



Three Common Coverage Gaps

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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. So today, I'll discuss the three most commonly underinsured and overlooked coverage gaps for affluent individuals.

The first two forms of insurance I'll discuss 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 type I'll cover today 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 If tax rates increase in the future, the amount of after-tax money that can be withdrawn (what really matters), could be significantly reduced.

This segment of Mastering Your Wealth aims to bring to light those three critical and commonly overlooked forms of insurance, and more importantly, I'll discuss straight forward approaches to better protect yourself.

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 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 & 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.

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.

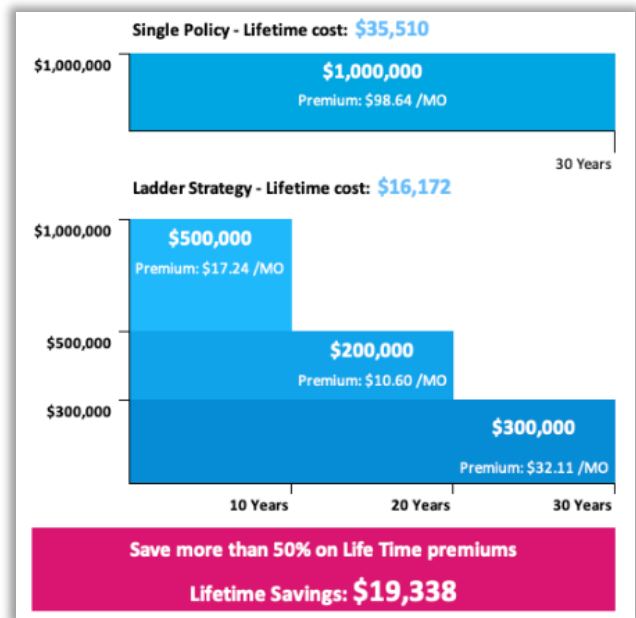
2. **Underestimation of All Future Expenses and Goals:** There are many rules of thumb for how much life insurance an individual should carry, e.g. 5X your current income. The issue with this approach is that it is obviously not specific, and often a multiple of an individual's income (even for affluent 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.



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 could be termed as what I call “tax insurance.” Especially in an era of growing government deficits and debts, and entitlements such as social security (which increase the risk of

future tax increases), the “tax insurance” provided by a Roth IRA is especially compelling.

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

Here is a scenario and let’s make the following two assumptions: 1. An affluent retired individual has a \$3MM traditional IRA. 2. Prior to IRA withdrawals, the individual’s ordinary income totals \$210,000 (e.g. this could include social security payments, pensions, rental property net income, etc.).

Any withdrawals made from their traditional IRA at this income level would be taxed at a minimum 24% Federal rate. Once the individual reaches total ordinary income of \$383,900 marginal tax rates increase to 32%. **

Similarly, any Roth IRA *conversion* at this income level (where you pay taxes on the amount of traditional IRA converted to a Roth), would be taxed at the same 24% Federal level. However, the funds in your Roth IRA now grow tax free, insulating yourself from potential future tax increases. And voilà, you now have “tax insurance”!

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.

Conclusion

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.

We covered several complex subjects and calculations at a high-level today. If you would like to learn more about these subjects, or speak about your specific situation, please reach out.

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.

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