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The Need for Responsible Planning

What If You Were to Die Today?

Many individuals recognize the benefits of planning for the future. Such efforts often uncover problems and frequently provide the motivation to make needed changes. For the most part, the issues involved are positive and enjoyable (e.g., retirement, well-educated children).

However, planning for the unexpected – known as risk management – can be less pleasant. A key part of risk management is answering the question, “What if I were to die today?” Preparing for an untimely death is often referred to as “survivor benefit planning.” A subset of estate planning, it addresses the need to keep one’s family in their current world, financially.

Understandably, no one likes to contemplate his or her own demise. For some, death seems a distant, future event. Others are simply too “busy.” Whatever the reason, delaying this part of planning can result in expensive, unintended, even tragic consequences.

Survivor Benefit Needs

The ultimate purpose of survivor benefit planning is twofold: (1) to ensure that the ongoing income needs of the survivor(s) are met, and (2) to provide for immediate lump-sum cash needs.

- **Income needs:** How much income will the survivors need, now and in the future, to cover the following:
  - **Household living expenses:** Will the family stay in the same house? Can they afford to? Do they want to? Will they have the option?
  - **Additional childcare:** Will there be a need for more help with young children?
  - **Educational expenses:** Will there be enough money for the children to go to college?

- **Lump-sum needs:** How much will the survivors need immediately and in cash? Consider the following:
  - **Final expenses:** More than the funeral, this includes unpaid medical bills, which, after a long illness, can be substantial.
  - **Estate settlement costs:** Probate expenses, attorney's fees, death taxes, etc.
  - **Mortgage payoff and debt reduction:** Will it be important to provide a paid-off house? Are there debts that should be retired?

One Final Question

If you died today, would your plan be ready?

General Purposes of Life Insurance

Life insurance is a unique asset that can be used to help solve some of life's perplexing financial problems.

Death Benefit Uses for Life Insurance

- Create an estate: Where time or other circumstances have kept the estate owner from accumulating sufficient assets to care for his or her loved ones, life insurance can create an instant estate.
- Pay death taxes and other estate settlement costs: These costs can vary from a low of three to four percent to over 40 percent of the estate. Federal Estate Taxes are due nine months after death.
- Fund a business transfer: Business owners often agree to buy a deceased owner's share from his or her estate after death. Life insurance provides the ready cash to finance the transaction.
- Pay off a home mortgage: Many people would like to pass the family residence to their spouse or children free of any mortgage. Often a decreasing term policy is used, which decreases in face amount as the mortgage balance is paid down.
- Protect a business from the loss of a key employee: Key employees are difficult to attract and retain. Their untimely death may cause a severe financial strain on the business.
- Replace a charitable gift: Gifts of appreciated assets to a charitable remainder trust can provide income and estate tax benefits. Life insurance can be used to replace the value of the donated assets. Proceeds from life insurance policies can also be paid directly to a charity.
- Pay off loans: Personal or business loans can be paid off with insurance proceeds.
- Equalize inheritances: When the family business passes to children who are active in it, life insurance can give an equal amount to the other children.

- Accelerated death benefits: Federal tax law allows a "terminally ill" individual to receive the death benefits of a life insurance policy on his or her life income tax free. Such "living benefits", received prior to death, can allow a person to pay medical bills or other expenses and maintain his or her dignity by not dying destitute. If certain conditions are met, a "chronically ill" person may also receive accelerated death benefits free of federal income tax.[1]

  Existing life insurance policies should be reviewed to verify that policy provisions allow for payment of such "accelerated death" benefits.

Other Uses for Life Insurance

While life insurance products are primarily used for death benefit protection, they are also used for long-term accumulation goals.

- College fund for children or grandchildren: Cash value increases in a policy on a minor's life (or the parent's life) can be used to fund college expenses.

- Supplement retirement funds: Many current insurance products provide competitive returns and may be a prudent way of accumulating additional funds for retirement.

Available cash values may also serve as an "emergency reserve," if needed, or a source of loans, since life policies frequently include features permitting borrowing against these cash values [2]

[1] The discussion here concerns federal income tax law; state or local tax law may vary.

[2] A policy loan or withdrawal will generally reduce cash values and death benefits. If a policy lapses or is surrendered with a loan outstanding, the loan will be treated as taxable income in the current year, to the extent of gain in the policy. Policies considered to be modified endowment contracts (MECs) are subject to special rules.

Types of Life Insurance Policies

In choosing the type of life insurance policy you purchase, consideration must be given to the need which is being filled, e.g., creation of an estate, payment of estate settlement costs (federal and state death taxes, last illness and burial costs, probate fees, etc.), business buy-out, key-man coverage, etc.

Decreasing Term

Level premium, decreasing coverage, no cash value: Used for financial obligations which reduce with time, e.g., mortgages or other amortized loans.

Annual Renewable Term

Increasing premium, level coverage, no cash value: Used for financial obligations which remain constant for a short or intermediate period, e.g., income during a minor's dependency.

Long-Term Level Premium Term

Level premium, level coverage, no cash value: The annual premiums are fixed for a period of time, typically 5, 10, 15 or 20 years. Used for financial obligations which remain constant for a short or intermediate period, e.g., income during a minor's dependency.

Whole Life

Level premium, level coverage, cash values: Cash value typically increases based on insurance company's general asset account portfolio performance. Used for long-term obligations, e.g., surviving spouse lifetime income needs, estate liquidity, death taxes, funding retirement needs, etc.

Single Premium Whole Life

Entire premium is paid at purchase, cash values, level coverage: Provides protection as well as serving as an asset accumulation vehicle.

Universal Life

Level or adjustable premium and coverage, cash values: Cash values may increase, based on the performance of certain assets held in the company's general account. Used for long-term obligations or sinking-fund needs: estate growth, estate liquidity, death taxes, funding retirement needs, etc.

Indexed Universal Life

Level or adjustable premium and coverage, cash values: Cash values may increase, based on the performance of an underlying stock or bond "index." The death benefit may increase or decrease (but not below a guaranteed minimum) depending on investment performance. Used for long-term obligations or sinking fund needs, estate growth, estate liquidity, paying death taxes, funding retirement needs, etc.

Variable Life and Variable Universal Life

Level or adjustable premium, level coverage, cash values: Used for long-term obligations, by those individuals who are more active investors, for estate growth, and death tax liquidity. The death benefit may increase or decrease depending on investment performance. The policy owner directs cash values to a choice of investment accounts (bond, stock, money market, etc.). However, cash values are not guaranteed.

Note: Withdrawals and loans may be available from permanent policies. Withdrawals and policy loans may reduce the death benefit and will reduce the cash value of the policy. There are different income tax consequences if they are modified endowment contracts.

Taxation of Life Insurance Proceeds

Income Taxation

Death proceeds of a life insurance policy are almost always income tax free.

Federal Estate Taxation

Proceeds of a life insurance policy will be included in your estate in two situations:

- If your estate is named as the beneficiary, or
- If you have incidents of ownership in the policy (for example, if you have the power to change beneficiaries, borrow against the cash values, surrender the policy, etc.).

Transfers Within Three Years Prior to Death

If you make a gift of a life insurance policy and then die within three years, the full face amount of the policy will be included in your gross estate for estate tax purposes.

Should You Cross-Own Policies?

Prior to 1982, married couples would frequently own the life insurance policies on each other's life. This technique often kept the insurance from being taxed when the first spouse died.

Since January 1, 1982, however, federal law has provided for an unlimited marital deduction. This means that any amount of assets transferred to one's spouse are not subject to estate or gift taxation. Therefore, any life insurance policies payable to the surviving spouse (no matter which spouse owns them) will not be taxed because of the unlimited marital deduction.[1]

The Problem

When the surviving spouse later dies, his or her estate will have been enlarged by the insurance proceeds collected at the death of the first spouse. Now there may be a substantial tax problem.[2] An irrevocable life insurance trust or ownership of the policies by children or grandchildren can remove the proceeds from the insured's estate, as well as the estate of the surviving spouse.

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[1] The unlimited marital deduction is disallowed for surviving spouses who are not U.S. citizens.

[2] When a person dies, there is an "applicable exclusion amount" available that exempts a certain portion of an estate from federal estate tax. For married couples, any applicable exclusion amount that remains unused at the death of the first-to-die is generally available for use by the surviving spouse, as an addition to his or her own applicable exclusion amount.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.