ADVISING CLIENTS ABOUT LIFE INSURANCE: A PRIMER[1]

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Introduction

Over the last several years, tax reform has made tax planning increasingly difficult. Life insurance, however, continues to provide significant tax advantages not found in other investments. The role of life insurance in corporate and estate planning therefore continues to grow. Succession planning for closely held businesses, the establishment of deferred compensation plans, and arranging for the liquidity needed to pay federal estate taxes are just a few examples of how life insurance and the practice of law have become inextricably interrelated.

Attorneys are facing an ever increasing number of questions from their clients concerning the selection of an appropriate life insurance policy. The advent of numerous new types of insurance policies in recent years has made it increasingly difficult for an attorney to advise clients on this critical issue. This article is intended to provide an overview of some of the relative advantages and disadvantages of various types of insurance policies and to provide general guidance on the types of insurance policies that often work best in specific situations.

Term Life Insurance

As its name implies, a term life insurance policy provides insurance protection for a finite time period. Term periods typically range from one to twenty years. If after the term expires the lapsed policy is replaced with a new policy, there will be a new two-year period during which the insurance company can contest the policy for any misstatements found in the policy application. There is also likely to be a new 2-year suicide clause as well.

With term insurance, policy premiums increase yearly because the odds of death increase with age. Some term policies also offer a guaranteed level premium for the term period (usually 5, 10, 15 or 20 years), but when the term period expires the premiums for future terms can increase dramatically, depending on the health of the insured.

Another popular feature that is available with many term policies is a "conversion privilege". This rider allows the insured person to convert the term policy to a permanent insurance policy prior to its expiration without demonstrating insurability. Of course, if the conversion privilege is exercised, the premium from that point forward will increase to an

[1] **We cannot guarantee that this information is consistent with current law. Please contact Willms, S.C. for current information on this topic.**

amount that is commensurate with a permanent insurance contract at the insured's attained age as of the date of conversion.

As is the case with all types of life insurance policies, the proceeds paid at the insured's death under a term insurance contract are not income taxable to the policy's designated beneficiary. [I.R.C. § 2101(a).] And, insurance proceeds can escape estate taxation as well, provided the proceeds are not payable to or for the benefit of the insured's estate [I.R.C. § 2042(1).] , and provided the insured does not possess a "incident of ownership" with respect to the policy within 3 years of his or her death. [I.R.C. § 2042(2); § 2035.]

The principal advantage of term insurance as compared to other types of life insurance is its short term cost. Generally speaking, term insurance will have the lowest cost over the initial years of the contract when compared to other types of insurance. The administrative expenses associated with the acquisition of a term insurance policy (such as commissions) are also significantly lower than with other types of policies. As a result, term insurance is most appropriate when there are cash flow limitations and a significant amount of death benefit required. These situations include:

- When insurance is needed by a young family with a limited budget;

- When insurance is needed to secure individual or business debts;

- When corporate insurance is needed (for buy-sell agreement funding, key person insurance, etc.) but corporate cash flow is tight due to low profit margins, expanding operations, etc.

The principal drawback associated with term insurance is that term insurance is often more costly over the long haul since the premiums for a term policy can increase dramatically as the insured ages. As a result, over 90% of term policies are allowed to expire before the insured dies. [Based upon actual actuarial experience of a major North American mutual life insurance company.] An additional potential drawback is that many insurance companies provide for more favorable underwriting for whole life and universal life insurance contracts than they are willing to provide for term insurance policies. As a result, term insurance may be less attractive for some clients with health problems.

Permanent Life Insurance

Unlike term insurance, permanent insurance policies are intended to provide insurance protection for the life of the insured. There are a variety of types of permanent insurance contracts, including whole life insurance, universal life insurance, variable insurance and second-to-die insurance.

The premium paid on a permanent insurance policy has three components: (i) the cost of the pure insurance protection afforded by the contract (ii) the administrative expenses associated with the contract and (iii) the balance of the premium that is invested by the

insurance company on behalf of the policy owner to establish policy reserves, also known as cash value. The investment return on the established policy reserves can then (i) be used to reduce future premiums, (ii) increase the death benefit and cash value, (iii) accumulate at interest, or (iv) be distributed to the policy owner.

A common feature to all permanent policies is that increases in the policies' cash values as a result of undistributed earnings on policy investments are not subject to current taxation to the owner. [I.R.C. § 72(e), 7702; Theodore H. Cohen v. Commissioner 39 TC 1055 (1963); Abram Nesbitt II v. Commissioner 43 TC 629 (1965).] As a result, the internal rate of return on a permanent life insurance contract can be very competitive with other investments, particularly if the cost of the insurance protection provided is considered. The Internal Revenue Code includes "modified endowment rules," which are intended to discourage individuals from purchasing insurance for the primary purpose of avoiding income taxes. [See I.R.C. § 7702A.]

Another tax benefit of permanent insurance is that the owner can borrow the tax deferred gain in the policy's cash value without incurring income taxes, provided the policy is not a modified endowment. [I.R.C. § 72(e)(5)(c).] And, dividends which are distributed to the owner are also tax-free until the aggregate dividends received exceed the total amount of premiums paid to date. [Id ; Treas. Reg. 1.72 -11(b)(1).]

The earnings that are credited to a permanent insurance policy's cash value will depend, in part, on the type of company that issues the policy. In the case of a stock insurance company, the stockholders of the company are not necessarily the policy owners. In comparison, a mutual insurance company is owned by its policy holders. As a result, a mutual company pays dividends to its policy holders that are added to the policy's cash value. A stock insurance company pays dividends to its stockholders, not its policy holders.

Whole Life Insurance

Whole life insurance is the most traditional form of permanent insurance. Traditional whole life policies feature a level premium which is sufficient to guarantee a stated death benefit for the rest of the insured's lifetime. Initially, the premium will be higher than the cost of the pure insurance protection afforded by the policy to create a cash value reserve. The cash value of a whole life insurance contract is invested in the general investment account of the insurer. As the insured ages, the earnings on the cash value reserve are used to supplement premiums paid to keep the premiums needed to support the policy's death benefit level. In some cases, the earnings on the cash value can reduce, and even eliminate, premiums in later years.

One of the principal advantages to a whole life policy relates to the policy guarantees that accompany such a policy. For example, whole life policies guarantee that the charges against the policy's cash value for mortality and administrative expenses will not be increased over the insured's lifetime. In addition, a whole life policy will guarantee that

the cash value will be credited with no less than a guaranteed minimum interest rate. As a result of these guarantees, a whole life policy provides a level premium that is guaranteed by the company not to increase over the insured's lifetime.

The primary disadvantage of whole life insurance is a by-product of the guaranteed death benefit and guaranteed level premium for life. As a result of these guarantees, relatively high premium payments are needed to create a cash value sufficient to support the cost of the policy over the life of the insured. There is also a lack of flexibility with regard to the payment of the premiums on a whole life contract. While it is possible to borrow against the cash value of the policy to pay premiums, these loans will reduce the rate of return on the cash value, thereby potentially significantly increasing the total cost of the policy. Further, interest paid on policy loans is generally non-deductible for personally owned life insurance. [I.R.C. § 163(h)(1).] The interest may or may not be deductible for corporately owned life insurance, depending on a number of factors.

A popular rider to whole life insurance contracts provides for policy dividends to buy additional insurance protection that is "paid up". In essence, each year dividends are used to purchase small amounts of insurance protection for which no further premiums are needed. This additional protection can then be used to increase the death benefit payable on the policy. The cash value of these paid up additions can also serve to reduce future premiums.

Whole life insurance will often work best when the insurance protection is needed for a long and indefinite period of time, or for the insured's lifetime. Examples include when insurance proceeds are needed to pay estate taxes, fund a corporate buy-sell agreement (if the shareholder does not have a mandatory retirement age and may own shares the rest of his or her lifetime), and when both family insurance protection is needed and the insured wants to take advantage of the force-saving nature of the whole life's fixed insurance premium.

Universal Life Insurance

Universal life insurance may be looked at as a hybrid between term and whole life insurance. A universal policy has a cash value like whole life insurance. However, unlike whole life insurance, a universal contract allows the owner to vary the amount that is paid as premium in any given year. The owner can pay an amount just sufficient to cover the cost of the mortality protection afforded by the policy (in which case the policy premium will increase annually, like a term contract). Or, the owner can pay a larger premium (in which case the excess will be added to the policy's cash value).

The primary advantage of universal life insurance is its flexibility. There is no fixed premium, and the death benefit is adjustable (subject to new evidence of insurability). There are three potential disadvantages to universal life insurance:

1. If the aggregate premiums paid are insufficient, the policy could lapse prior to the insured's death. At that point, the cost to continue or replace the coverage could be very high.

2. There are fewer guarantees with a universal life contract than a whole life contract. As a result, if the investment performance of the cash value is less than projected, or the insurance company's mortality or expense charges increase while the policy is in effect, the policy could lapse even if the owner had been contributing the target premium.

3.The policy illustrations for universal life insurance can be misleading. For example, some insurance companies substantially underestimate the cost of the future mortality expenses that will be charged in the contract, thereby overstating the projected performance of the policy. Therefore, the policy owner and advisors must be very careful to make sure that the projected policy performance is based upon accurate and conservative assumptions.

Notwithstanding its potential drawbacks, there are certain circumstances where universal life insurance may be the best choice. One is where the goal is to provide a death benefit protection for ten or more years but not necessarily for the life of the insured. Examples include:

• Where family insurance protection is needed until the children are grown and have completed their educations, at which point insurance protection will no longer be needed.

• Where insurance is being used to fund a stock redemption agreement in the event the insured dies prior to retirement. [Many buy-sell agreements will require that the stock of the owner/employee be sold at the time of retirement in exchange for a promissory note secured by the assets of the corporation and the remaining shareholders. At that point, insurance on the former owner may no longer be needed.]

In these instances, a universal contract may be more cost effective than term insurance because of the ability to use the tax-free earnings on the cash value to pay for insurance protection, and the universal contract may outperform whole life insurance because of the potentially lower initial premiums.

Another circumstance to which universal life insurance may be well suited is when the tax-free earnings aspect of the policy is of greater importance than the actual death benefit provided by the contract. That's because the yield on a universal life contract is more sensitive to current interest rates, and the modified endowment rules allow for a larger cash value to support a stated death benefit with a universal life contract than is possible with a whole life contract. Accordingly, if the objective is to minimize the death benefit and, therefore, the cost of the insurance protection, and to maximize the tax deferred cash value

growth in the life insurance policy, then a universal life insurance policy may be best (especially, if interest rates are expected to rise in the long term). Examples include when the contract is being used to fund a corporate deferred compensation plan [But see : Glass and Marshall, "Is Variable Universal Life An Appropriate Funding Vehicle For Deferred Compensation Plans?", Journal Of The American Society Of CLU and ChFC, May 1996 at page 54.] or as a savings vehicle for anticipated future needs such as college expenses, supplemental retirement income, and etc.

Variable Life Insurance

A variable life insurance [Also known as "Flexible Premium Adjustable Life Insurance"] contract is one where the owner, rather than the insurance company directs the investment of the policy's cash value. Variable life insurance can be designed within a whole life or universal life policy. The insurance agent must be securities licensed to sell this product.

With variable life insurance, the policy owner can choose to invest the policy's cash value in a variety of accounts offered by the insurer. The investment account choices usually include one or more guaranteed accounts, equity accounts, bond accounts and managed accounts. The cash value of the policy and, potentially, the ultimate death benefit will be based upon the performance of the investment accounts selected.

The potential advantage of variable life insurance is that the investment accounts selected by the owner could outperform the conservative managed general investment account of the insurer, which typically is heavily weighted in favor of real estate mortgages, bonds, and other conservative interest bearing investments. However, because a variable insurance contract is more expensive for the insurance company to administer, the administrative expenses on a variable life policy can be 1.5% to 3.0% in addition to those charged on a traditional life insurance contract. Furthermore, many companies credit a lower interest rate to their variable life policy guaranteed accounts than to similar guaranteed accounts for their traditional policies.

Variable life insurance is best suited to those circumstances where the policy owner wants to invest the cash value of their insurance contract in equities in hopes of a higher return, and is willing to assume the risk of that investment strategy. Variable insurance may also be the best choice when the insurance carrier is being selected because of the favorable mortality rating it is willing to offer an insured with health problems, but there are concerns about the company's investment performance (i.e. the insured would like to control the investment of the policy cash reserves). Variable life insurance may be inappropriate when the policy is intended to be kept in force for less than ten years because volatility in the equity markets in the short term can significantly affect the value of the policy.

Second-to-Die Life Insurance.

A second-to-die insurance policy [Also referred to as "Joint and Survivor Insurance" or "Survivorship Life Insurance".] is a policy whose death benefit becomes payable only after

the death of two insureds. Second-to-die life insurance can be a very effective way to fund the payment of estate taxes because the unlimited marital deduction allows federal estate taxes to be deferred until the date of the surviving spouse's death. [I.R.C. § 2056.] Second-to-die life insurance has two major advantages as in comparison to other types of permanent insurance. The two benefits are:

- Low premiums. Often, second-to-die insurance is purchased at older ages when the insureds are in their 50s, 60s, 70s or 80s. The joint life expectancy of two people is always somewhat longer than either person's individual life expectancy. Because of the reduced mortality risk, a second-to-die premium rate can be as little as one-half the premium which would be needed to provide the same death benefit on the life of the husband alone, and approximately two-thirds the premium to insure the wife individually.

- Easier insurability requirements. Since this type of policy matures only after both persons die, more emphasis is put by the insurance company's underwriting department on the healthier life. As a result, it may be possible to obtain this coverage even if one of the spouses is uninsurable as long as the other spouse is insurable.

There are two potential drawbacks to second-to-die life insurance. These two drawbacks are:

- There is normally no death benefit at the first death. A second-to-die policy therefore affords no financial security to the surviving spouse.

- The joint life expectancy could be very long, often 25 to 40 years or more. Therefore, it is extremely important that the policy be designed carefully with a financially strong company to make sure that the death benefit will be available when it is needed.

Conclusion

While the foregoing discussion is intended to provide attorneys and their clients with guidance on how to select the right insurance policy, the particular facts and circumstances of any individual case can greatly affect the appropriateness of the observations found in this article. Furthermore, once the type of policy has been determined, the question remains as to which insurance company to acquire the policy from. This determination involves the evaluation of both the competing companies' financial ratings and an analysis of complex policy illustrations, which can be very misleading to the untrained eye due to hidden assumptions (such as mortality rates, lapse rates, etc.) on which the illustrations are based.

As a result, most attorneys who have been asked to provide a client with advice concerning selection of an insurance contract should not attempt to go at it alone. Instead, the attorney

is well advised to consult with a qualified insurance agent, and to make sure the agent's observations and recommendations are fully documented. Otherwise, even the most diligent attorney could find himself being subject to criticism for providing advice he was not qualified to give.