

Life Insurance – it’s not just for liquidity anymore

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I often hear the sentiment from professional advisors that a large estate, if very liquid, need not include life insurance as part of the estate planning arsenal. Their position assumes that such a client can easily accomplish all liquidity-based objectives by simply using cash from the estate. While this may be true, it is mathematically demonstrable that this may *NOT* be “good business”. *In this article we will build a mathematical foundation for an assertion that the explosive leverage of the income-tax-free & estate-tax-free death benefit of life insurance is generally a much more efficient transfer tool than a straight “cash bequest”.* We will consider several variables, including: age, health, mortality costs, and tax implications.

Asset Growth - The Constancy of Change in the Estate

If we assume a net average asset growth rate of 8%, an estate can generally be expected to double in value every nine years. I.e. if a client’s assets total \$6 million today, and these assets are projected to grow at an average rate of 8%, the estate can reasonably be expected to grow to \$12 million in nine years, \$24 million in eighteen years, and \$48 million in twenty-seven years. Consequently a client’s age as well as his or her investing ability must be considered in the estate plan. With other rate assumptions, the estate will double according to the following schedule:

5%	=	14.20 years (doubling cycle)
6%	=	11.89 years
7%	=	10.25 years
8%	=	9.00 years
9%	=	8.04 years
10%	=	7.27 years

Leverage Effect -

The creation of trusts and appropriate gifting can minimize transfer costs to a large degree. However, when all has been done, any remaining assets left in the estate will be vulnerable to an anticipated tax rate of approximately 45%. If we assume this tax rate of 45% on assets for large estates, we can derive that *\$1,000,000 made available outside the estate (in an irrevocable life insurance trust - ILIT) is equivalent to about \$1,818,181 accumulated inside the estate (\$1,000,000 / 55%).* *The true value of life insurance lies in it’s ability to explosively leverage premium dollars outside the estate and inside an ILIT or Dynasty Trust under current law.*

Costs -

In order to address the impact of age on our evaluation, we must look at the variance of life insurance premium costs based on age. The following illustrated costs are derived as an average \$1,000,000 policy in a survivor life contract from a competitive insurer (based on 15 top competitive Survivor Guaranteed UL quotes). The illustrated contract will be funded to guarantee \$1,000,000 coverage for life.

<u>Joint Age</u>	<u>Annual Premium to Guarantee \$1,000,000 for life</u>
45	5,400
55	8,800
65	14,300
70	19,500
75	26,200
80	37,900
85	56,800

Real Impact of Leveraged Growth in an Irrevocable Trust - “The Assertion”

A consideration of costs must also consider the impact of the premium on the estate value through use of an irrevocable trust. By implementing a plan that includes life insurance in an irrevocable trust, we accomplish two goals simultaneously. First, we reduce net asset growth (doubling) by moving dollars systematically out of the taxable estate and into a non-taxable trust, and then we use those dollars to buy coverage leveraging that tax advantage for the benefit of the estate. Our resulting assertion is that life insurance generally provides a significant advantage over a typical investment scenario. It is very difficult to invest money over the long term with an expectation of outperforming the leverage of life insurance and it’s progressive tax advantage combined with the “doubling” cycle of the estate. This begs the question: ***“How long would we have to invest the premium dollars inside the estate to equal the net value of the non-taxed insurance coverage outside the estate?”***

Mathematical Projection -

In our calculation, we must invest the premium dollars for some period of time until they reach \$1,818,181 (45% taxable equivalent of \$1,000,000 inside the non-taxable trust) at an assumed interest rate. Let us assume our client can reasonably expect to earn 12% on their money over the long term in their own business. In a 39% tax bracket, this means the client can net about 7% after-tax investing the premium dollars in his own business.

Therefore, if our clients are joint age 65, we can derive that it will take 33.43 years investing the premium of \$14,300 to grow to \$1.8 million after taxes. In other words, one of them *must* live to age 98 and must earn an average return of 7% *after tax* in order to reach *equality* with the value of the insurance. Most advisors would agree this is not a prudent risk to assume. Following is a comparison of similar calculations at various ages.

<u><i>Joint Age</i></u>	<u><i>Time to Equal \$1M Inside Irrevocable Trust</i></u>
Age 45	\$ 5,400 @ net 7% = \$1.8M in 47 years (age 92)
Age 55	\$ 8,800 @ net 7% = \$1.8M in 40 years (age 95)
Age 65	\$14,300 @ net 7% = \$1.8M in 33 years (age 98)
Age 70	\$19,500 @ net 7% = \$1.8M in 30 years (age 99)
Age 75	\$26,200 @ net 7% = \$1.8M in 26 years (age 100)
Age 80	\$37,900 @ net 7% = \$1.8M in 22 years (age 101)
Age 85	\$56,800 @ net 7% = \$1.8M in 18 years (age 102)

We can raise the assumed net after-tax interest rate even further if the client wishes to presume extraordinary growth, or we can reduce the tax rate if the client wishes to presume congress will extend the law or go even further. Yet, no matter how we try to stretch the limits of credibility in our example to maximize the potential growth of cash inside the estate, it just does not make sense to ignore the simple and extraordinary efficiency of life insurance due to the inherent tax advantages under current law.

*Clearly, this study strongly supports our assertion that funding ANY anticipated bequest (or need) with cash from the estate is likely to be far less efficient than utilizing life insurance to fund that need. This model remains valid whether the purpose is for estate taxes, or for any other specific cash bequest. It is not a question of whether the estate **can** fund the need from cash assets, but rather a question of the advisability of **planning** to do so. It simply does not make good business sense to pay estate taxes or make any anticipated bequest with 100% cash rather than funding it at a cost of 1.4% on the dollar per year for a 65 year-old couple (\$14,300 / \$1M) or even at a cost of 2.6% per year for a 75 year-old couple (\$26,200 / \$1M).*

Other Considerations -

Single Life & Rated Coverage options -

It should be noted that single life contracts have a significantly higher premium than joint “second-to-die” contracts due to higher single-life mortality costs. Nevertheless, our premise remains intact. Although it may take less time to equal the non-taxed trust amount, it is still not prudent business to presume the client can live for the requisite amount of time in order to simply equal the life insurance.

Single Insured Example:

Age 65 Male Non-Smoker to endow \$1M @ 6.5% current interest = \$20,500/year

\$20,500 - \$14,300 (Joint age 65 rate) = \$6,200 difference = 43% mortality increase

\$20,500 = 2.05% of \$1,000,000 (or 01.1% of \$1,818,181).

Age 65 = \$20,500 @ 7% = \$1.8M in 29 years (age 94)

In other words, the single healthy male age 65 must live 29 more years in order to reach equality with the insurance plan available to him today. Consequently, a typical single-life insurance plan can still be a very efficient alternative to a cash bequest.

Charitable Planning – tax discounted bequest

In addition to all the arguments in favor of life insurance planning to fund anticipated estate costs, we should also point out that charitable bequests are especially well treated using such techniques. Life insurance purchased for a charitable bequest, and owned in the name of the charity, is currently income tax deductible to the extent of premiums paid. I.e. a 65-year-old couple can fund a \$1,000,000 lump-sum endowment to their church, alma mater, private foundation, or other charity for a net cost of \$8,727 per year (\$14,308 - 39% federal tax deduction = \$8,737, a true net cost of 0.87% per year).

Rather than a cash bequest, the client would be much better off putting the \$1M in a fixed-rate investment, paying the tax-deductible premium from interest, and then letting the remaining interest continue to grow for their heirs OR they could multiply the charitable bequest by using more of the earnings and increasing the bequest. Our clients could fund the “John and Jane Doe Chair for Entrepreneurial Research” at “Best State University” for very little net cost.

Conclusion -

It is clear that life insurance should never be discounted as a primary estate planning tool regardless of the client's level of wealth and liquidity. Simply because the client has the available cash to fund an anticipated need or desire does not mean the client **should** fund that need with 100% cash from his or her estate. Life insurance, at a fraction of the cost, can often provide a far more efficient use of those dollars.

BIO:

Thomas V. Robertson is President of Robertson & Company, LLC., a life insurance consulting firm providing due diligence and objective transactional sourcing of Trust-owned life insurance policies for professional advisors and their clients nationwide. Tom has been in the life insurance business for over 34 years, with extensive experience in advanced life insurance solutions for high-net-worth clients. Tom works primarily with professional fee-based advisors throughout the US: CPAs, tax attorneys, Trust companies, and their clients. Tom has authored several articles addressing complex life insurance strategies and is currently working on an article addressing the foundational weaknesses found in most Variable Life Insurance policies as they are now designed.

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