LIFE INSURANCE

The uses of life insurance in the estate planning process are as varied as the type of insurance products available in the market place. It is important to evaluate the needs for life insurance as well as the soundness of the insurance carrier and the insurance policy itself. If the ownership and implementation of the life insurance policy is properly structured, the proceeds of the policy can pass to family members free of estate and gift tax.

Purposes of Insurance

The motivations for obtaining life insurance are generally one or more of the following:

1. To replace the earning capacity of the insured.

2. To increase the size of one's estate.

3. To provide liquidity at the time of a death.

4. To defray the estate taxes payable upon the death of the insured and the insured's spouse.

5. To provide a college fund for children by using the income tax attributes of life insurance.

6. To support other tax saving planning in the event of early deaths, e.g.:

    a. Charitable Remainder Unitrusts

    b. Grantor Retained Annuity Trusts

    c. Personal Residence Trusts

    d. Installment payment of qualified plan benefits

7. To offset the double taxation (i.e. income and estate taxes) on qualified plan benefits.

8. To provide for a "fair" distribution to children when a family business is involved, particularly when certain of the children are active in the business.

9. To provide for a fair distribution between a spouse and children of a former marriage.

10. To provide for creditor protection for cash build-up in the policy.

11. To avoid dealing with the other wealth transfer techniques described in this outline.

Evaluating Insurance Policies

In today's environment, one of the most important criteria in evaluating an insurance product is the financial soundness of the insurance carrier. Also of paramount importance are the factors which govern the premiums charged by the various companies, i.e. the investment yield, the mortality assumptions, and the expense allocations used by the carrier to project policy performance. Careful evaluation of the insurance carrier and the policy will produce the safest and most effective long-term results. Prior to selecting an insurance product, a number of questions should be asked to determine whether a policy is likely to deliver as promised and whether the life insurance company has the financial strength to meet its obligations.

1. Company Analysis

   a. Company Profile. How long has the company been in existence? Is the company's life insurance line of business a meaningful segment of the total company? Is the insurance carrier a mutual or stock company?

   b. Company Rating. How is the company rated by various rating agencies -- Best (preferably A+), Moody's (preferably Aa or Aaa) and Standard and Poors (preferably AA or AAA)?

   c. Investment Portfolio. Does the company have a sound investment philosophy? Are the company's investments well diversified? What is the company's investment grade mix? What is the average maturity of the portfolio? What is the history of the company's profitability?

   d. Reserve Protection. What is the ratio of the company's capital surplus and reserves to high risk investments and to total assets?

2. Policy Evaluation

   a. Projected Investment Yield. What is the rate of return the company is using to project policy performance? How does this rate compare to the last five years' portfolio yield? How do the projections compare to investment assumptions in policy illustrations by other insurance carriers?

   b. Mortality Assumptions. What are the mortality assumptions built into the policy illustration? Is it realistic or overly aggressive? Is the carrier projecting mortality improvements? Is the company aggressively pursuing substandard risks?

   c. Projected Expenses. Is the carrier pricing the policy based upon projected expenses that are lower than what the company is currently experiencing?

   d. Lapse Assumptions. Has the company made overly aggressive assumptions regarding lapse rates (the number of policy holders who voluntarily let their policies lapse)? Can the company maintain its current projections under a zero percent voluntary lapse rate?

e. Non-Contractual Enhancements. Do the performance projections of the policy contain non-contractual enhancements which may be forfeited if the carrier's investment, mortality or expense assumptions do not hold up?

f. Projected Dividends. What is the company's track record for paying dividends and how does it compare to the dividends that were projected for the period? Are projected dividends in line with current investment yields? What would be the effect on projected dividends if the yield on investments is less than expected?

g. Internal Rate of Return. How does the internal rate of return on both death benefits and cash surrender value at various intervals during the policy's expected life compare to the internal rate of return for similar policies with other carriers?

Life Insurance Trusts

1. Benefits

Life insurance trusts should be established to keep life insurance proceeds out of the estate of the insured, the insured's spouse and the children of the insured.

2. Alternative to Insurance Trusts

As an alternative to a life insurance trust, one could establish a limited partnership to own the insurance for the purpose of keeping the proceeds out of the estate of the insured and the insured's spouse. A partnership structure is more flexible than a trust but the use of limited partnerships for this purpose are relatively new and are not appropriate for saving estate taxes on property passing from a child to a grandchild.

3. Typical Transaction

An irrevocable trust is established with provisions that provide for the Grantor's spouse and the children in coordination with the Grantor's will or living trust. The trust obtains insurance on the life of the Grantor; and the Grantor makes periodic contributions to the trust for the payment of premiums. Upon the Grantor's death, the life insurance proceeds are held free of taxes for the benefit of the Grantor's spouse and children. Among other things, the proceeds may be used to pay any death taxes which may be incurred upon the death of the Grantor (or the later death of the Grantor's spouse). The spouse of the insured may be the trustee of such a trust.

4. Income Tax Consequences

There is no income tax deduction for contributions to the trust. The trust does not have to file an income tax return since no income is earned by the trust.

5. Gift Tax Consequences

The contributions of money to the trust and the transfer of any existing life insurance policies to the trust are subject to gift tax.

a. Often, there is no gift tax consequence because through the use of withdrawal ("Crummey") powers the amount of the gift is covered by the annual gift tax exclusion.

b. Even if such contributions are not covered by the annual gift tax exclusion, generally no gift tax would be payable although the Grantor would use a portion of his or her unified gift and estate tax credit.

6. Estate Tax Consequences

The life insurance proceeds are not taxed on the death of the insured or the spouse of the insured.

a. If generation-skipping provisions are used the proceeds may also avoid tax on the deaths of the children of the insured.

b. The estate tax savings are substantial, they range from 37% to 60% of the face amount of the insurance.

Second-To-Die Insurance
(See Actual Case Studies 49% to 60% Annual Premium Savings)

Often the primary purpose in acquiring life insurance is to defray the estate tax cost at the death of the second of the spouses to die. In that event, one should consider the purchase of a "second-to-die" policy, i.e. a policy of life insurance which only pays when the surviving spouse dies.

1. The insurance is available when necessary to meet the staggering estate tax burden or alternate "wealth replacement" when combined with philanthropic opportunities presented in this outline.

2. The cost of insuring the second of the spouses to die is significantly less than the cost of insuring either spouse individually. Among other things, the reduced cost allows the following benefits:

a. The purchase of a greater amount of life insurance to cover the estate tax costs.

b. The purchase of life insurance at an advanced age when the cost would otherwise be prohibitive.

c. Coverage can be obtained on a spouse who may otherwise be uninsurable.

3. Caveats:

a. There will be no insurance proceeds available upon the death of the first spouse.

b. The insurance planning may not be appropriate in the event of a divorce.

4. Generally, a life insurance trust is utilized in the same manner and with the same benefits as trusts used for insurance on one spouse, individually.