A Widow’s Financial Plan

Q.

I am a physician with a fairly large amount of life insurance. I have a non-working spouse and a daughter. I would like to see an article aimed at a potential surviving spouse regarding how to best manage and utilize a large death benefit, in order to maintain a comfortable standard of living. I believe that there are many physicians in situations like mine whose spouses could benefit from having a plan in place if the unthinkable would happen. Pitfalls to avoid in that situation would also be valuable.

A.

I often tell doctors to buy oodles of term life insurance if they have someone else depending on their income. Getting that in place is far more important than having a pre-set plan about how to use it in the unlikely event it actually pays out. Nevertheless, this is an interesting financial planning question to think about, no matter how morbid.

In some ways, it is no different from any other windfall. But there are some unique things about getting a life insurance payout due to a spouse’s death that we can discuss. In reality, you should have the outline of a financial plan in case of your death (or the death of the person whose income you depend on) before you buy the life insurance. How much you buy really depends on that plan. For example, if the plan is for your spouse, the orthopedist, to continue working then there might not be any need for life insurance on you at all! For this reason, we don’t have any insurance on my spouse. We figure between our savings, WCI income, and clinical income, even if I cut back some, that we can scrape by. However, if I
die, things might be a little different. We’re rapidly approaching financial independence, but we’re not there yet, so we still carry significant life insurance on me ($1.75 Million actually, in a $750K 20 year policy that will expire when I’m 52 or so and a $1 M 30 year policy whose term goes to when I’m 57 or so.)

You all know I like making lists, so let’s make one about all the things to consider if you are the unfortunate recipient of a big life insurance benefit check.

**# 1 Don’t Do Anything Quickly**

There is no reason you have to do anything for months after your spouse’s death. This is the time to grieve. While it might be nice to distract yourself a bit with some financial chores, don’t feel like you have to do any of this for a while. As long as you had a big life insurance policy on the breadwinner and you’re not grieving your way into the Lamborghini dealership, you can likely ignore your finances for the most part for at least a few weeks, if not a few months. When they send you the life insurance check, deposit it someplace safe. Remember that each of your bank accounts may only have FDIC (Bank) or NCUA (Credit Union) insurance for $250K. So if it is the usual $1-5 Million I recommend, you may want to split it up a bit, just in case.

**# 2 Consider Your Other Income**

There’s a good chance that you have some other income, aside from the earned income of your deceased spouse. The more you
have, the less you will depend on that life insurance money to provide your income. This might include income from a rental property, your own earned income, income from a taxable investment account, or book royalties. Be sure not to forget about the Social Security survivor’s benefit, and I’m not talking about the bizarre one-time $255 check they’ll send you. You can check for the real survivor’s benefit on your (or your spouse’s) annual Social Security statement, (or log on to the Social Security website) to see how much you (or your spouse) may get. For example, my statement says that if I die my spouse caring for my child will get $1,961 per month and each of my children will get $1,961 per month, with total family benefits totaling not more than $4,577 per month. The rules are a little weird, but in my case, if I die my spouse starts getting $4,577 per month, indexed to inflation. That will continue until my second youngest graduates from high school more than a decade from now. Then it will decrease to $3,922 for another 4 years until the youngest is 16 at which time the spousal survivor benefit goes away until she hits full retirement age. But for another 2 years until the youngest turns 18 and finishes high school, she will continue to get $1,961 per month. At that point, my spouse will be 56 and closing in on retirement age anyway. At full retirement age, she would get $2,615 per month. The bottom line is that just the Social Security survivor benefit would pay my surviving spouse almost $55,000 per year for over a decade, with a lesser amount for most of another decade.

# 3 Consider Your Earned Income

The plan for many couples in the event of the untimely death of the breadwinner is for the spouse to go back to work, if not immediately then eventually (such as when kids are in school full-time or after they leave home.) That can obviously provide significant living income. If you carry enough life insurance, you can eliminate that need, but it is okay to bake that into your plan as well if your spouse is okay with it.
# 4 Figure Out The Student Loans

Now would be a good time to see what happens to your student loans in the event of your death. Federal loans are generally forgiven in the event of the borrower’s death, but that is not always the case for private loans (including loans that have been refinanced.) So read the fine print. That’s not to say don’t refinance, but if you refinance with a lender that would assess your loans against your estate in the event of your death, use some of your interest savings from refinancing to buy some more inexpensive term life insurance. If the loans are going to be forgiven, make sure you don’t pay them off with the life insurance money!

# 5 Consider Reducing Your Fixed Costs

While you shouldn’t do anything in the first few days, weeks, and maybe even months, as soon as you have moved through the initial grieving process it is a good idea to look into any fixed costs you could reduce. For example, if you are now the only driver in the family, you can probably sell one of the cars. That will reduce licensing, insurance, and maintenance costs, but also depreciation. Plus, if the car is worth anything it will boost your savings by a bit. You may also want to get rid of “his” (or “her”) toys like a boat, RV, guns, snowmobiles etc for the same reasons. Pay off any consumer debts like credit cards or car payments. Pay off your student loans. Consider using some of the insurance money to pay off the mortgage. While all of this reduces your available cash, it has a more important effect of reducing your need for cash flow. In fact, you might even get it down to the point where Social Security and investment income is enough to meet all your needs.
# 6 Remember Your Retirement and Other Savings

As time goes on, the retirement portfolio eventually replaces the life insurance need. Chances are by the time your spouse dies, there will at least be something of a nest egg started. If what was formerly the retirement nest egg makes up a relatively small portion of your new nest egg (previous savings plus life insurance), then maybe you should just let it continue to compound for your retirement and plan on using the life insurance for living expenses in the meantime. However, if the old nest egg makes up the majority of the new nest egg (and this is usually a good thing) then you may want to incorporate it into your current income plan. Don’t be afraid of the Age 59 1/2 rule, it’s relatively easy to work around.

# 7 Time For A New Financial Plan

Your financial life has now changed dramatically, and so must your financial plan. If you feel knowledgeable and confident doing that yourself, then go right ahead and draw up a new one. If that makes you quiver, now is a good time to seek some professional help. Even a couple of hours with a good hourly rate financial planner can make a big difference.

In a scenario like that of the question at the beginning, where the family’s only breadwinner has been replaced by a big life insurance check, the retirement date for the spouse has basically been moved forward. That means retirement will last longer and there will be a longer period of “retirement” before spousal (not survivor) Social Security benefits and Medicare kick in. So you may want to use a slightly more conservative initial withdrawal rate, perhaps as low as 3-3.5%. (i.e. a $3 Million nest egg provides $90K-105K in additional income per year. Now the retirement accounts, your taxable account, and all of the insurance money that didn’t go
toward debt reduction is one big pot of money with a single goal- to help you live comfortably for the rest of your life. So you should probably revisit your asset allocation with these changes in mind. Most will probably want a more conservative one than they were using a few months ago. Many spouses will want a simpler plan. That’s often easy to achieve. 401(k)s, 403(b)s, SEP-IRAs, Individual 401(k)s and defined benefit cash balance plans can be rolled into IRAs. Roth 401(k)s and 403(b)s can be rolled into Roth IRAs. Your spouse’s IRAs can be rolled into your IRAs (not the case if you aren’t married, in which case the inherited RMD will start having RMDs immediately.) You’re likely to have no more than three accounts to manage- a traditional IRA, a Roth IRA, and a taxable investing account. All of those can be held at the same mutual fund shop, such as Vanguard, and if you really want, they can all be invested in one simple investment such as the Target Retirement Income Fund or The Life Strategy Income Fund. Voila- the investing plan is done!

# 8 Withdraw Tax-Efficiently

Be conscious of how you withdraw from each account. If you’re careful, you may have a very low effective tax rate. You won’t be paying any payroll taxes. At least some of the Social Security survivor’s benefit won’t be taxable (remember a big chunk of it technically goes to your children and so will be minimally taxed if at all.) If you are in a low enough bracket (i.e. the 10% or 15% bracket) you won’t even have to pay taxes on any capital gains or qualified dividends from a taxable account. You can continue to tax loss harvest and use appreciated shares for charitable donations to further reduce your tax burden. Like a typical retiree, you can carefully balance withdrawals from the tax-free and tax-deferred retirement accounts to determine your own maximal marginal tax rate. You may be surprised at how low the rate applied to your
tax-deferred dollars can be. Remember, of course, the general rule is to spend taxable assets (including life insurance benefit money) before retirement assets, thus preserving the tax-protection and asset-protection benefits of the retirement accounts as long as possible. But opportunities to get tax-deferred money out at very tax rates (like 0-15%) are the exception to the general rule.

If this is all very intuitive for you, then you likely will not need a financial advisor. If it is not, then don’t feel badly about hiring one. You really don’t want to blow this. But do make sure you are hiring someone who is giving you good advice at a fair price and remember that money used to pay that fair price is money you cannot spend on something else.

# 9 Extra Money?

Now, if there is more money than you really need, there are two other considerations. The first is to give some to your children, perhaps as a 529 or UGMA contribution. Many people buy enough life insurance to pay off the mortgage, provide for their spouse for the rest of their life, AND pay for their kids’ educations. The second is to give some money away. Just like any retiree with more than “enough,” giving money away can enrich your life.

What do you think? Did I forget anything? What would you do if you had a big life insurance windfall from your spouse’s death? Comment below!