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Life Insurance: The Most Misunderstood Widely Held Investment

Three Magical Things about Life Insurance

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- Do not need estate tax inclusion for a Step-Up in basis
- In almost all jurisdictions, there is automatic asset protection
- It allows instant use of the most powerful force in financial and estate planning: the tax free build up of wealth

TRADITIONAL REASONS FOR ACQUIRING LIFE INSURANCE

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➢ LIFE INSURANCE IS AN ARRANGEMENT UNDER WHICH THE RISK OF DEATH IS SHARED. SOME COMMON REASONS FOR ACQUIRING LIFE INSURANCE INCLUDE:

- TO REPLACE EARNINGS (E.G., SALARY OR PARTNERSHIP INCOME) LOST ON DEATH.
  TO PAY DEBTS OUTSTANDING OR ARISING AT DEATH.
- TO PROVIDE WORKING CAPITAL FOR A BUSINESS TO OFFSET THE ECONOMIC LOSS CAUSED BY THE DEATH OF A KEY PERSON.
- TO FUND AN EMPLOYEE STOCK OWNERSHIP PLAN ("ESOP"), OR OTHER EMPLOYEE BENEFIT ENTITY, TO ALLOW IT TO BUY EMPLOYER SECURITIES (TYPICALLY FROM A DECEASED OWNER'S ESTATE).
- TO FUND A BUY-SELL AGREEMENT (UNDER WHICH THE BUSINESS OR ITS SURVIVING OWNERS MAY OR MUST BUY-OUT THE DECEASED OWNER).
- TO PAY INCOME TAXES ON ASSETS (SUCH AS PENSION PLAN PROCEEDS) WHICH DO NOT ENJOY A STEP-UP IN BASIS AT DEATH.
- TO PROVIDE FLEXIBILITY IN DECIDING WHEN TO SELL ESTATE ASSETS.
- TO BUILD SUFFICIENT WEALTH FOR SURVIVING FAMILY MEMBERS.
- TO SUBSTITUTE FOR AN INTEREST IN A TRUST WHICH WILL NOT PROVIDE BENEFITS AFTER THE INSURED'S DEATH TO HIS OR HER FAMILY MEMBERS.
- TO BUILD WEALTH FOR THE INSURED DURING LIFETIME (“RIDING THE BLUELINE”)
- TO PROVIDE A HEDGE TO OTHER SIGNIFICANT ESTATE PLANNING STRATEGIES (E.G., GRATS, INSTALLMENT SALES, GRANTOR TRUSTS, QPRTS)
- TO "COVER" DEATH TAX AND OTHER EXPENSES RELATED TO DYING.

BUILDING AN EFFECTIVE LIFE INSURANCE TRUST

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1. UNDERSTANDING WHEN LIFE INSURANCE PROCEEDS ARE SUBJECT TO ESTATE TAX. CODE SEC. 2042. ITS EASY TO AVOID IF KNOWN BEFORE ACQUISITION.
2. WHAT TO DO IF IT "DISCOVERED LATER": AVOIDING THE TRANSFER-WITHIN-THREE-YEARS-OF-DEATH RULE OF CODE SEC. 2035.

- A. CODE SEC. 2035 EXCEPTION: A BONA FIDE SALE FOR FULL AND ADEQUATE CONSIDERATION.
- B. ALLEN, 293 F.2D 916 (10TH CIR 1961).
- C. PLR 94-13-045 (NOT PRECEDENT).
- D. FULL VALUE OF A LIFE INSURANCE POLICY. REG. §25.2512-6 ("INTERPOLATED TERMINAL RESERVE"). CF. PRITCHARD, 4 TC 204 (1944).
- E. GAIN RECOGNITION. BASIS (LONDON SHOE V. PLR 94-43020(NOT PRECEDENT). CF. | VIATICAL/LIFE SETTLEMENTS. GRANTOR TRUSTS. CASH GIFTS FIRST. SPOUSAL CREATED TRUST. REV. RUL. 76-103. ALASKA, DELAWARE, UTAH, NEVADA, RHODE ISLAND TRUSTS.

F. NOTES. INTEREST INCOME/NO INTEREST DEDUCTION. GRANTOR TRUST. SPOUSAL CREATED TRUST.

- AFR INTEREST. NO INCIDENT OF OWNERSHIP.

3. GIFT TAX CONSIDERATIONS. ANNUAL EXCLUSION. PRESENT INTEREST. IMPORTANCE OF TRUSTS: "CRUMMEY POWERS."
4. DIRECT PAYMENT OF PREMIUMS.
5. "HANGING POWERS".
6. GENERATION-SKIPPING TRANSFER TAXATION: "CASCADING CRUMMEY POWERS".
7. "CRUMMEY POWER" NOTICES. REV. RUL. 81-7. WAIVERS OF NOTICES. *TURNER*: NO NOTICE REQUIRED AND MAYBE NOT EVEN KNOWLEDGE
8. "FALL BACK" MARITAL DEDUCTION. QTIP.
9. CHOICE OF TRUSTEE(S). DIFFERENT TRUSTEES FOR DIFFERENT POSITIONS.
10. JOINT TRUSTS. SECOND TO DIE POLICIES: NOT THE BEST IDEA.
11. PROPOSED CHANGES IN CONGRESS: CRUMMEY POWERS.

A CHART ILLUSTRATION OF AN EXAMPLE OF TERM INSURANCE (e.g., FOR ONE YEAR)

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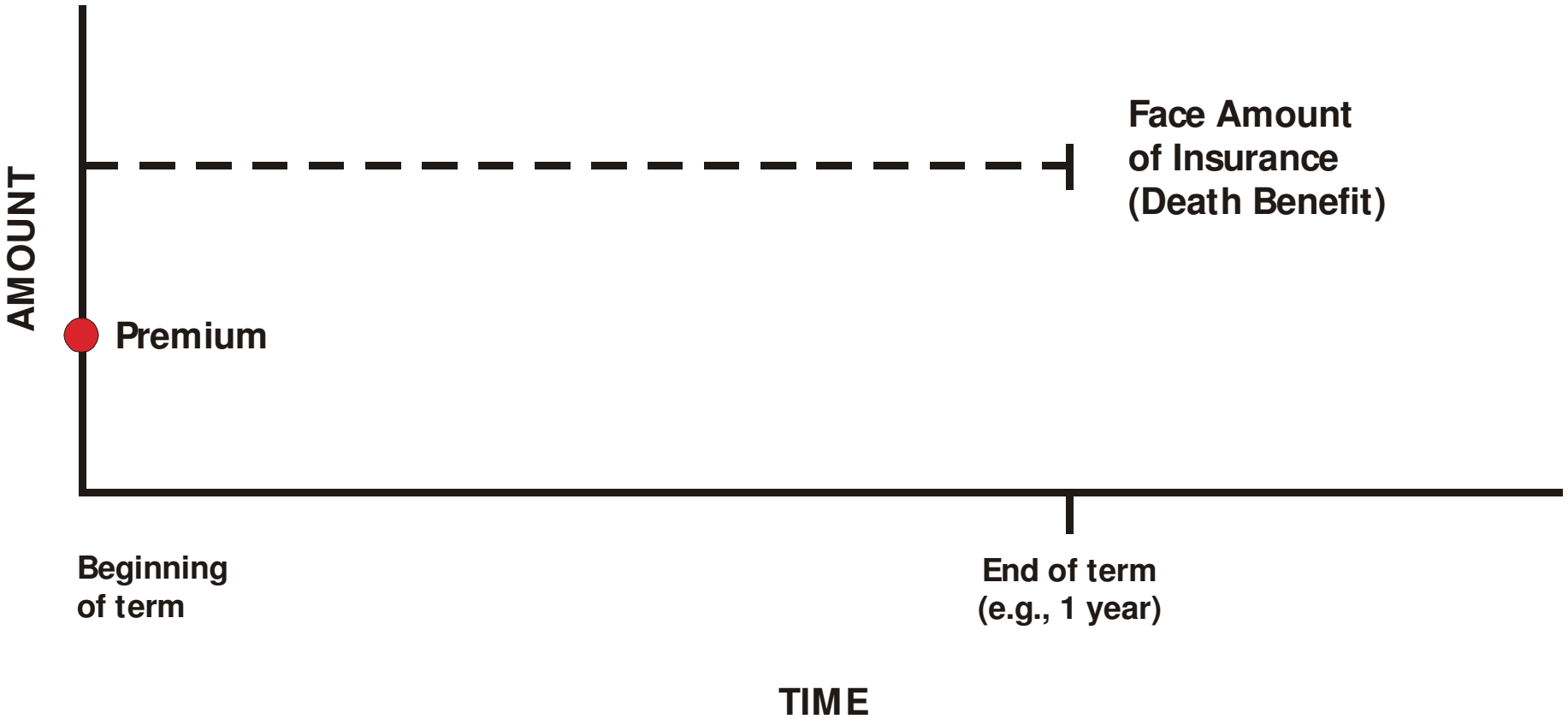
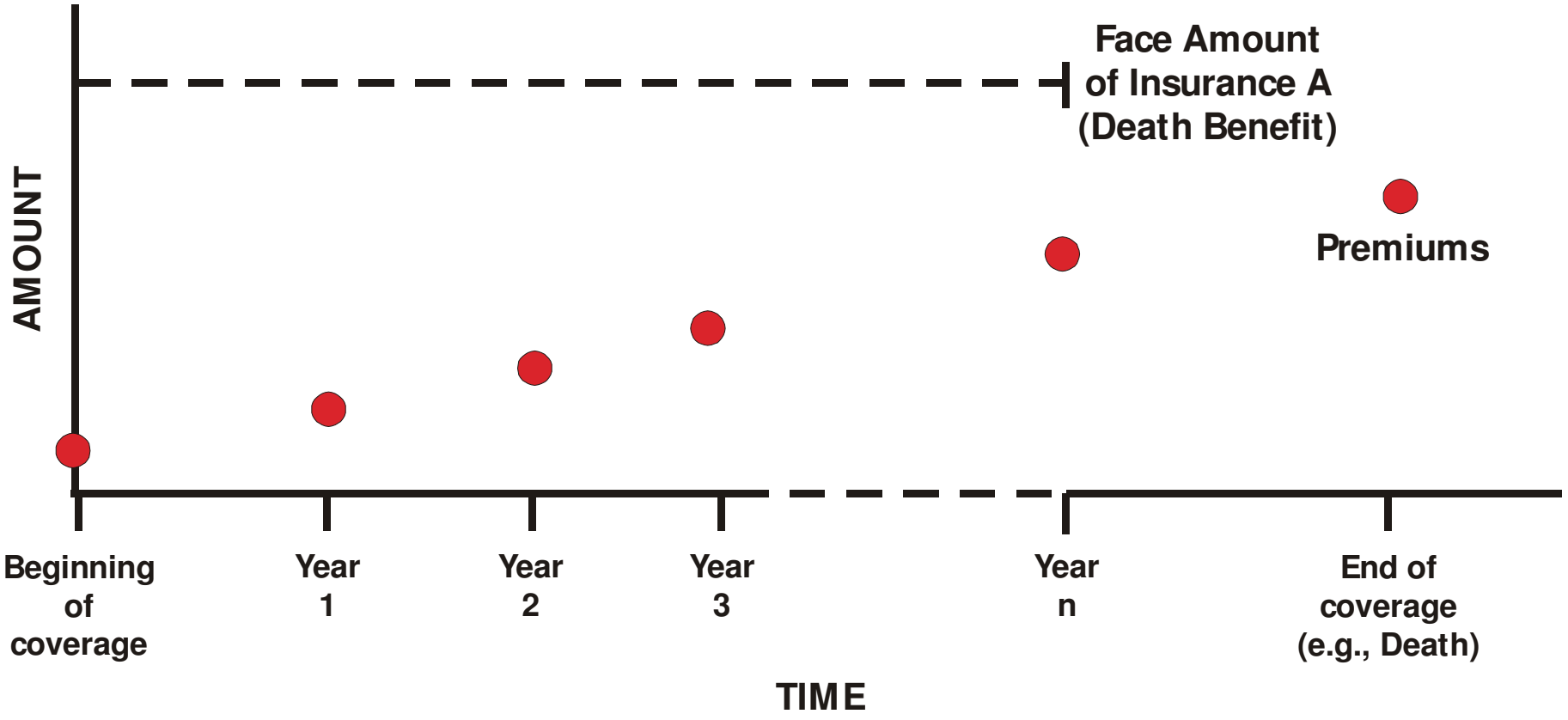


A CHART ILLUSTRATION OF AN EXAMPLE OF RENEWABLE TERM INSURANCE

PIONEER WEALTH PARTNERS



A CHART ILLUSTRATION OF AN EXAMPLE OF TRADITIONAL CASH VALUE INSURANCE

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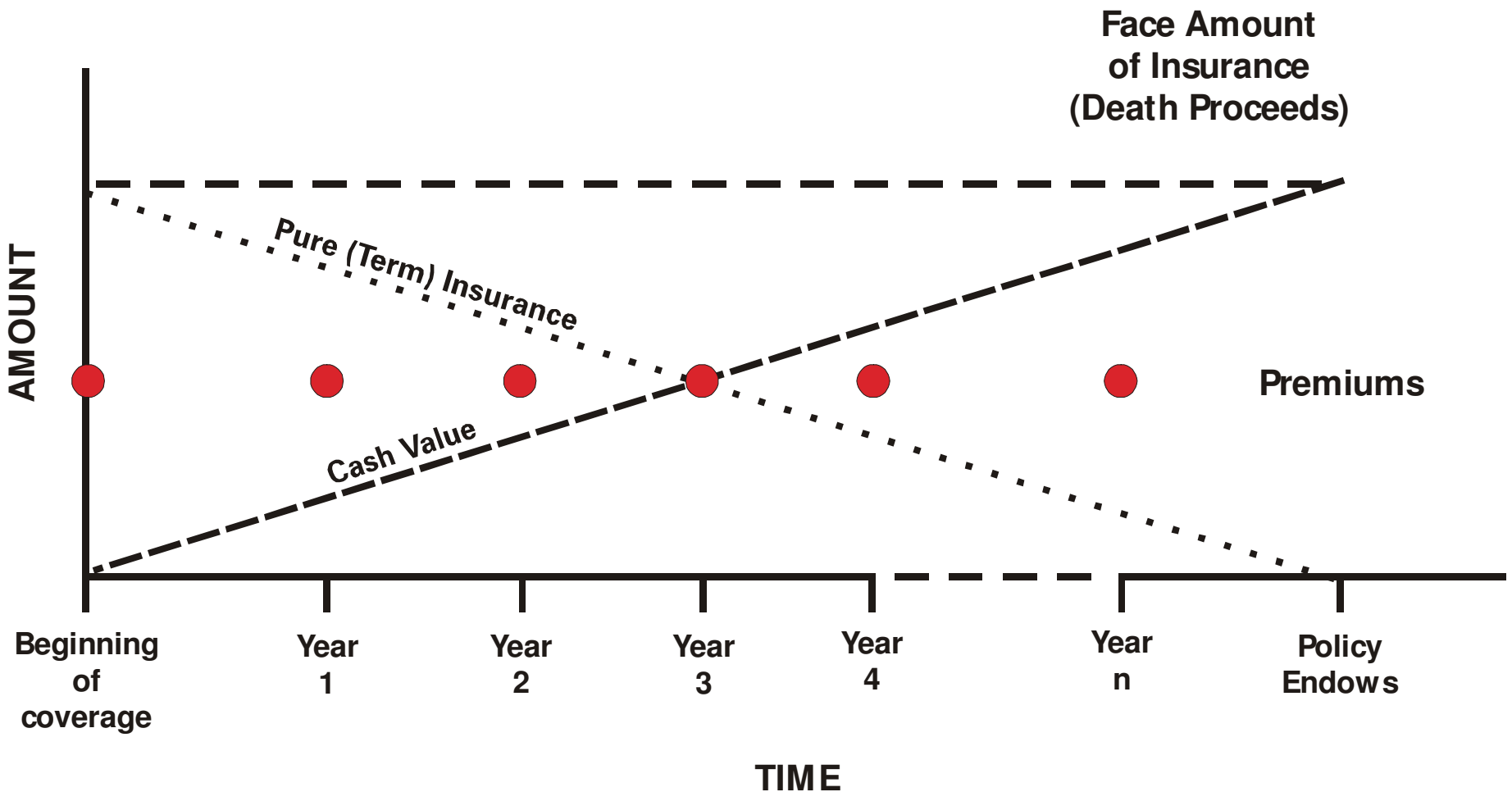

A CHART ILLUSTRATION OF AN EXAMPLE OF UNIVERSAL INSURANCE (ONE MODE)

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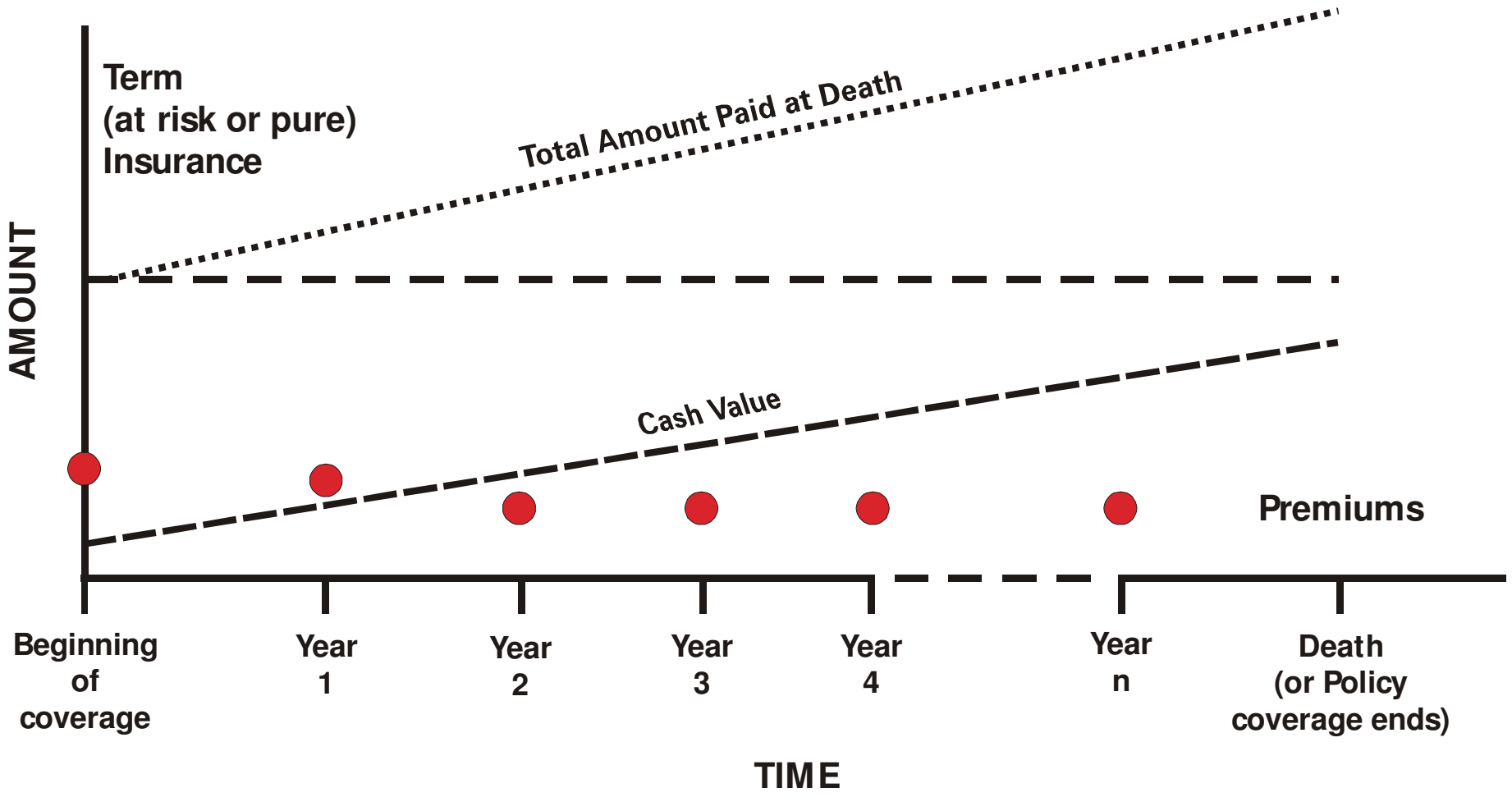

ILLUSTRATION OF MAXIMUM PREMIUMS AND VALUES FOR A $2 MILLION POLICY OF THE LIFE OF A 46 YEAR OLD TO MAINTAIN ITS STATUS AS A LIFE INSURANCE CONTRACT FOR TAX PURPOSES

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- **MAXIMUM PREMIUMS PAYABLE TO AVOID LOSING LIFE INSURANCE CONTRACT STATUS**

Policy Year	*Age (Beginning of Year)*	*Per Year*	*Total Cumulative*	*Maximum Cash Value Allowed to Avoid Losing Life Insurance Contract Status*
1	46	$478,567	$ 112,674	$ 1,834,862
2	47	0	225,348	1,941,748
3	48	0	338,022	2,061,856
4	49	0	450,696	2,197,802
5	50	15,840	494,406	2,352,941
6	51	98,881	593,287	2,564,103
7	52	98,881	692,169	2,816,901
8	53	98,881	791,050	3,125,000
9	54	98,881	889,931	3,508,772
10	55	98,881	988,812	4,000,000
11	56	98,881	1,087,693	4,347,826
12	57	98,881	1,186,575	4,761,905
13	58	98,881	1,285,456	5,263,158
14	59	98,881	1,384,337	5,882,353
15	60	98,881	1,483,218	6,666,667
16	61	98,881	1,582,099	7,142,857
17	62	98,881	1,680,981	7,692,308
18	63	98,881	1,779,862	8,333,333
19	64	98,881	1,878,743	9,090,909
20	65	98,881	1,977,624	10,000,000

ILLUSTRATION OF PAYING FOR THE TERM INSURANCE ELEMENT WITH PRE-TAX POLICY EARNINGS

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Policy Year	*Age (Beginning of Year)*	*Insurance Amount*	*Premium*	*Projected Earnings on the Cash Value at 7.5%*	*Cost of Term Insurance*
1	46	$2,000,000	$108,356	$ 7,787	$ 6,323
2	47	2,000,000	0	8,064	4,266
3	48	2,000,000	0	8,329	4,636
4	49	2,000,000	0	8,583	5,116
5	50	2,000,000	0	8,830	5,433
6	51	2,000,000	0	9,069	5,816
7	52	2,000,000	0	9,296	6,256
8	53	2,000,000	0	9,504	6,756
9	54	2,000,000	0	9,687	7,316
10	55	2,000,000	0	9,838	7,996
11	56	2,000,000	0	9,949	8,676
12	57	2,000,000	0	10,013	8,436
13	58	2,000,000	0	10,024	10,256
14	59	2,000,000	0	9,973	11,096
15	60	2,000,000	0	9,851	12,036
16	61	2,000,000	0	9,654	12,856
17	62	2,000,000	0	9,382	13,636
18	63	2,000,000	0	9,034	14,376
19	64	2,000,000	0	8,603	15,116
20	65	2,000,000	0	8,079	16,016
Total			108,356	183,547	183,547

The Effect Of Compounding

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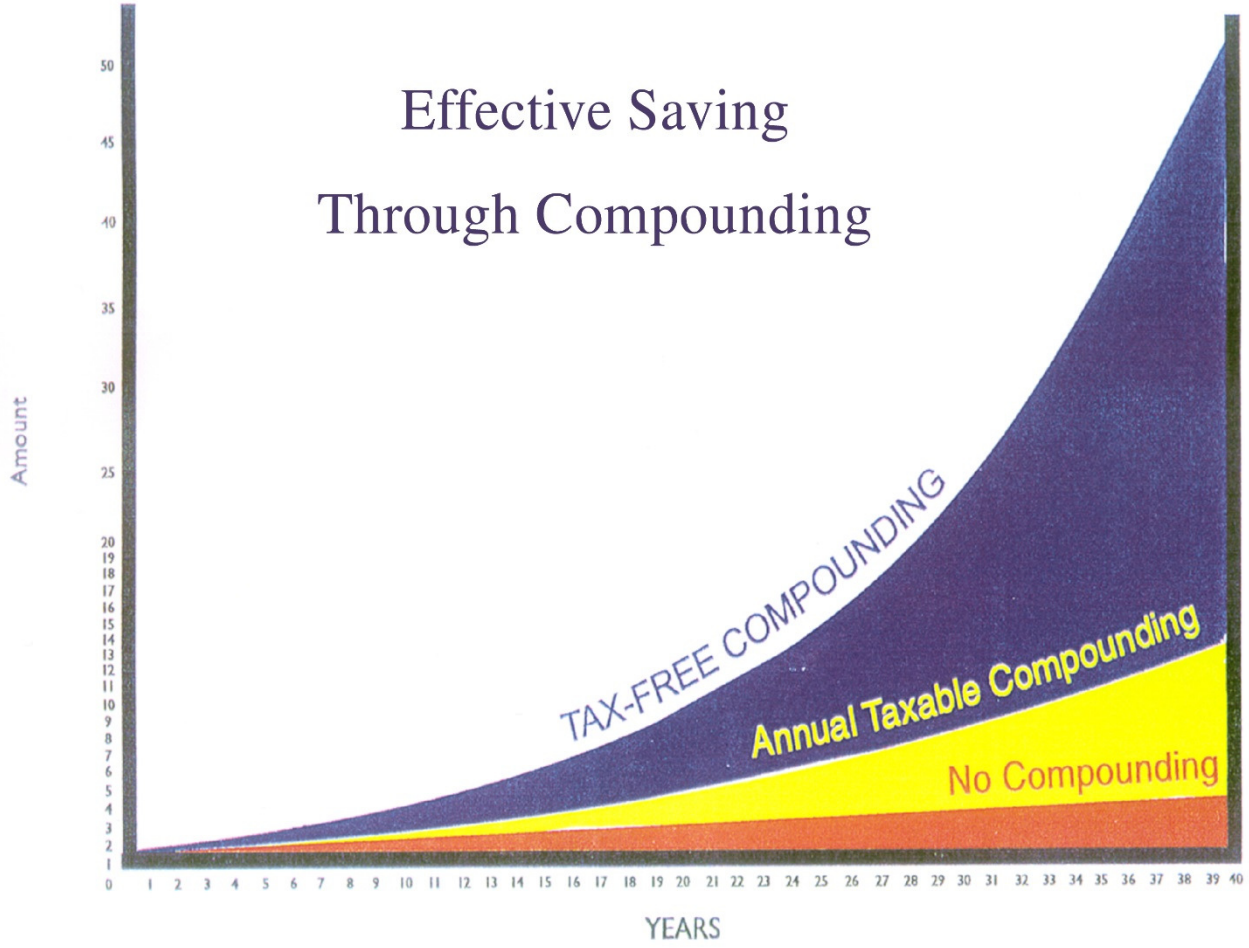
$100,000 invested using a Taxable 10% rate the assumed income tax rate is 40%

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
End of Year	Net Amount With Current Taxation	Gross Amount by Deferral (Before Taxation)	Benefit of Deferral Before Tax [(3)-(2)]	Percentage Increase in Wealth Base (Before Tax) [(4)÷(2)]	Tax Deferred Income	Net Amount After Tax on Deferred Income [(3)-(6)]	Percentage Increase in After-Tax Wealth Base [(7)÷(2)]	Growth of 97% of Investment (Reflecting DAC and State Premium Tax) with Earnings at 9.5% (Reflecting Additional 50 Basis Point Management Fee)
1	$ 106,000	$ 110,000	$ 4,000	$ 3.7%	$ 4,000	$ 106,000	0.0%	106,215
2	112,360	121,000	8,640	77.8%	8,400	112,600	0.21%	116,305
3	119,102	133,100	13,998	11.75%	13,240	119,860	0.64%	127,354
4	126,248	146,410	20,162	15.97%	18,564	127,846	1.265%	139,453
5	133,822	161,050	27,228	20.35%	24,420	136,630	2.098%	152,701
10	179,085	259,370	80,285	44.83%	63,748	195,622	9.234%	240,388
20	320,713	672,750	352,037	109.767%	229,100	443,650	38.33%	595,736
30	574,349	1,744,940	1,170,591	203.812%	697,976	1,046,964	82.29%	1,476,369
40	1,028,571	4,525,925	3,497,354	340.021%	1,398,942	3,126,983	204.01%	3,658,779

Effective Saving Through Compounding



Returns and Taxation – What the Numbers Tell Us

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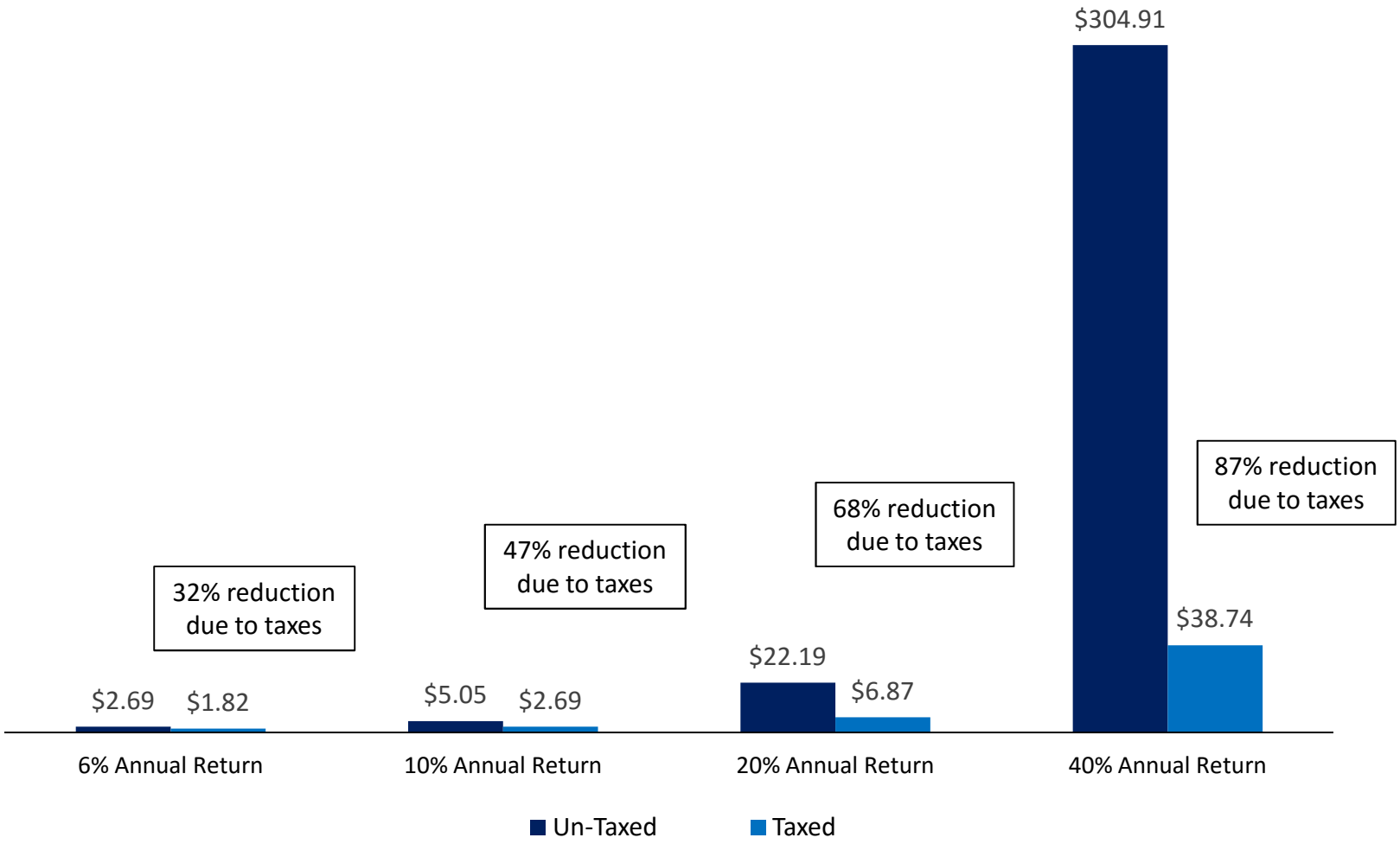
The Effects of Taxation on Compounded Returns After 17 Years



Private Placement Life Insurance

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- Is the cost worth the effort?
- Blattmachr's Formula: **Anticipated Annual Cost** (in BPs) divided by **Anticipated Annual Income Tax Rate** (in BPs) **must** be greater than the **Anticipated Annual Return** on the investment
  - Example: Anticipated Annual Cost (e.g., 100 BPs) divided by the Anticipated Annual Income Tax Rate (e.g., 40 BPs) equals the minimum threshold (e.g., 2.5 or rate of anticipated annual return should be higher than 2.5%)
  - Another Example: Fund's Anticipated Annual Return: 30%. Anticipated income tax: 45%.
  - The difference is having $4.61 for each dollar invested outside the policy vs. $12.76 inside the policy, after ten years
- Moral: **The higher the return and/or the higher the tax rate, the more powerful the private placement chassis becomes**

Index Performance Example

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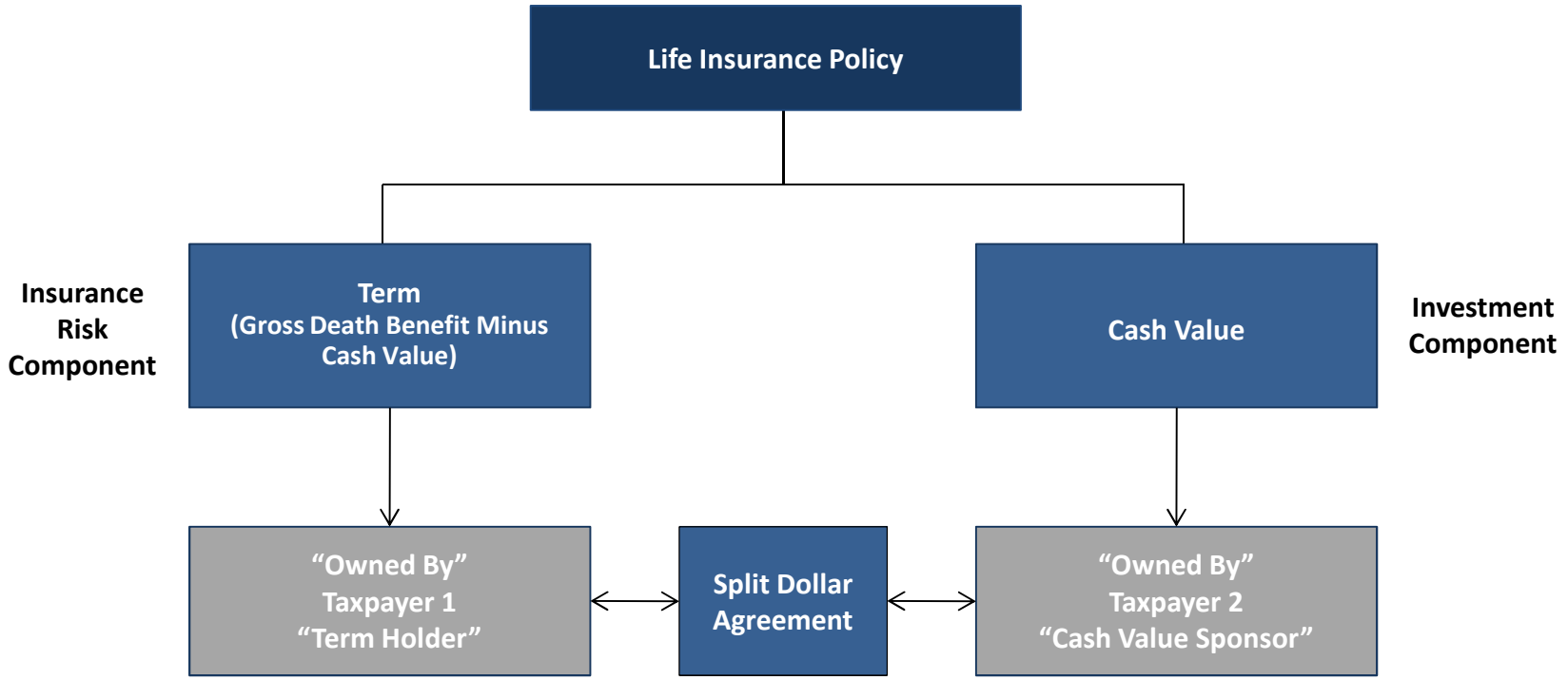
Calendar Year	S&P 500 Index Growth	Hypothetical Interest Credited	Rolling 5 year Averages	Rolling 4 year Averages	Rolling 3 year Averages
1985	26.23%	13.00%			
1986	17.50%	13.00%			
1987	-1.54%	0.00%			8.67%
1988	12.88%	12.88%		9.72%	8.63%
1989	27.95%	13.00%	10.38%	9.72%	8.63%
1990	-5.93%	0.00%	7.78%	6.47%	8.63%
1991	15.87%	13.00%	7.78%	9.72%	8.67%
1992	13.83%	13.00%	10.38%	9.75%	8.67%
1993	6.41%	6.41%	9.08%	8.10%	10.80%
1994	-1.73%	0.00%	6.48%	8.10%	6.47%
1995	35.49%	13.00%	9.08%	8.10%	6.47%
1996	20.88%	13.00%	9.08%	8.10%	8.67%
1997	28.10%	13.00%	9.08%	9.75%	13.00%
1998	23.52%	13.00%	10.40%	13.00%	13.00%
1999	20.24%	13.00%	13.00%	13.00%	13.00%
2000	-5.49%	0.00%	10.40%	9.75%	8.67%
2001	-14.99%	0.00%	7.80%	6.50%	4.33%
2002	-22.43%	0.00%	5.20%	3.25%	0.00%
2003	23.18%	13.00%	5.20%	3.25%	4.33%
2004	10.47%	10.47%	4.69%	5.87%	7.82%
2005	5.63%	5.63%	5.82%	7.28%	9.70%
2006	12.16%	12.16%	8.25%	10.32%	9.42%
2007	2.43%	2.43%	8.74%	7.67%	6.74%
2008	-39.37%	0.00%	6.14%	5.06%	4.86%
2009	23.81%	13.00%	6.64%	6.90%	5.14%
2010	13.39%	13.00%	8.12%	7.11%	8.67%
2011	-2.18%	0.00%	5.69%	6.50%	8.67%
2012	18.75%	13.00%	7.80%	9.75%	8.67%
2013	25.35%	13.00%	10.40%	9.75%	8.67%
2014	13.91%	13.00%	10.40%	9.75%	13.00%
2015	-0.94%	0.00%	7.80%	9.75%	8.67%

The Basics Of Split Dollar



The Split Dollar Concept:

"Joint ownership" of a life insurance policy

One party "owns" the death benefit – "Term Holder"

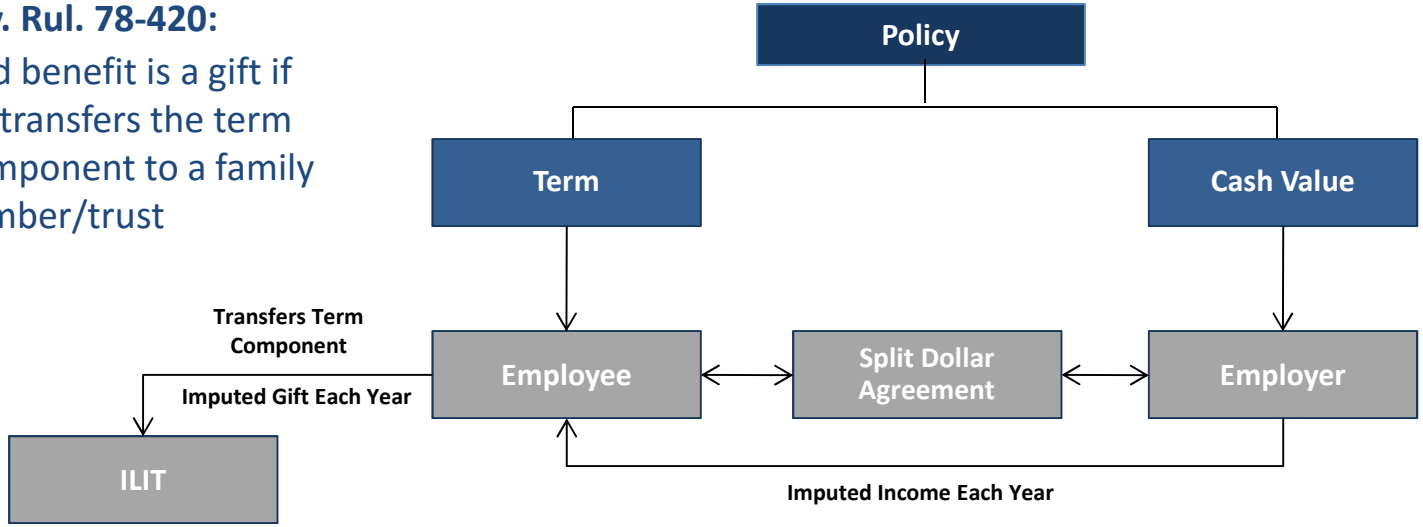
Another party "owns" the cash value (or premiums paid if greater) – "Cash Value Sponsor"

Each party pays for that party's respective share of the premium or one party is treated as conferring a benefit on the other

Development of Family Split Dollar

- **Rev. Rul. 78-420:**

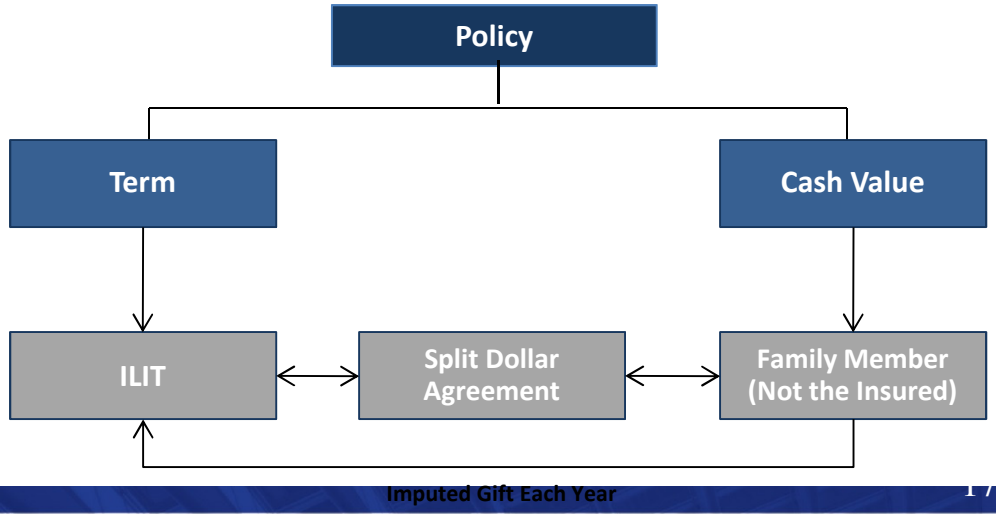
The imputed benefit is a gift if the insured transfers the term insurance component to a family member/trust



- **The Legend of Morris**

- **Private Letter Ruling 9636033:**

Split dollar principles apply where the arrangement is between a family member and an insurance trust (not precedent)



Intergenerational Split Dollar

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- Economic Benefit (as Described in Rev Rul 64-328)
- Old Generation “Owns” the Cash Value Portion (by Collateral Assignment) to be Repaid (Equal to the Greater of Premiums Paid or Cash Value) upon Death of Younger Generation Insured
- Allegedly a Gift Equal to Table Rate Value of the Annual Insurance Coverage to the Party that Holds the Net Amount at Risk (Total Death Benefit Payable If Insured Dies that Year reduced by the Greater of to Which the Older Generation Is Entitled to)
- How the Policies “Work”
- If Older Generation Dies Before the Insured, the Gross Estate of the Older Generation Allegedly Includes the Present Value of the Right to Receive the Great
- Morrisette: What It Says and Doesn’t Say

Five Ideas for Life Insurance

- "Shark Fin" Grantor CLAT Funded with Life Insurance
- Problems:
  - Section 170(f)(10)
  - Recapture Under the Code
  - Recapture at Death Under Regs
  - Small Payments Allowed?
- A Way that Works: Multi-Life Policy

Preserving Benefit of Use of $5 Million Exemption

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- Use the Exemption Early
- Bummer If Declines Below $5MM
- Insurance on Grantor's Life to Avoid Loss If Trust Declines

Preserving the Benefit of Roth IRA Conversion for Successors

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- When Roth IRA Conversions Work
  - What Do You Want to Inherit?
    - Targeting Grandchildren
- Preserving the Maximum "Stretch" for Minimum Required Distributions

Hedging Selected Estate Planning Strategies

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- GRATs
- QPRTs
- Installment Sales to Grantor Trusts
- They Need Time and Death Spoils the Party

Comment

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- People always want the most for the price
- But, almost always, acquiring the policy with the maximum initial death benefit for premium paid will prove to be less efficient over time.
- The likely best alternative is a policy with an initial minimum death benefit and maximum initial cash value.

Comment (cont'd)

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- Why Large Policies?
- Perception of an unacceptable erosion of wealth upon the owner's death on account of the imposition of estate tax or other debts
- Typically, the death benefit under the policy is selected by running numbers
- In most cases, however, buying life insurance to pay for estate tax often will be perceived as a wasteful decision if there is no such tax in effect when the insured dies.

Comment (cont'd)

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- Importance of Timing of Death and Life Insurance
- Even if no estate tax is in effect when the insured dies, the purchase of the life insurance policy likely would be viewed as a financially efficient decision if the insured dies earlier than the insurance company had forecast
- Forecasting When Death Will Occur. Example, on average, most insurers will forecast that a healthy 60 year old male will die in in 26 years. If that happens, on average, insurance policies have an approximate six percent return
- Earlier death, greater return
- Later death, poorer return

Comment (cont'd)

- Other Factors to Consider:
- The vast majority of policies are cancelled before the insured dies. One reason for this is that most life insurance policies become less efficient over time.
  - Human longevity has constantly increased and, therefore, the cost or level of the insurance premiums (on newly issued policies) for each age decreases. A new policy may be less expensive (lower premiums) if health has not declined.
  - If the insured lives "too long," of the insurance (the amount of premium or the charge "inside" the policy) increases significantly.

Comment (cont'd)

- Buy Term Insurance Instead?
- The Truth about Term Insurance (Net Amount at Risk)
- Cash Value Life insurance Always Includes a Term Component As Well As a Cash Value (Investment) Component.
  - Some Policies Have the Term Component Decline (with Cash Value Being "Substituted")
  - Some Policies Permit the Term Component to be Maintained

Comment (cont'd)

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- Limitations or Drawbacks of Term Insurance
  - Cost of Term Insurance Becomes Extremely High at Older Ages
  - Few Companies Offer Term Insurance After Age 80
- Funding Estate Taxes:
  - A life insurance policy is a sinking fund
  - Average Annual Return Is About Six Percent
  - Almost Always the Amount of Insurance Is Too Low as Wealth Will Increase (Einstein's Most Important Observation)

Comment (cont'd)

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- Role of Insurance
- A Balanced Plan Must Take Into Account Several Factors in Addition to Insurance
- Foremost: Other Estate Tax Planning Arrangements
- Many of These Arrangements Will Fail with an Early Death

Comment (cont'd)

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- Type of Policy to Acquire
- Choices:
  - Term
  - High Death Benefit/Low Cash Value
  - Guaranteed Death Benefit/Low Cash Value
  - Minimum Initial Death Benefit/Maximum Cash Value
- The Constant Important of Cash Value and Its Growth

*In the cash value of high death benefit policies erodes over time as compared with other with lower initial death benefit policies**

Age	Year	POLICY A		POLICY B		POLICY C	
		Current Cash Surrender Value	Minimum Death Benefit	Current Cash Surrender Value	Maximum Death Benefit	Current Cash Surrender Value	Maximum Guaranteed Death Benefit
51	1	$4,540,525	$14,615,640	$4,249,500	$22,610,000	$3,782,753	$25,609,897
55	5	5,667,847	15,541,063	5,344,487	22,610,000	4,299,462	25,609,897
60	10	7,393,223	16,724,133	6,971,579	22,610,000	4,958,611	25,609,897
80	30	17,570,340	23,713,634	14,534,208	22,610,000	447,378	25,609,897
85	35	20,971,721	26,063,864	16,492,859	22,610,000	-	25,609,897
90	40	24,333,718	28,432,247	17,926,001	22,610,000	-	25,609,897
95	45	27,771,092	31,133,338	18,914,483	22,610,000	-	25,609,897
100	50	31,666,640	34,491,304	19,725,975	22,610,000	-	25,609,897

* Assume a $5 million single premium universal life policy for a male age 50

— *Jonathan G. Blattmachr*

Summary and Conclusions

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- Life Insurance Is Uniquely Treated in Three Ways
- Tax Free Compounding Is the Most Powerful Force in Financial Planning
- Whether Investing in Life Insurance Will Increase Wealth Depends Upon Many Factors
- Start with the Blattmachr Formula: Cost (in BPs) Divided by Anticipated Annual Tax Rate on the Return
- For Long Term Held Insurance, Get the Highest Cash Value Policy