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Year-End Insurance Planning

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Year-end is a great time to evaluate opportunities to utilize life insurance in various aspects of financial planning. And, carriers are working hard to meet year-end sales objectives which may provide clients with opportunities to obtain improved pricing dynamics.

In this article we address the following strategies:

- Leveraging annual gifts using life insurance
- Taking advantage of the low interest rate environment
- Year-end policy performance reviews

Leveraging Annual Gifts

Under current gift and estate tax law, an individual can give $14,000 per year to any person without gift tax consequences. The gift can be cash, stocks, privately-held business interests or other assets.

Reasons to use the annual gift exclusion:

- The gift reduces the taxable estate
- If the annual gift is not used, it does not carry over to future years (use it or lose it)
- Life insurance can be used to leverage the gifts made

Consider a married couple both age 50 with two children. Each parent can gift $14,000 per year to each of the two children so they can transfer a total of $56,000 per year with no gift or estate tax consequences.

Assuming standard nonsmoker underwriting, a $56,000 annual premium funds a guaranteed second-to-die death benefit in excess of $8,000,000. In this scenario, life insurance leverages the $56,000 annual gift to pass more than $8,000,000 to future generations with no income taxation regardless of the timing of death.

Low Interest Rate Environment

Interest rates are at historical lows and the Federal Reserve Bank has been reluctant to increase rates. In this low interest rate environment, there are several planning opportunities that can help maximize the assets passed to future generations. We will discuss two strategies and how they can work together as part of a comprehensive gifting strategy:

- Financed Life Insurance Transactions
- Grantor Retained Annuity Trusts (GRATs)

Financed Transactions

In a financed life insurance transaction, the life insurance premiums are borrowed from a third party or from the estate and paid back at a future date. In most cases, the life insurance is owned in a trust and the trust pays interest annually to the lender. Upon the death of the insured, a portion of the death benefit proceeds is used to repay the outstanding loan balance and any excess death benefit passes to the beneficiaries of the trust. Alternatively, policy cash values or other assets (see below) may be used to repay some or all of the loan balance prior to death.

The objective of this strategy is to pay loan interest instead of premiums which can potentially reduce the amount of the gifts required to fund the life insurance inside the trust. These transactions are complex and it is important to work with a sophisticated professional advisor who understands the various risks and exit strategies.

GRAT

A GRAT is an irrevocable trust that receives gifted assets. The trust grantor retains a fixed annuity interest for a specified term. At the end of the term, any assets remaining in the trust pass to the GRAT beneficiaries free of estate tax. The annuity payment to the grantor is based on the Section 7520 rate which is currently 2.0%. As long as the asset increases at a rate greater than 2.0% and the grantor survives the term of the GRAT, assets will pass to the next generation free of the estate tax.

As a simple example, if the grantor gifts $1,000,000 to a 2-year GRAT, they will receive $515,050 per year for 2 years. At the end of the 2 year term the trust will have $128,000 of assets that will pass to the trust beneficiaries free of gift and estate taxes.

The beneficiary of the GRAT can be an Irrevocable Life Insurance Trust (ILIT). This arrangement allows the GRAT assets to be used to pay life insurance premiums or to help pay off the loan from a financed transaction summarized above.

Year-End Policy Review

Life insurance policies should be reviewed periodically to ensure performance meets planned expectations. Most policies should be reviewed annually with a focus on past performance and its impact on future performance.

We recently worked with a client who had a $20,000,000 death benefit and was originally scheduled to pay 10 premiums of $105,000 to fund a lifetime death benefit. However, because the dividend rate decreased by more than 200 basis points since the policy was issued eight years earlier, the policy required 32 premiums – an increased premium obligation of $2,310,000!

If the policy had been reviewed periodically while the rate was gradually declining, the client would have had an opportunity to adjust the funding overtime and avoid such a dramatic impact to performance.

This is an example of the impact decreasing carrier rates can have on product performance. Other variables should also be evaluated including pricing changes that are not always disclosed to policy owners. In recent years, some insurance carriers have maintained their crediting or dividend rates but have increased their internal expenses. These pricing changes are not typically disclosed to clients and can have a meaningful impact on long-term policy performance.

Summary

Year-end is a great time to implement a life insurance funding strategy and take advantage of planning opportunities available in the current low interest rate environment. When rates begin to increase, many of these planning techniques may no longer make sense.

Year-end is also a good time to evaluate existing life insurance portfolios to ensure they are performing as expected to provide the value needed to meet client expectations.