provided by a Roth IRA is especially compelling.

How do you take advantage of this? How does the math work out?

We’ll use two scenarios to illustrate this concept. In the first scenario (left table), we assume a retired individual has a \$3MM Traditional IRA and their marginal Federal income tax rate is 24%. If the individual were to withdraw from their IRA at this 24% marginal rate five years down the road, it would have an after- tax value of \$2.96MM which is the same after-tax value if the individual were to convert their \$3MM Traditional IRA to an after-tax Roth IRA at the 24% marginal tax rate.

Underinsured and Overlooked

In the scenario on the right, we make the same assumptions as the first scenario, except we assume the individual's marginal tax rate increases from 24% to 32% over time. And you can see, with that assumption, the after-tax value of a Roth IRA is higher than the Traditional IRA.

With an assumption of increasing marginal tax rates, an affluent individual would be well served executing a Roth IRA *conversion* (where taxes are paid on the amount of Traditional IRA converted to a Roth) and having the funds in the Roth IRA grow tax free, thus protecting themselves from potential future tax increases.

No Change In Tax Rate	Traditional	Roth
Pre-Tax Investment	3,000,000	3,000,000
Tax rate (now)	0%	24%
After tax investment	3,000,000	2,280,000
Pre-tax rate of return (total over 5 years)	30%	30%
Pre-tax gain	900,000	684,000
Tax rate (in five years)	24%	0%
After-tax value	2,964,000	2,964,000

Higher Bracket or Tax Increase	Traditional	Roth
Pre-Tax Investment	3,000,000	3,000,000
Tax rate (now)	0%	24%
After tax investment	3,000,000	2,280,000
Pre-tax rate of return (total over 5 years)	30%	30%
Pre-tax gain	900,000	684,000
Tax rate (in five years)	32%	0%
After-tax value	2,652,000	2,964,000

To learn more about Traditional to Roth IRA conversions, please visit: <https://osbornepartners.com/three-powerful-tax-strategies-to-evaluate-now/>.

In times of growing national debts, or when tax laws are subject to change, Roth IRAs provide a level of stability and predictability. By locking in tax-free growth and distributions, Roth IRAs offer a form of "tax insurance" that can be particularly advantageous to affluent investors.

While affluent individuals may appear financially secure and comfortable, underinsurance in critical areas such as life insurance, umbrella insurance, or tax insurance, can leave them vulnerable to significant risks. By recognizing the importance of these insurance types and following a refined process for adequate coverage, affluent individuals can better protect their assets, secure their family's future, and preserve their legacy.

Sources:

* Fidelity (22 April 2024). What is a Roth 401(k)?, <https://www.fidelity.com/learning-center/personal-finance/roth-401k>. Accessed 12 June 2024.

**IRS (Page last updated 18 March 2024). Federal income tax rates and brackets 2023, <https://www.irs.gov/filing/federal-income-tax-rates-and-brackets>. Accessed 12 June 2024.

The opinions expressed herein are strictly those of Osborne Partners Capital Management, LLC as of the date of the material and is subject to change without notice. None of the data presented herein constitutes a recommendation or solicitation to invest in any particular investment strategy and should not be relied upon in making an investment decision. There is no guarantee that the investment strategies presented herein will work under all market conditions and investors should evaluate their ability to invest for the long-term. Each investor should select asset classes for investment based on his/her own goals, time horizon and risk tolerance. The information contained in this report is for information purposes only and should not be deemed investment advice. Although information has been obtained from and is based upon sources Osborne Partners Capital Management, LLC believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss. Osborne Partners Capital Management, LLC does not provide tax or legal advice. Please consult with your tax and legal advisors regarding your personal circumstances. Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™ and federally registered CFP (with flame design) in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements.