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Second-Guessing Life Insurance

Inside or Outside the Estate?

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There are worse things in life than death. Have you ever spent an evening with an insurance salesman?

— Woody Allen

"Yadda-yadda, blah-blah," is what a lot of people register when presented with a description of life insurance…if you can even get them to listen.

Yet life insurance inhabits asset portfolios and estate plans and remains directly in the mix of financial planning decisions and strategies.

In light of recent estate tax changes and life expectancy rates, what is the modern role for life insurance?

Should life insurance be kept outside of the probate estate? Is an irrevocable life insurance trust (ILIT) still useful? Does Medicaid planning enter into the equation?

You're Welcome

Life insurance, anyone? Come, gather round and enjoy the rich tapestry of life insurance planning (or just grit your teeth). In terms of aversion-inducing topics, some people would choose to read Geoffrey Chaucer, have a spoonful of cherry-flavored Robitussin, or go bungee jumping au naturel before engaging in a detailed discussion of life insurance. Here is a reminder of Chaucer:

"Whan that Aprill with his shoures soote
The droghte of March hath perced to the roote,
And bathed every veyne in swich licour
Of which vertu engendred is the flour"

— The Canterbury Tales, The General Prologue by Geoffrey Chaucer

I rest my case.

Nevertheless, life insurance has important functions, and people keep buying it. The operative questions are: (1) Do people know what they are buying? (2) Are they purchasing the right insurance products for their various purposes? and (3) Are they incorporating life insurance into financial and estate plans in the most effective manner?

There is also a very practical question for the vast majority of mundane estates: Is it now okay to name your own estate as the beneficiary of your life insurance, or is there a compelling reason to avoid this?

Buy, Buy, Buy!

In past years, most life insurance was sold by an army of salespeople who were paid by commission. The Bureau of Labor Statistics reports that there were 434,000 people selling insurance in 2008. Other sources indicate a substantially higher number. In the wake of the Great Depression, having a life insurance policy to provide a sure financial reserve was attractive, regardless of the rate of return.

Studies and Congressmen have targeted the disconnect between consumers buying an investment product that is being explained by people who (1) have a vested interest in the outcome of the sale and (2) are not trained in investments or financial planning.

For almost seventy years the life insurance industry has been a smug sacred cow feeding the public a steady line of sacred bull.

—Ralph Nader

Others have pointed out that consumers who turn to their attorneys for advice on life insurance purchases

may be dissuaded from buying simply because their attorneys aren't fully conversant in insurance. Meanwhile, consumers may continue to pay life insurance premiums even when their insurance arrangements are no longer suitable for their financial circumstances.

Unhatched Chickens

How many life insurance policies result in the payment of death benefits? The answer might surprise you. For term policies, a 1993 study conducted by Penn State concluded that policies were terminated prior to death 99% of the time.

> ***Insurance is like marriage. You pay, pay, pay, and you never get anything back.***
>
> *—Al Bundy, Married…with Children*

Vincent M. D'Addona, CLU, ChFC, MSFS, AEP, who was interviewed in The Estate Analyst for the September 2007 issue (The ILIT Remixed) pointed out that this statistic means that term insurance has a 100% failure rate, 99% of the time.

Yes, term insurance provides an affordable solution to temporary risks, but that is not how it is marketed or perceived by consumers.

Many whole life policies also fail to produce death benefits. They are either abandoned or cashed in during life. According to the *ACLI Life Insurance Fact Book 2001*, data from the National Association of Insurance Commissioners reveals that in 2000, life insurers paid out $43.8 billion in death benefits under life insurance and annuity policies but paid out $183 billion in life and annuity surrender values that same year. A 2008 study by Bragg and Associates concluded that 40% of all whole life and universal insurance policies lapse during the first six years.

The Big Misconception

Another significant misconception D'Addona warns of relates to the traditional use of whole life insurance to finance the payment of estate taxes. There is a widely held perception that insurance dollars provide a greater value because they accumulate without taxation.

In a lecture to the American Association of Life Underwriters, D'Addona observed that the mortality curve on an underwritten life (or lives in the case of last-to-die insurance) is not fully understood or appreciated by the professional community of accountants, lawyers, and life insurance professionals.

There is a common belief that life insurance helps pay estate taxes with discounted dollars. Practitioners therefore believe that life insurance should be positioned outside of the estate ab initio.

But analysis reveals this is not the most effective approach. At or near life expectancy, life insurance arranged in the typical manner provides no more than a bond-like rate of return as a death benefit. Considering the conservative investment philosophy of life insurers, this is to be expected.

Insurance products that are designed to have low initial premiums have even poorer long-term results because there is a much smaller base for compounding future returns. In addition, many of those secondary guarantee products have high hidden costs. Every dollar that is used for premiums in the early years of funding a life insurance policy creates a higher opportunity cost for wealth shifting in the short run.

Assume a married couple with both spouses at age 50 purchases a $1 million survivorship life insurance policy with annual premiums of $12,500 and that dividends offset premiums after 18 years.

The total cost of the $1 million appears to be $225,000. That's a return of $1 for every 22-cent investment. But that overlooks opportunity costs, argues D'Addona. Assuming a 7% return, those premium payments would be worth $456,000 after 18 years. And the couple may not recover those funds after 18 years because both spouses must die before benefits are paid. Statistically, in this example, the joint life expectancy is 37 years. That $456,000 is not being invested for an additional 19 years.

In contrast, observed D'Addona, life insurance arranged inside the estate can leverage that "bond-like" return capability, and therefore act as a holding tank for money that is being held for a variety of purposes, including waiting for other higher value opportunities. "This creates empowerment through flexibility versus restriction," he says.

The ILIT Reconsidered

In light of higher estate tax exclusions, longer life expectancies, lower interest rates, and more attentive analysis of how investments can outperform conventional whole life insurance, does the irrevocable life insurance trust (ILIT) still make sense for as many estates?

Survivorship or second-to-die life insurance in an ILIT was born in response to the unlimited marital deduction that arrived with the Economic Recovery Tax Act of 1981. Today, most estates face no estate tax due to much larger exclusions, and the new portability of exclusion for married couples reverses the previous outcome of deferring taxes to the death of the second spouse. Instead, the second spouse to die has even larger exclusions to work with.

Gifts of insurance premiums may also place emphasis on transferring the wrong assets. Transferring other assets, such as interests in a family business, might be better options.

For larger estates, the increased growth of assets inside an estate can make up for the potential estate tax liability and has a better result than ILITs in many models. There are certainly good uses for ILITs, but their supremacy should not be taken for granted by any means.

Fun is like life insurance; the older you get, the more it costs.

—Kin Hubbard

Tax-Related Misconceptions

There are several tax aspects to life insurance that are clear winners. First, life insurance proceeds that are paid at the death of the insured will not constitute taxable income to the beneficiary or the estate of the insured. Second, even though the value of the premiums that were paid or invested has increased over time, the appreciation of the assets is not taxed as a capital gain.

People who assume that all distributions from life insurance policies are tax free, however, will be surprised and disappointed. When funds are distributed prior to death, such as when a policy's cash surrender value is paid out, the appreciation in the premiums is taxed to the insured/recipient as regular income.

Note that a number of exceptions apply. When distributions are made from the cash reserves of a policy, the IRS has rules to determine when distributions are of the original basis (and not subject to tax on gains) or distributions of appreciation (and taxable). Distributions that are loans are also not taxable. When a policy is surrendered, the appreciated amounts are taxed as ordinary income.

In some business contexts, a company's payments of life insurance premiums on a key employee may be treated as a deductible expense. However, if the employee is the beneficiary of the policy, the premiums will be treated as taxable income to that employee.

Although death benefits that are paid to third parties under the terms of a life insurance policy are not controlled or redirected by the insured's Will and are not subject to the probate process, the value of the insurance may, nonetheless, be included in the insured's gross estate if the insured retained "incidents of ownership." If the insured had the power to change beneficiaries while alive, then the assets remain in the insured's taxable estate after death.

Inside vs. Outside

Should life insurance be kept outside of the probate estate? Should it be kept outside of the insured's taxable estate? Let's consider several scenarios.

Example #1: Ellen has an estate of $900,000 that will be subject to probate when she dies. She also owns a life insurance policy that will pay $100,000 to her brother when she dies. This $100,000 death benefit is not subject to probate and is not controlled by Ellen's Will. Yet the death benefit is included in Ellen's taxable estate because she held the right to change beneficiaries of the life insurance policy.

If Ellen changes the beneficiary of the insurance by naming her own estate as the beneficiary, the tax consequences are the same; the death benefits continue to be in her taxable estate. The proceeds will still not result in income tax or capital gains. However, now the assets will be included in Ellen's probate estate and will be distributed under the terms of her Will. The death benefits will also be available to pay any estate taxes.

Since the decision to change the beneficiary of the insurance to her own estate is tax neutral, Ellen can base her decision on how to best distribute the assets of her estate. If her circumstances have changed and she wants to utilize her Will as the organizing principle for how all of her assets are distributed, then naming her estate makes sense. If she has earmarked the death benefits for her brother for some specific reason and wants those assets

to remain private and not part of the public probate process, then she can leave the life insurance policy unchanged.

Example #2: Ellen makes an irrevocable transfer of the life insurance policy. She makes this transfer more than three years prior to her death. At her death, the insurance policy will not be included in Ellen's taxable estate. Here, the death benefits are truly outside her taxable estate.

Analysis: An estate planner needs to ask Ellen the right questions before assets are orchestrated. Even though an estate of Ellen's size appears safely below Federal estate tax levels, her estate may incur state death taxes. For example, in a state such as New Jersey, Ellen would be faced with both state estate taxes for assets exceeding $675,000 and state inheritance taxes for assets transferred to beneficiaries other than charities, children, descendants, spouses, or parents.

A Comment on Executor's Fees

Another concern in many estates utilizing arrangements that remain outside of probate is how the executor's compensation shall be calculated. Where the Will is silent, a state's statutory share may apply in some jurisdictions, while other states may require an accounting of the tasks performed in awarding an executor's fee.

In many estates that rely extensively on nonprobate arrangements, such as life insurance, retirement accounts, joint bank accounts, jointly owned real estate with right of survivorship, and transfer-on-death brokerage accounts, assets may be transferred automatically with very little involvement on the part of the executor.

Yet because such assets were under the control of the testator at the time of death, the executor would, in many jurisdictions, include these assets in the total used to calculate a statutory fee…unless the Will provides other specific instructions.

I detest life-insurance agents: they always argue that I shall some day die, which is not so.

—Stephen Leacock (1869 – 1944)

Medicaid-Ready Estates

Regrettably, good planning has been corrupted by the desire to anticipate the need for Medicaid by making estates "Medicaid ready."

In other words, instead of trying to make assets last as long as possible and maintain self-sufficiency, the five-year look-back rule and estate recovery requirements for Medicaid have essentially encouraged self-impoverishment.

Ironically, larger estates that in the past were the prime candidates for ILITs that would keep assets outside of the estate for tax purposes may now have reasons to reconsider, while small and moderate estates may now have more reasons than in the past to keep assets outside of their estates using ILITs. Someone who is making an estate Medicaid ready with transfers may consider an ILIT an option.

Second-Guessing the Second-Guessers

Should we really be second-guessing life insurance, a ubiquitous asset with unique properties and great utility?

"If you are always second-guessing your decisions in life, chances are you're not a very happy person. More likely than not, you find yourself so riddled with anxiety that it's difficult to maintain healthy relationships, work effectively, or function properly. Learn how to reduce your self-doubt by not second-guessing your decisions."

–eHow Health: How to Stop Second-Guessing Decisions

The problem with decisions about life insurance, however, is that the financial planning context surrounding it keeps changing. Insurance designed to pay estate tax can have an identity crisis when there is no estate tax to pay. And second-to-die insurance seems so affordable until compared with long-term investments.

Yes, life insurance has the incomprehensibility of legislation administered by a conglomerate wrapped inside a bureaucracy, and a presentation lacking even the charisma of wheat germ. Yet even after identifying flaws in its traditional applications, life insurance can have a positive role in an estate plan. It can be a foundational asset and a vital tool. But life insurance should neither be taken for granted nor discouraged simply because it is poorly understood. It is the estate planner's role to understand where life insurance continues to provide utility in the estate.

[For a collection of life insurance data and resources, see: *http://www.efmoody.com/insurance/commentary.html*]

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