

INSURANCE INSIGHTS

LIFE INSURANCE FOR THE ULTRA- HIGH-NET WORTH

Many ultra-high-net-worth (UHNW) families may feel that life insurance is unnecessary because they have such immense wealth. What gap could life insurance possibly fill when assets total \$100 million or more? This wealth can easily provide for them and be passed on to future generations.

But what many don't realize is that when their estate is transferred to its beneficiaries, it can lose up to 40% in federal estate taxes alone. For some families, the tax liability doesn't end there as, currently, there are 17 states¹ that levy an estate and/or inheritance tax that must be paid in addition to the federal tax liability. This means that, without proper planning, a large portion of an estate can essentially "disappear" upon the owner's death. This tremendous loss in value can compound liquidity problems for loved ones, as discussed below.

Income taxes can also erode a family's wealth. These taxes hit UHNW individuals hard while they are alive and can then decrease the net value of assets again when they are passed on to beneficiaries. Some retirement accounts, for example, can lose up to half their value in income taxes when passed to a non-spousal beneficiary.

Finally, while most UHNW understand the importance of diversification, they may not realize that some of the most common asset classes can be closely correlated. This often means that the value of these assets can all

be diminished during a market downturn which, in turn, can also create liquidity issues at pivotal moments.

UHNW families can address many of these unfavorable outcomes with life insurance. Life insurance can be used for many reasons, but three of the most popular purposes are for estate and business liquidity, asset diversification, and tax mitigation.

In fact, there is no other financial product that can address all of these needs in a single package.

LIQUIDITY

UHNW families often have illiquid assets such as a family business, concentrated asset positions, and substantial debt holdings. These holdings and positions can be problematic at pivotal junctures, such as at a family member's death or a business partner's exit; substantial value can be lost in an unplanned quick sale, and opportunities or debt calls might be missed. Many families may overlook these looming liquidity issues until it's too late.

CASH VALUE

Permanent life insurance policies have a cash value element that can provide immediate funds via a loan or withdrawal. This quick access to cash can help

prevent the selling of other assets. Other advantages of choosing cash value for liquidity are:

- There is no approval process.
- It can be accessed for any reason.
- Distributions happen quickly, often within a few days.
- Loans bear favorable interest rates.
- No additional collateral is needed beyond the policy.
- There is no repayment schedule or deadline.
- The amount borrowed continues to earn interest.
- Generally, loans do not constitute taxable income.

This immediate access to cash can provide UHNW families the flexible liquidity they may need to seize opportunities and cover large expenses or debts while the insured is alive.

Death Benefit

Life insurance death benefits also provide immediate, tax-free liquidity at the time when it is most needed—when a family member or business partner passes away.

At death, the estates of UHNW individuals are often subject to significant estate taxes. The presence of a large degree of illiquid assets, such as a closely-held business or real estate, can create challenges when trying to pay these taxes and other costs associated with the transfer of wealth to heirs.

A common and elegant solution is large death benefit life insurance, which can infuse the estate with additional funds and prevent the forced sale of illiquid assets. In addition, it can be highly beneficial for the policy to be owned by an irrevocable life insurance trust (ILIT). The creation of the ILIT is important as it keeps the policy outside the decedent's estate. If the life insurance is personally owned, it exacerbates the liquidity problem because the policy's death benefit is included in the estate, thereby increasing the need for even more funds to cover estate taxes.

A death benefit can also provide the immediate liquidity needed to buy out a deceased owner's share in a business. Rather than turn to traditional funding options, such as a bank loan, or being forced to liquidate other assets, business owners who have buy-sell agreements can use life insurance proceeds to fund their obligation to purchase the former partner's interests.

DIVERSIFICATION

Modern Portfolio Theory proposes there are two fundamental elements of risk that exist with any collection of investments:

- *Specific (or non-market) risk*—the risk related to an individual investment or an investment sector
- *Systematic risk*—the degree to which an asset's return is affected by changes in the investment market as a whole

A traditional portfolio consisting of only equities is subject to both specific and systematic risks. Although specific risk can be reduced by diversifying assets in a portfolio, systematic risk in a traditional portfolio of equities cannot be reduced simply through diversification. The 2020 financial crisis, which negatively impacted an array of asset classes, serves as a pertinent reminder.

When traditional whole life insurance is added to a portfolio, systematic risk is reduced since the policy's cash value is not tied to market performance. Instead, it grows at its own, separate rate. Alternatively, standard universal life and indexed universal life both offer guaranteed minimum returns, regardless of market performance. Perhaps most importantly, the payment of a life insurance policy's death benefit is guaranteed and not triggered by market events. It is a truly uncorrelated asset that offers additional diversification in the event of the insured's death.

In addition, life insurance carriers are highly regulated, employ conservative capital structures and strategies, and invest primarily in high-grade fixed income investments, which are held to maturity. The risk of a life insurance carrier defaulting on its obligations is significantly lower as a result. The same does not always hold true of other assets in an investor's portfolio.

For these reasons, life insurance should be considered as its own asset class. UHNW families who include it in their portfolios add a degree of diversification against systematic risk not available in portfolios without it.

TAX REDUCTION

Most investments, unless they are held in an IRA or a qualified retirement plan, do not grow on a tax-deferred basis. Regardless of how they are held, many assets are subject to taxation when they are passed from one generation to the next.

Life insurance, however, holds unique, tax-favored qualities:

- Life insurance policies with a cash value component can generate tax-deferred growth.

- Life insurance death benefits are generally income tax free to beneficiaries.
- In many cases, death proceeds can be free from estate taxes through the use of irrevocable trusts.

Moreover, Section 1035 of the Internal Revenue Code offers a tax-favored transfer strategy—policyholders have the opportunity to exchange an underperforming policy for a new one without recognizing taxable gain at the time of the exchange. This level of flexibility is simply not available with traditional asset classes.

DYNASTY TRUSTS

A dynasty trust is an irrevocable trust that is established by UHNW families for the benefit of children, grandchildren, and successive generations. It is designed to use the grantor's generation-skipping transfer (GST) tax exemption to protect the trust assets from the GST tax and estate taxation of future generations. The trustee of the dynasty trust can make distributions to the trust beneficiaries free from federal estate, gift, and GST tax.

Grantors may achieve their goal of passing the greatest amount of assets to as many successive generations as possible by using their lifetime gift and GST tax exemption amounts to fund the trust with life insurance. Then the trustee would use the gifts to pay premiums on a life insurance policy owned by the dynasty trust.

If the dynasty trust is properly drafted and administered, the death benefit proceeds from the life insurance policy should not be subject to federal income, estate, or GST tax. Distributions to trust beneficiaries (children, grandchildren, great grandchildren, and future generations) should also be free from estate and GST tax.

There are myriad reasons why life insurance may be an ideal asset to be held by a dynasty trust:

- A large life insurance policy may be purchased using a small amount of an individual's lifetime gift and GST tax exemptions, which leverages the amount of assets free from GST tax.
- Life insurance premiums are relatively small compared to the amount of the life insurance death benefit proceeds.
- Life insurance policy cash value grows tax-deferred and generally does not generate income tax while the insureds are alive.
- Death benefit proceeds are generally excludable from the beneficiary's gross income for federal income tax purposes.
- Life insurance funds can provide estate liquidity.
- The life insurance death benefit proceeds can remain in the dynasty trust and continue to grow for the benefit of future generations.

These characteristics make life insurance a particularly attractive asset for a dynasty trust to own.

ADDITIONAL ADVANTAGES

Life insurance can provide benefits beyond the liquidity, portfolio diversification, and tax reduction features discussed above. Some of these advantages are:

- The inherent leverage of life insurance policy premiums to death benefit proceeds—the fact that \$N

of premium provides multiple \$N paid out as a death benefit—can enhance wealth substantially at the time of death.

- Life insurance can reduce the percentage of total assets that must be reserved for estate planning

expenses, while increasing the proportion of investable capital.

- Life insurance makes the equitable treatment of heirs much easier to achieve in the estate settlement process.
- With proper planning, life insurance proceeds may be protected from creditors (subject to state law).

CONCLUSION

There are many asset classes that provide diversification and the opportunity for enhanced returns. Of these, life insurance is often overlooked. By adding life insurance to their portfolio, UHNW families have the opportunity to complement their more traditional asset class holdings, establish protection for their heirs in the event of an untimely death, and benefit from tax efficiency, reduced risk, and liquidity.

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An insurance contract's financial guarantees are subject to the claims-paying ability of the issuing insurance company.

¹ As of 2023, the states that levy an estate and/or inheritance tax are CT, HI, IL, IA, KY, ME, MD, MA, MN, NE, NJ, NY, OR, PA, RI, VT, and WA. Washington, D.C. has an estate tax.

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