Three life insurance rules of thumb

If you want to quickly determine your existing life insurance needs, rules of thumb can be an easy way to get a value. These systems are better than a random guess but often fail to account for important parts of your financial life.

Use the calculator above to get a more refined idea of how much life insurance you need, then compare that value to these estimates.

Rule of thumb No. 1: Multiply your income by 10.

"It's not a bad rule, but based on our economy today and interest rates, it's an outdated rule," says Marvin Feldman, former president and CEO of insurance industry group Life Happens.

The "10 times income" rule doesn't take a detailed look at your family's needs, nor does it take into account your savings or existing life insurance policies. And it doesn't provide a coverage amount for stay-at-home parents, who should have coverage even if they don't make an income.

The value provided by the stay-at-home parent needs to be replaced if he or she dies. At a bare minimum, the remaining parent would have to pay someone to provide the services, such as child care, that the stay-at-home parent provided for free.

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Rule of thumb No. 2: Buy 10 times your income, plus $100,000 per child for college expenses

Education expenses are an important component of your life insurance calculation if you have kids. This formula adds another layer to the "10 times income" rule, but it still doesn't take a deep look at all of your family's needs, assets or any life insurance coverage already in place.

Rule of thumb No. 3: The DIME formula

This formula encourages you to take a more detailed look at your finances than the other two. DIME stands for debt, income, mortgage and education, four areas that you should account for when calculating your life insurance needs.

- **Debt and final expenses:** Add up your debts, other than your mortgage, plus an estimate of your funeral expenses.
- **Income:** Decide for how many years your family would need support, and multiply your annual income by that number.

- **Mortgage:** Calculate the amount you need to pay off your mortgage.
- **Education:** Estimate the cost of sending your kids to school and college.

By adding all of these obligations together, you get a much more well-rounded view of your needs. However, while this formula is more comprehensive, it doesn't account for the life insurance coverage and savings you already have. It also doesn't consider the unpaid contributions a stay-at-home parent makes.

How to calculate how much life insurance you need

Follow this general philosophy to find your own target coverage amount: financial obligations minus liquid assets.

1. Calculate obligations: Add your annual salary (times the number of years that you want to replace income) + your mortgage balance + your other debts + future needs such as college and funeral costs. If you're a stay-at-home parent, include the cost to replace the services that you provide, such as child care.
2. From that, subtract liquid assets such as: savings + existing college funds + current life insurance.

Calculation example

To illustrate, let's look at a fictional couple: Jason and Heather. They have two children, ages 2 and 5. Heather makes $75,000 a year, and Jason is a full-time stay-at-home dad. They have a $150,000 balance on their home mortgage, owe $16,000 on two car loans and have $3,000 in credit card debt.

Heather has group life insurance equal to double her annual salary, and Jason has none. Together, they have $20,000 in a savings account and $10,000 in their kids' college funds.

The couple decide they want 30-year term life insurance policies. By the end of the term, their children will be adults, their mortgage will be paid off and, if they stick to a savings plan, the remaining spouse will have a retirement nest egg.
To calculate her life insurance needs, Heather would add her obligations:

- $1.2 million for income replacement ($75,000 times 16, the number of years before her youngest child graduates from high school).
- $150,000 for the mortgage balance.
- $19,000 for debt ($16,000 in car loans, plus $3,000 in credit card debt).
- $200,000 for two children's college educations.
- $7,600 for final expenses — approximately the median cost of a funeral with a casket, according to the National Funeral Directors Association.

This totals $1,576,600. From this, Heather would subtract:

- $20,000 in savings.
- $10,000 in the kids' college funds.

- $150,000 of group life insurance.

This means Heather should buy a $1.4 million ($1,396,600) term life policy.

Here's how a calculation would work for Jason. His obligations would include:

- $100,000 to replace the child care that he now provides, until the kids are teenagers.
- $150,000 for the mortgage balance.
- $19,000 for debt.
- $200,000 for two children's college educations.
- $7,600 for final expenses.

This totals $476,600. From this, he would subtract $30,000 to account for the couple's savings and their kids' college funds. His final estimated life insurance need is about $450,000.

Jason might also want to figure income replacement into his policy, says Johanna Fox Turner, a partner and vice president of Fox & Co. CPAs, Inc., in Mayfield, Kentucky. She notes that the surviving parent might want to quit work to take care of the kids for a few years — in which case, the stay-at-home parent's policy should include income replacement, rather than child care costs, for those years.

Tips for life insurance calculations

Keep these tips in mind as you calculate your coverage needs:

- Rather than planning life insurance in isolation, consider the purchase as part of an overall financial plan, says certified financial planner Andy Tilp, president of Trillium Valley Financial Planning near Portland, Oregon. That plan should take into account future expenses, such as college costs, and the future growth of your income or assets. "Once that information is known, then you can map the life insurance need on top of the plan," he says.
- Don't skimp. Feldman recommends buying a little more coverage than you think you'll need instead of buying less. Remember, your income likely will rise over the years, and so will your expenses. While you can't anticipate exactly how much either of these will increase, a cushion helps make sure your spouse and kids can maintain their lifestyle.
- Talk the numbers through with your spouse, Feldman advises. How much money does your spouse think the family would need to carry on without you? Do your estimates make sense to them? For example, would your family need to replace your full income or just a portion?
- Consider buying multiple, smaller life insurance policies, instead of one larger policy, to vary your coverage as your needs ebb and flow. "This can reduce total costs while ensuring adequate coverage to the times needed," Tilp says. For instance, you could buy a 30-year term life insurance policy to cover your spouse until your retirement and a 20-year term policy to cover your children until they graduate from college. Compare life insurance quotes to estimate your costs.

- Turner recommends parents of young children choose 30-year versus 20-year terms to give them plenty of time to build up assets. With a longer term, you’re less likely to get caught short and have to shop for coverage again when you’re older and rates are higher.