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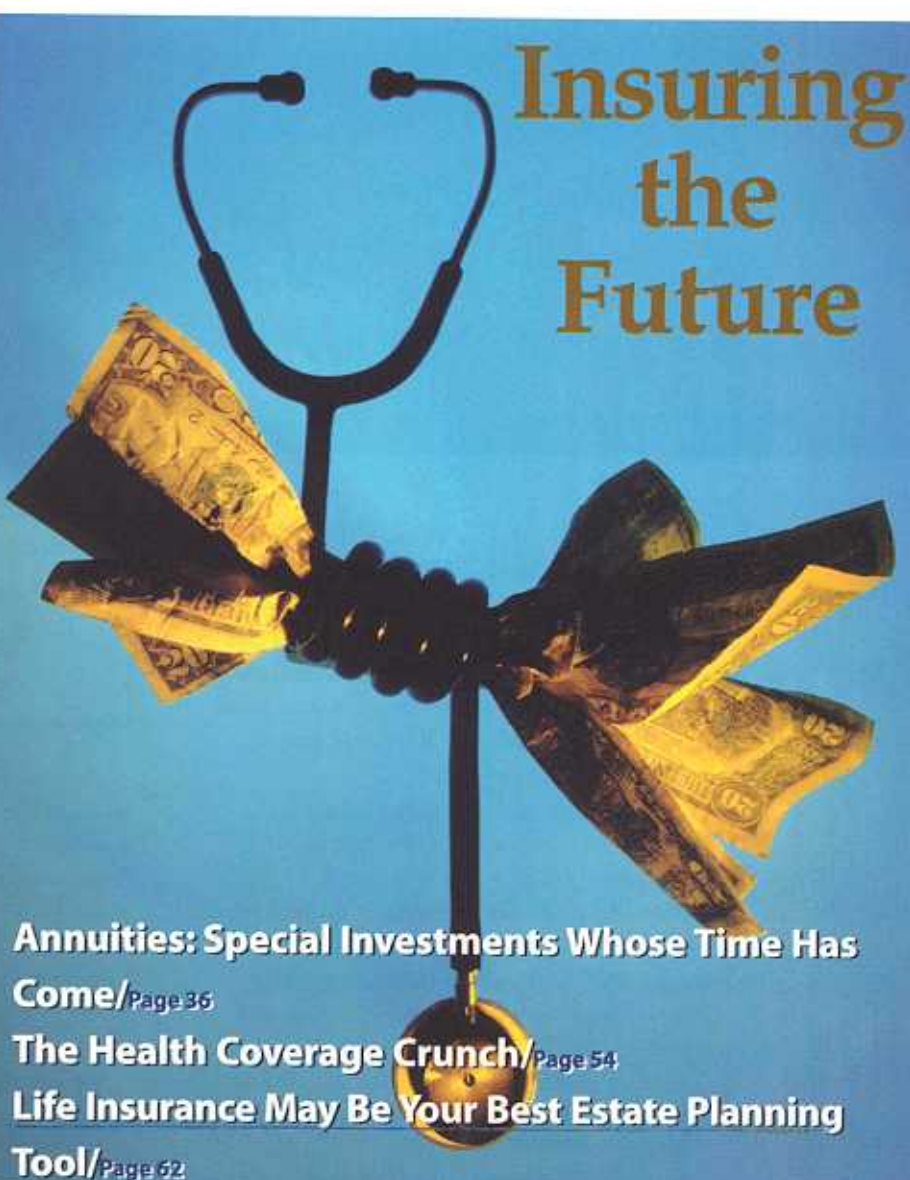
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# Life Insurance May Be Your Best Estate Planning Tool

by Nancy Opiela

Over the next 15 years, it's projected that more than \$12 trillion will be passed from America's World War II generation to their heirs. Combine this substantial inheritance with baby boomers' 401(k) plans and other assets, and many of your clients who never thought of themselves as wealthy may find themselves with estates that far surpass the unified credit.



Says Paul Hrisko, J.D., CFP, in Cleveland Heights, Ohio: "Many people don't realize how wealthy they are. It's only once they marshal all their assets and come up with a firm number that they discover they are worth a million and a half."

Those active in the estate planning arena stress that clients with estate planning issues are different today than they were a generation ago, and warn that planners should not overlook clients who don't fall into the traditional molds:

Explains Malcolm Greenhill, CFP, of Sterling Futures in San Francisco, California: "We're seeing a totally different kind of client walk in the door—the assistant to the assistant to the assistant to the assistant to the human resources director at Sun Microsystems. This client has a clerical job, but has stock options worth \$1.8 million. People who never thought they would become this wealthy now have the problem of managing the money and also dealing with potential estate tax issues."

What's more, with the unprecedented intergenerational transfer of wealth, Richard Duff, J.D., CLU, in Denver, Colorado, notes that in addition to reviewing the client's net worth, it's important to discuss possible inheritances the client might receive from others—and how that inheritance might be protected using life insurance: "Clients need to think about inheritances they may receive from their parents or an older sister or brother, and buy insurance on that person's life," he says. "Potential inheritors need to pay more attention to these issues. Buying an insurance policy on another person's life in which you have insurable interests is simply an opportunity to preserve what is coming to you—it's a sound investment."

With more clients facing estate taxes, more financial planners are using life insurance as a tool to protect the estate from estate taxes and allow more of it to remain intact for heirs or charitable causes. While clients often have a negative feeling about insurance and balk at the



Paul Hrisko, J.D., CFP

“Many people don't realize how wealthy they are. It's only once they marshal all their assets and come up with a firm number that they discover they are worth a million and a half.”

expense, the estate tax savings may help many stomach the premiums. Here, your colleagues who routinely use life insurance in estate planning share their strategies:

### The Irrevocable Life Insurance Trust

The life insurance tool of choice for many planners is the irrevocable life insurance trust (ILIT). A common life insurance mistake is to leave one's spouse as the owner or beneficiary of life insurance. Because this increases the gross estate, it ultimately increases estate tax bills. Accordingly, explains Lawrence Brody, J.D., LL.M., partner in the law firm of Bryan Cave LLP, in St. Louis, Missouri, the starting point for any kind of sophisticated life insurance transaction is to not have the insured own the policy; this ensures that the proceeds are not hit with federal and estate taxes. "The usual way we do it is with an irrevocable life insurance trust. That gives us some basic transfer tax leverage. If you do it right, the insurance proceeds won't be taxed at the insured's death, you can give the surviving spouse an interest in the trust, it won't be taxed at their death, and you can move the

proceeds down to the insured's children with no estate tax," says Brody.

Generally, an ILIT works this way: Money is gifted to the trust. The trust then applies for life insurance on the insured. The trust is the owner and beneficiary of the life insurance policy. Usually, children or grandchildren are beneficiaries of the trust.

Brody notes that an ILIT also allows your clients to leverage the gift transaction. "For gift tax purposes, the gift is only the premium," he explains. "If the policy is \$1 million and the premium is \$10,000, the gift is only \$10,000 a year—not \$1 million. What's more, you can arrange by using *Crummey* withdrawal powers in the trust to have that \$10,000 gift to the trust qualify for the gift tax annual exclusion and not require any use of our insured's unified credit. So it's essentially a free gift transaction that, in our example, moves \$1 million out of the client's estate, lets the spouse live on the million and then moves it to the children—income-tax and estate-tax-free."

### Second-to-Die Insurance

It is possible to leverage the benefits of an



Richard Duff, J.D., CLU

“Potential **inheritors** need to pay more attention to these issues. Buying an **insurance policy** on another person’s life in which you have insurable interests is simply an opportunity to **preserve** what is coming to you—it’s a sound **investment.**”

ILIT even more by using the increasingly popular survivorship or second-to-die life insurance. Second-to-die policies work this way: since spouses generally can leave an unlimited amount of assets to each other without federal estate tax, estate taxes are paid at the death of the second spouse. A survivorship policy insures both spouses under one policy and pays the death benefit at the second death—when it is needed to pay taxes.

Second-to-die offers several other attractive features. First, the cost of this coverage is generally less than the cost of coverage on either spouse alone. In addition, second-to-die life insurance can be easier to qualify for than conventional life insurance.

Let’s return to Brody’s example of the \$1 million policy on one person’s life costing \$10,000. “If we make that a survivorship policy with husband and wife, the premium might be \$7,000. So there’s an even broader spread between the current gift and the eventual death proceeds, and we’ve increased the leverage of the transaction,” he says.

### Split-Dollar Contract

A split-dollar arrangement, a very common benefit for top executives, can leverage the transaction even further. Says Brody: “You start with the same basic transaction. Now, if your client is employed, the employer might pay the \$10,000 premium under a split-dollar arrangement. That says the employer will advance the \$10,000 every year for the premiums, and when the client dies, or if the arrangement is ended earlier, the employer gets all of his premiums back.”

There are two significant benefits with this approach. First, there is no \$10,000 out-of-pocket expense. Second, taxes are levied, not against the whole \$10,000 payment, but on something called the economic benefit of that payment. Explains Brody, “The economic benefit is measured by the term cost of the \$1 million policy. If the term cost is \$10,000, income tax cost is \$1,000 and it will go up every year. But the nifty thing is that the gift I make to the trust now isn’t \$10,000, it’s \$1,000. So now my spread is greater—for

a \$1,000 gift, I move the same million of my estate.”

You may already be ready for the step—a split dollar with a survivorship policy. Says Brody, “Take the same \$1 million policy on me and my wife. My employer advances the premium of \$7,000. The term cost of the survivorship policy might be \$100. So now, my income tax cost of moving \$1 million out of my estate is \$100.”

### Generation Skipping

In another twist with an ILIT, you can have the trust go on for your client’s grandchildren or great grandchildren instead of stopping with the children. “You can skip as many generations as your client is comfortable skipping and state law says you can,” says Brody. One way, instead of just moving \$1 million to my children, I move it to my great-grandchildren, with no estate tax at my death, my wife’s, my kids’ or my grandchildren’s death. The first time there’s a tax is when my great-grandchild gets the money and dies with it. That’s 100 years from now. In the meantime, my wife, children and grandchildren can live off the trust. My money has grown for 100 years with no estate tax, so the deferred estate taxes are insignificant.”

Establishing an ILIT sounds like a win/win situation, so is it easy to get clients on board? Says Hrisko, “ILITs have been around for a long time and always the ‘irrevocable’ part that has kept people up. Even though people understand that there are great tax benefits of people just don’t like to give up control. The tax benefits are so astounding, however, that it’s important for planners to take an active role and elucidate the tax savings.”

Continues Hrisko, “When we talk about estate planning tools, we are talking



Judith Shine, CFP

“Clients will say, ‘Wait a minute, I just got this money, it’s being taxed at 50 percent and you want me to give away the rest of it!’”

about mortality. Clients in their twenties or fifties who may have estate planning issues are not thinking about how they are going to pass on the money. What they want is to control their assets during their lifetime for the benefit of others. Once clients understand that estate planning is important and the benefit of an ILIT to the overall financial plan, they will come around.”

As Duff notes in “Irrevocable Trusts and Life Insurance: They Stand the Test of Time,” published in two parts in the April and August 1999 issues of the *Journal*, “For my money, the unbeatable combination is life insurance and a well-drafted trust instrument. You don’t need much more than that. But you have to present it right or it can sound really dry and turn off your most sophisticated clients.” (For plenty of strategies for getting your clients excited about ILITs, see the articles.)

Diane Blakeslee, CFP, of Blakeslee & Blakeslee in San Luis Obispo, California, has an alternative to the ILIT. Explains Blakeslee, “We have a client with \$1 million in an IRA and other assets, so his estate is close to \$4 million. What we did is to sell him four \$500,000 life insurance policies naming each of the four children as beneficiaries rather than going through the insurance trust bit.

“The client gives his children the money for the premium every year. If they let it lapse, they don’t get their \$500,000 when he dies. This is more straightforward and gets it done more quickly and at less of an expense. I recommend term insurance rather than cash value because I am optimistic that we’ll see something happen in the way of reducing estate taxes in the near future.”

### Family Foundations

Judith Shine, CFP, of Shine Investment Advisory Services in Englewood, Colorado, encourages her clients with excess cash flow to buy life insurance and establish a family foundation with the proceeds. “Using life insurance this way allows clients to do philanthropic good and to pass their values onto their children along with their money,” she explains.

Shine provides the following example: “Let’s say a couple has \$2 million, Social Security, pensions and their home is paid for. Of the \$2 million, they take \$20,000 a year to live on and give their two kids each \$10,000—that’s \$40,000. Meanwhile, the \$2 million is growing and growing. Why not take another \$10,000 off of that and buy a \$1-million life insurance policy

to found a foundation? Why just let the money keep accumulating and accruing? If they will not be able to spend the money they have in their lifetime, why wouldn’t they look at leveraging the money and creating something positive for future generations?”

While the example is convincing enough and, in fact, many of Shine’s clients use the strategy, she notes that timing is important when broaching the subject with clients. “When someone starts a business, inherits a large sum of money or takes control of their 401(k), it’s a sum of money that is more than what they are used to and that is not the time when they are most receptive to the idea of building multi-generational wealth or contributing to needy causes through the ages,” she explains. “Clients will say, ‘Wait a minute, I just got this money, it’s being taxed at 50 percent and you want me to give away the rest of it?’”

“It helps to look outside of our culture to the Asian culture. There, you are encouraged to live your life, not only for your current family, but for the next generation. Many Americans don’t have that perspective. Not only is that not very generous, but from a financial standpoint, it’s not very smart.”

### Charitable Remainder Trusts

Other planners use charitable remainder trusts (CRTs) concurrently with life insurance in the estate planning process. CRTs generally are used when a client has highly appreciated assets with a very low cost basis. Because selling the asset would trigger substantial capital gains tax, a CRT can result in a loss of much of the asset’s value; the asset is contributed to a CRT that could sell the asset without having to pay the capital gains taxes. The proceeds could then be reinvested in income-producing vehicles and an investment in

paid to the client, or the client's spouse for the rest of their lives. The client receives an immediate income tax deduction and, upon his or her death, whatever assets are left go to the charity of his or her choice.

The price paid for avoiding the capital gains tax and getting income for life, an immediate tax deduction and benefiting a charity is loss of direct control of the asset and disinheriting children from the asset in the CRT.

To minimize the second disadvantage, life insurance is frequently used to replace the asset that the children have lost to the CRT. Creating this trust has the advantage of replacing an asset that is in the taxable estate with one that is outside of the estate and therefore not subject to estate taxes. Explains Hrisko, "What clients typically do is use the money they saved because of the tax deduction to establish an ILIT. What that does is bring back into the estate for the children the value of the asset."

Continues Hrisko, "I tell my clients in order to get something from Uncle Sam, they have to give up something—ownership. Once I've explained the CRT, it needs to percolate in a client's mind. If they go along with giving up control, they don't have much of a problem with it."

### Funding for Buyouts in Closely Held Businesses

Imagine a small-business owner—his son works in the business and his daughter does not. When the owner dies, he leaves everything to his two children. The daughter may not want the business, but she wants the money. So, the business would have to be sold—in some instances at fire sale value.

If the business owner is concerned with equalizing inheritances, the business could be valued and life insurance policies bought in that amount for the children not

active in the business.

Brody also points out another strategy to use if one child is active in the family business and one is not. "If you give the

business to the active child and the insurance proceeds to the other child, the problem is that the values will never be the same. If the business is successful, it will



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continue to grow in value and you are not going to go back and buy more insurance," he explains. "An alternative is to have a buy-sell agreement with the active child and fund it with life insurance. You then let the active child buy the business for its fair market value, and in your will, leave everything equally—or split other assets however you want."

An ILIT is also handy for business partners because the proceeds of life insurance can be used to carry out a buy-sell agreement, whereby the interests of a deceased partner could be purchased by the survivor, providing money to the family of the deceased partner and clear ownership to the survivors. Notes Brody, "Assuming the surviving spouse or children don't want to continue in the business, this is a way of liquefying an illiquid asset and not having your surviving spouse dependent on your partner's ability to run the business. This takes that risk away."

## Protection for an IRA

Ellen W. Fairbanks, CFP, CLU, of The Acacia Group in Pittsburgh, Pennsylvania, sees another use for life insurance in the estate planning arena—protecting those million-dollar IRAs. "You can leave IRAs for offspring, but they are still taxed as part of the estate. So the potential shrinkage on this pool of money is huge," she says. "We insure clients for an amount that will see them through the growth of their estate, but it depends how much money they are willing to allocate to paying the premium. Anything they do is better than nothing—assuming they care about minimizing estate shrinkage. If they do care, the challenge is to get them to understand that an expenditure today is worth a whole lot more money down the line."

Fairbanks acknowledges that these con-

versations are not the easiest to have, especially for younger clients in the accumulation phase of their lives. Says Fairbanks, "First, life insurance assumes mortality. People don't want to talk about that. Second, I'm asking for their money now. For people who care what happens to their estate down the line and can afford it, it is a good deal."

In Fairbanks' experience, most clients care about what will happen to their money after they are gone. "I just spoke with a man who is 46, had inherited half a million in stock and has his own retirement plan. We are underwriting his insurance on the basis of the growth of his assets. While he cared about what would happen to his money after he was gone, he also made it clear he did not want to compromise his lifestyle to fund the policy."

Fairbanks points out that timing can be the critical factor in one's ability to protect an estate. For example, she works with a couple where the wife wants to conserve the estate for the children, but the husband is unhappy with the way the children treat him. "The assumption is we can do this later. Well, maybe we can and maybe we can't. He's already uninsurable. Will his wife be uninsurable next year? I work with a physician couple and we were talking and talking. In between one appointment and the next, he ended up in the hospital with a heart attack. Now, life insurance is no longer an option," she says.

Concludes Fairbanks, "I don't believe in life insurance much as an investment, but it does have its uses. The first is to provide for the family in the event that the breadwinner dies. The second is equalizing an inheritance in an estate situation. The expenditure seems so simple to me. You have the choice of paying the money out in taxes later, or taking a fraction of the money you would pay in taxes and allocating it now toward paying those future taxes."

## What If the Tax Landscape Changes?

Could capital gains and estate taxes be abolished in the next five to ten years? In Malcolm Greenhill's opinion, that's not way off course. "Clients mention this as a concern," he says.

So, what if you set up an ILIT and estate taxes go away? "Many of these policies are second-to-die because they are a lot cheaper. And the only purpose of the second-to-die policy is to pay the estate taxes. If you have second-to-die, and tax and estate liabilities disappear, the trust can be terminated and insurance can be cashed out—but that would cost the client something because there is a very high initial acquisition cost on life insurance. When you cash it out in the early years, you take a hit," Greenhill says.

Greenhill sees other changes on the horizon that will also have an impact on your clients. The first is what he sees as a gradual movement toward full disclosure on life insurance. "A couple of years back, the National Association of Insurance Commissioners approved, in principle, the idea of full disclosure," he says. "Consider the fact that an agent selling life insurance does not have to disclose his compensation, while someone selling a mutual fund has to provide a prospectus. The average load on a commissioned mutual fund is 4.5 percent and, according to insurance companies' own statistics, the average sales charge on a commissionable life insurance product is 165 percent of the first year's premiums. That's not a widely known figure. If you get full disclosure, what would that do to the life insurance industry?"

Greenhill notes that there are some companies moving toward leveled commissioned products. "Instead of having all the commission up front, they level it out to the agent over a few years. They see full disclosure in the cards," he says.

Although there are non-commission products out there, many planners don't



Ellen W. Fairbanks, CFP,  
CLU

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know about them. Greenhill notes that a now-defunct company, Fee for Service, did a great job of helping financial planners sell non-commission policies, but now there are no real resources.

What are the benefits of a non-commissionable policy? “Most of these policies are funded by the gifting amount of \$10,000,” explains Greenhill. “One of the problems is buying enough insurance for the \$10,000 because many people are older when they buy it. \$10,000 buys a lot more with non-commission policy than it does with commission.”

Non-commissionable policies also can

benefit companies providing life insurance as a benefit to top executives. “With commission policies, the corporation owns it, they bought the asset for \$10,000, but there's no cash value on the book. The asset is on the book with non-commission policies,” says Greenhill.

### A Few Tips

Finally, some tips from the experts:

Before you begin talking with your own clients about life insurance, check

that you're within your rights to do so. Greenhill notes that there is a law on the books in California that prevents financial planners from discussing insurance policies. “Many planners review insurance and recommend a policy for a flat fee, but in California, you need to be an insurance analyst to do this,” he explains. “California's Department of Insurance recently clarified what a financial planner who is not an insurance analyst could do. Planners can determine the amount of insurance that is needed, but the moment a specific policy is opened up, planners are in violation of that regulation.”

Duff suggests taking a course at a law school on what to look for in legal documents. “Ideally, the course covers wills and other documents,” he says. “With this background, the planner can help the attorney with the preparation of documents.”

Forging relationships with attorneys is also important. It's particularly effective, says Hrisko, to work with an attorney who will travel to clients' homes or offices.

And, finally, also from Hrisko, “Sometimes the first step in introducing something like an ILIT is convincing a client that it is worth their time and money to go through a comprehensive financial plan.”

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Nancy Opiela is an associate editor of the Journal of Financial Planning and is based in Medfield, Massachusetts.