AS SEEN IN THE MAY 5, 2015, ONLINE EDITION OF
TRUSTS & ESTATES
The WealthManagement.com Journal for Estate Planning Professionals

Shakes on a Plane: Why Proper Life Insurance Planning Can Give You Peace of Mind

Three Secrets to Simplifying Life Insurance Decisions

By **Aaron Abrahms**

Last year my wife and I were flying to Hawaii when the pilot announced that one of the plane's two engines had failed. Ordinarily, he explained, this would mean we would land immediately at the nearest airport. But because we were over the Pacific Ocean, we had no choice but to continue forward with one engine.

It was scary. I began thinking about what might become of our three young children if we crashed. We knew our families would be heroic in their love and care for our kids. I also knew that because of the life insurance we had in place, there would be absolutely no financial burden for the children or those who would be giving them care.

On reflection, I realized that while life insurance is obviously a benefit at death, it also provides peace of mind and comfort in moments when we must consider our mortality.

But navigating the purchase of life insurance can be overwhelming, leaving many of us as stalled out as that plane's engine. How much is the "right" amount? What type of insurance is "right" for me?

Because one size certainly does not fit all, some general guidelines can help you navigate the unknown of life insurance decisions.

Secret No. 1: Starting Out? Start Off with Term Life Stage: A Young Couple with a Growing Career and Emerging Family

First comes love, then comes marriage, then the baby carriage, and then life insurance? Sure. Typically, the topic of life insurance comes up when a couple is recently married or is expecting a first child. Most of these couples are young, and are just settling into their careers. While both spouses are likely income-earners (at least before the first child arrives), they are beginning to become financially dependent on one another, perhaps buying their first home or apartment together.

To generalize, these "Stage I" couples don't have a lot saved; student loans may even still be a lingering cause of debt. Thus, they depend on their current and future incomes to support one another. If one spouse were to die prematurely, the other might suffer financially or have increased child care expenses. That makes life insurance sensible for "income protection" purposes—easing the potential financial burden.

For this stage, the solution is often term life insurance, which provides protection for a certain length of time (e.g., 10, 15, 20, or 30 years). The premium and the insurance benefit are fully guaranteed, and while the insurance company is obligated to have the premium remain level for the specified duration, the owner of the policy can stop payments at any time. If the individual passes away during the term period, an insurance benefit is paid out to the beneficiary. Because premature death is so infrequent and improbable, the actuaries at the life insurance carriers can price this product at a very low price point, while still having the business be profitable.

In addition to low cost protection, term insurance has another very valuable feature called a Conversion Option. Life insurance is priced based on the health of the individual, and generally speaking, people are healthiest when they are younger. The conversion option allows you to convert your term insurance to permanent insurance at a future date, without having to go through medical underwriting again. The insurance company has to honor the health classification you received when you were young and healthy, even if your health has deteriorated by the time you exercise the conversion feature. Many people view this as effectively owning an option on your insurability that you have the right to exercise at any time.

Secret No. 2: Living in Luxury? Think Legacy Life Stage: Ultra-High Net Worth Individuals

Ultra-high-net worth individuals (UHNWI)—generally defined as having assets of $50 million or more—have enough money to sustain a luxurious lifestyle from a combination of their earnings and passive income on their investment portfolios. That makes them, in general, feel self-insured. If an UHNWI dies, there are plenty of assets available to protect the family. College tuitions will be paid, mortgage payments will be met, lifestyles will be maintained, regardless of whether or not this individual is still alive and earning a living.

But a traditional life insurance policy can still make sense for an UHNWI as a means to protect their spouse and leave a financial legacy to their children and grandchildren. Yes, most of us will be focused on saving enough money to retire comfortably, put the kids through school, and live a decent life with a few vacations thrown in—and not on how much money will we leave to our heirs. But UHNWI have substantial enough balance sheets that they can afford to move

Aaron Abrahms is a Principal of Winged Keel Group. Winged Keel is widely recognized as one of the leading experts in the structuring and administration of Life Insurance programs for ultra-affluent individuals. For more information, please visit www.wingedkeel.com.

assets to the next generation, and not compromise their lifestyle in any meaningful way.

For UHNWI, there are three primary schools of thought when it comes to life insurance.

1. Self-insured:

Many who have amassed $50 million-plus estates take the posture that they are self-insured and do not need traditional life insurance. There's nothing wrong with this thinking, and many who are fortunate to be in this life stage make the decision to have no life insurance. Those who have no life insurance generally feel that their children have "enough" already, or will be fine even without the added protection of life insurance (through the terms of the individual's will or estate plan). Many want to protect their children from the complexities of having too much money. Again, there's nothing wrong with this thinking, and the decision to have life insurance or not in this life stage is a very, very personal one.

2. Estate liquidity oriented uses of life insurance:

UHNWI generally spend some amount of time focused on their estate planning. They face a contingent liability at death that can equal approximately 50 percent of their gross estate. To take a simplistic example, imagine a family with approximately $100 million of assets. This sample family's balance sheet includes $20 million of marketable securities, $20 million of personal real estate (a primary residence and two vacation properties), $10 million of art and other property, and $50 million of private partnership interests including a family business, a commercial real estate investment, and other direct investments in businesses. At the second death of this husband and wife, the heirs will need to come up with nearly $50 million of liquidity to pay the estate tax bill.

Traditional life insurance (particularly permanent second-to-die insurance that pays out at the second spouse's passing) is often used to create some of the liquidity to pay the estate tax bill. Because a significant portion of this family's portfolio is held in illiquid assets, the liquidity provided by life insurance is critical to helping to avoid the forced sale of assets. By working in conjunction with a capable estate-planning attorney and an experienced life insurance broker, these families can preserve their legacy, and limit the financial strain on the heirs for paying estate taxes.

UHNWI might also use life insurance to leave a specific inheritance to each heir. For example, we recently worked with a retired chairman of a public company who wanted to use life insurance to assure each of his ten grandchildren would receive a $2 million inheritance. He was able to accomplish this goal through a $20 million second-to-die life insurance policy.

Many UHNWI have already moved substantial assets into trusts for their heirs through the use of estate-planning techniques. The Lifetime Gift Exemption, for example, allows tax-free gifts of approximately $10 million (per married couple) into trust. Other common techniques include loans from one generation to another, and variations on these leveraged techniques such as Grantor Retained Annuity Trusts (GRATs). As trustees of these trusts consider investment alternatives, they often turn to life insurance with a portion of their trust assets. Typically, in today's interest rate and pricing environment, life insurance carriers will guarantee a payout of approximately 4 to 4.5 percent at the insured's life expectancy. Life insurance pays to the trust, free of income tax, so many trustees see a 4.5 percent income and estate tax free (because it is in trust) return, backed by a well-rated insurance carrier, as a prudent (albeit unsexy) investment.

3. Income tax oriented uses of life insurance:

In our current income tax environment, UHNWI are very focused on how to maximize after-tax returns. Thanks to the tax-free growth of life insurance policy values, this is one way to invest assets—particularly those in trust for the benefit of heirs—in an income-tax efficient manner. Private Placement Variable Universal Life (often called "PPVUL" or "PPLI") allows individuals to invest in what would ordinarily be tax-inefficient asset class investments (such as credit, managed equity, hedge funds, direct lending funds, or fund of hedge funds) in a more tax-efficient manner. A number of private banks market their investments inside of these tax inefficient structures, so UHNWI who haven't yet heard about PPVUL and its sister product, Private Placement Variable Annuities (PPVA) likely will in the near future from their advisors.

Well-Off but Still Working? Pick Permanent Along with Term Life Stage: Mass Affluent and High Net Worth Individuals

In the US, there is a growing Mass Affluent and High Net Worth market segment. These are very successful individuals who have amassed some assets, and have certainly moved beyond the first Life Stage, but are not yet self-insured.

For these individuals (who have less than $50 million in assets), who still go to work in the morning to earn a living, term life insurance often plays a role (just as it does the first Life Stage). It can protect the family and cover the shortfall between current savings and the assets they hope to amass by retirement.

While high net worth individuals are more focused on saving money and maintaining their lifestyle than estate planning, permanent life insurance can still play an important role in securing their legacy for their heirs. For example, imagine a 50-year-old couple with a $20 million net worth living in New York City with three children in private schools. While they are very fortunate, by all means, they're not inclined to meaningfully and irrevocably move substantial assets off their balance sheet to minimize their future estate tax burden. They do, however, have the luxury of moving some (more modest amount) of their assets into trust for their heirs, and may think about using permanent life insurance as a way to leverage that asset within the trust. Here, permanent life insurance allows the couple to know that their children will have some inheritance no matter when they pass away. Additionally, for a family with this profile, a significant portion of their wealth may be in their homes, and having the liquidity that life insurance provides at death could help avoid the need to sell the properties at an inopportune time. Finally, it affords the husband and wife the financial freedom to spend down their assets during retirement without feeling as though they are disinheriting their children.

And One More Tip

The decision about how much life insurance to acquire and what kind of life insurance—term vs. permanent—is a very personal one. Identify your life stage, and identify a capable independent insurance broker and estate planning attorney to get this important decision "right." ■