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## When Life Insurance Earns Its Keep

by Dennis C. Reardon, JD, LLM, CLU, ChFC

### ABSTRACT

It is important to understand how estate planning attorneys and life insurance professionals need to work with each other. There are many times when the professions combine to produce a beneficial result for their clients. Several examples remind us about the important role insurance plays in the financial plan.

At the moment (early March), estate planners across the nation are waiting for a shoe to drop as to the future of the federal estate tax. In this column, I have often described estate planning strategies centered on reducing the future estate tax clients may face. When future tax legislation arrives, we will all be scurrying around to adjust plans in response. Soon enough for that. In the meantime, I offer these thoughts on a familiar topic—life insurance—that keeps rolling along while larger questions loom as to the feasibility of various tax planning techniques.

### Saving the Family

It has been said that people buy life insurance because they love someone or owe someone. A recent experience with a client featured a situation in which both circumstances were true. When Mr. Client was married with young children, we established an irrevocable trust to own an insurance policy on his life. Last year Mr. Client called to express interest in changing his estate plan. His business had struggled in the aftermath of the 2008 financial crisis, and he and his wife had divorced. We made a number of changes in his plan, and the upshot was that his new will and irrevocable trust provided solely for his children. When he signed his new will, he expressed hope that his business was on the upswing and the struggles were in the past. Unfortunately, he had an undetected medical condition and suddenly died a few months after he had signed his will.

Vol. 71, No. 3 | pp. 23-25

This issue of the Journal went to press in April 2017.  
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The estate administration process revealed chinks in Mr. Client's financial armor. While his business had met payroll and continued to operate as the financial crisis subsided, a close look at its true financial condition showed that it was barely solvent. As often happens in smaller companies, Mr. Client was the classic key person and driving force of the enterprise. Like most industries, his operated in a small world, and his sudden absence from his corporation created disruption and ensuing financial chaos. Personal finances were no better. The combined effect of the costs of divorce and business struggles, along with increased mortgage debt, left the estate barely above water. Creditors also surfaced, although their prospects for collection were dim because there was little blood that might be squeezed from the stone of the estate.

In these circumstances, the life insurance proceeds paid to the trust represented a bulwark of protection for the decedent's children. The funds offered sustenance over time for the (teenage) children to complete their education and enjoy a level of support consistent with what they would have received had their father lived. In addition to the management structure the trust offers, the funds held by the trust can be safely invested for the children's benefit outside of the reach of the creditors of the estate or the business.

I cite this experience as an example of just how life insurance can work in a uniquely effective way. The funds held by the trust provided a financial rescue for the children and offered a lifeline for their future that no other financial solution could have produced. Your clients may turn away from life insurance because it makes them think of their own demise and requires a financial cost for an unselfish purpose. However, it has long had widespread acceptance for a reason, and Mr. Client's family members are the poster children for a striking example of how life insurance can secure the future.

### The Widow's Dilemma

A byproduct of preparing clients' estate plans for many years is that you eventually see how the story

turns out when a decedent's estate is administered. I have two recurring client experiences. One is that a client, usually the husband, wonders why he should keep life insurance in effect when the mortgage is paid, the kids are grown, and retirement is here or looming. The other experience is that the surviving spouse, often the widow, has ample means but feels financially lost while the payment of taxes and expenses must be handled after the other spouse's death. Worse yet, she is naturally upset after her husband's death and may have relied on him to do the financial steering. Once again, life insurance can serve a particular function especially well: It can be paid not long after death, free of the natural delays of retitling and distribution that typically occur in estate administration.

So, the advice to the husband that seems appropriate is to think twice before you decide having no life insurance works just fine. Let me qualify that by adding that a client with major wealth may have no need for insurance because cash needs following death can easily be met and no new funds are needed to support the widow in her accustomed style. However, for the greater number of clients who are somewhat affluent but not quite wealthy, extra cash upon death may provide comfort for the surviving spouse, and all the more so these days as greater longevity becomes more commonplace. It is objectively true that people are living longer, and examples of that are all around us. In addition, those who can more easily afford medical care in their advanced years are favored to have longer lives. The mathematics needed to project insurance needs is not especially difficult, but not everyone is conversant or comfortable with numbers and calculations. However, the current statistics regarding longevity should be closely considered in the estate planning process. Few clients will enjoy hearing about a plan that works well as long as neither spouse lives past an age that one of them expects to see.

### Split-Dollar Life Insurance Is Still with Us

Some years ago, split-dollar insurance was widely discussed and promoted in the world of life insurance

planning. The Treasury regulations issued in 2003 in regard to income taxation were like a rainstorm that chased the customers off the beach. The regulations left many life insurance agents with a “party’s over” feeling when it became clear that the “something for nothing” claims of equity split-dollar proponents were shown the door. However, split-dollar can still work very effectively in a variety of situations.

Here’s a recent one that landed on my desk. My client is the sole owner of an S corporation in a long-established business. He has reached a point where he will work for several more years but would be glad to throttle down a bit and let a key employee have more responsibility. In fact, that employee now works for him and is willing and fully capable of assuming that greater role in the business. So, the question becomes how best to compensate the key employee with the right incentives to keep him fully engaged as the client eases the pace for himself. He will not offer shares of the corporation to the employee because he has no desire to share ownership. The corporation has a bonus plan in place, but a life insurance benefit was appealing because it could address two needs that required solutions. The corporation had a classic need for a capital infusion if the key employee dies in harness. Keep in mind that the client could step back into a more active role but is much more interested in the shareholder part of the role of shareholder-employee. At the same time, the key employee is in the full bloom of being “married and mortgaged.” In addition, funding his children’s education is paramount, and his life insurance needs will be substantial for many years.

The split-dollar plan will operate so that the corporation will be the applicant and owner of a \$1.5 million insurance policy on the key employee’s life. The corporation will retain the right to receive \$500,000 as a beneficiary of the policy and will endorse to the employee the right to designate a benefi-

ciary for \$1 million. During the employee’s lifetime, the corporation will be entitled to receive the cash value of the policy. As a result, if the corporation pays the entire premium, the employee would be taxed on compensation equal to the term insurance cost of the policy. At a specified point in the future, perhaps the employee’s retirement age, the corporation will transfer its ownership in the policy to the employee, and the split-dollar agreement will end. The cash value of the policy will constitute compensation, deductible by the corporation and taxable to the employee. Other points may be considered with regard to the duration of the plan and the ultimate compensation paid to the employee. The important point to recognize is that a policy held in a split-dollar plan of this type may serve a dual purpose in a factual setting often applicable to many owners of closely held corporations.

So, let me imagine how you react to what you have just read. My paean to the efficiency of life insurance may get a heartfelt cheer from the choir to whom I preach. And it may elicit counterclaims and criticisms from other planners who are skeptical or wary of anything having to do with life insurance. It took me a relatively long time to understand how often estate planning attorneys and life insurance professionals may look askance at each other. However, there are times when each profession combines to produce a beneficial result for their clients. Maybe my saga of Mr. Client and his family and my ruminations about widows and insurance needs will move the needle for the advisor who needs a reminder. ■

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