LIFE INSURANCE QUICK STUDY

The Basics

--- Insurance Services

(For advisor use only – not for use with clients)

I. WHAT WILL THIS OUTLINE ACCOMPLISH?

A. A Little Knowledge – This overview is particularly for advisors who straddle many areas of their clients' financial affairs, but whose core competency is *not* life insurance planning.

B. Intention and purpose – This will provide you with the common body of knowledge you need to initiate proper life insurance planning for a client. For purposes of the discussion, we assume you use ***--- Insurance Services*** as your full-service insurance brokerage source and "back-room" to assist you in all matters addressed or that may arise as a sale progresses.

C. Use of (*) throughout – When a term, concern or concept is important, but beyond the scope of this discussion, an asterisk will indicate where further assistance is available from ***--- Insurance Services*** and which in most cases may eventually require support from a qualified legal or tax advisor.

II. HOW IS LIFE INSURANCE TAXED?

Note #1: *Where taxes are concerned, the federal government gets you "coming and going". It taxes you when you get your money (income tax) and they may tax it again when you try to give away what's left (gift and estate tax). Both are discussed below.*

Note #2: *In addition to federal taxes states may apply either income taxes, death taxes, or both on their own. --- Insurances can provide helpful resources that alert you to taxation that may exist on the state level.*

A. Federal Income Tax

1. Non-deductibility of premiums – The cost of coverage is *not* a tax deductible expense.

2. Tax-deferred growth – Returns paid on values inside the policy are taxed only under some circumstances when either when taken from the policy or if the policy is a MEC (*modified endowment contract, i.e. one into which too much premium was paid too quickly – the carrier keeps track of this**) and the policy is used as security.

3. Policy loans – "Policy loans" are actually borrowed from the general assets of the carrier and the policy simply serves as security; loan proceeds received are non-taxable unless the policy is a MEC.*

4. Policy withdrawals/partial surrenders – Different policies have different methods for accessing inside values; the money is received tax-free to the extent of basis in the policy (i.e. "FIFO" treatment – unless the policy is a MEC*, then money taken is taxed "LIFO").

5. Death benefits – Generally received tax-free by the beneficiary; an ownership change during the life of the policy may cause taxation under the "transfer-for-value rule*".

B. Federal Gift Tax

1. <u>*FMV of a policy*</u> – Ownership transfer for non-business purposes is a gift and subject to tax on an amount that is usually either a reserve number calculated by the carrier or the total premiums paid on the policy.
2. <u>*Charitable donations*</u> – The deduction available for a policy gifted to a tax-exempt entity is the lower of the FMV or the donor's basis.

C. Federal Estate Tax

1. <u>*Death benefits*</u> – Proceeds paid on a policy in which the deceased/insured has <u>*any*</u> *"incidents-of-ownership"** are totally includible in the taxable estate.
2. <u>*The 3-year rule*</u> – If incidents of ownership are gifted away by the insured, he/she must survive three years for the proceeds not to be included in the taxable estate.

III. WHAT ARE SOME COMMON CONCERNS THAT CAN CREATE PROBLEMS?

A. Policy ownership issues

1. <u>*Insured-owner*</u> – An alternative should be considered if there are either potential estate tax issues or the life circumstances of the insured may make 3rd party ownership and management of the policy advisable.

2. <u>*Contingent owners*</u> – Should always be designated to take responsibility for the policy if a non-owner insured dies.

3. <u>*Non-insured, non-beneficiary owner*</u> – Whenever the insured, owner and beneficiary are different entities (often referred to as the "unholy triangle") there may be adverse tax implications when death proceeds are paid – it should be checked out*.

B. Policy beneficiary issues

1. <u>*Contingent beneficiaries*</u> – Should always be designated to avoid death proceeds reverting to the estate and the probate court (see below).

2. <u>*Minors*</u> – Depending on state law, young beneficiaries may not have legal capacity to own a policy or accept death proceeds requiring the cost and time of seeking a court-appointed guardian.

3. <u>*Estate of the insured*</u> – This is a common, but usually undesirable, designation; death proceeds become subject to the cost, delay and public record of the probate count.

4. <u>*Creditors*</u> – If a policy is used to secure a loan the creditors should be issued a collateral assignment and not made a party to the contract as a beneficiary.

C. Amount of coverage – common insurable needs

1. <u>*Income replacement*</u> – To replace the earnings denied to the insured's survivors because of a death-shortened work life; a justifiable amount is usually determined by the carrier as a multiple of annual compensation based on age.

2. *Anticipated taxes at death* – Estimated by subtracting the current lifetime exemption amount (2015 - $5.43MM per taxpayer, $10.86MM per married couple) from the net worth and multiplying by 40-50%. C***aution:*** half the states have death taxes, usually with much lower exemption amounts.

D. Kind of coverage

1. *Types of insurance* (simply put)
   a. Permanent – Higher premiums initially, potentially lower over the long run, building policy values to which returns are credited according to a variety of methods depending on the policy.
   b. Term – Lower premiums, usually fixed for a defined level period, with no policy values.

2. *Length of the time of need* – Usually permanent coverage is purchased to address needs that won't go away (e.g. estate tax liability) and term insurance is purchased for needs of limited duration (e.g. income replacement for the working life of the insured) or where permanent coverage is not currently affordable.

3. *The advantage of convertibility* – Most term policies allow for conversion of coverage to a permanent contract up to a certain age at the original medical offer without evidence of insurability. This allows for continuation of coverage as needed beyond the level premium-paying period without excess cost due to poor subsequent health history.

IV. WHAT'S THE BEST WAY TO START? AN EASY FIRST STEP – POLICY REVIEW

A. Managed outsourcing – A good insurance advisor will provide as a free service full review of a client's existing coverage for all the issues listed above as well as to determine if the policy is performing as effectively as others that might be available in the market.

B. Procedure

1. *Information collection* – Often a full review can be conducted once a client has signed a simple one-page authorization form that allows for the collection of all information needed from the carriers involved.
2. *Analysis* – Policy performance, structure and the client's current needs are considered.
3. *Recommendations* – A full report is made on the adequacy of current policies as well as how retained and new coverage can be managed to best serve the risk management needs of your client going forward.

C. A profitable endeavor – Policy review support is available through your --- Insurance Services office.

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