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Changes in Family and Business Dynamics Help Drive Need for Life Insurance Policy Reviews

Life insurance is often a key component in the success of a family's financial, business, and estate plans. Changes to the dynamics and goals of your family, your business, and your estate may have a corresponding impact on what is required of your life insurance. These changes, along with changes in tax and regulatory legislation, may trigger a need to review your policies.

In March 1979, the Unit-2 reactor at the Three Mile Island nuclear power plant near Harrisburg, Pennsylvania, experienced a partial nuclear meltdown. Known as the worst nuclear accident in U.S. history, investigators later determined that the primary cause of the accident involved a pilot-operated relief valve that had failed to close.[1] This is an extreme example of how a lack of focus on one small component can negatively affect a complex system.

It may seem like a sizable leap to compare a process that involves the splitting of atoms to an individual's family financial plan, business plan, or estate plan, but the lesson may apply—the failure of one seemingly small component can have a significant negative impact.

One often overlooked financial instrument that plays a key role for families and businesses is life insurance. Failing to review your life insurance portfolio could lead to issues that could derail your financial, business and estate planning goals.

In this article we focus on the importance of life insurance policy reviews and instances when a review might be performed.

Policy Performance

A regular review of your life insurance portfolio could result in maximizing its effectiveness. Consider the following:

- Life expectancy continues to climb, but the standard mortality rates used by life insurance companies since 2009 have been based on the 2001 Commissioners Standard Ordinary Table (2001 CSO table). As of January 1, 2017, the National Association of Insurance Commissioners adopted a new mortality table, the 2017 CSO tables. Products[2] developed under these new mortality assumptions should have more competitive pricing than existing policies.
- The policy may not be performing as previously illustrated for a number of reasons. An adjustment

[1] http://www.world-nuclear.org/information-library/safety-and-security/safety-of-plants/three-mile-island-accident.aspx

[2] Society of Actuaries, Product Matters (July 2016) Issue 104 – *2017 CSO Implementation: Product Implications and Considerations.*

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to premium payments or consideration of a new policy may be appropriate.

- The financial strength of the carrier may have declined, possibly making it appropriate to consider obtaining coverage through a more financially stable carrier.
- Improvements in your health, avocations, or smoking habits may allow you to obtain coverage at a better price.

Changes in Family Goals and Dynamics

There are lifetime events that could trigger an inspection of your life insurance portfolio, such as marriage, the birth of a child, a promotion, inheritance, or the purchase of a home. But there are also a number of other instances when a review could be valuable.

Family Dynamics and Changing Beneficiaries

In a recent survey,[3] 53% of respondents who have established a trust did so specifically to reduce family conflict. Imagine the family conflict that could arise if more than one family member believed they had a legitimate claim to a life insurance death benefit. This scenario plays out in civil courts on a regular basis and often arises when multiple beneficiary changes have been made during the life of the insured. A regular review of the policy and any transactions that have occurred since the policy was initially acquired should prevent this issue.

Divorce

One of the most common issues involving life insurance and divorce is when an ex-spouse is still listed as the beneficiary after the death of the insured spouse. In some states, absent a prior spousal agreement or court order, a final divorce decree will automatically nullify the beneficiary designation of an ex-spouse. In other states, the beneficiary designation of the ex-spouse would govern and the ex-spouse would receive the death benefits. This would be an important time to review the policy and all beneficiary designations.

Shifting Financial Concerns (Longevity)

Acquiring life insurance to protect your family addresses the financial risk of passing away too soon. As children become independent and retirement approaches, a different financial risk may become apparent—living too long. The Internal Revenue Code (IRC) contains a provision[4] that permits the nontaxable exchange of life insurance policy cash values for a new life policy, an annuity contract, a long-term care policy, or a hybrid life insurance/long-term care policy. New policy features, riders, and benefits are continuously being developed that may present options that were not previously available when the policy was initially acquired.

Shifting Financial Concerns (Charity)

A review of your life insurance portfolio may result in discovering that you are underinsured or overinsured based on changing financial goals and family dynamics.

[3] The Estate Planning Awareness Survey 2016, WealthCounsel.

[4] IRC Section1035.

For those who find they no longer need the amount of coverage they have, they may want to consider using a portion of the policy to support their favorite charity.

Changes in Business Goals and Dynamics

Business owners often acquire life insurance to fund buy-sell agreements, cover potential losses from the death of a key employee, and fund executive compensation arrangements. A number of events or changes in the business dynamics should prompt a review of the ownership structure, beneficiary designations, performance, and premium funding levels of any insurance policies the business or business owners have an interest in:

- When a new shareholder/partner has been added, or when a shareholder/partner relinquishes their ownership interest.
- When the value of the business increases or decreases substantially. Buy-sell agreements include provisions that define the price to be paid for any transfer of an ownership interest, and the amount of life insurance death benefits should be coordinated with this value.
- When a new executive qualifies as a participant in an executive compensation arrangement. Life insurance used to fund the arrangement needs to be reviewed.
- When a key employee terminates employment. Options should be explored to determine what to do with the policy (there are many options available beyond surrendering the policy).
- When a business debt is paid off. Life insurance on the life of the primary business owner may have been required by the lender and the policy may have been assigned to the lender.

Changes in Estate Planning Goals and Dynamics

The federal estate tax places a liquidity burden on estates, especially estates that include family businesses and farms. In addition to federal estate taxes, a number of states levy estate and/or inheritance taxes. Life insurance may provide an efficient, timely means of providing liquidity to pay estate taxes.

Note: The current version of the federal estate tax, created by the Revenue Act of 1916, has gone through multiple changes over the years, and there have been a number of recent efforts to repeal the tax. This uncertainty has created challenges for families attempting to plan for the transfer of their estates. With the estate tax being levied upon the occurrence of a future event, the timing of which is uncertain (death), overreaction to legislative changes should be avoided.

Trust-Owned Policies

The type of policy, funding, ownership, design, and beneficiary designations of the life insurance must be compatible with trust provisions related to the timing of distributions, rights retained by the settlor of the trust, trustee rights and duties, and so forth. In addition, as time passes, a family's estate planning goals may change. As steps are taken to modify wills, trusts, and other estate planning documents, it is important to review policies to assure they continue to be designed, owned, and funded appropriately.

Potential Benefits of a Policy Review

- A review may uncover opportunities to improve policy performance (i.e. lower premiums, increased death benefits, improved contractual guarantees, etc.).
- A review could help identify, avoid, and correct unfavorable tax results.
- Reviewing policy beneficiary designations on a regular basis, and upon changes in family dynamics, may help avoid family discord.
- Changing financial needs may create an opportunity to use a life insurance policy to support a favorite charity.
- Reviewing life insurance for business purposes may help avoid poorly funded business succession plans.
- New policy options and features may be available to meet your changing financial goals.

Tax Considerations

The IRC contains a number of provisions specific to the taxation of life insurance, and new tax laws are introduced on a regular basis. Consideration should be given to each of the following:

- If an employer owns a life insurance policy insuring the life of an employee, new tax laws[5] passed in 2006 need to be complied with in order to avoid having the death benefit being recognized as taxable income.
- Distributions from a cash value life insurance policy may be received on a tax-favorable basis. However, policies that are overfunded in the early years may be deemed modified endowment contracts (MECs)[6] by the Internal Revenue Service. Distributions from a MEC policy lose their favorable tax treatment.
- Prior to any transfer of a life insurance policy (or any interest in a policy) to a new owner, the proposed transfer should be reviewed to assure it does not violate the "transfer-for-value rules,"[7] which could cause a substantial portion of the death benefit to be recognized as taxable income.
- In any situation where the owner, insured, and beneficiary are all three different people, a little known tax rule known as the Goodman Triangle[8] could create an unexpected gift tax issue.

Conclusion

Financial plans comprise many inter-related components, and your life insurance is an integral part. Unfortunately, all too often families do not review their policies, negatively affecting the overall effectiveness of

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[5] The Pension Protection Act of 2006, §863(a) & IRC §101(j).

[6] IRC Section 7702A.

[7] IRC Section 101(a)(2).

[8] See *Goodman v. Commissioner*, 156 F.2d 218 (1946).

their financial plans. The coverage you need is affected by changes to your family, business, and estate planning goals and dynamics. Life insurance also needs to be monitored for performance, the health of the carrier, and tax considerations. A policy review will help you have the appropriate insurance at the proper rate to meet your needs and that it is supporting your goals and expectations for your financial plan.

For more information, please contact your Hawthorn advisor.