Life Insurance Efficiency Planning

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BACKGROUND

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ADDITIONAL CONSIDERATIONS

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Background - Overview

- Life insurance is a means of sharing the financial risk of an insured's premature death
- It is usually purchased to replace an income stream for the care of dependents, to provide liquidity to pay estate taxes, or to create wealth for beneficiaries
- Life insurance is unique within the insurance industry
- Tax policy encourages the purchase and use of life insurance

Types of Life Insurance

- Life insurance either insures one life or two lives
- Insurance on two lives is usually referred to as second-to-die or survivorship insurance
- Survivorship life insurance pays the death benefit at the second death of the two insured's – typically a married couple
  - Almost always less expensive than insuring only one spouse
  - Typically the product of choice to efficiently fund estate tax liability due at the second death

Types of Life Insurance Policies

Two general types: **Term Insurance and Permanent Insurance**

Term Insurance

- Lower premiums that increase with age
- Premium for each specified term only covers the risk of the insured's death during that specific term
- Increasing premiums are projected at the inception of the term policy, typically, without guarantees
- Sold in blocks of time, e.g., for 20 years and, therefore, are guaranteed for these specific blocks of time
- Prohibitively expensive as an insured approaches life expectancy
- At a certain age of the insured, most life insurance companies will no longer offer term insurance products
- Only about two percent (2%) of term life insurance actually pays a death benefit
- Does not include cash value buildup inside the policy and, therefore, does not have an associated cash surrender value
- Best suited for someone with a short term need or who cannot afford the higher premiums of permanent insurance

Types of Life Insurance Policies

Permanent Insurance

- Higher initial premiums than term insurance
- Premiums pay term cost of insurance with excess set aside within the insurance policy for investment
- Cash value buildup inside a permanent life insurance policy generates an associated cash surrender value
- Cash value may generate income that can be used to pay the policy premiums
- Cash value may eliminate the need for cash premium payments at some point during the insured's lifetime
- Because of certain tax laws, the policy death benefit may actually increase over time as its cash surrender value increases

Structure of Permanent Life Insurance Policies

- Four main parts
  - Mortality
    - Varies by Rating Classes
    - Highest Preferred down to lowest Rated
  - Lapse rate
  - Administrative costs
  - Investment
    - Whole Life and Universal Life only
    - Minimum guaranteed return
- Desire of insurance company to remain competitive
  - Current charges instead of guaranteed maximum
  - Current investment returns instead of guaranteed minimums
- Premiums paid over life or for finite period
  - Lifelong payment to minimize premium for maximum death benefit
  - Shortest payment schedule to maximize investment return

Types of Permanent Life Insurance Policies

Three general types:

Whole Life

Universal Life

Variable Life

Types of Permanent Life Insurance Policies

Whole Life

- Generally fixed premium amount for the life of the policy that must be paid each and every year
- Premium amounts based on guaranteed investment rate of return (typically around 4%) and maximum cost of insurance
- "Dividends" declared if the investment of the cash value performs better than the minimum guaranteed rate and/or the insurance company charges less than the maximum allowed under the contract
  - Dividends can be paid to the policy owner or used to buy small amounts of insurance called "paid-up additions" (PUAs)
  - The surrender of PUAs or the dividends can be used toward the cash premiums due in certain policy years
- The policy cash value is invested by the insurance company with all of its other policy cash values in one investment pool
  - Insurance company investment portfolios are generally limited to fixed income investments and the dividends are limited by the returns associated with these types of investments
- Cash value in a policy may be accessed via loans against the policy or a surrender, but cannot otherwise be withdrawn

Types of Permanent Life Insurance Policies

Universal Life

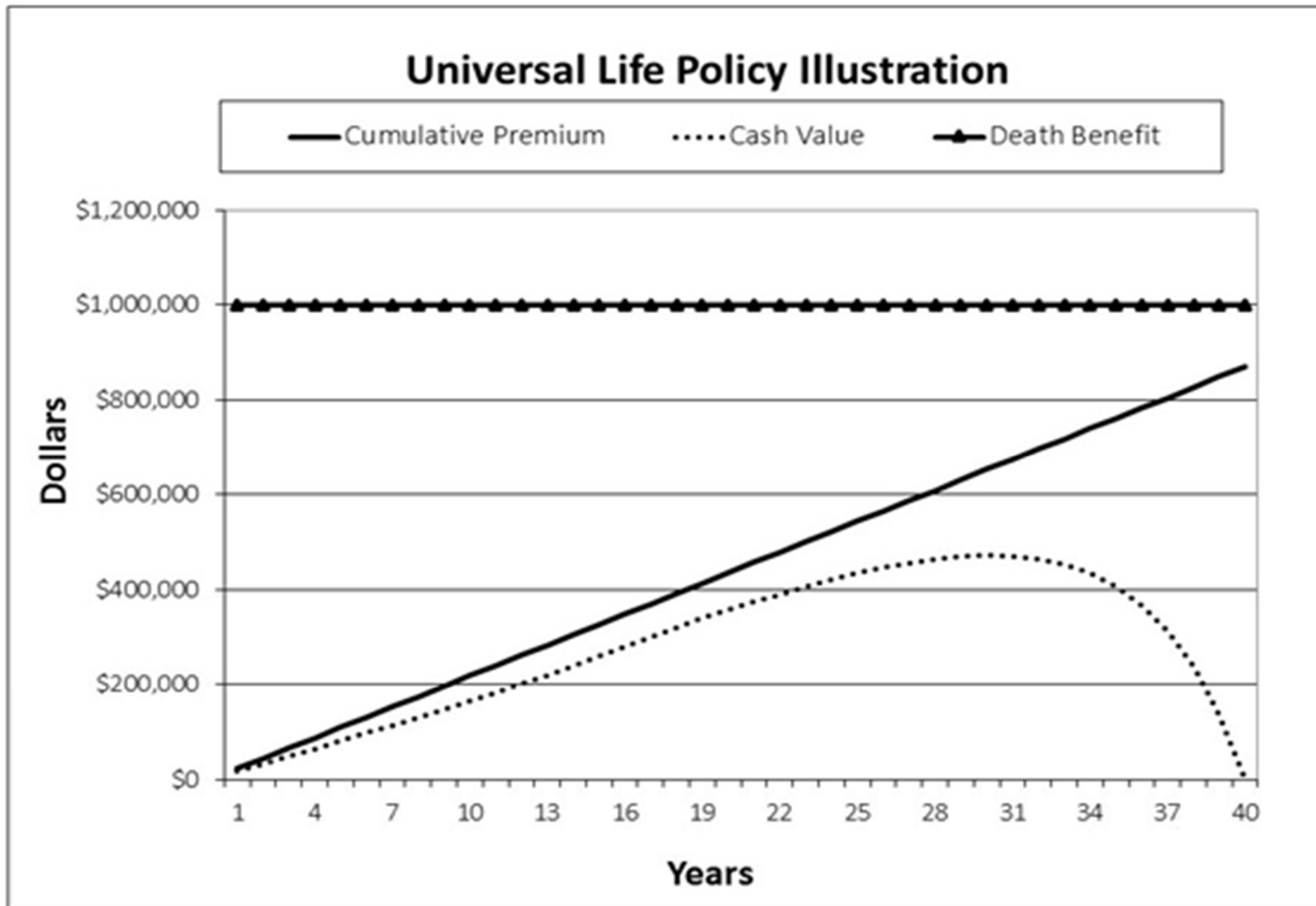
- Allows for flexible premiums (i.e., the cash premium can be changed from time to time within limits)
- Initial targeted policy premiums are typically lower than a similar whole life policy
- Premium amounts based on <u>expected</u> investment rate of return and <u>expected</u> cost of insurance
- The insurance company credits interest to each policy based on the investment performance of its investment pool
  - The insurance company guarantees an investment rate of return (typically around 3% or 4%)
  - The investments associated with universal are generally the same investments within whole life insurance (insurance company investment portfolios are generally limited to fixed income investments)
  - The credited interest is limited by the returns associated with these types of investments

Types of Permanent Life Insurance Policies

Universal Life

- Using performance and cost expectations allows for a lower premium that will sustain the policy only if these expectations actually occur
  - If expectations are not achieved, additional future cash premiums may be needed to avoid a policy lapse
  - As long as the cash value remains, the policy will not lapse
  - It is crucial to review the investments within a universal policy on a regular basis like any other investment
- Equity Indexed Universal Life adds equity exposure with principal protection and upside participation modifiers
- The cash value may be accessed via withdrawals of the cash value, loans, or a surrender of the policy

Types of Permanent Life Insurance Policies



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Types of Permanent Life Insurance Policies

Variable Life

- Generally allows for flexible premiums (like universal life)
- The policy owner directs the underlying policy investments within investment choices - typically mutual funds
- Ability to direct investments into equities presents the opportunity for greater rates of return along with the higher volatility and risk
- Like universal, premium amounts based on <u>expected</u> investment rate of return and <u>expected</u> cost of insurance

Types of Permanent Life Insurance Policies

Variable Life

- Targeted policy cash premiums associated with variable insurance policies are typically less than other permanent insurance products
- Since the policy owner controls the investment decisions, the insurance company does not guarantee a minimum rate of return.
- The policy internal expenses of variable policies are higher than those associated with other permanent insurance
- Generally, only individuals expecting to invest primarily in equity markets should use variable life
- Accumulated cash values in variable life policies are kept separate from the insurance company’s assets and are not subject to the claims of the insurance company’s creditors
- The cash value may be accessed via withdrawals of the cash value, loans, or a surrender of the policy

Types of Permanent Life Insurance Policies

Universal Life -- Guaranteed or No-Lapse

- Newer form of universal life insurance which is popular among older insureds
- Universal based product designed to maintain its full death benefit without regard to the policy cash value
- To obtain the full guarantee, the policy owner must pay a set premium each year by the premium due date
- These policies will exhaust their cash value at some point most likely in the early years of the policy, which is when the guarantee or no-lapse feature applies
  - The insurance company guarantees payment of the death benefit
  - Usually the age chosen to maintain the death benefit is at least through age 100
  - Should be used if only interested in the death benefit without the expectation of building cash value
- Similar to term insurance for the insured's entire lifetime

Tax History Background

- Per Code Section 101(a), a life insurance death benefit is generally excluded from gross income
- The Service accepts that the cash value build-up within permanent life insurance grows tax-deferred
  - In general, the basis (or premiums paid) within the cash value of a life insurance policy can be withdrawn before the earnings on that cash value
  - Further, policy loans against the cash value can be withdrawn without recognizing the earnings on the cash value as gross income
- These benefits encourage the use of permanent variable life insurance for tax-deferred investing
- To obtain these benefits, a life insurance policy must be deemed a lawful insurance contract
- Prior to the 1980s, this determination was based on case law which used a "risk shifting" analysis

Codified Definition of Life Insurance

- Code Section 7702 was added in the early 1980s to define life insurance contracts eligible for lifetime tax benefits
- A life insurance contract must meet certain objective tests designed to show the policy shifts the risk of a premature death from the insured to the insurance company
- One of these tests related to variable universal life policies (the cash value corridor test or CVCT) requires the death benefit to be no less than a certain percentage of the policy cash value – a percentage based on the age of the insured decreasing over time in steps
  - At age 40, the percentage is 250%
  - By age 95, the percentage decreases to 100%

Codified Definition of Life Insurance

- Code Section 7702A, also added in the early 1980s to discourage the use of life insurance as an investment, requires the first distributions from a policy (cash withdrawal or loan proceeds) to be out of the policy earnings if the policy owner paid too much in premiums in relation to the death benefit
  - The test is based on premiums paid in the first seven years of the policy
  - A policy that fails this test is called a Modified Endowment Contract or MEC
  - A MEC is still life insurance, so that tax deferral within the policy can continue and the death benefit may continue to be tax-free

Special Tax Requirements of Variable Life Insurance

- Code Section 817(h) requires the investments within variable life insurance to be diversified
  - The diversification must meet specific objective tests
  - If the diversification test is not satisfied, the policy cash value accumulation will be currently taxable
  - These diversification rules define what is deemed to be one (1) investment
  - A mutual fund or hedge fund would generally be treated as one (1) investment
  - However, for funds offered exclusively within insurance products,
    - A special rule looks through the fund to its underlying investments for the diversification test
    - These funds are sometimes referred to as Insurance Dedicated Funds or IDFs

Special Tax Requirements of Variable Life Insurance

- Another special variable life requirement is a rule referred to as the Investor Control Doctrine
  - This doctrine is based on the Service's position in a series of Revenue Rulings
  - It is designed to curtail the abusive use of life insurance to avoid current income taxation on investment income
  - In essence, the policy owner/investor is free to choose an investment manager, however, the owner must not have control over the actual selection of investments
  - If the investor control doctrine is violated, the policy cash value accumulation will be currently taxable
  - The Revenue Rulings provide guidance on the limits of investor control with examples

Life Insurance – Other Tax Rules

- Transfer for Value Rule -- If a life insurance policy is sold, the new owner may not qualify for the tax-free receipt of the death benefit
  - Various exceptions to this rule apply including if the transferee is a permitted transferee
  - Permitted transferees include the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is an officer and/or a shareholder
  - If the transfer is from the grantor to his wholly owned grantor trust, since the grantor trust is ignored for income tax purposes, the transfer is deemed to be a transfer to the insured for purposes of this rule (or it is considered as if no transfer occurred)
- Tax-Free exchange of life insurance policies
  - This rule permits a life insurance policy to be exchanged for another life insurance policy provided that both policies apply to the same insured(s)
  - Does not have to be the same insurance company that issued the original policy
  - Single life policy cannot be exchanged for a second-to-die policy (unless it occurs after the death of one of the insureds)
- The death benefit is included in the insured's estate if the insured has any incidents of ownership

Life Insurance Company Due Diligence

- Insurance companies are rated by independent third parties regarding financial stability and claims paying ability
- The most highly regarded rating services include A.M. Best, Moody's, and Standard & Poor's
- Although these rating services help to determine the strength of any particular insurance company, additional due diligence may be appropriate before purchasing any insurance product
- An insurance company's ratings may be reflected when comparing its policy premiums to like products of differently rated insurance companies

Life Insurance Policy Illustrations

- Projections of future values based on assumptions regarding the expected investment earnings and costs within the policy
  - For whole life and universal life, the earnings are typically at the insurance company's current rate of return along with an illustration at the guaranteed rate of return
  - For variable life, under FINRA insurance requirements the illustration cannot show a return in excess of 12% and the illustration must include a 0% return illustration
  - The costs are typically illustrated at current levels and at the maximum amount under the contract

- Illustrations should be viewed as tools which are only directionally accurate

Life Insurance Policy Illustrations

- Additional illustrations should be reviewed showing a reduced earnings rate to determine sensitivity to investment declines
- If investment rates of return do not meet the projections, further cash premium payments may be required in the later years where cash premium payments may not be illustrated
- Investment volatility may also cause the policy to perform differently than illustrated, since illustrations are based on a constant earnings model

Efficient Replacement of Existing Insurance Policies

- Permanent life insurance products should be monitored like any other investment
- It should not be a one-time purchase that is thereafter ignored
  - Policies must be adjusted overtime to meet the insured's goals and objectives
  - Assuming the insured remains healthy, it may be wise to replace an older policy with a newer insurance policy, as newer policies tend to be designed with more efficient cost structures
  - Even after the payment of an additional commission to an agent, the policy owner may still obtain a cost savings with a policy replacement compared to keeping an older, less efficient policy
  - Therefore, a policy owner should implement a periodic review to determine if replacement will add efficiency

Is the Insurance Policy Performing as Expected?

- Was the life insurance product purchased in a period of relatively high interest rates?
- Was the original illustration prepared with reasonable expectations?
- Was the original illustration prepared with reasonable expectations prior to an extended period of low interest rates?
- Was a the original variable policy illustration expected to generate reasonable returns, or were significant premiums paid just prior to a sell off in the stock market?
- Is the life insurance policy performing as expected?

How to Determine Policy Efficiency?

- Locate all policies in which the individual is listed as the insured – include individually owned, corporate owned, trust owned, any held in a retirement plan, and group term
- Create a policy inventory that includes:
  - Name of the insured
  - Name, address, and telephone number of the insurance company
  - Policy number
  - Owner and beneficiary(ies) of the policy
  - Policy type (term, whole life, universal life, etc.) and issue date
  - Annual premium (and term of premium if a limited pay policy)
  - Term of coverage if not a permanent policy
  - Death benefit and face amount (if different from the current death benefit)
  - Death benefit option (level or increasing)
  - Current cash value
  - Amount of any outstanding loans

How to Determine Policy Efficiency?

- Most of the policy “inventory” information can be found on the most recent “Statement of the Policy” issued to the owner on the last anniversary of the policy purchase date

- This Statement of the Policy will also highlight any change of owner or beneficiary since the policy was issued

- Any information not available from the Statement of the Policy should be available from the original policy

How to Determine Policy Efficiency?

- Review the financial strength of the current insurance company or companies
- Determine if the current coverage for the insurance need is adequate or unnecessary
  - A policy purchased to replace the income of the insured may no longer be needed
  - A greater death benefit may be needed to generate liquidity to prevent a fire sale of illiquid assets at death

How to Determine Policy Efficiency?

- Obtain and review an "in-force" illustration for each policy which can be obtained from the original insurance agent or directly from the insurance company
- The in-force illustration should show the original premium expectation indicating the policy cash value and death benefit through age 100
- One or more additional in-force illustrations should be obtained to determine the sensitivity of the policy to lower interest rates (for whole life or universal policies) indicating any additional premium needed to carry the policy cash value and death benefit through age 100
- For variable policies, the in-force illustration should be obtained showing a reasonable gross return rate based on the investments in the policy as well as a reduced rate of return of 1% or 2% less

How to Determine Policy Efficiency?

- The in-force illustrations for each policy will help determine what premium schedule will be necessary to maintain the policy to the appropriate age of the insured
- These new in-force illustrations are the base line for comparison to a new policy
  - It can be used to determine how much additional death benefit, if any, can be obtained assuming a transfer of the existing net cash value (after any surrender charge) into a new policy with the same new premium schedule
  - Alternatively, it can be used to determine if a policy can be obtained at the same death benefit level with the existing net cash value and a reduction in the new premium schedule
- It may make sense to also revisit the type of policy appropriate for the insured

Additional Considerations in Policy Replacement

- The insured must be insurable at reasonable rates
- The surrender charges of the old policy and the sales commission of the new policy may make an exchange expensive
- The tax consequences need to be considered – 1035 exchange or surrender
- Buying a new policy begins a new two-year period for suicide and contestability
- Replacing a policy with a new policy with the same company may produce certain efficiencies
  - The company may be willing to reduce a surrender charge for coverage in the same or lesser amounts
  - The company may be willing to waive medical tests (since they are already at risk for the current death benefit)

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Lawrence J. Macklin is managing director and senior wealth strategist at U.S. Trust, Bank of America Private Wealth Management. In this role, Larry provides wealth management guidance and helps clients pursue their individual goals in financial and estate planning, insurance, risk management, wealth transfer, intergenerational planning, business succession, pre- and post-liquidity event strategies, and philanthropy. Larry also coordinates with the client's team of advisors and conducts periodic reviews to help clients monitor progress.

Prior to joining U. S. Trust, Larry was a tax and estate planning attorney with Venable LLP, a national law firm, and a Tax Manager with Price Waterhouse.

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Larry does not provide legal or tax advice in his role at U.S. Trust.