Lifeco Associates, Inc.
Life and Health Insurance Agency

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March, 2014

The Diverse Nature Of Life Insurance

Life insurance is a valuable and flexible asset that serves many purposes. As with any asset, it should be periodically reviewed, monitored and analyzed to determine whether changes are warranted – such as those triggered by life or business circumstances (e.g. the birth of a child; marriage; divorce; forming or expanding a business with other owners) and/or external factors (e.g. changes in federal or state estate tax or income tax laws).

Life insurance has some unique advantages. First and foremost, the death benefit is not subject to income tax (there are notice and reporting requirements for life insurance owned by a business on its employees to preserve the income-tax free nature of the death benefit). Secondly, to the extent the life insurance is owned properly it will also avoid being included within one's estate and, therefore, avoid estate taxes. Thirdly, for permanent life insurance (e.g. universal life and whole life) the cash value grows on a tax-deferred basis, similar to a retirement account. Additionally, with respect to permanent life insurance any withdrawals up to the cost basis are not subject to income tax (they represent a return of capital). Withdrawals in excess of the policy's cost basis may be taken via loans which accrue interest but do not necessarily have to be repaid (at death any outstanding loan amount will reduce the death benefit accordingly).

The following summarizes certain ways **life insurance** may be used to best satisfy one or more needs that may not always be considered. Every concept may be tailored to meet the desired objectives; much of the below focuses on permanent life insurance, specifically whole life insurance, although other types of insurance may also be suitable for a given situation.

- **Lifecycle planning for a child, grandchild or other loved one**
  - One planning concept which may be used is obtaining permanent life insurance on a very young individual (as young as 1 year old) to serve as a 'life cycle' policy. The primary purpose of such a policy is for the tax-deferred accumulation of cash value. The death benefit is a secondary benefit although important because it does guarantee insurability in the event the child were to develop some medical condition in the future which would render him or her uninsurable. Utilizing whole life insurance from a mutual carrier which has a strong history of paying dividends, cash value may be accumulated over time and used at the discretion of the policy owner (e.g. a trustee), such as for the following:
    - Education: 529 plans may only be used commencing with college (other than paying income tax and a penalty on non-qualified withdrawals); Coverdell Educational Savings accounts are limited to a maximum contribution of $2,000/year. Permanent life insurance enables the cash value to be tapped whenever desired, such as for private high school.
    - The down payment for the purchase of a primary residence or business.

- Supplemental retirement income: Unlike pre-tax retirement accounts which are subject to required minimum distributions (see below), life insurance has no such schedule – cash values may be accessed at any point in time as needed, offering flexibility to the policy owner.

The policy may be elected to be 'paid-up' after a certain number of years, rather than having to pay premiums for life. Also, policy loans are generally not taxable and may **(a)** enable one to delay selling an appreciated asset which would trigger a taxable gain; **(b)** allow for an asset to continue to be invested at a higher rate of return; **(c)** provide funds to pay the taxes on a Roth conversion and **(d)** even pay expenses in a year with lower than expected income.

- **Compensating for the loss of value associated with income taxes**

Under The American Taxpayer Relief Act of 2012, income tax rates were raised for those in higher marginal tax brackets. Additionally, higher taxes were imposed on the receipt of dividends and capital gains for those in higher tax brackets, along with new taxes which commenced last year on those earning above certain adjusted gross income limits (including a 3.8% investment income tax and 0.9% Medicare surcharge tax).

IRD assets made whole

- Income in respect of a decedent (or "IRD") is income that was owed to a decedent at the time he or she died. Common examples of IRD include retirement accounts/ IRA distributions, annuity payments, a final pay check, etc. Although beneficiaries often receive most assets of the estate income-tax free, IRD assets are generally taxed at the beneficiaries' ordinary income tax rates (there is an IRD tax deduction available for beneficiaries wherein the decedent owed federal estate tax; however, this is an entirely separate topic). This is because IRD assets do not receive a step-up in basis to fair market value at the decedent's death (unlike non-IRD assets).
  - Given the above, an individual may acquire permanent life insurance in order to replace the IRD assets so the beneficiary(ies) receives the full value of the inheritance (they are "made whole"), rather than merely the pre-tax amount.
- Certain older individuals who are required to take minimum distributions from their pre-tax retirement accounts may not need or wish to take out all of the monies required each year. In this case, why not use the excess funds to acquire permanent life insurance? When the account owner dies, the beneficiary(ies) will need to continue taking RMDs (the sole exception is a surviving spouse who is not yet 70 ½, as he or she may roll the IRA into his or her own name and does not need to commence RMD's until he or she turns 70 1/2). When RMDs are taken the amount gets included in taxable income for the year and is subject to federal and state income taxes. In order to preserve the value of the pre-tax retirement accounts (having the gross equal the net for the beneficiary(ies)), permanent life insurance may be used to compensate for the amount lost to taxation each year.

        - Often times there is a 'tax spiral' when it comes to pre-tax retirement accounts (particularly inherited IRAs). In order to provide the estate with liquidity to cover estate taxes, in conjunction with income taxes owed on the mandatory distributions, it is possible to lose between 60% and 80% of the value of the pre-tax retirement accounts to taxes because there may not be any liquidity to cover the tax liabilities, requiring more of the IRAs to be liquidated (further accelerating the income tax liability). What an awful occurrence which could have been prevented by obtaining life insurance owned in a preferred manner.

- **Create a dynasty of wealth**

    - By having life insurance owned in a dynasty trust, the death benefit avoids all transfer taxes (estate, gift and generation-skipping). The dynasty trust, irrevocable in nature, funded with permanent life insurance offers liquidity to cover any estate taxes, administrative expenses, etc. There are big potential tax savings by making use of the annual gift tax-free allowance ($14,000/donee/year in 2014) and lifetime gift-tax exemption ($5.34 million in 2014) in order to avoid or reduce estate taxes.

        - Many permanent insurance policies offer competitive internal rates of return on a projected basis. Remember, the cash values grow on a tax-deferred basis; accordingly, a 5.00% internal rate-of-return on the cash value over a number of years for someone in a combined federal and state marginal tax bracket of 40% is a tax-equivalent average rate of return of 8.33%. This is a competitive return on an asset that is principally invested by the insurer in diversified income-oriented investments.

            - An individual who is insured with permanent life insurance, such as whole life, may be able to invest the rest of his assets more aggressively, knowing he has **(1)** guaranteed cash values, **(2)** non-guaranteed cash values which may perform better or worse than illustrated based upon the dividend rate (incorporating investment returns, mortality charges and administrative expenses) declared each year, **(3)** a guaranteed death benefit and **(4)** potentially growing death benefit (if dividends are used to buy paid-up additional coverage).

            - Since permanent insurance has a guaranteed and non-guaranteed component, and with interest rates at historically low levels, now may be an opportune time to acquire permanent life insurance since one could reasonably assume interest rates will rise over the next twenty to thirty years (as compared with the past twenty to thirty year period which has seen interest rates throughout the yield curve decline– causing a stain on many policies).

- **Enable a business to grow or stay in existence and continue with new owners**

    - **Insuring key employees**

        - Every organization has at least one, and often more than one, key employee. This may be an owner, manager, key salesmen or anyone possessing specialized knowledge and expertise. What would be the value lost to the business in the event of this individual's untimely death? Whether based upon **(1)** a multiple of compensation, **(2)** contribution to gross or net profits, **(3)** the cost to replace the employee, or some other metric/formula, life insurance is a great funding mechanism to enable the entity to remain afloat while enacting its contingency plans.

- As merely one example of a possible arrangement, a company may be the owner of a permanent life insurance policy on the life of a key employee. The cash value would be reflected as a corporate asset on its balance sheet and the employee would not have access to it. The employee would also have to pay tax on the premium paid by the business (which is considered imputed income), although the company may loan the tax to the employee so he/she has no out-of-pocket expense. The non-guaranteed dividends may be used to help cover the tax liability. This type of set-up provides golden handcuffs for the employee in that he or she would need to remain with the company in order for the owner and/or beneficiaries to receive any portion of the growing cash value and/or death benefit.

- Return of premium term life insurance, wherein the cumulative premiums paid during the policy term are refunded to the business, would provide a company with coverage for a specified period of time. To the extent the employee does not pass away during the term, the company may use the return of premium to pay the key employee upon his or her retirement as part of a deferred compensation package.

- **Insuring the future viability of the business**

  - Any business with more than one owner should have a Buy/Sell Agreement within a Shareholders (or Partnership/Members) Agreement that addresses, among other things, various triggering events which would require the mandatory purchase of an owner's shares and mandatory sale of a different owner's shares at an agreed upon valuation. One such triggering event would be the death of an owner in order to ensure that the decedent's beneficiaries receive fair value for his or her ownership interest and the continuing owner(s) increases his, her or their ownership in the firm. Among other things, the Buy/Sell Agreement **(a)** guarantees a buyer; **(b)** establishes a fair price based upon the specific triggering event; **(c)** defines the terms of purchase; **(d)** assures a smooth transition and **(e)** provides confidence to employees, creditors and other stakeholders that the business will continue in a relatively uninterrupted manner.

    - When adequately funded with life insurance, each respective owner can rest assured that, no matter what transpires in the future, both the business and the deceased owner's family will be taken care of in a satisfactory, pre-agreed upon manner.

There are countless other examples of how **life insurance** may be utilized to best satisfy a given need (such as providing financial protection to a spouse and children, serving as collateral for one or more loans of a business, as part of a combination policy with long-term care insurance and being incorporated as part of a divorce settlement). Whether using term, permanent or a combination of both types, the importance of planning with **life insurance** and the advantages associated therein should not be overlooked. As an independent producer and strategic consulting firm, **LIFECO ASSOCIATES, INC.** remains available to work with you on any personal or business life, disability and/or long-term care insurance cases.