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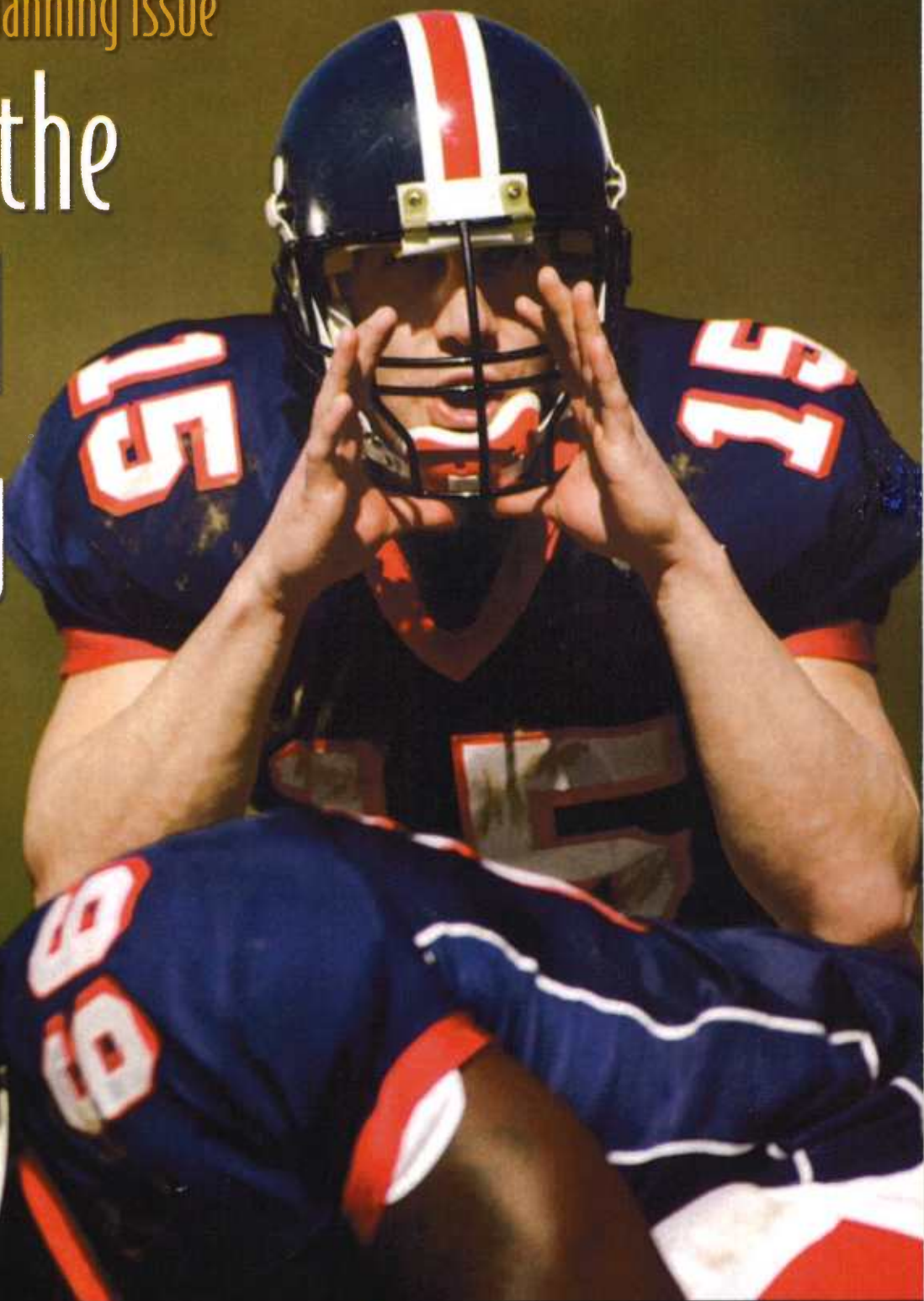


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# A Financial Planner's Guide to Life Insurance Strategies:

*An Eight-Step Life Insurance Checkup*

*By Lee Slavutin*

## **In Brief**

Life insurance is often one of the most neglected assets in an individual's portfolio. If policies are not periodically reviewed and updated based on an individual's changing circumstances, the result can generate unnecessary costs and taxes. CPA financial planners can help in the process by guiding clients through a "life insurance checkup," a method developed by the author.



Life insurance is one of the most neglected assets that most individuals own. All too often, an insured individual purchases a policy and then stows it away somewhere in his files, where it collects dust. Neglected insurance policies can change quite dramatically over an individual's life. Regularly monitoring an insurance policy can help reduce costs, ensure appropriate coverage, avoid thousands of dollars in taxes, and guarantee that policy proceeds go to the correct beneficiaries.

Financial advisors have a great opportunity to forge an active, ongoing relationship with their clients by offering them a life insurance checkup, which is the best way to obtain a comprehensive overview of a client's current situation. This process answers the following four questions:

- What insurance is already in place?
- What are a client's insurance needs?
- Do any strategic changes need to be made to current policies?
- Are there policies with outdated or incorrect information, inadequate premiums, negative tax consequences, or forgotten benefits?

### The Eight-Step Process

The eight steps of a life insurance check-up are as follows:

- Locate all of the policies and riders.
- Create an inventory for the client.

- Review the financial strength ratings of each issuing insurance company.
- Identify the policy owner.
- Identify the policy beneficiaries.
- Determine if the amount of coverage is adequate.
- Review a policy's in-force illustrations.
- Be aware of important tax rules.

### Step 1: Locate all of the policies and riders.

Locating all of a client's policies and riders might seem like a simple first step, but in practice, this requires some investigation and detective work. Many individuals have long-forgotten or neglected policies, or may keep policy records in multiple locations. A financial advisor must be thorough in order to compile a complete summary of a client's life insurance coverage. Consider the reasons a client may have purchased life insurance to help identify what insurance he may have, as well as its possible location.

A business owner might have policies in various locales, whether owned individually and kept in a safe deposit box, managed by an irrevocable life insurance trust (ILIT) and kept by the trustee, managed by the business and kept at the business office, or managed in a retirement plan and kept by the plan administrator. Members of a professional association might have a policy managed by their local or state profession-

al organization and kept at the office of the association; employees may have policies where the employer keeps the policy and pays the premiums directly.

Asking clients to review their payment records over the past 12 months is another helpful way of gathering information about what policies they own.

*Example.* A current client is a 63-year-old male physician. In a meeting, he told the author that he owned one life insurance policy with Penn Mutual. I requested that he search his files for confirmation of the policy and any other additional information. About two weeks later, he reviewed his files and discovered two disability insurance policies with Penn Mutual (not life insurance) and two policies with MassMutual (one term life and one variable life). If I had taken the client at his word, and not asked him to perform this first step, I would be lacking a complete picture of his life insurance coverage.

### Step 2: Create an inventory for the client.

Once all of the client's policies have been located, they should be organized into an inventory chart that both the advisor and the client can understand. An inventory chart simplifies policy maintenance and allows the client to easily make decisions about suggested policy changes, ensuring that premium and loan payments are made in a timely fashion. See *Exhibit 1* for a sample inventory chart.

When creating the inventory chart, consider the following:

- *Address.* Insurance companies often have subsidiaries. Be sure to use the address of the actual company that issued the policy.
- *Cash value.* Include the cash value and the cash surrender value. These are often different amounts because of the surrender penalty on a policy. A client should be aware of both amounts.
- *Outstanding loans.* It is very important to keep loan information current.

*Example.* A client borrowed \$100,000 from a policy with a cash value of \$250,000. The life insurance company charged interest on the loan. The loan had a fixed interest rate of 8% (extreme, but plausible). The interest was allowed to accrue (without repayment); in nine years, the loan balance has doubled to \$200,000. If the interest accruals continue, eventually the loan amount will be greater than the cash value of the policy.

## EXHIBIT 1

### Sample Inventory Chart

Policy	Mass Mutual #123456
Name of insured	John Doe
Insurance company contact info	Name, Address, Phone #
Type of policy	Term, Variable, Whole, Universal
Policy number	#123456
Policy owner	John Doe ILIT
Policy beneficiary	John Doe ILIT
Death benefit	\$10 million
Annual premium	\$75,000
Cash value/surrender value	\$2.5 million / \$2 million
Premium due date	January 1 (annual)
Outstanding loans	n/a

At this point, the insurance company will send a letter to the client, notifying her that the policy will lapse unless the client either makes an additional premium payment or pays down the loan interest.

After receiving this notice, the client will take no action and just allow the policy lapse. If the policy is permitted to lapse, for the taxable year in which it lapsed, then the insurance company will send the client a Form 1099 reporting the taxable income she received upon policy lapse and subsequent cancellation of the loan. The taxable income is the difference between the amount of the loan and the client's basis in the insurance policy. If the policy is cancelled when the outstanding balance of the loan is \$340,000, and the basis in the policy is \$200,000, the Form 1099 would reflect \$140,000 in taxable income. Unfortunately, when the client gets the Form 1099 (likely at least several months after the policy lapsed), it will be too late to correct the problem.

### **Step 3: Review the financial strength ratings of each issuing company.**

Joseph Belth, longtime editor of the *Insurance Forum*, once said: "Financial strength is the most important factor a consumer should consider in selecting a company from which to buy insurance." When clients purchase life insurance, they tend to be most concerned with policy's cost. It is an advisor's duty to make the client aware of other concerns—especially identifying a strong, reputable underwriter.

Financial strength has two important implications: First is the company's ability to pay claims; secondly, and not so obvious, is the effect of financial weakness on the cost of an insurance policy. If a company experiences financial difficulty, it may attempt to increase revenue by increasing the cost of insurance premiums of existing clients. (Non-guaranteed universal life policies may be subject to these increases.) Advisors should point out that the real issue at hand is not only the payment of claims, but also a policy's potential long-term cost.

The primary source for determining financial strength is a company's rating. The four major rating firms are A.M. Best, Fitch, Moody's, and Standard & Poor's. Ratings information is available directing from an insurance agent or broker, directly from the insurance company, or via ratings agencies websites such as

<https://www.ebix.com>. Never second-guess the ratings agency's evaluation. An advisor should also ascertain a company's stability by reviewing the company's ratings of the last three to five years. A good rating that has been decreasing over a number of years, or ratings that have been inconsistent between rating agencies, should raise a red flag.

### **Step 4: Identify the policy owner.**

Incorrect policy ownership can have major tax consequences for estate planning. For

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A financial advisor must be thorough in order to compile a complete summary of a client's life insurance coverage.

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example, the ownership of a policy by the insured will cause the death benefit to be included in his gross estate. On the other hand (subject to the three-year rule), ownership of a policy by an ILIT created by the insured will not cause the death benefit to be included in the insured's gross estate. Although a client's direct ownership of the policy is readily evident in a review, an advisor should also watch out for any incident of ownership. This occurs when a client who has transferred ownership of the policy to another individual or trust retains an incident of ownership (i.e., the ability to borrow or change beneficiary) that would cause inclusion of the insurance proceeds in his estate for tax purposes. A corporation's right to borrow against a split-dollar policy it owns might be imputed to the insured shareholder as an incident of ownership and cause inclusion of the insurance proceeds in his estate.

### **Step 5: Identify the policy beneficiaries.**

It is critical that policy beneficiaries are correct so that the policy proceeds end up

in the hands of the correct individuals or organizations. Clients often overlook updating policy beneficiaries after major life events have occurred, most frequently in the case of divorce. If a client gets divorced and does not change the policy's beneficiary designation, the ex-spouse will often remain the beneficiary of the policy. Some (although not all) state statutes automatically revoke the ex-spouse as beneficiary on all policies in the event of divorce. In the absence of such a statute, if the insured does not change the beneficiary designation, then an ex-spouse—rather than the client's children or other intended beneficiaries—would likely receive the life insurance proceeds. Furthermore, if a policy's beneficiaries are individuals, unfavorable gift or estate tax treatment of the life insurance proceeds may result.

*Example.* A husband buys a \$5 million policy. His wife is the owner, and their children are the beneficiaries. When the husband dies, the death benefit would not be included in his gross estate (assuming he did not have any incidents of ownership) because his wife owns the policy, and the proceeds are treated as a \$5 million taxable gift from the wife to the children. Thus, that gift might trigger a substantial gift tax. Ideally, the policy should be owned by a trust in which the children are beneficiaries. In that case, the trust can distribute the insurance proceeds to the children as an estate tax-free gift.

### **Step 6: Determine if the amount of coverage is adequate.**

The amount of coverage needed depends on the purpose of the policy. Potential scenarios and different insurance needs include:

■ *Family income:* How much income does a family need if the breadwinning spouse dies? (This is the most common scenario.)

■ *Key man:* How much insurance does a company need to replace a key employee if the employee dies?

■ *Buy-sell:* What is the value of the shares required to be purchased from the estate of a deceased insured shareholder or partner?

■ *Estate liquidity:* How much insurance does a family with a valuable business or substantial real estate holdings need to provide liquidity for its estate tax liability? Some clients will purchase sufficient insurance to cover their entire estate tax liability.



ity, while others will purchase enough to cover only a portion. This is another decision that advisors can help clients make.

If the husband dies at age 35, the family will lose his earnings over the next (assumed) 30 years. The value of that lost

sum needed to replace the lost income is 15 to 30 times the after-tax salary, depending upon the age. For a 35-year-old, the multiple is 25–30:

$$\$180,000 \times 25 = \$4,500,000$$

The husband should purchase \$4.5 million in insurance. Although this amount might seem high, a young person can buy term insurance with little financial burden.

## A closer look at the family income scenario reveals that, without proper calculation, insurance needs are often underestimated.

■ *Charitable bequests:* How much does a client wish to leave to a particular charity?

A closer look at the family income scenario reveals that, without proper calculation, insurance needs are often underestimated.

*Example.* A husband is a lawyer, aged 35, who earns \$300,000 annually. His wife was a lawyer, but now stays at home with their three young children. The family does not have significant liquid savings. How much life insurance does the family need if the husband dies prematurely?

income is the *human life value* for insurance purposes.

Human life value describes how much money is needed today, as a lump sum, to generate the lost income of each year for 30 years. This calculation will be based on the assumption that money will be invested at a 5% after-tax rate, with an inflation rate of 2–3%.

Assuming a 40% income tax bracket, the \$300,000 of income has an after-tax value of \$180,000. In general, the lump

### Step 7: Review a policy's in-force illustrations.

An in-force illustration is a snapshot of a client's current life insurance policy, including its past performance and future projected performance, which are not used with term insurance because premiums are typically level each year, although they are very important for cash value insurance. They are measured in whole life, variable life, and universal life.

These policies have variables that fluctuate and determine the amount of premiums needed to maintain the insurance for the client's lifetime. Interest earned on the cash value and the subsequent investment return is the most important but unpredictable factor in a cash value policy. In

## EXHIBIT 2

### The Eight-Step Process

Step	Action	Importance
1	Locate all of the policies and riders.	Obtain a clear picture of a client's insurance scenario.
2	Create an inventory for the client.	Create a simple, easy way to review policies, and to calendar premium payments on a regular basis.
3	Review the financial strength ratings of each issuing company.	Ensure a company will be able to pay insurance claims. Weak companies may raise premiums.
4	Identify the policy owner.	Verify that insurance will not be included in a client's estate. Policies should often be held by trusts.
5	Identify the policy beneficiaries.	Life changes may require changing policy beneficiaries, particularly a spouse in the event of divorce.
6	Determine if the amount of coverage is adequate.	Guarantee that a family, business, or charity will receive the desired and adequate amount of proceeds.
7	Review a policy's in-force illustrations.	Confirm whether premiums are adequate to provide the desired level of coverage. Possibly reduce premium costs based on a client's improved health status.
8	Be aware of important tax rules.	Avoid inadvertently triggering estate or income tax with incidents of ownership, loans, or improper designations.

whole and universal life, interest is credited to a policy's cash value annually.

In whole life, the interest is part of a dividend; in universal life, it is a straight insurance credit. These credits are based on the performance of the company's investment portfolio. If investment interest rates go down, policy interest rates go down.

**Example.** A universal policy purchased in 1990, when interest rates were 7–9%, with premiums based on the assumption that those rates would continue, would probably be grossly inadequate today. This individual has been paying a premium of \$30,000 annually for a \$2 million policy. Today, such an annual premium would only keep the policy in force until the client reaches age 74, rather than his full life expectancy. This can only be ascertained by reviewing the policy's in-force illustration.

Advisors should make sure that premium funding is adequate. In-force illustrations should project results to age 100 or beyond, and the policy should last well beyond a client's life expectancy. Compare current interest rates with a lower interest rate, to see what the impact will be if interest rates continue to decrease.

The same scenario of declining investment returns rates and declining policy coverage may apply on a variable life policy where investments are chosen by the client. Advisors should review guaranteed universal life policy illustrations for the policy timing of premium payments. These policies have a fixed premium. The timing of premium payments can impact the guarantee. Late payments may shorten the guarantee period. In-force illustrations can reveal these changes, and clients can make extra premium payments if need be.

Finally, a client's health might become more favorable and decrease premiums. For example, quitting smoking, reducing high blood pressure, and benefiting from other health changes could lower costs.

### Step 8: Be aware of important tax rules.

As previously mentioned, estate tax rules can cause policy proceeds to be includible in a client's estate. Under the incidents of ownership rules, if an individual has the right to borrow against a policy, the death benefit will likely be included in their gross estate. As another example, split-dollar agreements may cause unexpected incidents of ownership if not drafted correctly.

Failure to plan for income tax rules may result in a client owing income tax on policy proceeds, cash value, or loans. Advisors, for instance, should verify policy ownership to make sure that the transfer of a policy from one person to another will not be subject to the transfer for value rules that will trigger income tax liability. In the case of policy loans, if the loan balance exceeds the cash value of the policy, the insurance company may cancel the policy. In such circumstances, the amount by which the loan exceeds the basis of the policy will be considered taxable income.

An old policy may have grandfathered tax benefits and replacing such a policy may be detrimental to the client—for example, a single premium policy issued before 1988 will not be subject to the modified endowment contract rules.

### Strengthening Client Relationships

The eight-step process described above is summarized in *Exhibit 2*. CPA finan-

cial planners looking to solidify client relationships for many years to come should think about providing a life insurance checkup, which may alert clients of common mistakes and errors of policy maintenance, as well as to major opportunities for tax savings and cost reductions. □

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