

# Life insurance

Advanced Planning Group



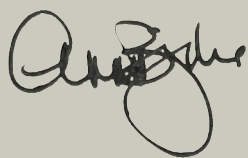
# Foreward

Most people know what life insurance is, but they may not understand how it works and how to plan with it. As a result, life insurance is often overlooked, misunderstood and neglected.

The purpose of this guide is to summarize some key aspects of life insurance and how to incorporate it into your overall plan. In this guide, we start with a high-level discussion of the various uses of life insurance, from income replacement to helping business owners prepare for future events. We then explore how each type of life insurance works and their different features.

We go into more depth in our discussion of planning with life insurance. We cover a range of topics from estate planning and wealth transfer strategies that encompass both the estate and gift tax issues, as well as income tax considerations and the appropriate structures to hold life insurance. We then focus on the unique aspects of life insurance as it relates to business owners and the fulfillment of philanthropic goals. Finally, we discuss the life cycle of the policy and the importance of periodic reviews.

The goal of this guide is to help you better understand this well-known but misunderstood planning tool. We hope you find this guide useful in your planning.

A handwritten signature in black ink, appearing to read "Ann Bjerke". The signature is fluid and cursive, with a large loop at the end.

**Ann Bjerke**  
Head of Advanced Planning



# Introduction

Life insurance can play a crucial role in many estate plans; however, it is often overlooked as a potential strategy, or may not be appropriately utilized and coordinated with other planning objectives. Whether the purpose of insurance is to replace the income of a deceased loved one or to provide liquidity to pay estate taxes in order to preserve a family business, life insurance does something few other assets can do—provide liquidity at a time of great need.

This guide will address several uses of life insurance and outline the types of life insurance, specific issues to consider and why an individual's life insurance portfolio should be reviewed periodically.

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# Uses of life insurance

Life insurance can be used to address a broad range of financial concerns, including providing a safety net for an individual's family in the event of the individual's death, protecting business and financial interests, planning for estate and wealth transfer, or fulfilling a philanthropic goal.





## Income replacement

Life insurance can be used as a means of providing funds to replace lost income of a decedent. It can be used to: (1) cover living expenses, funeral expenses and death taxes, (2) pay off existing debt or (3) create a fund for future expenses (such as college tuition). Even in families where there are multiple income-earners, it may be worthwhile to use life insurance to replace the lost income of the decedent, thereby enabling the family to maintain their accustomed lifestyle and continue savings plans that counted on multiple incomes.

Term insurance (where the policy is designed to stay in place for a specified duration and its lower cost compared to other types of insurance) may be a key reason why it often is used to

provide income replacement. For example, a couple with dependents may need to hire a caregiver in the event one of them dies and this may represent a significant expense which was not previously planned. Life insurance can be the backup plan for unforeseen circumstances.

## Estate planning and wealth transfer

Life insurance can be used as a means to help pay estate and other death taxes at the decedent's death and provide an alternate source of inheritance for family members.<sup>1</sup>

### **Estate liquidity**

The federal estate and gift tax exemption is \$12.92 million per individual in 2023

(\$25.84 million for married individuals).<sup>2</sup>

The exemption is indexed annually for inflation but is scheduled to decrease on January 1, 2026 (at which point it will be \$5 million indexed annually for inflation after 2011). The federal tax rate for transfers over the exemption amount is 40%. For large estates that have a significant amount of illiquid assets, such as interests in closely held entities or real estate, paying the estate tax within nine months after the decedent's death could result in a forced sale of assets at potentially unfavorable prices.<sup>3</sup> A life insurance policy can provide liquidity at death that could be used either to pay the estate tax or to purchase illiquid assets from the estate, and thereby avoid a forced sale or the burden of a loan.<sup>4</sup>

<sup>1</sup> This guide uses the term "inheritance" in its colloquial sense—referring to money or property received from a decedent or by reason of the decedent's death—rather than its strict legal sense. It likewise uses the term "inherit" in its colloquial sense rather than its strict legal sense.

<sup>2</sup> This assumes that each spouse is a US person for estate tax purposes. For a discussion of the gift and estate taxation of non-US persons, see Carrie Larson, *Planning for Non-US Citizens* (a publication of the UBS Advanced Planning Group).

<sup>3</sup> United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) is generally filed within nine months of the decedent's date of death. Filing an Application for Extension of Time to File a Return and/or Pay US Estate (and Generation-Skipping Transfer) Taxes (Form 4768) gives the decedent's estate an automatic six-month extension to file Form 706. Payment is still generally due within nine months of the decedent's death.

<sup>4</sup> The liquidity provided by the life insurance may also be used to pay other death taxes, such as state and foreign death taxes. For a broader discussion of strategies for addressing estate liquidity needs, see Rebecca Sterling, *Planning for Estate Liquidity* (a publication of the UBS Advanced Planning Group).

### **Wealth replacement**

Life insurance can also be used to replace assets from an individual's estate that have been used for other purposes (e.g., charitable bequests or estate taxes) in order to ensure the family's financial legacy isn't diminished by testamentary charitable gifts or estate taxes.<sup>5</sup>

### **Inheritance equalization**

Adult children are often involved in a family business, but sometimes not all family members participate equally. Accordingly, the senior generation may plan to pass the family business only to active family members, but do not wish to disinherit the non-active family members. In this situation life insurance can solve several issues.

In addition to providing liquidity for the family members to pay estate taxes without having to sell the business, it can also provide an alternate source of inheritance for those not involved in the business, thereby allowing the transfer of the family business to active family members without financially disadvantaging non-active family members.

### **Inheritance for blended families**

Foundational estate plans (which, in terms of wealth transfer, generally comprise wills and revocable trusts) frequently leave the majority of the estate to the surviving spouse, and the children do not receive an inheritance until both parents have passed away. Blended families have estate planning needs and considerations that do not

always fit into this structure. Life insurance can be a useful tool in creating an estate plan that addresses the more complex needs of blended families.

For example, assume an individual has children from both a current relationship and a prior relationship. The individual, upon death, would like to provide for the surviving partner and their children. At the same time, the individual wants to leave an immediate inheritance to the children from the prior relationship, rather than delay their inheritance until the surviving partner's death. The children from the prior relationship can be beneficiaries of a life insurance policy insuring the individual's life and receive their inheritance via the life insurance proceeds, leaving the remaining estate to the surviving partner and their children.



<sup>5</sup> This guide uses the term “testamentary” in its colloquial sense—referring to something occurring or taking effect on a decedent's death—rather than its strict legal sense.





Life insurance can be a valuable asset that can help business owners prepare for future events. It can be used to fund a buy-sell agreement and insure against the loss of a key person in the business.

## Business interests protection

Life insurance can be a valuable asset that can help business owners prepare for future events. It can be used to fund a buy-sell agreement and insure against the loss of a key person in the business.

### **Buy-sell agreement**

A buy-sell agreement is a contractual obligation between a business owner and a willing buyer to purchase that business upon the owner's death. Buy-sell agreements are often between co-owners of a business. Life insurance is often used to fund a buy-sell agreement because it provides an immediate source of cash upon an owner's death for the buyer to purchase the deceased's business interest. For example, in a business with two business partners, a buy-sell agreement might require the surviving partner to buy the interest of the deceased partner. Each partner would purchase life insurance on the other partner's life and name themselves as the beneficiary. When one partner dies, the other partner uses the insurance proceeds to purchase the deceased partner's share of the business.

### **Key person insurance**

Key person insurance helps protect a company from the loss of a valuable employee. It is purchased by the business owner or the company to insure an employee who is critical to the success of the business. The company is the owner and beneficiary of the policy. Although the life insurance proceeds can be used for any purpose, it is often used to replace the revenue that the employee would have generated for the company during the period it takes to replace the employee. It can also be used toward the cost of recruiting a replacement—either actual recruitment costs or providing a source of funds to create a competitive compensation package to attract a new recruit.

## Philanthropic goals

Life insurance can also be used to fulfill philanthropic goals. Existing life insurance policies that an individual no longer needs or a new policy, if so desired, can either be donated to a charity or a charity can be designated as beneficiary of the policy.

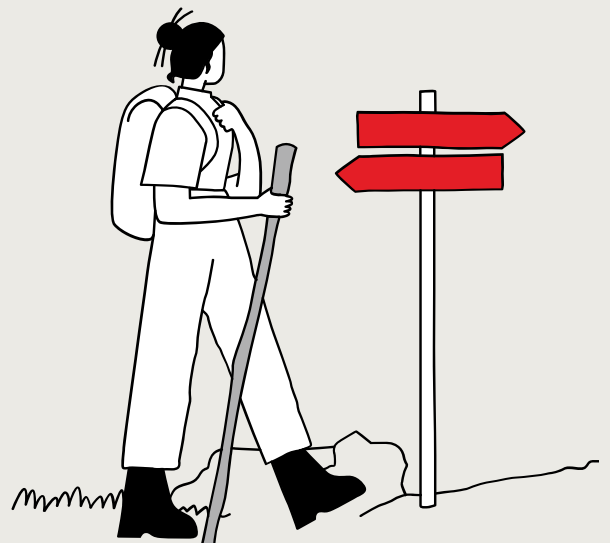
## Conclusion

Permanent life insurance is primarily attractive to an individual who is able to make a long-term financial commitment with minimal need to access the cash of a policy during their life; however, an individual may be able to access cash value in certain circumstances.<sup>6</sup> It is necessary to note, however, that although this guide may analyze life insurance as an investment, it is not an investment in the traditional sense. Although it is acceptable to consider the investment performance of life insurance, and to consider life insurance as an asset class, life insurance should be purchased primarily for its death benefit feature, and not be bought by clients solely as an investment, savings or retirement plan.

<sup>6</sup> For more information on utilizing cash value, see the chapter entitled "Types of Life Insurance."

# | Types of life insurance

There are several different ways that life insurance policies can be structured, and each has features and benefits that are appropriate for different situations. Before purchasing a policy, it is important to understand what the individual is trying to accomplish and how the policy works.





## Basic features

By definition, life insurance is a contract that provides a cash benefit upon an individual's death. That individual is the insured. In a single-life policy, there's one insured. The death benefit is paid when the insured dies. In a joint policy, there are two insureds. Broadly speaking, there are two different types of joint policies. In a survivorship policy (sometimes called a second-to-die policy), the death benefit is paid when the surviving insured dies. For example, a married couple might purchase a survivorship policy on their lives. In a first-to-die policy, the death benefit is paid when the first of the insureds dies.

There are several parties involved in life insurance contracts: the insured, the owner and the beneficiaries. It is common for the owner of the policy to also be the insured, but this may not be appropriate for all situations. At times, the owner of the policy may also be the beneficiary, for example when the owner purchases a policy on their spouse's life. The owner,

not the insured, controls the policy, is responsible for making premium payments and often has the power to designate a beneficiary.

In order to determine the premium, the intended insured is required to go through the underwriting process. Underwriting involves an evaluation of current health, medical history, family medical history, lifestyle, finances and hobbies.

## Term insurance

The simplest contract is a term policy that provides insurance for a specified duration. Typical durations for term policies are 10, 15, 20 and 30 years. Term policies can have a renewable term feature. Another feature of some term policies is convertibility, which allows a policyholder to exchange the term contract for a permanent one. Both renewability and conversion require no evidence of insurability, and the premium is recalculated based on the current age of the policyholder.

Group term insurance is a term policy that is typically provided through a corporate employer as an employee benefit. It allows for fixed rates across the employee pool without going through the underwriting process required for individual term insurance. Premiums may be paid by the employer, and premiums paid for coverage over \$50,000 in death benefit are considered income to the employee. The insurance will typically last the duration of employment, although some group term policies may offer a portability feature, which allows the insured to keep the policy in force after employment ends. The cost of insurance will no longer be priced at group term rates, which typically results in an increase in the premium amount. Similar to the features discussed above, portability requires no evidence of insurability. This feature is particularly beneficial if the insured has new health issues that could make a new insurance policy cost-prohibitive.

## Permanent insurance

An alternative to term insurance is permanent insurance, which is designed to last during the insured's lifetime. This section discusses types of permanent life insurance policies and using them as an alternative asset class.

### Features of permanent life insurance

Permanent life insurance has two key components that distinguish it from term life insurance discussed below.

#### Cash value

Cash value is a savings component unique to permanent policies. Unlike term life insurance, permanent policies do not have a specific duration; therefore, premiums tend to be significantly higher. A portion of the premium for permanent policies may be used to accrue cash value. The cash value generally grows tax-deferred within the policy, and may be withdrawn or borrowed. While there are benefits to having the ability to accrue cash value, it is important to note that any withdrawal or loan can decrease cash value and may reduce the death benefit. Loans will also require interest payments. There may also be tax consequences arising from accessing cash value, depending on the policyholder's basis for income tax purposes.

#### Surrender options

If a policyholder decides to no longer maintain permanent life insurance, several surrender options may be available. In exchange for giving up the death benefit, the policyholder can withdraw the available cash value to use for any purpose. Alternatively, the existing policy can be surrendered, and the cash value used to purchase a new paid-up permanent or term policy with no further premium payments due. The new policy's death benefit amount (and duration of policy, if it is a term contract) will vary based on a number of factors including the amount of cash available, the insured's current age and the current cost of insurance.





Whole life insurance generally is designed to last throughout the insured's lifetime. Whole life policies are typically purchased for two primary purposes: cash value accumulation and death benefit.

### **Whole life insurance**

Whole life insurance generally is designed to last throughout the insured's lifetime. Whole life policies are typically purchased for two primary purposes: cash value accumulation and death benefit. Many buyers of these policies view the cash value component as an additional retirement savings vehicle that they can draw from when the funds are needed to meet future retirement expenses. The death benefit provides liquidity to meet family expenses upon the death of the insured. The value of both components may increase over time but there are some risks associated with owning this type of policy.

Whole life insurance most often is designed so that premiums are paid each year for the insured's lifetime. The policy has the potential to build up significant cash value over time as well. The death benefit and premiums most often are fixed in whole life insurance policies. If the cash value builds significantly, the death benefit may increase over time as long as loans are not taken from the policy. The premiums may also be structured to be paid for a fixed number of years, usually 10, 12, 15 or 20, and in some cases may even be structured as a single payment.<sup>7</sup>

Whole life policies may also pay dividends. The dividend levels of the policies are dependent on investment returns of the insurance company's general account, administrative expenses and mortality costs. Dividends can be received as a cash

payment to the policy owner or used to accrue as cash value, purchase paid-up additions or riders, or reduce or pay premiums.

### **Universal life insurance**

Universal life insurance is a variation on whole life and is designed to offer more flexibility on the timing and amount of premium paid. There is a suggested amount of level premium to be paid to maintain the policy; however, other than the first year when a minimum payment is required, the policyholder has complete discretion over how much is paid.

Payments can be reduced or even skipped; however, this can negatively impact the potential growth of cash value. Unless a minimum amount of cash value is maintained, the policy will lapse. In addition, depending on the policy's investment returns, additional premium payments may be needed even if the suggested level premiums are paid.<sup>8</sup>

Similar to whole life policies, cash value can build up in universal life policies. When the owner pays the premium on a universal life insurance policy, a portion of each payment goes toward paying for the death benefit and another portion goes to building up the policy's cash value. Over time, after money has accumulated, the owner may be able to withdraw or borrow against the cash value of the policy. However, it's important to know that this may reduce the death benefit, create a tax implication or even cause the policy to lapse.

<sup>7</sup> However, when structuring premium payments, owners should be aware of whether or not they are creating a modified endowment contract issue. IRC § 7702A.

<sup>8</sup> For example, indexed universal life insurance policies allow the policy owner to periodically allocate cash value to either a fixed account or one or more equity-indexed accounts. These policies usually guarantee a minimum return for the fixed account but cap the maximum return that a policy owner can receive from the indexed accounts.



The flexibility of a universal life policy also extends to the death benefit by giving the owner the ability to increase or decrease the death benefit. Increasing the policy's death benefit will most likely increase the premium. Alternatively, the owner may choose to reduce the death benefit to reduce the cost of the policy. As circumstances change, this adjustment feature can be attractive.

#### **Variable universal life insurance**

Variable universal life insurance policies are a variation of standard universal life insurance policies. They do not provide any minimum cash value. The policy owner is able to decide how to allocate the policy's premiums among the investment options provided by the insurance company including investment subaccounts or options with a fixed rate of return. The variable feature shifts the investment risk from the insurance company to the owner, and increases and decreases are directly credited to the cash value in the policy.

However, unlike a direct investment in the market, investments within the policy are subject to mortality charges, which will reduce overall returns. Although there is an investment component to these policies, a variable policy is still a life insurance contract. Variable universal life insurance policies have the flexibility of universal policies, while also providing investment opportunity.

#### **Guaranteed universal life insurance**

Another subset of universal life insurance policies is guaranteed universal life insurance. Guaranteed universal life insurance strikes a middle ground between term and whole life. Guaranteed universal life provides a guaranteed death benefit along with a fixed premium payment schedule. Guaranteed policies are generally not designed to generate cash value. Although the guaranteed feature removes the flexibility associated with typical universal policies, it also removes the uncertainty on how much will need to be paid to prevent the policy from lapsing.

### Private placement life insurance

Private placement life insurance (PPLI) is a form of variable universal life. PPLI is available only to purchasers who can demonstrate business or financial experience to understand what they are buying, can pay at least the substantial initial premium for the policy and, presumably, can tolerate the risks associated with the product.<sup>9</sup> Like variable universal life, PPLI cash values are held in separate or segregated accounts at the insurance company. PPLI generally is an unregistered investment product (i.e., it is not registered with the Securities and Exchange Commission (SEC)).

Like standard insurance products, investment earnings within a PPLI policy accumulate on a tax-deferred

basis and may be withdrawn without taxation via policy loans or tax-free withdrawals up to basis. There is no immediate tax due if changes in the PPLI portfolio are made, such as replacing one fund with another or rebalancing the portfolio, subject to the portfolio's limitations. Additionally, as is the case with other life insurance products, death benefits are income tax-free (so long as there's no transfer for value). (We discuss the transfer for value rule below.)

As noted above, PPLI is similar to other variable universal life insurance products; however, it offers access to unregistered alternative investment options. PPLI provides death benefit protection, while also providing potential tax advantages, asset protection and

access to capital through policy loans or tax-free withdrawals up to basis. Rather than specifying a death benefit amount, the PPLI buyer typically specifies an amount to be invested, keeping in mind the minimum amount required so that the policy still qualifies as a life insurance contract for federal tax purposes.<sup>10</sup> PPLI provides policy owners an ability to select alternative asset classes not available in other life insurance policies, such as hedge funds and credit strategies.

Some considerations with respect to PPLI include (1) potentially riskier subaccounts, (2) less liquidity (e.g., lock-ups on hedge funds and other alternative investments<sup>11</sup>) and (3) lack of guarantees when compared with traditional life insurance products.

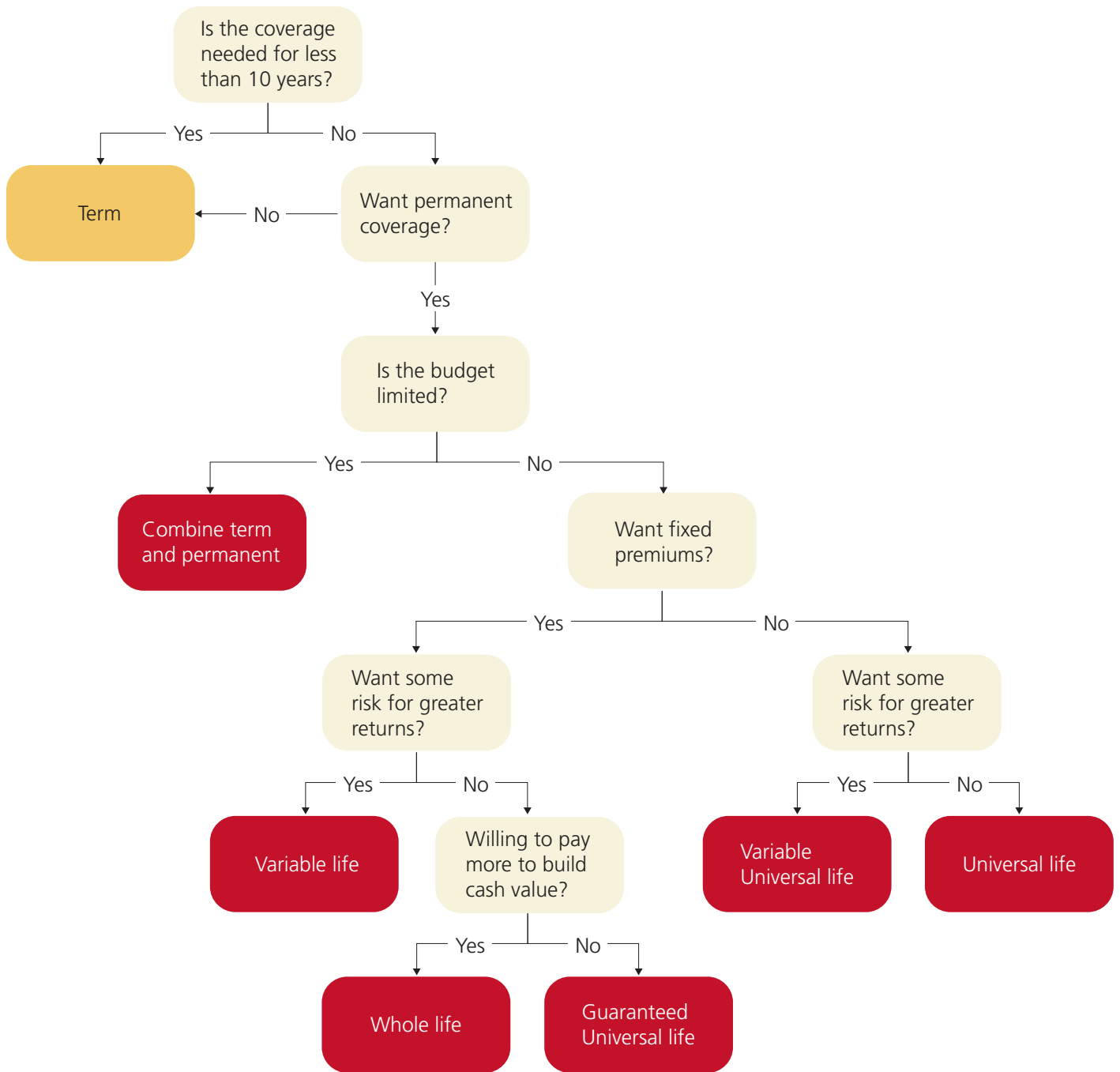


<sup>9</sup> Prospective purchasers must be accredited investors and qualified purchasers. For a discussion of accredited investors, see Ann Bjerke and Laura M. Chooljian, *Estate Planning and Securities Law Implications* (a publication of the UBS Advanced Planning Group).

<sup>10</sup> IRC § 7702.

<sup>11</sup> Lock-ups may be waived by the investment manager in the event of death of the insured, or the PPLI policy may be issued with a rider deferring the locked-up cash values in the event of death until the lock-up period is satisfied.

## Questions to consider when thinking about life insurance



Please note that this decision tree does not apply absolutely or universally. This diagram represents a sample of some questions an individual may consider when thinking about life insurance.



# Trusts and estate planning considerations

Life insurance is purchased for various purposes—to replace lost income, for estate tax liquidity or as a means of wealth transfer—to name a few. The purpose of the insurance often dictates the ownership structure. While it is commonly known that life insurance is generally not subject to income tax, life insurance owned in an individual’s name causes the life insurance proceeds, or death benefit, to be taxable in the owner’s estate for estate tax purposes.<sup>12</sup>



<sup>12</sup> If a decedent’s estate is subject to federal estate tax, the death benefit of any life insurance policy includable in the decedent’s estate will be subject to the 40% federal estate tax. In 2023, the federal estate tax exemption amount is \$12.92 million (indexed for inflation annually).



## Irrevocable life insurance trusts

If life insurance is owned by the insured, the death benefit will be includable in the insured's estate for estate tax purposes. If the insured has a taxable estate for federal estate tax purposes, it may be preferable to structure the ownership of the life insurance so that the death benefit is not part of the insured's estate. The most frequently employed means to accomplish this is for the policy to be owned by an irrevocable life insurance trust (ILIT).<sup>13</sup> If structured correctly, an ILIT can hold and distribute insurance proceeds estate- and income-tax free to the intended beneficiaries.

An ILIT is typically established by the owner, as the insured, with family members as the ILIT beneficiaries. The trustee, who may be an individual or an institutional fiduciary, is responsible for holding and managing the policy (or other trust property) according to the trust document. To ensure that the insurance proceeds are not taxed in the insured's estate, the insured cannot retain any incidents of ownership in the policy nor any beneficial interest in the trust.<sup>14</sup> The insured therefore cannot serve as trustee, and the selection of the trustee and beneficiaries will depend on the type of policy the ILIT owns.

For example, if the ILIT is designed to own a policy on the insured's life, the insured's spouse could be the trustee and could even be a beneficiary of the trust provided certain provisions are included to protect against adverse estate tax consequences. For tax reasons, however, the spouse should not be a trustee if the trust owns a second-to-die policy. (For additional considerations regarding community property, see the discussion below.)

<sup>13</sup> The policy also could be owned by the intended beneficiaries (whether initially purchased by or gifted to such beneficiaries). Although this may be simpler than holding the policy in ILIT, it has a couple potential disadvantages. If a beneficiary owns a policy, the policy's value would be includable in the beneficiary's estate for estate tax purposes, and it generally would be reachable by the beneficiary's creditors.

<sup>14</sup> An incident of ownership denotes the possession or retention of certain rights or benefits over property. In the context of life insurance, incidents of ownership include, among other factors, the right of the insured or their estate to the economic benefits of the insurance, the power to change the beneficiary and the power to surrender or cancel the policy.



Gifts of an existing policy to an ILIT will trigger the three-year lookback rule. The grantor will have to survive the transfer of the policy by three years; otherwise, the proceeds will be includable in the grantor's estate.

### Ownership of policy

There are a variety of ways to fund an ILIT with a life insurance policy. The simplest way is for the ILIT to be the owner of a new policy from the onset. Once the trust is established, the grantor (creator of the trust) makes a cash gift into the ILIT (using some of the grantor's lifetime exemption). The trustee of the ILIT then uses the funds to purchase the life insurance policy (most likely on the life of the grantor). By structuring the transfer of the policy this way, the three-year lookback rule (discussed below) is generally avoided.

However, if the grantor wants to gift an existing life insurance policy into the ILIT (as opposed to purchasing a new one), then the grantor will have to use lifetime exemption. The amount of lifetime exemption used for the gift will depend on the fair market value of the policy. The fair market value is typically provided by the insurance carrier and will depend on a variety of factors including age of the policy, premiums paid or outstanding, replacement cost and interpolated terminal reserve of the policy.<sup>15</sup> Gifting an existing policy to an ILIT will trigger the three-year lookback rule. The grantor will have to survive the transfer of the policy by three years; otherwise, the proceeds will be includable in the grantor's estate.

Alternatively, another method to transfer an existing policy to an ILIT is a bona fide sale for adequate consideration. Issues to consider if employing this strategy include policy valuation, transfer for value rule and

ongoing premium payments. For additional information on transfer for value rule and premium payment options, see below.

There are also additional considerations for those individuals living in community property states. If the surviving spouse is an intended beneficiary of the ILIT or serving as trustee, appropriate steps and documentation need to be in place in order to ensure the policy is kept outside of the grantor's estate for estate tax purposes. The type of policy, funds used to purchase the policy, ongoing premium payments and other contributions should be assessed carefully. Any funds or policies contributed to such an ILIT must come from the grantor's separate property. Proper documentation memorializing the separate property nature of any property contributed to the ILIT is crucial. If the policy is a second to die policy, this may not be as big of a concern; however, neither insured should act as trustee of the ILIT.

By contrast, if the insured wants the proceeds outside of their estate but does not want to use an ILIT, there are other options available. As discussed above, the intended beneficiaries can be the initial purchasers of the policy, the intended beneficiaries can purchase the policy from the insured owner or the insured owner can gift the policy to the intended beneficiaries. Also discussed above, these strategies have similar concerns such as policy valuation, transfer for value rule, and ongoing premium payments.

<sup>15</sup> The interpolated terminal reserve (ITR) is a value calculated from the policy's reserve value at a particular point in time (e.g., date of the gift). A policy's terminal reserve is the amount of money that the life insurance carrier has set aside by law to guarantee the payment of policy benefits and is determined once a year. ITR is most typically used to value a life insurance policy for transfer tax purposes and is provided by the issuing life insurance carrier.



### **Premium payment**

Unless the life insurance policy is fully paid, in order to keep the policy intact, the trustee will need a source of funds to pay these premiums. The grantor could contribute funds to the ILIT that would generate enough resources to pay the premiums. Such upfront contribution will most likely require the grantor to use a portion of the grantor's lifetime exemption amount. If feasible, this approach may be the simplest and potentially eliminate the procedural requirements associated with annual funding, discussed below.

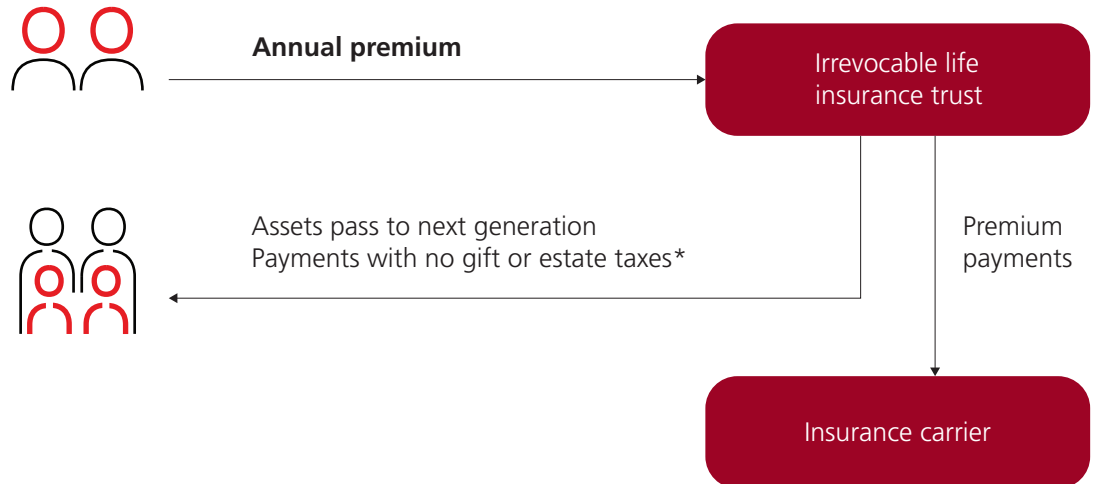
Alternatively, the grantor may be able to take advantage of the gift tax annual exclusion instead of using their lifetime exemption. An ILIT is typically structured so that transfers to the trust qualify for the gift tax annual exclusion to the maximum extent possible.<sup>16</sup>

For a gift to qualify for the annual exclusion, it must be a present interest gift, i.e., the beneficiary has an immediate right to use, possess and enjoy the property contributed. To create the requisite present interest in a trust, the ILIT generally provides that each beneficiary has the right to withdraw a portion of each contribution.

To help make certain that the gift to the ILIT is treated as a present interest gift, an ILIT generally provides that the trustee must notify the beneficiaries of the gift and of their right to withdraw the gifted funds. The beneficiaries typically have 30 to 60 days to make the withdrawal. The trustee should keep copies of the letters notifying the beneficiaries of their withdrawal rights in case of any future questions by the Internal Revenue Service (IRS).

<sup>16</sup> The annual exclusion permits an individual to make gifts of up to \$17,000 in 2023 (indexed for inflation) per beneficiary to as many beneficiaries without the gifts being considered taxable. A married grantor may elect with their spouse to treat all gifts made by either (other than gifts to the other spouse) as being made one-half from each. This has the effect of doubling the annual exclusion available for each donee, enabling them to make annual gifts of up to \$34,000 (indexed for inflation) per beneficiary, and allowing for the possibility of utilizing both spouses' annual exclusion. The gift-splitting right is optional and may be taken or ignored in any calendar year. In order to exercise the right, the spouses must consent, on an annual basis, to treat all gifts made by either as split gifts. A couple may not, therefore, elect to apply the gift-splitting privilege to some gifts but not others in the same calendar year. However, if the non-grantor spouse is a beneficiary of the ILIT, gift splitting may not be available.

*Example.* Sam creates an ILIT for the benefit of Sam’s two children, Avery and Logan. The ILIT purchases a life insurance policy on Sam’s life, and the annual premiums are \$20,000. The ILIT provides that each time Sam makes a gift to the ILIT, Avery and Logan each have a temporary right to withdraw their pro-rata share of the gift (in this case, one-half). When the premium is due, Sam transfers \$20,000 to the trust. The trustee notifies Avery and Logan that they each have the right for 30 days to withdraw \$10,000 from the trust. As a result, Avery and Logan each have a present interest in the gift. Because each child’s right of withdrawal is less than the annual exclusion amount of \$17,000, the gifts qualify in full for the annual exclusion and do not use up any portion of Sam’s gift tax exemption.<sup>17</sup>



\*Assuming trust is structured and administered properly and premiums fall within certain limits, as discussed herein.

Alternatively, as discussed above, if the life insurance policy is not owned by the insured and instead owned by the intended beneficiaries, the insured may make gifts to the intended beneficiaries without paying gift taxes.<sup>18</sup> The policy owner can then use these gifted assets for the payment of premiums to the insurance company.

When making gifts of assets to an ILIT (or policy owner), premium payments must be made in cash to the insurance company. The source of these cash gifts may be cash reserves or earned income, but if those types of assets are not readily available, many other sources can be tapped for these gifts. Investment assets, such as stocks or bonds, could be liquidated, although it is important to consider the potential income tax consequences. In addition, the grantor may consider whether (1) to liquidate the investment, pay the taxes and then gift the cash proceeds, or (2) to gift the investment itself and instead have the trustee of the trust sell the assets and use the proceeds for premium payments. The income tax status of the trust may impact this decision.

<sup>17</sup> These gifts count against the grantor’s overall annual gift exclusion limits with regard to the trust beneficiaries, so other annual gifts to those beneficiaries should be coordinated with the grantor’s gifts to the trust.

<sup>18</sup> Individuals generally may gift \$17,000 per year (or \$34,000 if married), and additionally up to \$12.92 million in 2023 (indexed for inflation), without paying gift taxes.



## Split dollar

A split dollar arrangement is a plan in which a life insurance policy's premium, cash values and death benefit are split between two parties. These types of plans are generally used in a private (family) or employment context. Private split dollar arrangements can help with estate tax liquidity, potentially minimizing income, estate and gift taxes connected with the funding of large premiums and reducing the cash flow required to fund a life insurance policy. Employment split dollar plans are generally used by entities as an executive benefit to encourage employees to remain with the employer, to provide key person protection and to provide an employee with supplemental retirement income.<sup>19</sup>

### Structure of a split dollar arrangement

Split dollar plans are generally structured with either an endorsement or collateral assignment approach.

#### Endorsement split dollar

An endorsement split dollar arrangement is most often used in the employment context or when

the employer wishes to maintain control of the policy. Generally, in an endorsement plan, an employer owns a policy on the employee's life and endorses some or all of the death benefit to the employee or their ILIT.<sup>20</sup> This authorizes the employee to designate a beneficiary of the remaining life insurance death benefit. Pursuant to the split dollar arrangement, the employer receives its interest in the policy (i.e., return of premiums, cash value or greater of the two) upon maturity of the policy or termination of the split-dollar arrangement prior to the death of the employee, and any remaining proceeds pass pursuant to the employee's designation discussed above.

#### Collateral assignment split dollar

Collateral assignment split dollar arrangements can be established in a private or employment context. In the private context, a collateral assignment arrangement is typically structured where the owner and beneficiary of the policy are an ILIT. The non-owner, generally the grantor of the ILIT, will pay, directly to the insurance company or indirectly through a loan to the ILIT,

all or a portion of the premiums on the policy. The ILIT will then assign or pledge the policy's cash value or death benefit as security for the repayment of premiums advanced by the grantor.

### Taxation of a split dollar arrangement

Split dollar arrangements are generally taxed under two separate regimes: the economic benefit regime and the loan regime. How the split dollar arrangement is structured will determine the appropriate taxing regime. Endorsement split dollar arrangements are almost exclusively subject to the economic benefit regime; growth (equity) in the policy's cash value benefits the owner (i.e., the individual or the employer). Generally, collateral assignment arrangements are structured in two different ways based on who benefits from the growth (equity) in the policy. If the non-owner benefits (often referred to as a non-equity collateral assignment split dollar), then the economic benefit regime generally applies. If instead the owner benefits, then the loan regime generally applies.

<sup>19</sup> When used in an employment context, the employee should also be cognizant of the potential compensatory nature of the arrangement.

<sup>20</sup> If the employer endorses some or all of the death benefit to the employee's ILIT to keep the proceeds from being subject to estate tax in the employee's estate, the employee will be making a gift to the ILIT of the economic benefit amount. (The economic benefit amount is discussed below.) This amount will be subject to gift taxes annually. Provided that the amount of the gift is covered by the employee's annual gift tax exclusion, the employee should not incur gift taxes.

### Economic benefit regime

For example, if an employer is the owner of the life insurance policy under a split dollar arrangement, the employer's premium payments are treated as providing taxable economic benefits to the employee. The value of the economic benefits provided to the employee for a taxable year would include the employee's interest in the policy's accessible cash value, if any, and the current life insurance protection afforded the employee.<sup>21</sup> In this employment context, the employee annually reports the economic benefit cost as income. Additionally, if the employee has endorsed the death benefit to an ILIT, the economic benefit amount also constitutes a gift for federal gift tax and generation-skipping transfer (GST) tax purposes. A similar analysis would also apply in a family context, whether endorsement or non-equity collateral assignment.<sup>22</sup>

### Loan regime

Unlike a split dollar arrangement under the economic benefit regime, a split dollar arrangement under the loan regime includes a loan interest component. Interest is applied to the cumulative premiums paid instead of an economic benefit cost as discussed above. Generally, under the loan regime, the insured lends the annual premium to the ILIT (owner of the policy). The trustee of the ILIT repays the loan either during lifetime using a portion of the policy's net cash value and other available funds or at death using the life insurance proceeds. The principal loan balance is equal to the cumulative premiums paid. In addition, if interest is not paid on an annual basis, the unpaid interest may be capitalized and added to the principal balance of the loan. The gift and income tax value of the arrangement will be based on the annual loan interest.

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## Summary of split dollar treatment

Type of arrangement	Equity/non-equity	Owner of policy	Regime
Non-equity collateral assignment	Gain in the policy benefits the non-owner	Insured or ILIT	Economic benefit regime
Endorsement	Gain in the policy benefits the owner	Employer or business	Economic benefit regime
Loan arrangement	Gain in the policy benefits the owner	Insured or ILIT	Loan regime

## Estate tax considerations

In addition to removing a policy from the owner's estate and providing wealth replacement, life insurance can help pay estate taxes. Often, one objective of owning life insurance is to provide liquidity to pay estimated estate tax liability. As a result, an ILIT is generally structured to allow the ILIT to lend assets (i.e., insurance proceeds) to the insured's estate to pay estate taxes, which are generally due nine months after death.<sup>23</sup> Alternatively, the ILIT could buy illiquid assets from the insured's estate to provide the necessary liquidity. If the purpose of the insurance is to provide wealth replacement for a spouse, children or other family members, the proceeds may be retained in the trust for their benefit, and other assets are used to pay the estate tax. The ILIT will set forth the terms for the administration and distribution of the funds.

<sup>21</sup> Treas. Reg. § 1.61-22(d).

<sup>22</sup> The compensatory nature of the arrangement may not be applicable in a family context.

<sup>23</sup> An ILIT cannot pay the insured's estate tax directly. One of the options above should be utilized to preserve the estate planning benefits.



One advantage of life insurance policies is that the death benefit is not normally subject to income tax when received. One notable exception to this is the transfer for value rule, which stipulates that if a life insurance policy is transferred for something of value, a portion of the death benefit is subject to taxation as ordinary income.

## Income tax status considerations

A trust that owns an insurance policy on the life of the grantor or the grantor's spouse (or both) is generally a grantor trust. A trust qualifies as a grantor trust when the grantor retains certain rights, interests or powers under the trust.<sup>24</sup> Consequently, the grantor is treated as the owner of the trust assets for federal income tax purposes (and thus must report the trust's income, deductions and credits on their personal income tax return).<sup>25</sup> A nongrantor trust is its own taxpayer. The income status of the trust should be kept in mind when determining whether to give cash or other assets to the trust in order to pay the premium. Most often, a gift of cash will be the most efficient method.

For example, if the grantor has insufficient cash for payment of premiums, the grantor may gift investment assets to the ILIT. The trustee will subsequently need to sell the assets and use the cash proceeds for premium payments. The income tax consequences to the grantor as a result of the sale will be dependent on the ILIT's income tax status. If the ILIT is characterized as a grantor trust, the grantor generally is held responsible for reporting and paying the income generated by the ILIT (i.e., the sale of the investment assets). All such income is reported on the grantor's personal

income tax return.<sup>26</sup> In contrast, if the ILIT is characterized as a nongrantor trust, to the extent possible, the trustee of the ILIT is generally responsible for filing a trust income tax return, and the trustee will use trust assets to pay any income taxes due.<sup>27</sup>

Beyond the structure of the ILIT, there are other income tax issues associated with life insurance policy. One advantage of life insurance policies is that the death benefit is not normally subject to income tax when received. One notable exception to this is the transfer for value rule, which stipulates that if a life insurance policy (or any interest in that policy) is transferred for something of value (i.e., money or property), a portion of the death benefit is subject to taxation as ordinary income.<sup>28</sup> For example, if a grantor sells a life insurance policy to a nongrantor trust, because a nongrantor trust is considered a separate taxpayer, this will trigger the transfer for value rule. The portion of the death benefit equal to the consideration paid by the nongrantor trust to acquire the policy, plus all future premiums paid by the nongrantor trust (i.e., the transferee's basis in the policy), are received income tax-free, but the remaining death benefit is taxed as ordinary income.<sup>29</sup>

<sup>24</sup> For more information on grantor trusts, see Casey Verst, *Using Irrevocable Grantor Trusts to Transfer Wealth* (a publication of the UBS Advanced Planning Group).

<sup>25</sup> If structured properly, the trust assets should be excluded from the grantor's estate for estate tax purposes.

<sup>26</sup> Generally, the grantor would use personal assets, held outside of the ILIT, to pay these income taxes. Therefore, the grantor should ensure that sufficient non-trust liquid assets are available to pay this tax.

<sup>27</sup> The grantor should therefore ensure that the gift of non-liquid assets to the ILIT will also be sufficient to pay the associated income tax liability.

<sup>28</sup> There are certain exceptions to the transfer for value rule, including, but not limited to, transfers to the insured, to a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is a shareholder or officer. See IRC § 101(a)(2).

<sup>29</sup> Treas. Reg. § 1.101-1(b)(3)(i).





## Generation-skipping transfer tax considerations

The GST tax is a separate and additional layer of tax on transfers to recipients who generally are two or more generations younger than the donor (known as skip persons). The GST tax may be imposed on transfers that may or may not also be subject to gift or estate tax. Simply stated, the GST tax is a flat tax applied at the highest estate tax rate in effect at the time of the transfer (40% in 2023) and applies to both direct transfers and transfers in trust.

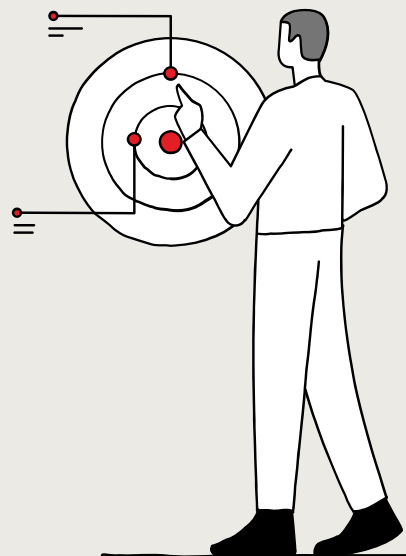
Every individual currently has a \$12.92 million exemption from GST tax that they may use over their lifetime (or if unused during the individual's lifetime, at death).<sup>30</sup> The GST tax exemption can shelter transfers made directly to skip persons from GST tax (e.g., a gift to a grandchild), or it can be allocated to a properly structured trust, which enables the trust and all appreciation on its assets to pass to future generations free of wealth transfer tax.

This GST tax exemption enhances the ability to maximize wealth transfer through lifetime gifts—when used in conjunction with the estate tax exemption, it can remove all future return on gifted assets from the grantor's estate so that it is not subject to any wealth transfer tax at death. One way to invest some, or all of the gifted assets, is in a second-to-die life insurance policy held in an ILIT. If properly structured as a dynasty trust, the ILIT can leverage the GST tax exemption, and the assets in the dynasty trust will not be subject to estate tax. A dynasty trust is a trust that: (1) is designed to last for as long as state law allows (and in some states there is no maximum term for trusts, so they can, in theory, be perpetual); and (2) is exempt from the GST tax as a result of the grantor's allocation of GST tax exemption to the trust, which allocation may be automatic in certain circumstances.

<sup>30</sup> Like the estate and gift tax exemption, this exemption is indexed for inflation and scheduled to decrease to \$5 million (indexed for inflation from 2011) on January 1, 2026.

# Life insurance planning for businesses

Life insurance can play an integral role in both estate planning and business planning. Although there are many types of business insurance designed to mitigate various risks, this section will focus on the risks associated with the death of an owner or key employee.





## Buy-sell agreements<sup>31</sup>

One of the most important, and sometimes overlooked, issues for a business is planning for continuation after the death, disability or retirement of an owner. A buy-sell agreement can provide for the orderly transition of the business and avoid the need for a fire sale (or forced liquidation for less than market value) of the business or the need to transfer the business to family members who may not be capable of running the company.

A buy-sell agreement is an agreement between the owners of a business in which they require a future sale of interests in the business upon a triggering event, such as the death or disability of an owner. The purchaser may be a key employee, a co-owner of the business, the business itself or a third party. A buy-sell agreement creates a market for a business owner's interest as a means for all of the

owners to control who does and does not ultimately own an interest in the business—and under what terms—after a triggering event.

A key consideration is how the buy-sell agreement will be funded. There are many ways to fund a buy-sell agreement: take the funds from business or personal assets, implement a savings program, make installment payments or life insurance. Life insurance may be a cost-efficient way to fund a buy-sell agreement and is often used to provide liquidity to fulfill obligations under the buy-sell agreement. The other funding mechanisms rely on the availability of cash within the business or owner's personal resources, or positive investment returns on savings, and there is no certainty that the amount needed would be available upon the death of a business owner. The

particular facts and circumstances of the business and its owners should ultimately drive that decision.

### Types of buy-sell agreements

There are three types of buy-sell agreements: the redemption agreement, the cross-purchase agreement and the hybrid agreement.

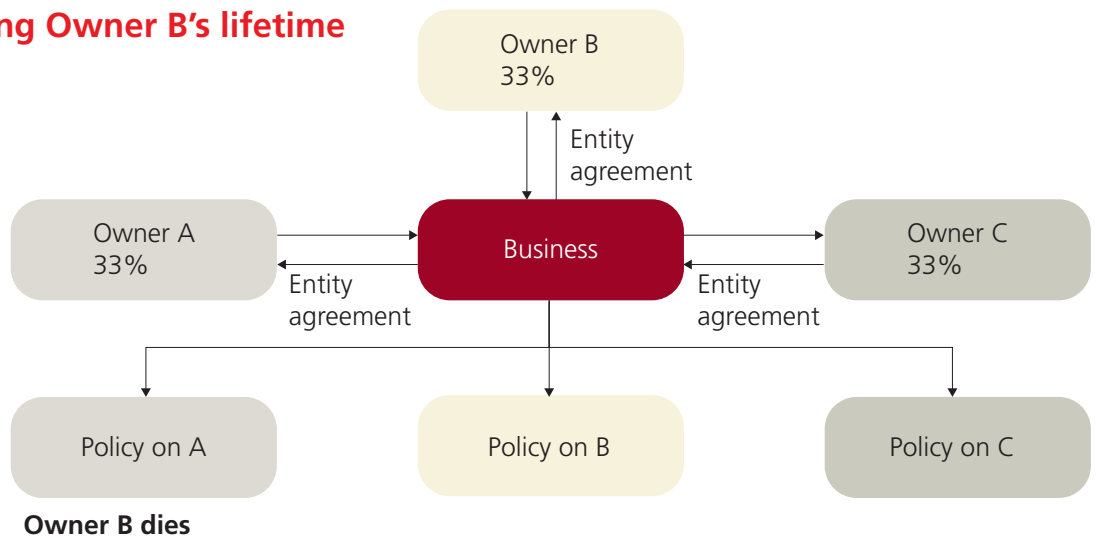
#### Redemption agreement

With a redemption agreement approach, the business agrees to purchase the departing owner's interest. The departing owner must commit to sell their interest back to the business upon the triggering event. When there are multiple owners of a business, using a redemption agreement funded with life insurance is usually simple and straightforward, because the business owns the life insurance policies.

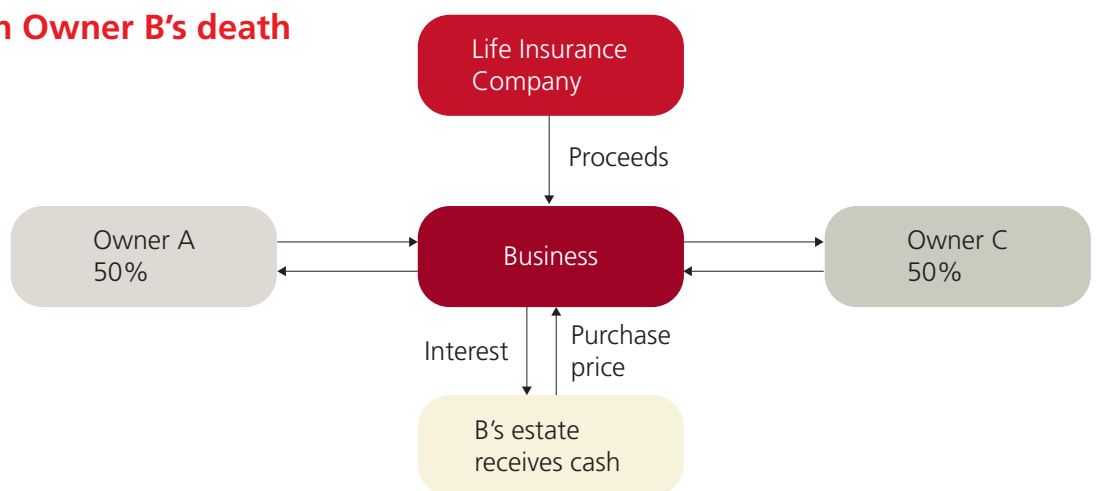
<sup>31</sup> For more information on buy-sell agreements, see Jacqueline Denton, *Buy-Sell Agreements* (a publication of the UBS Advanced Planning Group).

Generally, with a redemption agreement, the business can buy life insurance policies insuring each owner. At the death of an owner, the insurance proceeds received by the business can be used to liquidate the deceased owner's business interest. A redemption agreement can also cover the disability of an owner by including a disability rider on the life insurance policy to provide flexibility and assistance in the event of the unexpected disability of an owner.

### During Owner B's lifetime



### Upon Owner B's death



### Cross purchase agreement

A cross purchase agreement involves an agreement between the individual co-owners of a business. Each co-owner agrees to purchase a portion of or all of the departing co-owner's business interest. In addition, each co-owner must legally bind their estate to sell their business interest to the surviving owners pursuant to the agreement.

When insurance is used to fund a cross purchase agreement, each business owner purchases a separate insurance policy on each of the other co-owners. As the number of business owners increases, the complexity of managing the number of policies required under the cross purchase agreement increases and can become onerous. Also, the payment of required premiums may be problematic due to the varying ages and medical history of each of the owners. One way to address these concerns is by establishing a trusteed cross purchase agreement.

A trustee cross purchase agreement limits the required number of insurance policies to the number of owners in the cross purchase agreement. Under this arrangement, the trustee purchases one life insurance policy on each individual owner. Each business owner contributes their share of the premium to the trustee in proportion to their ownership interest. When established in a business context, the owners' contribution of premium amounts to the trust should not constitute a gift, nor should it trigger gift tax implications as it might with other trust arrangements. When an owner dies, the insurance proceeds are collected by

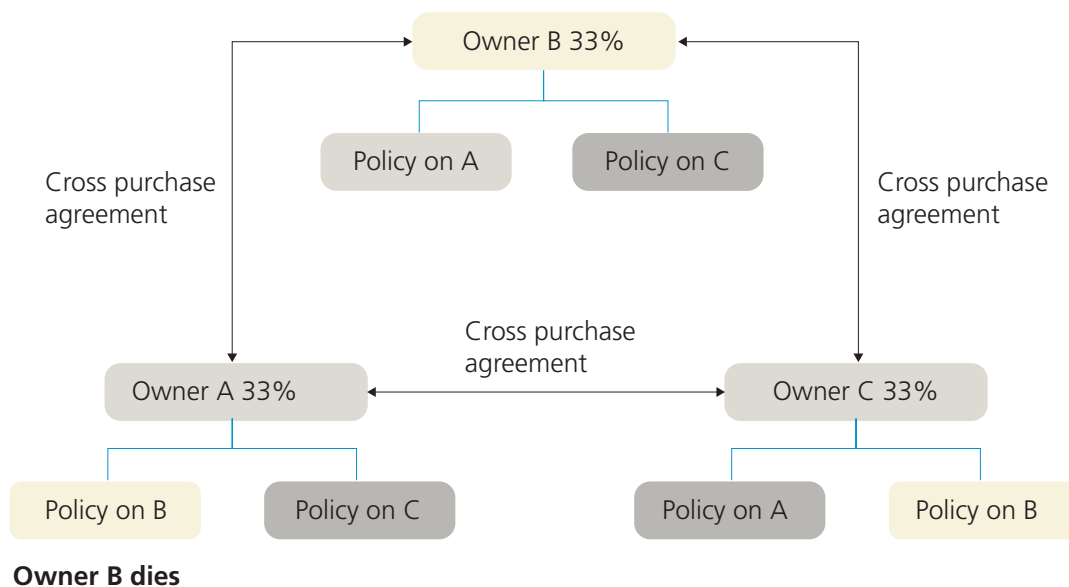
the trustee who then distributes a proportionate share to each of the surviving owners. The surviving owners in turn use the proceeds to buy the decedent's business interest as outlined in the cross purchase agreement. The life insurance proceeds received by the trust should not be subject to estate tax. However, the decedent's business interest is includable in their estate and may or may not be subject to estate tax.

*Example.* Avery, Sam and Cameron are equal owners of a business valued at \$3 million. Pursuant to the trustee cross purchase agreement, the trustee

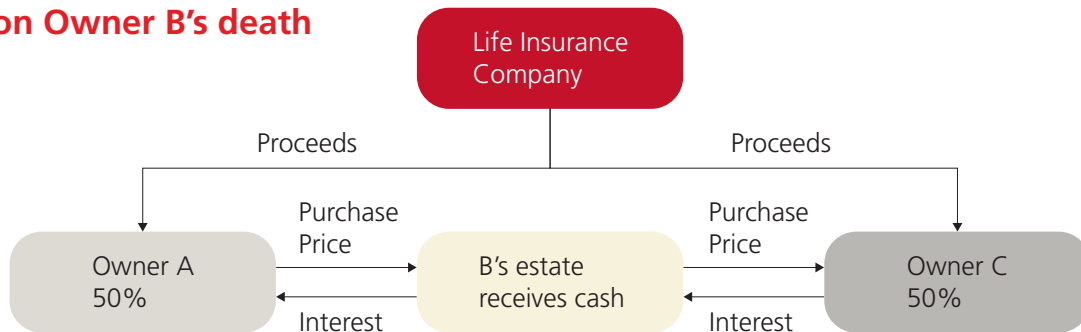
purchases a \$1 million policy on the life of each owner (a total of three policies). Each owner contributes their share of the insurance premiums to the trust. At Cameron's death, the trustee collects the \$1 million insurance proceeds and distributes \$500,000 each to Avery and Sam. They each use the proceeds to purchase Cameron's interest from Cameron's estate.

In contrast, if Avery, Sam and Cameron funded a standard cross purchase agreement with life insurance, there would be a total of six \$500,000 insurance policies.

### During Owner B's lifetime



### Upon Owner B's death





Implementing a funded buy-sell agreement that fits the needs of the business is an important factor to a potential smooth and efficient transition of a business upon an owner's departure.

### Hybrid agreement

Often, determining whether the business itself or the co-owners should purchase a departing owner's interest may be difficult to assess at the time the buy-sell agreement is executed. A hybrid agreement, also referred to as the wait-and-see method, provides more flexibility to the owners by allowing them to defer the decision on which method to use: cross purchase or redemption. The hybrid agreement allows the business owners to wait until the departure of a business owner to decide who will purchase the departing owner's interest: the business, the owners or both. If the business decides not to purchase the departing owner's interest, the business can loan the insurance proceeds to the remaining owners to use for the purchase. Conversely, if the remaining owners purchase the insurance and the business is the ultimate buyer of the departing owner's interest, the remaining owners can use the insurance proceeds to make a capital contribution to the business. The business then uses these proceeds to complete the purchase.

### Buy-sell agreement considerations

Implementing a funded buy-sell agreement that fits the needs of the business is an important factor to a potential smooth and efficient transition of a business upon an owner's departure. There will be income tax implications that should be considered when deciding which buy-sell approach is most appropriate for a particular business. The buy-sell agreement should also be reviewed periodically to ensure it continues to meet the owners' needs particularly when there are material changes in the business (e.g., death of an owner, extraordinary growth in the business and change in ownership structure). As well, periodic reviews of the life insurance policies should be conducted to evaluate policy performance and ensure the death benefit amounts remain adequate to fund the buy-sell agreement. Having a funded buy-sell agreement in place provides additional assurance that the business will continue with minimal disruption.

## Key person insurance

Key person insurance is a life insurance policy a company buys on the life of a top executive or another critical individual. Such insurance is needed if that person's death or disability would be devastating to the future of the company. The key person typically is the owner or founder. The disability of a key person may result in lost revenue and the impact could be far greater in the event of a key person's death. One way to protect the business against this risk is to purchase key person life insurance. The name of this insurance refers to the purpose of the insurance rather than the type of insurance.

The first step is to determine who is a key person critical to the success of the business. Contributing factors may include:

1. Management responsibility
2. Specific knowledge, skills or experience
3. Generation of revenue or contribution to profits
4. Personal relationships with customers or vendors



Once a key person has been identified, the next step is to determine the potential financial impact the business may suffer in the event of the key person's death or disability. Some of the factors used to determine this financial impact include the key person's salary, profits attributable to the key person and the cost of replacing the key person. Determining the value of the key person will identify the potential loss at stake and can guide the decision on the appropriate amount and type of life insurance to purchase.

After a key person's value to the business has been assessed, the business will need to consider what type of life insurance is most appropriate to offset the potential loss of value. If the period of risk has a specific duration then term insurance may be the best option. For example, if an employee is currently 45 years of age and expects to retire at 65 years of age, then a 20-year term policy may be appropriate. Term policies are generally less costly than a permanent policy and there would be no need for the extended coverage. Permanent insurance, on the other hand, is

commonly selected when the goal is to provide a death benefit for the duration of the insured's life.

## Conclusion

Life insurance adds a layer of protection that may make the difference in a business's success or failure. Life insurance may be able to offset the potential losses caused by the business's or co-owner's lack of liquidity or loss of a key person. When planning for a business's continuation after the death, disability or retirement of an owner, a properly structured and funded buy-sell agreement may expedite the transition process and potentially avoid considerable stress and financial loss to co-owners and family members. Key person insurance may provide the buffer necessary to reduce loss of revenue and fund recruitment expenses. Life insurance often serves multiple purposes and may provide a solution to many of the planning concerns of a business. Therefore, when designing a business plan, it is prudent to identify and analyze all forms of risk and consider life insurance where applicable.

# Philanthropy

Life insurance can also be used to fulfill philanthropic goals. The two most common ways to fulfill charitable goals with life insurance are donating the policy to a charity or designating the charity as the owner and beneficiary of the policy. Depending on how the gift is structured, the donor will either take a current income tax deduction during their lifetime or their estate will receive a charitable deduction for estate tax purposes.







## Donating a life insurance policy to charity

A gift of life insurance may be accomplished in a number of ways, as discussed below.

### **Gift of an existing policy**

A simple, outright gift of an existing life insurance policy can qualify for an income tax charitable deduction. To do so, the donor should assign all rights in the policy to charity by naming the charity as both owner and beneficiary. If the donor retains any rights in the policy after the assignment, such as the right to borrow cash values or to change the beneficiary, the result would be a gift of a partial interest that would not qualify for a charitable deduction.

The deduction amount will also depend on whether the policy is fully paid-up or premiums are still outstanding. Generally, the gift of an existing paid-up policy results in a current charitable deduction to the donor equal to the policy's replacement value (i.e., the cost of an identical policy given the donor's age and health). The deduction for a policy for which premiums remain payable is usually the lesser of the policy's value or the donor's basis in the policy (i.e., the net premiums paid). In general, the donor's basis in a policy equals the total amount of premiums paid by the donor.

The donor will also be subject to adjusted gross income (AGI) limitations for charitable contributions.<sup>32</sup> An individual can generally deduct cash contributions to public charities up to 60% of their AGI and generally can deduct non-cash contributions to public charities up to either 50% or 30% of their AGI depending on various factors.<sup>33</sup> When a donor makes non-cash contributions (other than publicly traded securities) to a charity, the donor generally must obtain a qualified appraisal to substantiate the value of the property.<sup>34</sup> If contributions surpass these limits, the excess is carried over and may be deductible over the succeeding five years, subject to the percentage limitation in those years.

<sup>32</sup> More precisely, these limits are based on the donor's contribution base, which is the donor's AGI calculated without regard to any net operating loss carrybacks.

<sup>33</sup> For more information on charitable deduction limitations, see Todd D. Mayo and Jacqueline Denton, *2022 Year-End Planning Guide* (a publication of the UBS Advanced Planning Group).

<sup>34</sup> IRC § 170(f)(1)(C). For more information on substantiation requirements for charitable deductions, see Todd D. Mayo and Jacqueline Denton, *2022 Year-End Planning Guide* (a publication of the UBS Advanced Planning Group).

## Charitable deduction amounts and AGI limits<sup>35</sup>

Type of asset donated	Public charity	Private foundation	Amount of deduction
Cash	60% <sup>36</sup>	30%	Amount of cash
Publicly traded securities held long term	30%	20%	Fair market value
Long-term capital gain property (other than publicly traded securities noted or tangible personal property)	30%	20%	When gifted to a public charity, fair market value; when gifted to a private foundation, basis.

When a life insurance policy is gifted to charity and premium payments are still required, an open discourse with the charity is important to ensure that the goals of the donor and the charity are aligned. These goals include who and how the premium payments will continue to be made to keep the policy intact. If the donor continues making premium payments, the donor has a number of options: (1) make a large upfront gift to the charity, (2) make periodic payments to the charity or (3) continue making payments to the insurance company. If the donor discontinues payments, the charity has a number of options: (1) continue to pay the premiums themselves until the insured's death, (2) place the policy on paid-up status at a lower face amount (death benefit) with no further premiums payable, (3) surrender the policy for its cash value or (4) sell the policy to a settlement company (assuming certain conditions are met).

Premium payments made by the donor after the policy has been transferred to charity may be treated as gifts *for the use of* charity if the premiums are paid directly to the insurance company. On the other hand, transfers of cash directly to the charity in the amount of the premium are considered gifts *to* charity (which then pays the premiums itself). Gifts *for the use of* charity are only deductible up to 30% of the

donor's AGI, while gifts *to* charity are deductible up to 60% of the donor's AGI.

A donation of insurance may be a greater benefit to the donor and the charity than a cash gift. Instead of making direct cash payments to the charity (without a life insurance policy involved), putting that money toward an insurance policy with a sizeable death benefit will multiply the donor's generosity. The charity will receive the entire face amount of the policy upon the death of the insured, and it may also reduce the donor's taxable estate for estate tax purposes.

### Purchase of a new policy

Instead of donating an existing policy, a new life insurance policy can be purchased. One option is for the donor to apply for a new life insurance policy and to name the charity as the owner and beneficiary. The value of the policy is the premium paid, and this is the amount of the charitable deduction. (See the table above for charitable deduction amounts and AGI limits.) Another option is for the charity to apply for a life insurance policy on the life of the donor and pay the premium with funds provided by the donor. An advantage of this approach is that the donor never owns the policy so the donor never holds any incidents of ownership that could pull the policy's death benefit into the donor's estate.

<sup>35</sup> More precisely, these limits are based on the donor's contribution base, which is the donor's AGI computed without regard to any net operating loss carrybacks.

<sup>36</sup> Beginning in 2026, cash contributions to public charities (and CRTs that ultimately may benefit only public charities) generally will be 50% of AGI.

Different charities have different gift acceptance guidelines so it is always wise to consult the charity early in the gift planning process. As noted above, it is important to have an open discourse with the charity to ensure that the goals of the donor and charity are aligned, and that an agreement is in place to keep the policy intact.

## Naming a charity as beneficiary of a life insurance policy

Naming the charity of your choice as the beneficiary of your life insurance policy is the simplest way to provide a charity with the death benefit proceeds from a policy. It doesn't offer the income tax advantages that come with gifting a policy, but it still reduces the donor's estate by the amount of the death benefit. At the same time, donors can enjoy flexibility by withdrawing cash from their policies or even borrowing against the equity in their insurance contract.

Generally, the donor may retain the right to change the beneficiary of the life insurance policy prior to their death. By listing a charity as the policy's revocable beneficiary, the donor can enjoy the flexibility of changing their mind if their financial situation changes. Additionally, naming a charity as a beneficiary also ensures the privacy of the transaction during the donor's lifetime, which can be important for donors who wish to keep their gifting intentions confidential.

In order to fulfill philanthropic goals, an individual has options beyond typical assets, such as cash and investments. Life insurance when leveraged appropriately can result in a charitable deduction for the donor and a generous gift to charity.



# Policy review and life insurance maintenance

As with any investment, ongoing care and attention of life insurance policies is essential to maximize the probability that current and future goals will be achieved. Periodic life insurance policy reviews ensure the long-term effectiveness of this investment. Changes in goals and objectives, policy performance, tax and wealth transfer laws, and insurance offerings are factors to consider when reviewing the portfolio and considering whether the insured's existing life insurance supports those goals.





## Goals and objectives have changed

As goals, finances and families change, the type of policy needed might change as well. The specific reason an insurance policy was initially purchased may no longer apply. For example, the insured is now an empty nester, their children are financially independent, their business has sold or they have accumulated a substantial investment portfolio.

## Policy performance

Market performance and interest rates fluctuate over time. As a result, some policies may not be performing as originally illustrated. While some insurance agents or companies will monitor policies and regularly discuss policy performance, many may not reach out to discuss underperforming policies. In a worst-case scenario, ignoring a policy that is not performing as expected could result in the lapse of the policy. Depending on the status of the policy, a lapse could cause unintended adverse consequences, including, for example, an income tax liability if there is an unpaid loan on the policy.

## New insurance offerings

Insurance companies continue to develop new offerings to meet changing market conditions and client needs. For example, changes in mortality tables, as well as expanded use of medical underwriting, has resulted in new insurance products and policy riders.<sup>37</sup> A policy review can identify a new need as well as a new solution.

<sup>37</sup> Riders are modifications to the insurance policy added at the same time (or sometimes after) the policy is issued and may carry an additional charge.



## Trustee considerations

If the legal owner of a life insurance policy is an individual, there may be no repercussions for failure to review and monitor the policy. If the legal owner of the policy is an ILIT, the trustee of the ILIT generally has a fiduciary duty to act as a prudent investor in investing and managing the trust assets, usually including any life insurance policies.<sup>38</sup>

Some of the issues that a trustee should consider include:

1. Has the policy performed as expected?
2. Are there changes in performance that need to be addressed?
3. Is the type of policy and policy amount (or death benefit) appropriate given current goals and objectives?

4. Are premium payments still necessary, how much should be paid and where will the funding come from in the future?
5. Should a surrender or exchange be considered?

Many individual trustees do not realize that the ongoing management of an insurance policy is an important part of their overall duties and that failing to periodically review insurance policies owned by the trust could subject the trustee to liability.<sup>39</sup>

## Overview of policy review

As life evolves and changes over time, there are many reasons for an individual to review their insurance coverage. The policy should be

analyzed both as an investment and as a part of the overall estate plan. Some of the areas that will generally be assessed during a policy review:

1. Protection: Is the death benefit still sufficient?
2. Annual premiums: Are coverage needs met efficiently?
3. Ownership structure: Is the policy ownership tax-efficient?
4. Beneficiary designations: Are beneficiary designations up to date?
5. Supplementary benefits: Are new benefit options appropriate for current goals and circumstances?
6. Cash value and performance: Is the policy performing as expected?

A life insurance policy review, in light of life events, legislation and product offerings, may uncover opportunities to improve a portfolio.

<sup>38</sup> For more information on the trustee's fiduciary duty to invest and manage trust assets, see Todd D. Mayo, *Investing and Managing Trust Property* (a publication of the UBS Advanced Planning Group).

<sup>39</sup> For more information on the role of trustees, see Casey Verst, *Duties of a Trustee* (a publication of the UBS Advanced Planning Group).



# Conclusion

Life insurance can be a powerful planning tool. When properly integrated into an estate plan (often involving an ILIT), life insurance can provide liquidity to cash-strapped but taxable estates, fund gifting vehicles to benefit subsequent generations, and equalize inheritance allocations among descendants where a closely held business accounts for the lion's share of a person's legacy. Individuals should evaluate their existing policies and ensure that their goals are adequately addressed.

# | About the Advanced Planning Group



The Advanced Planning Group consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning and family governance.

The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.



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