Morgan Stanley

Topics in Wealth Strategies:

# Life Insurance Toolkit

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# LIFE INSURANCE TOOLKIT

## Executive Summary

**Life Insurance** may be a powerful tool for investors when applied in context of other strategic decisions.

It is prudent for investors to consider life insurance in combination with their overall wealth and trust, tax and estate plans so that the features of life insurance may be complementary to other decisions taken.

The Life Insurance Toolkit intends to compare and contrast general features of life insurance products to highlight the differentiating characteristics. With this information, the toolkit suggests potential applications of insurance in various contexts.

As with trust, tax and estate strategies, insurance strategies should also be periodically reviewed to reconfirm their appropriateness and sustainability in the context of an overall strategic plan.

# LIFE INSURANCE TOOLKIT

## Types of Life Insurance

A **life insurance** policy is a legal contract between an insurer and a policyholder, where the policyholder pays premiums in exchange for a sum of money that upon the insured's death, will flow to a named beneficiary. Generally, there are **two** major types of life insurance:

1. **Term**
2. **Permanent**
    a. Whole Life
        a. Traditional
        b. Variable
    b. Current Assumption Universal Life
    c. Guaranteed Universal Life
    d. Indexed Universal Life
    e. Variable Universal Life
    f. Private Placement Life

Each product type has unique features related to the premium, cash value, death benefit, and other features that are associated with more or less risk and are appropriate for different planning scenarios and different types of clients.

### Risk-(Potential) Reward Spectrum

Term | Guaranteed Universal Life | Whole Life | Current Assumption Universal Life | Indexed Universal Life | Variable Universal Life | Private Placement Life

Lowest Risk → Highest Risk

# LIFE INSURANCE TOOLKIT

## Key Terms

**Premium Payments:** A premium payment is an amount of money that one must pay for an insurance policy. The amount depends on numerous factors including age, health status, amount of death benefit and type of coverage and may be fixed or flexible.

**Death Benefit:** The death benefit is the amount payable to the named beneficiary when the insured passes away, assuming required premiums have been paid. It can vary in terms of size and structure depending on the type of life insurance contract held, and it is generally exempt from ordinary income tax.

**Cash Value:** For some types of insurance policies, a cash value may accumulate tax-deferred as a result of the combination of premiums paid and investment performance or crediting rate. Additionally, some policies may allow for loans, surrenders or withdrawals with regard to the cash value subject to additional considerations including possible tax consequences.

**Withdrawal:** A partial surrender of cash value resulting in reduced net cash value and generally a reduced death benefit. A partial surrender may have tax consequences.

**Loan:** An amount borrowed from the cash value at a specified interest rate that must be repaid or if not repaid, will be deducted from the policy's death benefit and may cause a taxable event. In addition, if not repaid and the policy lapses, the owner may incur tax consequences.

**Surrender:** A withdrawal of the total cash value from the policy at the owner's request. A complete surrender will result in payment to the owner of any remaining net surrender value and will terminate all coverage under the Policy. A complete surrender may have tax consequences.

# LIFE INSURANCE TOOLKIT

## Types of Life Insurance

<table>
<tr><th>Types of Life Insurance</th><th>Permanent</th><th>Death Benefit</th><th>Cash Value</th><th>Premium Payments</th><th>Duration</th><th>Held</th><th>Who Invests</th></tr>
<tr><td>Term</td><td>• No</td><td>a. Level<br>b. Decreasing</td><td>• No</td><td rowspan="2">• Fixed</td><td>• Specified time</td><td rowspan="5">• Pooled</td><td>• N/A</td></tr>
<tr><td>Whole Life (WLI)</td><td rowspan="6">• Yes</td><td rowspan="6">a. Level<br>b. Increasing<br>c. Return of Premium</td><td rowspan="6">• Yes</td><td rowspan="6">• Up to Lifetime</td><td rowspan="3">• Insurance Company</td></tr>
<tr><td>Current Assumption Universal Life (UL)</td><td>• Flexible</td></tr>
<tr><td>Guaranteed Universal Life (GUL)</td><td>• Fixed</td></tr>
<tr><td>Indexed Universal Life (IUL)</td><td rowspan="3">• Flexible</td><td>• Policy Owner in an Indexed Crediting Option provided by Carrier</td></tr>
<tr><td>Variable Universal Life (VUL)</td><td rowspan="2">• Separate Account</td><td>• Policy Owner from sub-account menu (provided by Carrier)</td></tr>
<tr><td>Private Placement Life (PPLI)</td><td>• Policy Owner into separate account in IDF</td></tr>
</table>

# LIFE INSURANCE TOOLKIT

## Types of Life Insurance

<table>
<tr><th></th><th colspan="3">Living Benefits[1]</th></tr>
<tr><th>Types of Life Insurance</th><th>Withdrawals</th><th>Loans</th><th>Surrenders</th></tr>
<tr><td>Term</td><td colspan="3">• No</td></tr>
<tr><td>Whole Life</td><td>• Yes (If dividends available)</td><td>• Yes<br>• Limited to a percentage of cash value designated by the carrier</td><td>• Yes (Up to dividends accumulated)</td></tr>
<tr><td>Current Assumption Universal Life</td><td>• Yes<br>• Does not affect premium, but reduces cash value and death benefit dollar for dollar<br>• Cash value less surrender charges<br>• No interest<br>• Cannot pay back</td><td>• Yes<br>• Cash value less surrender charges<br>• Repaid</td><td rowspan="5">• Yes</td></tr>
<tr><td>Guaranteed Universal Life</td><td>• Yes but may be restricted</td><td>• Yes but may be restricted</td></tr>
<tr><td>Indexed Universal Life</td><td>• Yes</td><td rowspan="3">• Yes</td></tr>
<tr><td>Variable Universal Life</td><td rowspan="2">• Yes<br>• Cash value less surrender charges</td></tr>
<tr><td>Private Placement Life</td></tr>
</table>

1. Withdrawals, loans, and surrenders may have tax consequences

# LIFE INSURANCE TOOLKIT

## Characteristics - TERM

**Term life insurance provides coverage for a specified period of time, known as a specified "term" of years. Once the policyholder stops making premium payments in a timely manner, or the term expires, whichever occurs first, the insurance coverage ends. Many term products are renewable and convertible to permanent products based on carrier guidelines. There is no cash value component.**

| | |
|---|---|
| TYPES OF PREMIUMS | 1. **Fixed:** Premiums stay level over term<br>2. **Annual Renewable / Increasing:** Premiums can be annually renewable after 1 year or after the specified term ends at a higher rate |
| TYPES OF DEATH BENEFITS | 1. **Level:** Death benefit stays level over term<br>2. **Decreasing:** Death benefit decreases until it reaches zero at the end of the term |
| APPROPRIATENESS | • May be used for short-term coverage and may be eligible to be converted to permanent insurance<br>• May be used for families who do not have sufficient resources to afford premiums for other types of insurance |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages - TERM

| ADVANTAGES | DISADVANTAGES |
| --- | --- |
| • Initial premiums may be lower per $1,000 of death benefit in comparison to other product types<br>• Pure protection<br>• Can be renewable and convertible | • May end up with no insurance at older ages, since age limits apply to renewability<br>• When initial term ends, generally the policy is annually renewable<br>• Temporary, fixed amount of time<br>• No cash value so cannot withdraw, take a loan, or surrender policy to cash |

# LIFE INSURANCE TOOLKIT

## Characteristics – WHOLE LIFE

**Whole Life contracts are designed to produce cash value and are generally more expensive than other types of permanent policies. The premium, cash value, and death benefit all have a guaranteed component. The cash value may be comprised of non-guaranteed dividends. In some cases, the dividends can be used to cover some or all of the premium payment, can increase the cash value, or go towards purchasing additional death benefit. Clients can access their cash value via potentially tax-free loans or through withdrawals (taxes may apply to withdrawal (and loan).**

| | |
|---|---|
| **TYPES OF PREMIUMS** | 1. **Continuous:** Premiums are paid until insured dies<br>2. **Limited:** Premiums are paid only for a limited period of time: 10, 15, or 20 years or until a specified age. At which time, insurance stays in force and coverage is permanent (assuming loans are repaid and there are no withdrawals). Premiums are higher and cash value may accumulate faster |
| **TYPES OF DEATH BENEFITS** | 1. **Level:** Death benefit remains level at specified amount as stated in policy subject to policy owner-initiated increases or decreases<br>2. **Increasing:** Death benefit can increase as cash value builds or with paid up additions dividend option |
| **APPROPRIATENESS** | • May be used by those who have insurance needs that extend for their lifetime<br>• May be used by those who have sufficient resources to pay a higher premium than other types of permanent policies<br>• May be used by those who desire cash accumulation for flexibility and living benefits<br>• Conservative, risk averse investors<br>• Generally best suited for younger clients |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – WHOLE LIFE

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • Guaranteed death benefit<br>• Permanent<br>• Can take withdrawals, loans and surrenders against cash value<br>• Insurance company may distribute dividends which might be used to reduce premiums and/or buy more insurance<br>• Insurance company bears investment risk | • Expensive (higher premiums per $1,000 of death benefit than other permanent policies)<br>• Inflexible – bundled premiums, cash values, and benefits<br>• Dividends are not guaranteed<br>• Withdrawals, loans and surrenders may have tax consequences |

# LIFE INSURANCE TOOLKIT

## Characteristics – UNIVERSAL LIFE

**Current Assumption Universal Life relies on the carrier's current portfolio crediting rate to keep the policy in force based on planned premium projections. These policies may have options to add limited guarantees, perhaps up to age 85 or age 90, but beyond that it must have a positive cash value to stay in force. That cash value is predicated on the amount and timing of premiums that are paid and the interest rate credited to the policy. If interest rates drop, the insurance company can ask for more premium; conversely, if interest rates increase, it could result in a lower cost. The insurance company can also adjust the mortality charges subject to certain maximums.**

| | |
|---|---|
| TYPES OF PREMIUMS | 1. **Flexible:**<br>a. Can pay greater than / same as/less than billed premium<br>b. Can pay at different dates / times |
| TYPES OF DEATH BENEFITS | 1. **Level:** Death benefit remains level at specified amount as stated in policy subject to policy owner-initiated increases or decreases<br>2. **Increasing:** Death benefit can increase as cash value builds or with return of premium death benefit option |
| TYPES OF INTEREST CREDITED TO CASH VALUE | 1. **Current Assumption:** These policies are credited with interest on their cash values based on the carrier's current portfolio crediting rate and assumptions. |
| CASH VALUE | 1. **Cash value** = premiums + interest credited – cost of insurance and other policy fees<br>2. **Risk:** can lapse if cash value is zero and minimum premium is not received |
| APPROPRIATENESS | • Permanent need for coverage<br>• Desires flexibility<br>• Clients with moderate risk profile |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – UNIVERSAL LIFE

| ADVANTAGES | DISADVANTAGES |
| --- | --- |
| • Flexibility (premiums and death benefit): may pay more or less than billed or no premiums at all as long as cash value covers monthly expenses and cost of insurance<br>• Can take loans, withdrawals and surrenders against cash value<br>• Insurance company bears investment risk<br>• Policy charges and credits are stated separately | • Cash value or premium payment must be sufficient for the insurer's monthly deductions<br>• Insurance company can change mortality and administrative expenses (up to the stated maximum in the policy) which may impact cash values and premiums required<br>• Limited guarantee on death benefit<br>• Withdrawals, loans and surrenders may have tax consequences |

# LIFE INSURANCE TOOLKIT

## Characteristics – GUARANTEED UNIVERSAL LIFE

**Guaranteed Universal Life transfers 100% of the investment risk to the insurance company. It has a guaranteed premium and a guaranteed death benefit. If the planned premium is paid on time, it will be guaranteed for lifetime or for the period chosen at policy inception.**

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| **TYPES OF PREMIUMS** | 1. Can be structured as continuous payments over lifetime or short pay or periodic payments<br>2. Flexibility in payments subject to a reduced guarantee period or catch up premium payment |
| **TYPES OF DEATH BENEFITS** | 1. Level<br>2. Face amount plus cash value<br>3. Face amount plus premiums |
| **APPROPRIATENESS** | • Permanent need for coverage<br>• Desires some flexibility, but does not require cash value<br>• Clients with low risk profile<br>• Focused on wealth transfer strategies<br>• May have estate or business planning needs |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – GUARANTEED UNIVERSAL LIFE

| ADVANTAGES | DISADVANTAGES |
| --- | --- |
| • Guaranteed death benefit<br>• Permanent<br>• Insurance company bears investment risk<br>• Low maintenance<br>• Policy charges and credits are separately stated | • Generally little to no cash value<br>• Missing a premium payment can affect the guaranteed death benefit period |

# LIFE INSURANCE TOOLKIT

## Characteristics – INDEXED UNIVERSAL LIFE

**Indexed Universal Life generally has limited guarantees, if any. The cash value is tied to an index or series of indices such as the Standard & Poor's 500 index. This type of contract provides some downside protection with a non-guaranteed floor and a non-guaranteed upside cap set by the carrier. The policy mortality charges are also subject to change. In some instances you can add a no-lapse rider to these policies. A no-lapse rider can help protect the policy from lapsing, and in those cases, a stipulated premium is required to keep the rider in force.**

| | |
|---|---|
| TYPES OF PREMIUMS | 1. **Flexible:** Can be structured as continuous payments over lifetime or short pay or periodic payments |
| TYPES OF DEATH BENEFITS | 1. **Level:** Death benefit remains level at specified amount as stated in policy subject to policy owner-initiated increases or decreases<br>2. **Generally Increasing:** Death benefit increases as cash value builds and declines as cash value declines. When the insured dies, the named beneficiary collects the specified amount plus the cash value assuming all required premiums have been paid |
| TYPES OF INTEREST CREDITED TO CASH VALUE | 1. **Indexed:** These policies are credited with interest on their cash values based on index returns subject to participation rates, minimum interest thresholds and interest caps determined by the carrier. Generally there is a FIXED ACCOUNT within an indexed Universal Life product |
| CASH VALUE | • Can earn interest that is linked to the movement of a selected market index over a specific period of time |
| APPROPRIATENESS | • Desire greater opportunity for tax-advantaged accumulation for future cash needs<br>• Believe long-term equity markets will outperform bonds<br>• Clients with moderate to high risk profile<br>• Clients have high / stable cash flow to pay premiums |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – INDEXED UNIVERSAL LIFE

### ADVANTAGES

- Flexibility (premiums and death benefit): may pay more or less than billed or no premiums at all as long as cash value covers monthly expenses and cost of insurance
- Permanent and there may be a no lapse guarantee on certain products
- Can take loans, withdrawals, and surrenders against cash value
- Policy owner may earn interest that is linked to the movement of a selected market index within a floor , cap, and participation rate
- Interest credited can have a floor at 0% or higher to limit downside
- Potential for higher cash values than current assumption or guaranteed universal life policies

### DISADVANTAGES

- Limited cash value guarantee
- Cash value or premium must be sufficient for the insurer's monthly deductions
- Dividends from market index are not credited to policy cash value
- Interest is credited only at the end of the segment
- Interest is credited only up to a cap and specified participation rate
- Must monitor performance and investments regularly
- Insurance company can change mortality and administrative expenses (up to the stated maximum in the policy) which may impact cash values and premiums required
- Withdrawals, loans and surrenders may have tax consequences

# LIFE INSURANCE TOOLKIT

## Characteristics – VARIABLE UNIVERSAL LIFE

**Variable Universal Life contracts allow the policyholder to select the allocation of the premium to subaccounts that are similar, but not identical, to mutual funds. There is generally a limited term guarantee that is built into the policy, and it typically relies on the performance of the investments in order to keep the policy in force based on the planned premium. In limited circumstances, there may be a no-lapse rider available to be added to the policy at an additional cost.**

| | |
|---|---|
| **TYPES OF PREMIUMS** | 1. **Flexible Premiums**<br>a. Flexible in amount and timing<br>b. Even if planned premium is paid, policy may require additional premium |
| **TYPES OF DEATH BENEFITS** | 1. **Adjustable:** Policy owner may choose to reduce death benefit within guidelines<br>2. **Increasing or Decreasing:** Impacted by cash value in separate account |
| **CASH VALUE** | • Separate account allocation menu provided by the carrier: money market, bond, equity |
| **APPROPRIATENESS** | • Desire flexibility<br>• Willing to add to premiums to cover insurance costs<br>• May have business planning or other wealth accumulation needs<br>• Willing to bear investment risk<br>• Clients with higher risk profile |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – VARIABLE UNIVERSAL LIFE

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • If market increases, separate account may increase<br>• Flexible<br>• Permanent<br>• Policy owner may select among asset classes and a menu of investment managers<br>• Potential for better investment return on cash values<br>• Separate account provides some protection against insurance company creditors | • Policy owner bears investment risk<br>• Policy may require more than the planned premium if investment performance is not met<br>• No guaranteed cash values (dependent on separate account)<br>• No death benefit guarantee unless the policy has a no lapse guarantee rider<br>• Subject to diversification requirements and investor control rules under federal tax law. |

# LIFE INSURANCE TOOLKIT

## Characteristics – PRIVATE PLACEMENT LIFE

**Private Placement Life insurance (PPLI) is a type of permanent life insurance that works well for ultra high net worth individuals, family offices, and other sophisticated investors. The owner of the policy must qualify as an Accredited Investor as defined in Reg D of the Securities Act of 1933 and a Qualified Purchaser as defined in section 2(a)(51) of the Investment Company Act of 1940.**

| | |
|---|---|
| **TYPES OF PREMIUMS** | • Flexible in amount and time<br>• Even if maximum premium is paid, policy may lapse due to performance and expenses |
| **TYPES OF DEATH BENEFITS** | • Adjustable<br>• Impacted by cash value in separate account |
| **CASH VALUE** | • Separate account in insurance dedicated fund (IDF)<br>• There may be other traditional sub accounts available<br>• There is always a money market account |
| **APPROPRIATENESS** | • High net worth<br>• Need flexibility<br>• Willing to bear investment risk<br>• Willing to add to premiums to cover insurance costs<br>• Have business planning or other wealth accumulation needs<br>• Want exposure to alternatives |

# LIFE INSURANCE TOOLKIT

## Advantages and Disadvantages – PRIVATE PLACEMENT LIFE

| ADVANTAGES | DISADVANTAGES |
|---|---|
| • If market increases, separate account may increase<br>• Flexible<br>• Policy owner may select among asset classes and a menu of investment managers by using insurance dedicated funds (IDFs) offered by the carrier<br>• Potentially better investment return on cash values<br>• Separate account provides some protection against insurance company creditors<br>• Policy charges and credits are separately disclosed | • No cash value guarantee<br>• Cash value or premiums must be sufficient for the insurer's monthly deductions<br>• Policy owner bears investment risk<br>• Expensive<br>• Not widely available<br>• Subject to diversification requirements and investor control rules under federal tax law<br>• Permanent but may lapse<br>• Only available to accredited investors and qualified purchasers<br>• Withdrawals, loans and surrenders may have tax consequences |

# LIFE INSURANCE TOOLKIT

## Uses of Life Insurance

**One role of life insurance is to assist in achieving strategic goals. To do so, one must understand the salient features of the types of insurance and select the appropriate policy for the given context. Generally, term insurance is helpful for shorter term, definable and quantifiable needs and not beneficial for longer term needs. Whole life provides the longer term horizon that a term product does not and is also appropriate for known and measurable future needs. Universal and Variable Universal Life insurance are also designed for the longer term but provide additional flexibility in the payment of premiums and the death benefit and may solve for more unknown outcomes. Variable Universal Life is more applicable for those willing to assume responsibility for investment performance and volatility. Finally, private placement life insurance is similar to variable but with additional eligibility restrictions.**

**With an understanding of the general types of life insurance (term, whole, universal, variable, private), the toolkit now suggests potential applications in the following contexts.**

| Financial Planning | Estate Planning | Income Tax Planning & Charitable Giving | Business Planning | Retirement Planning |
|---|---|---|---|---|

# LIFE INSURANCE TOOLKIT

## Financial Planning

**Insurance may provide financial assistance should a primary breadwinner or caregiver die. The death benefit may provide some of the following for the surviving beneficiaries:**

1. Income replacement for daily living expenses
2. Paying off a mortgage on survivor's home or invest death benefit and take periodic withdrawals to make mortgage payments
3. Education fund for children of deceased
4. Paying off existing debts

# LIFE INSURANCE TOOLKIT

## Estate Planning

**Insurance may provide financial flexibility with regard to settling an estate and transferring wealth from one generation to the next. The death benefit may provide the following for the surviving beneficiaries:**

1. Liquidity needed to pay estate taxes
2. Legacy planning and intergenerational wealth transfer
3. Specified and prescriptive wealth transfer
4. Estate equalization

# LIFE INSURANCE TOOLKIT

## Timeline of Key Changes in the Federal Estate Tax

1916 – The modern federal estate tax was enacted as part of The Revenue Act of 1916 in response to the costs of World War I.  Rates ranged from 1% to 10% and estates had an exemption of $50,000.

1924 – Federal gift tax was enacted to prevent avoidance of the estate tax. (The gift tax was repealed in 1926 and then reinstated and made permanent in 1932).

1930s – Various changes made to the estate tax system, including introduction of an optional valuation date election.

1940s – First version of the marital deduction.

1976 – An overhaul of the system by combining separate estate and gift tax exemptions into one, unified estate and gift tax credit.

1981 – The Economic Recovery Tax Act (ERTA) of 1981 expanded the marital deduction, increased unified credit amount, and a decrease in the top rates from 70% to 50% (though full implementation of the decrease was delayed and then superseded by subsequent legislation).

# LIFE INSURANCE TOOLKIT

## Timeline of Key Changes in the Federal Estate Tax

1997 – The Taxpayer Relief Act of 1997 introduced an incremental increase of the unified credit, introduced inflation indexing.

2001 – Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided extensive changes in the system, most notably, the sunset of the estate tax. The law provided for increases to the exemption amount over time to $3.5MM in 2009 followed by a full repeal of the estate tax for decedents who died in 2010. It also reduced the rate from 55% to 45%. Under the legislation, the estate tax exemption would have returned to $1MM in 2011.

2010 – The estate tax was repealed. For decedents dying in 2010, executors had the choice of (1) subjecting the estate to the reinstated federal estate tax rules and permitting the decedent's assets to receive a full step-up in basis or (2) electing out of the estate tax, allowing for only a modified carry over basis of the decedent's assets at death.

2011 – 12 – After EGTRRA expired, estate tax was scheduled to return to a 55% rate and a $1MM exemption. Congress then passed legislation introducing a 35% tax rate and increased the exemption to $5MM, but was only in force for two years.

2013 – 17 – American Taxpayer Relief Act (ATRA) made provisions of the 2011 legislation governing estate, gift and GST taxes permanent, including a $5MM exemption indexed for inflation after 2011, top rates of 40%, and portability of the estate and gift exemption between spouses.

2018 – The Tax Cuts and Jobs Act of 2017 (TCJA) increased the federal estate, gift and generation-skipping transfer tax exemptions to $10MM (indexed for inflation after 2012) per person beginning January 1, 2018. The increased exemptions are scheduled to sunset effective December 31, 2025.

# LIFE INSURANCE TOOLKIT

## Payment of Estate Taxes

Federal estate taxes are due nine months after the date of death. The death benefit from insurance may provide financial flexibility with regard to settling an estate. Otherwise, the beneficiaries will have to create liquidity by either:

1. Using the liquid assets held in the estate which might result in:
   a. Loss of liquidity
   b. Loss of potential accumulated income
   c. Increased illiquidity with remaining assets
2. Selling assets to produce cash which might result in:
   a. Selling at discount due to time constraints
   b. Liquidating a treasured family asset
   c. Loss of liquidity
3. Borrowing funds to pay costs which will result in:
   a. Needing to pay interest
   b. Increasing costs for the borrower

The **insurance death benefit** can provide the liquidity to pay the estate tax and alleviate the need to borrow against or sell all or some of the assets in the estate at an inopportune time. The death benefit may:

   a. Purchase illiquid assets from the estate with the beneficiary retaining ownership
   b. Protect against forced selling of a concentrated position
   c. Retain use of existing assets
   d. Mitigate additional costs to beneficiary

# LIFE INSURANCE TOOLKIT

## Legacy Planning / Intergenerational Wealth Transfer

The federal estate and gift exemption of each spouse allows them to transfer assets to the next generation during life and at death free of federal gift and estate taxes. Additionally, each spouse may make annual exclusion gifts to each child free of federal gift tax and without using their gift tax exemption. Some or all of these transfers may be used by the second generation to purchase life insurance on the first generation. Intergenerational transfers may reduce or eliminate estate taxes by not only getting assets out of the first generation's future estate through gifting, but also by funding the purchase of insurance to provide a death benefit to pay the estate taxes, if any.

It is critical for the insurance policy to be excluded from the estate so the death benefit will not be included in the first generation's estate and will not be subject to estate tax. To do this, the:

- Insured should not retain ownership in policy, any right to receive dividends, any right to change beneficiary at time of death, or the right to take loans and/or surrender the policy
- Beneficiary of policy should not be the insured's estate
- Irrevocable Life Insurance Trust (ILIT) is established to:
  - Own the life insurance policy
  - Receive the death benefits which are therefore excluded from the insured's estate
  - Receive gifts from the insured to pay premiums on the life insurance policy. In order for gifts made to the trust to qualify for the annual gift tax exclusion, the trust instrument must provide the beneficiaries of the trust the power to withdrawal the gift made to the ILIT for a period of at least 30 days, and the trustee must notify the beneficiaries that they have that withdrawal power, commonly referred to as "Crummey Notice"
- The death benefit will be included in the insured's estate if an existing insurance policy is transferred by gift to an ILIT and the insured dies within 3 years

# LIFE INSURANCE TOOLKIT

## Estate Specified and Prescriptive Wealth Transfer

If someone knows they want to leave a specific amount of money to the next generation and/or is unsure of the wealth they might accumulate during their lifetime, insurance may provide some security with regard to transferring wealth from one generation to the next. Rather than gifting to the next generation during the first's lifetime, the first generation, may purchase life insurance on their life with the second generation as the beneficiary. This way, the first generation can determine the specific death benefit that will be paid at death and the amount of premiums that must be paid during life so that the first generation does not have to gift more than they can afford to and still live comfortably. As a result:

- The first generation may transfer a specific amount to beneficiaries
- The first generation can limit their gifting during life to the premium amount thereby retaining assets to support their lifestyle. Furthermore, the life insurance can be federal income and estate tax free if held in a properly drafted irrevocable life insurance trust

# LIFE INSURANCE TOOLKIT

## Estate Equalization

The use of insurance for purposes of estate equalization may be appropriate when a family has assets that are meant to benefit a specific individual but, in doing so, would disinherit one or more of the beneficiaries of the estate. For example, one child runs the family business that comprises the majority of the parents' estates and the other children are not active in the business and have no interest in participating. The parents may want to bequeath the business interest to the child active in the business but also remunerate the other children for the equivalent value.

This strategy also comes up with blended families. For example, proceeds from a life policy could be established to be left to the children of a prior marriage to ensure that those children don't have to wait for the surviving step-parent to pass in order to receive their inheritance.

- Life insurance can be used to equalize the bequest in terms of value
- Nonparticipating children will receive the insurance proceeds and the participating child receives the business interest
- Estate equalization can be used in the case of an unequal bequest of a business, art, real estate, or any other asset

# LIFE INSURANCE TOOLKIT

## Income Tax Planning & Charitable Giving

**If your goal is to give money to charity but your allowable income tax deduction is lower than your intended donation then you may consider donating an insurance policy on your life to charity. Your subsequent payment of insurance premiums may be eligible for a federal income tax deduction (depending on applicable state law). This can allow you to benefit from a federal income tax deduction during your lifetime and maximize the amount going to charity at your death.**

**Additionally, you may use life insurance as an asset replacement mechanism when using a split interest trust to get an income tax deduction and defer capital gain when selling an asset. This works as follows:**

- Transfer an asset to a **charitable remainder trust** (CRT) where the donor is the income beneficiary and a qualified charity is the remainder beneficiary
- The up front income tax deduction is equal to the gift made to charity less the present value of the income interest retained by the donor
- Sell the asset in the CRT which is tax-exempt and defer capital gains
- Establish **ILIT** with life insurance on the donor’s life with a death benefit equal to net after tax value of the sold asset
- Donor makes premium payments to the ILIT annually from the distributions of CRT which should not exceed federal gift tax exemption amount
- When donor dies, beneficiaries receive the death benefit in the trust whose value they would have received if it had not been gifted to charity
- Remainder of CRT goes to charity

# LIFE INSURANCE TOOLKIT

## Business Planning

**Insurance may be instrumental in business planning by providing financial flexibility and relief with regard to addressing the death of a business owner or employee. Additionally, insurance may also provide incentives to retain critical executives. The following are instances when businesses may purchase life insurance on their employees:**

1. **Buy-Sell Agreement:** to meet the financial obligations when it comes to purchasing deceased partner's or co-owner's business interest when they die
2. **Key Employee Insurance:** to provide compensation upon the death of an important employee (i.e. a key employee)
3. **Split Dollar Life Insurance:** to permit an executive to meet personal life insurance needs

# LIFE INSURANCE TOOLKIT

## Buy-Sell Agreement

A **buy-sell agreement** allows a company to meet the financial obligations of purchasing a deceased partner's or co-owner's business interest when they die. The buy-sell agreement that is funded by life insurance generally:

- Ensures continuation of a business in the event of a partner's death
- Obligates the disabled / deceased business owner's estate to sell the business interest to the surviving business owners
- Helps provide a liquid source of funding to facilitate the purchase of the deceased owners share of the business

### Types of buy-sell agreements

**Cross purchase plan:** Partners / stockholders each buy insurance on the other partners so that there will be funds to purchase his/her part of business. Number of policies needed in this case = n(n-1) where n is the number of owners

**Entity Plan:** Corporation buys one insurance policy on each owner. Business entity buys the disabled / deceased business owner's share of business. Policy is owned and premium is paid by the business, so that the business has the necessary funds to buy the owner's interest. If the owners are also employees, consent is required.

**One Way Buy-Sell Agreement:** Key employee / competitor will buy the proprietor's interest at death and the estate agrees to sell it. The buyer purchases life insurance on proprietor's life. When proprietor dies, the buyer generally receives the death benefit income tax free and purchases the proprietor's interest

# LIFE INSURANCE TOOLKIT

## Key Employee Insurance

**Key employee insurance** provides compensation upon the death of a key employee defined as having unique talents and without whom the company would suffer a financial loss. With key employee insurance the:

- Policy is owned by the corporation which pays the premiums and receives the death benefit if employee dies while the policy is in force
- Insured employee has no rights of ownership and generally must consent to the coverage
- Premiums paid by the corporation are not tax deductible (i.e., paid with after tax dollars) and the death benefit may be free of federal income tax
- Proceeds can be used to pay the cost to search for a replacement, to train the replacement, to replace lost profits and to protect the firm’s credit rating

# LIFE INSURANCE TOOLKIT

## Split Dollar Life Insurance

**Split dollar life insurance** may permit an executive to meet personal life insurance needs. Split dollar life insurance occurs when the employee and employer share one or more of the premium cost, ownership, dividends, death benefit and cash value. Split dollar life insurance generally:

- Can provide key employee with a valuable benefit at lower cost because in many split dollar life insurance arrangements the:
  - Employer pays the annual premium equal to the lower of the increase in policy's cash value or net premium
  - Employee pays the balance of premium
  - Employer recovers its total premiums from the death benefit if the insured employee dies during the term of the agreement
  - Death benefit in excess of what is paid to the employer is paid to the beneficiary selected by the employee
  - Tax treatment depends on who owns the policy (employer or employee). In either case, the employee is generally subject to an amount of federal income tax with respect to the policy each year
- Can provide cost effective insurance
- Helps retain key employees
- Does not allow for deductibility of premiums

# LIFE INSURANCE TOOLKIT

## Retirement Planning

**Insurance may be integrated into retirement planning whether or not retirement income is needed. The following are examples:**

**If retirement income is needed**

- Provided that the life insurance contract is not a modified endowment contract, a policy owner can withdraw from the cash value up to an amount equal to policy owner's cost basis (total premiums less dividends) and then can switch to policy loans to continue to take funds from the cash value potentially income tax free. This strategy is subject to challenge by the IRS and could result in the policy being treated for tax purposes as having lapsed. Adverse tax consequences may apply and this strategy should be reviewed frequently if initiated.

**If retirement income is not needed**

- Each year, up to $100,000 (indexed for inflation) of the required minimum distribution (RMD) from IRAs may be transferred to qualified charitable organizations federal income tax free after age 70½ and/or
- The RMD's can be used to pay the premiums for life insurance
- Ideally, the insurance would be purchased in an irrevocable life insurance trust outside the insured's estate so the death benefit would not be subject to federal estate tax (as discussed on page 27 – see ILIT explanation)

# LIFE INSURANCE TOOLKIT

## Disclosure (1 of 2)

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# LIFE INSURANCE TOOLKIT

## Disclosure (2 of 2)

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