

TOP 20 USES FOR LIFE INSURANCE

In Estate, Business Succession, and Financial Planning

Permanent life insurance is not just about death benefits. It's an essential tool in estate, business succession, and financial planning, with myriad and diverse uses.

1) As a Financial Planning Tool

Cash value life insurance enjoys unique status among financial products. The cash values grow tax-deferred. The policy owner has potentially tax-free access to the cash values (by surrendering to basis and borrowing the excess or by simply borrowing the cash values)¹. The death proceeds² are income tax free to the beneficiaries of the policy, and estate tax free if the insured does not own the policy. Finally, the internal rate of return³ for most insureds — even if they live to age 95 and beyond — is competitive with other financial products.

2) Estate Liquidity

Some clients will wait until death to transfer all or most of their assets to their children. If the client has a taxable estate, life insurance can provide the beneficiaries of the estate with the cash necessary to pay estate taxes. Usually, the insurance policy will be owned by an irrevocable life insurance trust so that the beneficiaries will receive the death proceeds both income and estate tax-free.

3) Capital Needs

Life insurance has long been used to protect young families from the disastrous effects of a breadwinner's untimely death. It is the only way to guarantee that the potential shortfall in a family's capital needs will be covered in the event of a premature death.

4) Creditor Protection

Under Florida law, the cash value of a life insurance policy and/or the death proceeds from a policy may be protected from creditors if the insured's spouse and/or children are the beneficiaries of the policy.

5) Fixed Annuity Arbitrage

Many people, who are adverse to the stock market's daily fluctuations, prefer to park their investments in municipal bonds or certificates of deposit (CDs)⁴. In exchange for this security, the yield on these investments is quite low. A better alternative to municipal bonds and CDs in many cases is a single-premium immediate annuity contract. Not only can the annuity be a safe investment² (based on the strength of the carrier), it has the potential produce a significantly higher yield than muni-bonds or CDs. One disadvantage of an annuity is that the payments cease when the annuitant dies. Accordingly, unlike the case with muni-bonds or CDs, the annuity owner's children will not inherit the annuity. One solution is to purchase a life insurance policy to "replace" the wealth lost when the annuitant dies. The cash to pay the premiums is generated from the increased cash flow from "converting" the muni-bonds and CDs into an immediate annuity.

6) Second Marriages

When children from a previous marriage are involved, estate planning becomes more complicated. Take the example of a second marriage in which the husband has children from a prior marriage. The husband establishes a living trust that, upon his death, provides his wife with income and principal as needed to maintain her accustomed standard of living, with the remainder passing to his children at his wife's subsequent death. This approach has two problems. First, the children have to wait until their stepmother's death to inherit their father's wealth. Second, as the remainder beneficiaries of the trust, the children have legal rights to challenge the distributions from the trust to their stepmother if those distributions exceed (in the children's opinion) the amount called for by the trust. A solution to these problems is life insurance on the husband's life. The policy beneficiaries can be either the wife or the children. If the wife is the beneficiary, the husband can leave his estate to his children (either outright or in trust). Alternatively, if the children are the beneficiaries, the husband can leave his estate to his wife outright. In either case, the second wife and the children from the first marriage will have no financial involvement with one another after the husband's death.

7) Special Needs Children

A developmentally disabled individual is usually eligible for Supplemental Security Income (SSI), a federally funded program administered by the states, upon reaching age 18. Prior to age 18, SSI eligibility is dependent upon the parents' income and assets. SSI eligibility generally is accompanied by eligibility for Medicaid, a state-administered federal program which primarily provides medical assistance. Many parents are skeptical about the future and/or level of the SSI and Medicaid programs. As a result, they establish (at the death of the surviving parent) a "special needs" trust for the benefit of the disabled child. A special needs trust is designed to "supplement" SSI and Medicaid without disqualifying the child from any government assistance. Unfortunately, the special needs trust strategy provides little consolation to those parents who do not have funds to provide for their disabled child or for parents who eventually would have to disinherit their other children to provide adequately for the disabled child. A solution to both of these problems is for the parents to purchase a survivorship life insurance policy. The policy would be owned by the parents and payable to a special needs trust or the benefit of the disabled child at the surviving parent's death. Upon the death of the disabled child before the complete distribution of the trust property, the assets remaining in the trust can pass to the other children.

8) Medicaid Planning

For a person to become eligible for long-term care Medicaid benefits (i.e., nursing home care), the recipient must have income and assets below frightfully low levels (i.e., as low as \$2,000 in some states). What about those persons with substantial assets who are not financially eligible for Medicaid? What options are available to them to protect their assets from the high cost of long-term care? First, at least 60 months before applying for Medicaid (or 36 months for those states that have not enacted the Deficit Reduction Act of 2005), the recipient can "divest" himself or herself by gifting away all of his or her assets to children and grandchildren. Many people reject the idea because of the loss of control and financial independence, among other disadvantages. Second, long-term care (LTC) insurance can be purchased to pay for such care. LTC insurance premiums, however, increase dramatically for persons over age-65. A better answer may be to purchase life insurance. If the insured needs long-term care and, therefore, must use private funds to pay for such care, the insurance proceeds will someday "replace" the assets spent on long-term care. Life insurance assures that the insured's heirs are not disinherited" by the high cost of long-term nursing care. In the event that the insured never requires long-term care, then, upon the death of the insured, the heirs will receive a larger inheritance.

9) Avoiding Income Taxes on Retirement Plans⁵

Contributing to a retirement plan or IRA is perhaps the best way to accumulate wealth because of the combination of tax-deductible contributions and tax-deferred savings. Such plans, however, may be the worst way to distribute wealth because of the double tax (estate and income taxes) imposed on the distributions. Even without an estate tax, upon the death of the surviving spouse, the children must begin taking distributions and incurring income taxes. A better strategy for a charitably inclined IRA owner, that does not need the assets in the IRA to maintain his/her standard of living, might be to withdraw cash from the IRA, pay the income tax, and use the after-tax proceeds to purchase a life insurance policy for the benefit of the owner's heirs. The policy would have a face value equal to the IRA's projected value at the death of the owner. After the owner has died, the heirs would receive the insurance proceeds income tax free, and the balance in the retirement plan could pass to charity or to a private foundation — income tax free! For a married owner, a survivorship policy can be used. The only “loser” in this scenario is the IRS.

10) Charitable Planning

Even without transfer taxes, many charitably inclined persons will want to make lifetime gifts to their favorite charities. The advantages of naming a charity as the owner, beneficiary, and premium payer of a life insurance policy are numerous. First, the insurance proceeds eventually will provide the desired capital gift for a comparatively small outlay in the form of premium payments. Second, each year the donor-insured will receive an income tax deduction equal to the premium payments gifted to the charity (subject to the 50% of adjusted gross income deduction limitation). Third, because only the purchase of life insurance is involved, there are no complex details to be handled. Fourth, if the donor is unwilling or unable to gift future premium payments to the charity, the charity either can continue to make the premium payments or surrender the policy for its cash value. Finally, during the donor-insured's lifetime, either in the form of a loan or a partial surrender, the charity can access the policy's accumulated cash values to meet an emergency need.¹

11) GRATs

With a Grantor Retained Annuity Trust (GRAT), the grantor transfers assets to a trust for the benefit of a child or children (the “remaindermen”), while retaining the right to receive a fixed annuity from the trust for a stated term of years. The longer the stated term and the larger the annuity, the smaller the taxable gift. At the end of the stated term, the balance of the trust property passes (gift-tax-free) to the remaindermen. The risk with a GRAT is that if the grantor dies during the stated term, all of the assets in the GRAT are included in the grantor's estate for federal estate tax purposes. By funding an irrevocable life insurance trust for the benefit of the GRAT's remaindermen, the grantor can leave the assets in the GRAT to the remaindermen who can then use the life insurance proceeds to pay the federal estate taxes due. Alternatively, a married grantor might qualify the assets in the GRAT for the marital deduction and have an ILIT (for the benefit of the GRAT's remaindermen) use the life insurance proceeds to purchase the assets from the grantor's estate.

12) Private Annuities and SCINs

With a private annuity, a person (the annuitant) sells an asset to a child or children (the purchaser) for an unsecured promise to make periodic payments to the annuitant for the rest of his/her life (a single life annuity) or for the life of the annuitant and his or her spouse (a joint and survivor annuity). Because the private annuity is a sale and not a gift, it allows the annuitant to remove the asset from his or her estate without incurring gift or estate tax. The child or children purchasing the asset can fund an irrevocable life insurance trust for his/her/their family's benefit in order to have the cash to continue to pay the annuity should he/she/they predecease the annuitant. Conversely, the annuitant can fund an irrevocable life insurance trust for his/her family's benefit as a hedge against the annuitant's premature death. In either case, the amount of life insurance needed would be based on the present value of the future annuity payments.

When a person decides to sell an asset to a child in installments, the promissory note may be a self-canceling installment note (SCIN). With a SCIN, upon the seller's death, all remaining payments under the note are canceled, similar to a private annuity. The purchaser must pay a "premium" for this cancellation feature, either by a higher interest rate or a higher purchase price. Like a private annuity, a SCIN avoids estate and gift taxes. Unlike a private annuity, a SCIN allows the seller a security interest in the transferred asset. When using a SCIN, just as with a private annuity, the seller can fund an irrevocable life insurance trust for his or her family's benefit as protection against the seller's premature death. Conversely, the purchaser can fund an irrevocable life insurance trust for the benefit of his/her family so that they will have the cash to continue to pay the SCIN should the purchaser predecease the seller.

13) Wealth Replacement

Charitable remainder trusts are often used by people who wish to sell highly appreciated assets without generating any capital-gains tax liability. The main drawback of using a CRT is that upon the death of the donor and the donor's spouse, the assets remaining in the CRT pass to charity. A life insurance policy can be purchased for the benefit of the donor's heirs to "replace" the wealth passing to charity.

14) Asset Protection Planning

Businesses assuming the risk of potential environmental contamination (i.e., waste hauling, landfills, chemicals, etc.) are subject to liability under federal and state pollution laws. Moreover, such liability is not limited to the business itself, as the business owners also may be personally liable under such laws. As the business passes to the next generation, so does the potential liability. Life insurance is ideal in this situation. The business owner can establish an irrevocable life insurance trust to run for the maximum period permitted by state law (i.e., at least 90 years in most states and in perpetuity in a handful of states). The trust would provide the business owner's descendants with income and principal as needed for health, education, maintenance and support. If properly structured, the assets in the trust cannot be reached by the beneficiaries' creditors, including state and federal environmental agencies.

15) Estate Equalization

A business owner can use life insurance to provide the children who are not involved with the business with ‘equitable’ treatment. Leaving the business to the active children and life insurance to the inactive children equalizes the inheritances among them. In addition, it avoids the need for the active children to purchase the interests of the inactive children, perhaps at a time when the business may be unable to afford it. Depending on the particular facts and circumstances, the insurance may be owned by an irrevocable trust for the benefit of the inactive children, and the insured may be the business owner or the business owner and his or her spouse.

16) Buy-Sell Agreements

A properly designed buy-sell agreement guarantees a market and fair price for a deceased, disabled or withdrawing owner’s business interest. It also ensures control over the business by the surviving or remaining owners and can set the value of the business interest for estate tax purposes. Life insurance is the best way to provide the cash necessary for the business or the surviving owners to purchase a deceased owner’s interest. In many instances, the cash surrender value in a life insurance policy can also be used (tax-free) to help pay for a lifetime purchase of a business owner’s interest.¹

17) Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation (NQDC) plan can be used by a small business to provide members of the senior generation with death, disability, and retirement benefits. A NQDC plan may be particularly useful in situations where the senior members have transitioned the business to the junior members and are no longer receiving compensation. A NQDC plan also ensures that key employees remain with the business during the transition period — a so-called “golden handcuff.” Because life insurance offers tax-deferred cash value growth and tax-free death benefits, it is the most popular vehicle for “informally” funding NQDC plan liabilities.

18) Key-Person Insurance

Many family businesses depend on non-family employees for the company’s continued success. To guard against financial loss due to the absence of a key employee, and to ensure that the business stays in the family, many companies take out “key-person” life insurance, disability insurance, or both.

19) Section 303 Redemptions

Internal Revenue Code Section 303 enables the estate of a business owner to remove cash from a corporation with no tax cost. To be eligible for a Section 303 redemption, the stocks value must exceed 35% of the shareholder’s estate. Also, the maximum amount that can be redeemed is limited to the amount of the federal estate tax, state death taxes, funeral, and administrative expenses. The corporation can purchase a life insurance policy on the shareholder’s life to ensure that the corporation has sufficient funds with which to accomplish the Section 303 redemption.

20) Family Bank

When the decision is made to leave a family business to both active and inactive children, it is usually advisable to leave only the active children with voting interests in the business. In addition, “put” and “call” agreements should be entered into. Usually, a put option requires the business to purchase all or a portion of the inactive children’s interest in the business upon a set price and terms. Without a put option, there may be no practical way for an inactive child to benefit from owning the business interest unless the business is sold. On the other hand, a call option allows the active children (or the business itself) to purchase the business interests of the inactive children upon a set price and terms. Without a call option, there may be no effective way for the active children to avoid conflicts that can occur between the active children who are receiving salaries and bonuses, and the inactive children who are not. By having the active children own life insurance on a senior family member’s life, a “bank” is created to provide the funds to satisfy any such puts and calls. Usually, the policy will be owned outside of the business entity, such as in a trust for the benefit of the active children, or by a limited liability company owned by the active children.

Succession planning seeks to help a business owner confronting many issues. There is no “one size fits all” approach to keeping the family business in the family. The tools and techniques best suited to a particular business are fact-specific. Life insurance plays an important role in helping a business survive and thrive as it moves from one generation to the next.

CONCLUSION

Even if you have life insurance, a regular review of existing policies is a must. It’s quite possible that the same premium can purchase significantly more insurance. Regular reviews will also reveal if and when you need to purchase additional insurance, and if you have the potential for leveraging an existing policy or other asset for the benefit of your heirs.

¹ Loans and partial withdrawals will decrease the death benefit and cash value and may be subject to policy limitations and income tax.

² Insurance product guarantees, including the death benefit, are subject to the claims-paying ability of the issuing insurance company.

³ The internal rate of return (IRR) on the death benefit is equivalent to an interest rate (after taxes) at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the death benefit of the policy.

⁴ CD’s are FDIC insured bank instruments guaranteed up to the current FDIC limit. Securities products, such as municipal bonds, as well as annuities are not FDIC insured, lack a bank guarantee, and may lose value.

⁵ This material is intended for informational purposes only and should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor or plan provider.