Lifetime Planning with Life Insurance

By Robert J. Adler and Sidney Kess

Life insurance is one of the most important tools in modern financial planning, but it is not always the most appreciated. It has a role to play in virtually all phases of the typical family's economic life cycle. This article outlines the steps CPAs and their individual clients should take regarding life insurance at each stage.

Young Couples with Children: Maximize Death Benefit

A key decision facing young couples with children is whether to buy term life insurance or cash value life insurance. The factors that ought to influence this decision include the amount of discretionary income available to the family, the duration of the life insurance need, and the long-term economic prospects of the family.

Term life insurance policies are initially less expensive than an equivalent face amount of cash value insurance (also referred to as permanent insurance). If a family can only afford term life insurance, then they have no other choice; however, families with a sufficient level of discretionary income should closely examine their particular needs and consider the duration of those needs. Term insurance can be appropriate for needs expected to last for 20 years or less, such as paying off a mortgage or funding a child's education. Needs likely to exist for more than 20 years might better be covered by some form of cash value life insurance.

Purchasing a cash value policy is more expensive in the short run, but the insured will likely have the option to maintain a level premium throughout his lifetime; therefore, it is never too soon to start building a portfolio of permanent cash value life insurance if cash flow allows for that luxury. For young couples with children, ensuring the proper level of death benefit is the paramount consideration. Families suffer enormous damage when a young breadwinner dies with a $300,000 cash value life insurance policy (because that's all he or she could afford) when he or she should have acquired a $1.3 million term life insurance policy. Cash flow permitting, however, even young couples should consider assembling a portfolio of permanent policies with an eye to anticipating needs that arise later in life.

Middle Age: Capital Accumulation Phase

Using life insurance to supplement retirement cash flow by overfunding a cash value life insurance policy. Life insurance contracts have traditionally been accorded highly favorable income tax treatment. Two of the most important of these benefits are first-in, first-out (FIFO) withdrawals from cash value (i.e., basis can be recovered first) and the tax-free inside buildup of cash value in a policy as long as it satisfies the Internal Revenue Code's (IRC) definitional parameters for a life insurance contract. Not only does the cash value accumulate within the policy without current taxation, but this untaxed income can even be utilized by the policy owner, still without income recognition for tax purposes, in the form of an interest-bearing policy loan.

The nonrecognition of this income will become permanent when the insured dies and the death benefit (net of any policy loan balance) is paid. Under the general rule of IRC section 101, the death benefit under a life insurance contract is excluded from gross income; however, this avoidance of income recognition will not be permanent when a policy loan is effectively retired by offset against the cash value in connection with cancellation of the contract. In such an event, the income recognition will have only been deferred, and it will be recognized at the time of cancellation or lapse of the policy. Thus, CPAs and financial planners should be vigilant in assuring that clients understand the potential income tax consequences when loan-encumbered policies lapse. With this awareness, overfunded cash value life insurance policies can be employed as an effective way to supplement retirement income.

Seniors: Passing Wealth to the Next Generation

Now more than ever, wealth transfer planning requires knowledge and imagination. A veritable alphabet soup of tools, some very complex, has emerged in recent years, such as FLPs, QPRTs, GRATs, GRUTs, CRUTs, and NIM-CRUTs. Planners must understand and use these tools if they are to serve their wealthy clients adequately. Yet no matter how sophisticated the planner and the tools, the simple fact remains that the simplest way to guarantee success in wealth transfer tax planning is through life insurance.

The importance of being post-gift. Imagine an individual with a net worth is $16 million who needs estate planning. He is receptive to transferring up to $1 million to heirs this year, but what is the best asset to effect this transfer? Making the right choice requires understanding the mechanics of the wealth transfer tax system.

Wealth transfer tax planning has a simple goal: to minimize or eliminate transfer taxes, such as the gift tax, the estate tax, and the generation-skipping transfer (GST) tax. The planner's tools are the exemptions and exclusions and the opportunity to leverage them:

■ The gift tax is subject to an exclusion of $14,000 per year per donee (as indexed).

■ The estate and GST tax are subject to an exemption of $5.49 million in 2017 (as indexed).

A central point is the importance of using an inter vivos (lifetime) transfer rather than a testamentary (death time) transfer. Assuming that the transfer vehicle of choice among sophisticated planners, an irrevocable trust, will be employed, an inter vivos transfer means that any post-gift appreciation of the transferred assets will be excluded from the gross estate and thus avoid estate and GST taxes. For a testamentary transfer, which does not take effect until the death of the testator, any appreciation will not be excluded from estate or GST taxation. This is crucial, because appreciation of the gifted assets is central to the transfer objective.

The above suggests that the best method to maximize exemptions and exclusions is to leverage the post-gift appreciation of the transferred assets. It's easy to demonstrate that life insurance has the advantage here. In a rising market and economy, securities and other investment assets, such as real estate, will likely appreciate—but there is no assurance that they will appreciate fast enough. An investment portfolio with an annual return of 8% funded with $1 million worth of portfolio assets will take more than 20 years to appreciate to $5 million. By contrast, a properly structured life insurance policy with a $5 million death benefit would obtain full leverage from the moment the transfer becomes effective. Life insurance is the only asset that can offer this result. (Note that the transaction must be structured to avoid the three-year lookback rule of IRC section 2035, which takes life insurance proceeds back into the gross estate if the policy was transferred within three years of death.)

Life insurance and estate tax repeal. Given the current debate in Congress, the fate of the federal estate tax remains unclear at this time; one of many possible scenarios is a proposed trade of the estate tax for either a carryover basis regime or a capital-gains-at-death tax. In this state of uncertainty, estate planners should focus on techniques that ensure successful planning whether the estate tax is ultimately repealed or not (permanently or temporarily).

The unique characteristics of life insurance make an irrevocable life insurance trust (ILIT) a hedge against both the uncertainty of the law and the reality of death, ensuring predictable results whether the estate tax is repealed or not, whether transferred assets are treated as having a stepped-up or carryover basis, and whether the transferor lives for one year or 20. Such a trust can serve as a vehicle for the passage of wealth, free of the burden of a possible future carryover basis regime or a capital-gains-at-death tax; as a funding vehicle for an irrevocable trust in the event the estate tax and GST tax are ultimately retained (or reappear), sheltering those funds from wealth transfer taxation; and as a device for elevating the plan above the political vagaries of an ever-shifting set of tax rules.

The most likely estate tax repeal model affects the basis of assets transferred at death; instead of stepping the basis up to fair market value at the date of death, it carries over the acquirer's basis. The capital gains consequences could be great, eroding wealth even in the absence of an estate tax. Life insurance avoids this problem altogether; because death benefits are exempt from income tax, there is no question of the recipient's basis, regardless of any change in estate tax law. Even if the estate tax and the GST tax are ultimately not repealed, ILITs will remain the attractive vehicles for wealth transfer they have always been. The life insurance proceeds that fund the trust will still be exempt from estate tax, and the trust can be structured so as to exempt them from the GST tax as well. The individual wins either way.

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Older Age Groups

The first priority for most individuals nearing retirement is to ensure an adequate retirement income; however, especially cautious individuals will look well beyond those healthy retirement years and consider the possibility of declining health and the potential need for assistance in day-to-day living, commonly referred to as long-term care.

The need for long-term care occurs when an individual can no longer perform the normal activities of daily living [i.e., eating, bathing, dressing, toileting, transferring (walking), and continence]. The usefulness of long-term care insurance for any given individual depends on several factors, but the most important is net worth. For ultrawealthy families with substantial income-producing assets, the same investment income that sustained the standard of living during the healthy years may be sufficient to cover the annual costs of long-term care (which can exceed $10,000 per month), and long-term care insurance may well be optional. The decision turns on the subjective desire to hedge (or not hedge) against this risk.

Families whose assets will not be sufficient to generate enough annual income to pay for long-term care without eroding principal can be further divided into two groups: those whose net worth is not sufficient to cover long-term care even if principal were to be fully expended for such care, and those who might be able to cover long-term care through a combination of income and gradual depletion of principal. Thus, the suitability of long-term care insurance seems to fall within the range of individuals who have assets significant enough that they would not qualify for Medicaid, individuals whose income might not be sufficient to cover annual long-term care costs, and individuals who prefer not to deplete their principal in payment of long-term care costs.

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The above notwithstanding, many consumers are reluctant to buy long-term care insurance because they are concerned that their investment will be wasted if they do not use it. To address this concern, some insurance companies have developed hybrid products that combine life insurance with long-term care insurance; these products are relatively new, and the features and benefits are still changing. The amount of the long-term care benefit is often expressed in terms of a percentage of the life insurance benefit. Where estate preservation for the ultimate benefit of children or other survivors is important, these hybrid life insurance/long-term care policies may prove beneficial.

The Varieties of Life Insurance in a Nutshell

Term insurance. Term insurance is perhaps the simplest variety of life insurance. Premiums pay only for the death benefit, and only during the term of coverage. If the insured does not die during the term, there is no benefit, although the policy may carry a right of renewal at the stated premium. Term insurance may be convertible to "permanent" cash value insurance without additional evidence of insurability. Term insurance itself has no cash value.

Whole life. "Whole life" is so called because premiums are paid for the whole life of the insured. Like term insurance, whole life has level premiums. Because mortality costs are not level, but increase over the life of the policy, at first the premiums exceed the actuarial cost of the fixed death benefit so that the policy can build up a cash reserve to prefund the mortality costs when they come to exceed the premiums. The surrender value grows slowly at first, partly because the reserve covers the costs of administering the policy; in later years, the absence of these costs and the effect of compounding cause the surrender value to grow much faster.

Limited-payment whole life. As its name implies, limited-payment whole life is whole life insurance that is paid up after a specified number of years rather than over the life span of the insured. The premiums are larger than ordinary whole life, but once they are paid, the policy is guaranteed to remain in force for the insured's lifetime. The extreme case is single-premium whole life, which requires a single, very large, up-front premium.

Participating whole life. In participating whole life, death benefits and cash values are guaranteed, and the resulting profits are distributed among the policyholders as dividends. If cash values plus dividends are high enough, at some point (the vanishing point) no further premiums need may to be paid. Of course, if investment performance declines, the vanished premium may reappear, to the policy owner's chagrin.

Variable life. Here, "variable" refers to the investment vehicles for the policy's cash value. With an ordinary whole life policy, premiums are retained by the insurance company in a general account and invested. Cash values are guaranteed to the policy owner out of this general account, and the insurer chooses the investments and bears the risk of loss. With variable life, premiums are held in a separate account, segregated from the insurer's general portfolio; the policy owner can choose among various investments and bears the risk of loss. That risk is reflected in the fact that policy values are variable, tied to the investment performance of the particular separate account.

Universal life. Universal life differs from whole life in many crucial respects. First, the premiums are flexible (hence the alternative name, flexible premium life). Within limits, the policy owner can pay larger or smaller premiums, or even none at all, if the cash value in the policy is sufficient. The death benefit can also be increased or decreased by the policy owner, who chooses a specified amount of the insurance, which may include or be added to the cash value. There are two options for the payout the specified amount; under the first, it is paid when the policy owner dies, while the second pays the cash value in addition to the specified amount.

Variable universal life. Variable universal life (VUL), as its name implies, combines features of universal life and variable life. As with universal life, premiums are flexible and can even be skipped if there is sufficient cash value in the policy, death benefits are adjustable, policy withdrawals are possible if there is sufficient cash value, and policy expenses are frequently back-end loaded. As with variable life, premium investments are segregated in separate accounts and the policy owner has control of the investments. Consequently, policy values depend upon separate account investment performance.

No-lapse-guarantee universal life. The hallmarks of no-lapse-guarantee universal life (also known as universal life with a sec-

Checklist for Life Insurance

Determine the Proper Type and Amount of Life Insurance
Term Life Insurance: Useful for individuals seeking income replacement protection during their working years to protect their dependents. Generally appropriate for needs expected to last for 20 years or less; for example, paying off a mortgage or funding a child's education.
Cash Value Life Insurance: Whether universal life or whole life, cash value policies fulfill the traditional indemnity role of life insurance and also serve as a vehicle for the tax-effective transfer of wealth to the next generation.

Ensure Beneficiary Designations Are Up-to-date
The designation that was sound and sensible a year or so ago may not be appropriate today. Beneficiaries may die, or get married, or have children, and any such event may well alter the insured's plans for distribution of the proceeds of his or her policies.

Properly Fund Cash Value Policies
The best way to determine the funding status of a policy (and thus avoid an unintended lapse of coverage) is to request an "in-force" ledger from the life insurance company.

Understand Key Tax Rules
IRC section 2042 includes the value of life insurance proceeds in the gross estate if the proceeds are payable to the decedent insured's estate, either directly or indirectly; or to named beneficiaries, if the decedent insured possessed any "incidents of ownership" in the policy at the time of his death.
IRC section 1035 permits owners of life insurance and annuity contracts to exchange their contracts for similar or related types of contracts without the recognition of any unrealized gain that may have accrued in the contract given up in the exchange.

Other Resources
PPC's Guide to Life Insurance Strategies, by Lee Slavutin
2017 Tax Facts on Insurance & Employee Benefits, the National Underwriter Company.

ondary guarantee) are low-cost, permanent death benefit guarantees and low–cash value accumulations. The death benefits are designed to provide high internal rates of return at all ages of the insured, even beyond life expectancy. The policy is designed to provide a guarantee of life insurance coverage, if all contractual conditions are met, even if the policy's net cash value falls to zero. Thus, this policy type has become popular among affluent families seeking tax-efficient intergenerational death-time transfers of wealth, typically through an irrevocable life insurance trust. The main disadvantages of this policy type are low–cash value accumulations and inflexibility, which is underscored by the fact that, in certain policy forms, premiums must be paid no later than the due date in order to preserve policy guarantees. Depending on contract specifics, policy loans might also impact the original guarantee. ❑

***Robert J. Adler, JD**, is a wills, trusts, and estates lawyer at Adler & Adler PLLC, New York, N.Y. **Sidney Kess, JD, LLM, CPA,** is of counsel to Kostelanetz & Fink and a senior consultant to Citrin Cooperman & Co., LLP. He is a member of the NYSSCPA Hall of Fame and was awarded the Society's Outstanding CPA in Education Award in May 2015. He is also a member of* The CPA Journal *Editorial Advisory Board.*