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Are Second to Die Life Insurance Policies Worthwhile Investments?

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Background

A second to die (survivorship) life insurance policy differs from the usual life insurance arrangement in that two people are insured and must be deceased before the policy proceeds are paid. The most common situation is where a husband and wife are the insured and the policy proceeds are used to provide liquidity to an estate where estate taxes are projected to be substantial.

Under current interpretations of tax laws, life insurance proceeds are free from federal income taxes and if a policy is owned by a trust that meets certain requirements (seek legal and tax advice regarding these requirements), the policy proceeds are not included in the taxable estate of the deceased. The reason why a husband and wife are typically the insured is that under current federal tax rules, estate taxes, in the husband and wife situation, may be postponed until after the second death.

Survivorship policies are often a cost effective way of providing an estate with liquid assets so that illiquid assets, such as real estate, do not have to be sold at "fire sale" prices or a stock and bond portfolio does not have to liquidated in a down market. Survivorship policies are generally more cost effective than insuring a single person because a joint life expectancy is usually greater than a single life expectancy.

Although survivorship policies are often useful estate planning vehicles, one disadvantage of this type of policy that is sometimes overlooked is that premiums may still be due after the first of the insured individuals is deceased. That is why in the typical husband and wife situation, it is essential that the surviving spouse be able to keep paying the premium because no proceeds are paid until after the second death. One way of partially alleviating this issue is to consider a customized premium payment structure that enables the policy to be fully funded within a specified number of years.

Are Survivorship Policies Worthwhile Investments?

Whether a survivorship policy is a worthwhile investment depends upon the rate of return of the life insurance policy compared to the rate of return that would have been provided (net of income and estate taxes) by the investments that would have been made if life insurance premiums had not been paid. In addition to all of the assumptions that would have to be made about the rate of return of the alternative investments and the taxes paid, one would have to select a date of death for the second insured to die. An ironic aspect of life insurance, regardless of whether one or two lives are insured, is that the sooner you die, the higher the rate of return on the premiums paid.

- The Asset Allocation View of Survivorship Life Insurance

Rather than attempting to construct a complicated algorithm to determine the value of a survivorship policy, we think that a more useful approach is to view the issue from an asset allocation perspective. That is, in our experience, people view life insurance as a conservative investment to protect dependents from the premature demise of an income earner or to protect the estate from the ravages of estate taxes.

The type of survivorship policy that The Fishbein Group at Morgan Stanley favors is one in which the insurance company guarantees the death benefit if the premium schedule has been met. Unlike some life insurance policies that attempt to build cash value, the sole purpose of this type of policy is to provide a guaranteed death benefit. Under current tax laws, if the survivorship policy is owned by a properly constructed trust and the requirements of the trust have been met (again, seek legal and tax advice), the proceeds will be free from federal income taxes and not includable in the taxable estate of the deceased.

- <u>How to View Survivorship Life Insurance In An Asset Allocation</u>

One way to view a survivorship life insurance policy is that it is an investment guaranteed by an insurance company, with an unknown maturity date and, therefore, an unknown rate of return. The rate of return is dependent upon the date of death of the second insured to die. Furthermore, if the life insurance is owned by an appropriate trust and the rules of the trust have been followed, under current tax rules (again, consult a legal and tax advisor), the proceeds will not be part of the taxable estate of the deceased.

Are the returns on a survivorship policy acceptable? Although we have not examined the returns offered from every major insurance carrier that sells survivorship policies, in our experience, using the carriers available at Morgan Stanley, the returns are acceptable for those who can qualify for "standard" or better health ratings and pass away before age 95. This makes sense when one considers that the insurance company keeps and invests all of the premium payments in taxable investments but does not have to pay the beneficiary until both of the insured are deceased. A unique advantage of life insurance, and one of the primary reasons why it works, is that the insurance company invests the premiums in taxable investments but the proceeds are paid to the beneficiary income tax free.

When considering a survivorship policy, we recommend that a chart showing the internal rates of return on the death benefit be included in the policy illustration. These are the rates of return that one would compare to other investments as a means of determining whether the survivorship life insurance policy is an appropriate alternative. Also, if one wishes, the taxable equivalent rates of return, assuming a particular tax bracket, can be provided. Again, an ironic aspect of life insurance is that the sooner one passes away, the higher the internal rate of return.

Summary and Conclusions

A second to die (survivorship) life insurance policy is often a cost effective way of providing an estate with liquid assets so that illiquid assets or assets whose value fluctuates do not have to be sold at an inopportune time.

When viewed from an asset allocation perspective, it is reasonable to compare the death benefit from life insurance to other investments. The difference, however, is that unlike most other investments that can be sold before maturity, the life insurance proceeds are payable only after the second death whose date is in the future, and unknown. In The Fishbein Group's experience, for those individuals in average or better health who pass away before age 95, survivorship policies provide a reasonable rate of return.

As has been pointed out, an ironic factor about life insurance is that the sooner one passes away, the higher the rate of return on the invested money and the longer one lives, the lower the rate of return.

If one's goal is to pass along the maximum amount to younger generations, then if one dies prematurely and their assets have fewer years to compound, then a high return on life insurance can be a compensating investment. On the other hand, if one lives until their late 90's and the assets have grown substantially due to compounding, then a lower rate of return on insurance premiums may be more tolerable.