

Life insurance considerations for legal and tax professionals

CPAs | Attorneys | Enrolled agents | Tax professionals

Financial strategies



Life insurance options



Beneficiary designation



Contents

- 1 Introduction
 - 2 Basics of life insurance
 - 5 Insurance planning steps
 - 7 Types of life insurance
 - 11 Considerations when owning life insurance
 - 15 Beneficiary designations
 - 16 Cash loans versus cash withdrawals
 - 17 Policy replacement considerations
 - 20 Company ratings and state regulations
 - 20 Conclusion
 - 21 How Edward Jones can help
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Introduction

Trusted legal and tax advisors may find that their clients ask about life insurance. This brochure introduces some common life insurance terms, discusses the basic insurance planning process and explores its use within overall client financial strategies.

Life insurance is a financial resource that can help clients prepare for the unexpected and protect what is important to them throughout their lives and after they pass away by providing for their legacy goals.

Buying life insurance is a multifaceted decision for a client: *Which type of policy should I choose? How much coverage do I need and for how long? What premium level fits my budget?* Choosing insurance is not just

a financial decision but also an emotional decision: *How will my spouse/partner pay the mortgage if I die? Will my children be able to go to college? What will happen to my business? How can I ensure I pass on the legacy I want to provide?*

By better understanding life insurance, professionals can help their clients make informed choices about how best to protect and provide for those who matter most.

Basics of life insurance

Life insurance is a contract between a policyholder and an insurance company in which the insurer agrees to pay the contracted amount to the beneficiary or beneficiaries upon the death of the insured. Policyholders pay premiums to maintain coverage, either over a specified period or over their lifetimes. How much premium a policyholder pays may depend on many factors, including the insured's age, gender, occupation, hobbies, tobacco use, medical history, foreign travel or residence, type of policy and coverage amount, among others.

Life insurance can play different roles in an individual's financial strategy over time. In the early years, when clients are saving for the future, their primary need is typically income replacement to help protect a family in case a spouse/partner dies, or to help protect a business in case an owner or key employee dies. As client income and assets grow, their primary need is often protecting savings against risks, such as large expenses for medical treatment and long-term care. At the end of life, when asset transfer may be a goal, life insurance can be used to pass wealth to beneficiaries such as family members or charity.

Life insurance can help protect a family's financial security

Life insurance can help provide for a family's needs, including:

- **Funds to pay off liabilities** - Proceeds from the policy can be used to pay liabilities, such as a mortgage, alleviating some of the financial pressure on the family.
- **Income during the readjustment period** - Surviving family members need time to adjust financially to the loss of the insured's income. In some cases, the surviving

spouse/partner may need to acquire new skills to rejoin the workforce.

- **Income for the surviving spouse/partner and dependents** - Life insurance can provide the surviving spouse/partner with financial support for a certain number of years or for life. Funds from a policy can also support a policyholder's children until they become financially independent or can help meet the financial needs of physically or developmentally disabled children.
- **Funds to cover final expenses** - Proceeds from a life insurance policy can be used to cover funeral expenses, estate-processing fees, outstanding medical bills and other unpaid debts.
- **Funds for education expenses** - Life insurance can provide funds for college or other education costs.

Without life insurance, survivors may have to sell assets, such as a home, to pay expenses. With life insurance, the beneficiaries may have the financial resources they need for current expenses and to address long-term goals such as paying for education and preparing for retirement.

Life insurance can help individuals with long-term and legacy goals

As clients age, and their income and net worth grow, their needs often evolve from replacing income to protecting income and assets against risks, such as high medical and long-term care expenses. Near the end of life, clients may be thinking about the legacy they would like to leave to heirs or charity. While the primary purpose of life insurance is typically financial protection, it can also be used to help accumulate funds for long-term financial goals such as:

- **Building wealth for tax-efficient transfer to heirs** – Life insurance can serve as an estate-planning vehicle, allowing proceeds to be paid directly to beneficiaries, bypassing the probate process. Life insurance can be used as an efficient wealth transfer vehicle because death benefits are generally paid free of income tax to beneficiaries.
- **Liquidity for large estates** – For clients with large estates, life insurance can provide liquidity to pay federal and state estate taxes, state inheritance taxes, attorney fees and probate expenses. Regardless of the amount of estate tax due, liquidity may be necessary for estates with non-liquid assets (e.g., a family that owns real property) to balance an estate or legacy goal. Setting up an irrevocable life insurance trust (ILIT) to own the life insurance policy can generally be a tax efficient way to provide liquidity for estate taxes or wealth transfer to family members.
- **Gifts to charity** – Life insurance can provide money for a charity, a religious organization or an educational institution, or it can replace assets bequeathed to charity by providing an inheritance for heirs.
- **Income to help pay for long-term care expenses** – Insurance benefits could help clients avoid using outside assets to pay for a potential stay at a long-term care facility or for caregivers at home. There are several insurance options, including products that combine life insurance with long-term care benefit riders.

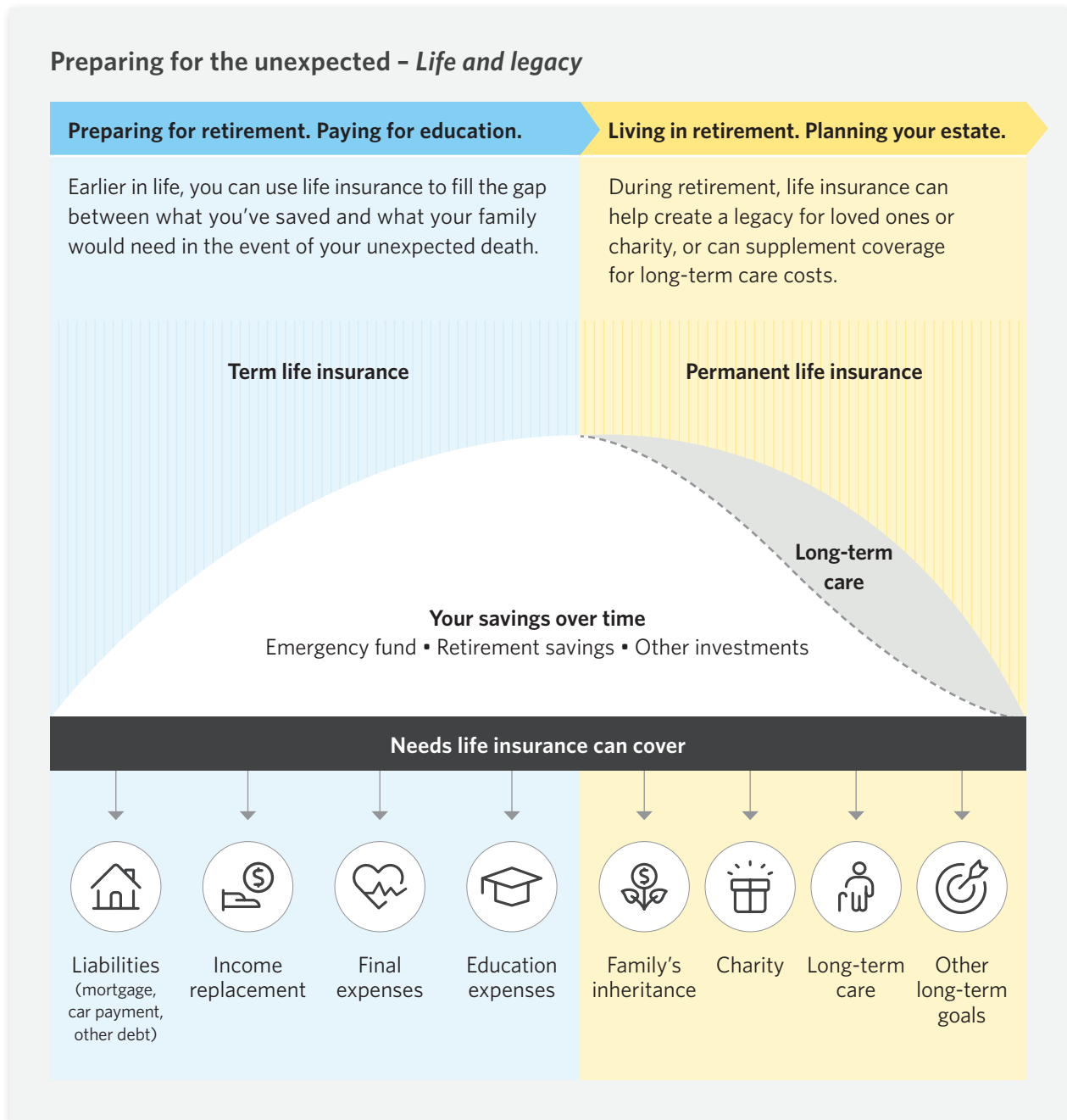
Life insurance can help business owners

Clients with an established, profitable business may want to consider key person life insurance if the success of the business is highly dependent on one or a few key employees. Typically, the business owns the policy, pays the premiums and is the beneficiary. Key person insurance not only provides cash to keep the business operational after a key employee's death, it can make it easier for the business to attract talent and secure credit during the key employee's life.

Businesses with more than one owner may choose to purchase life insurance on the lives of the owners under the terms of a buy/sell agreement. When one owner dies, the business or the surviving owners can use the death benefit to purchase the deceased owner's interest from the owner's heirs or estate. This transaction keeps the business intact and provides full value to the deceased owner's family.

Life insurance is a common executive compensation benefit and can be conditioned on meeting performance goals. Depending on how the policy is set up, it can be owned by the business or by the employee.

The following chart summarizes how life insurance can be used to meet different needs over a client's lifetime.



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Insurance planning steps

The first step is to determine client financial goals, such as providing assets for the family, preparing for retirement or planning the estate, and discuss how life insurance may play a role in helping reach these goals. Clients, their financial advisors, and their tax and legal professionals can then complete a needs analysis to determine how much life insurance coverage may be needed to help provide for the family's or business's financial needs based on those goals.

To determine which insurance policy or policies would be appropriate, several factors should be considered, including the appropriate coverage amount, the length of time the policy is needed, the premium amount that fits the client's budget, desired flexibility and the client's risk tolerance.

How much life insurance may be appropriate?

There's no magic formula for determining how much life insurance to buy, because no two people have the same needs or circumstances. The insurance needs of a single parent can vary greatly from those of someone supporting an elderly parent or those of a business owner planning succession.

When clients do not have a specific income amount they want to replace, or a specific amount they want to leave to their loved ones or a charity, performing a needs analysis can help determine the amount

of life insurance that might be appropriate. This process also helps advisors make suitable recommendations and helps clients make more informed decisions about how to support legacy goals or provide for loved ones in the event of an untimely death.

When the primary objective may be time-specific or a non-legacy goal, the following approaches can be considered to help determine the potential amount of insurance to consider:

Multiple of income approach: Calculate seven to 10 times the client's pretax annual salary.

Needs approach: Estimate the client's family expenses and savings needs over time using the acronym LIFE.

While both approaches can be used to determine the potential amount of insurance to buy, the needs approach may be a more tailored method, since it focuses on the individual's specific situation.

Use LIFE as a guide*

Add the following together to estimate life insurance needs:

- L** **Liabilities** (mortgage, car loans, credit card debt, etc.)
- I** **Income** needed for the client's family to replace future salary and cover ongoing living expenses, saving needs and an emergency fund
- F** **Final expenses** (funeral costs, medical bills, etc.)
- E** **Education expenses** for the client's child(ren)

Then subtract from this total the other available assets that the family could use to meet these needs. The difference generally represents the approximate dollar amount that life insurance proceeds (and income from investing those proceeds) could cover.

* Importantly, the LIFE framework does not include any potential legacy goals such as leaving a lump sum to heirs or charity. This objective may be added to LIFE, so the client's total life insurance needs would be "LIFE and legacy." Additionally, it is important to understand that the type of policy used for legacy goals may be different from the LIFE needs, as discussed later.

Example

John and Jane Smith are estimating how much life insurance to buy on John's life. They estimate their needs as follows:

Liabilities = \$375,000 (mortgage)
Income needed = \$200,000 (to provide for children),
\$500,000 (Jane's ongoing income needs and funds for retirement)
Final expenses = \$5,000 (medical), \$15,000 (funeral and burial)
Education expenses for children = \$200,000 (college)

Total needs = \$1,295,000

Then they look at the assets they have to meet these needs today.

Bank savings = \$20,000
Investments = \$200,000
Retirement assets (John's) = \$175,000

Total assets = \$395,000

The amount of life insurance needed is the difference between their estimated expenses and their assets: $\$1,295,000 - \$395,000 = \$900,000$.

Planning tip

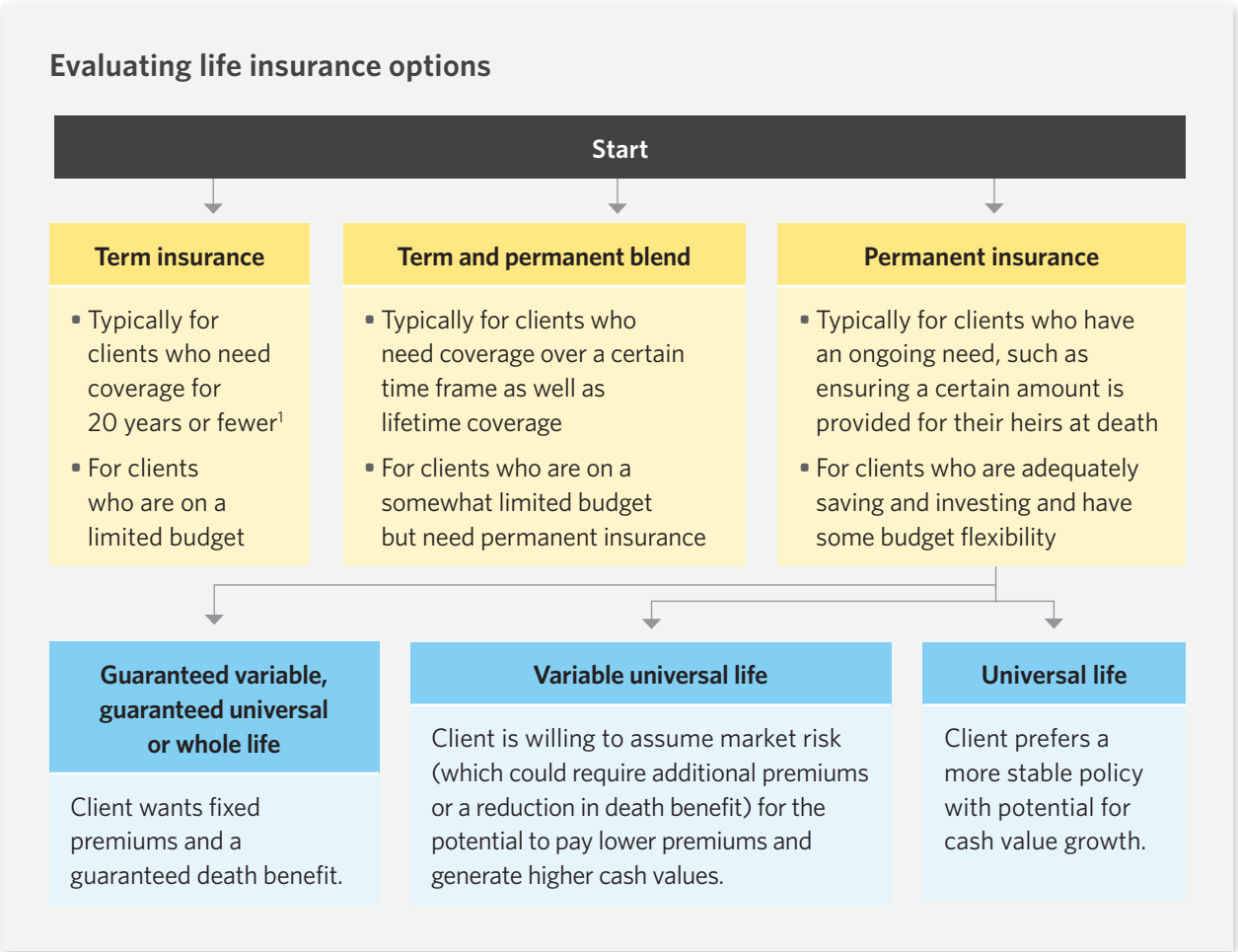
Edward Jones financial advisors provide a valuable resource to help analyze insurance needs and options for you and your clients. To learn more, contact an Edward Jones financial advisor.

Types of life insurance

Life insurance can be divided into two types: term and permanent. Clients should choose the policy that best meets their goals based on the amount of time the insurance may be needed. This is not an either/or decision. For example, the LIFE framework may help estimate cash needs for a specific period, which may be satisfied with term life insurance, while legacy goals, such as leaving a certain amount to loved ones at death, may be better satisfied by permanent life insurance.

What type of life insurance is right for my client?

Many factors should be considered when determining the appropriate life insurance contract for a client, including a full understanding of the client’s life insurance needs and objectives. The following chart is designed to help determine the right type of life insurance based on a client’s potential needs:



¹ Term insurance is available for longer time periods. However, we encourage comparing term policies of longer than 20 years to a permanent policy before making a decision.

Term life insurance

Term life insurance is the most basic type of life insurance and usually offers an affordable, level premium for a fixed number of years. The insured is covered for a specific time frame, such as 10 or 20 years, and benefits are paid only if they die during this period. If the policy owner stops paying premiums, coverage ceases.

Premiums are based on several factors, including the insured's age, gender, tobacco use and health, as well as the coverage amount requested. Premiums on some annually renewable term policies increase with age. Term insurance is typically purchased by people with shorter-term life insurance needs (typically 20 years or fewer) or by those with longer-term needs who, for budget reasons, need relatively inexpensive coverage. Many term life insurance policies can be converted to permanent policies issued by the same insurance company without providing additional medical information, but the conversion period may be limited. Consequently, it's important to understand the policy options when purchasing a life insurance contract.

A variation of term life insurance is group term life insurance, which large companies may offer to employees as part of the base benefits package. Generally, group term coverage is available on a guaranteed-issue basis (no medical underwriting) through an employer-sponsored, employer-paid plan with limited coverage amounts (usually no more than \$50,000 per person) for employee participants. The employer maintains the master policy for the group. State laws typically require that the employer furnish

the employee with a certificate of coverage in writing or electronically. If an employer pays for additional group term coverage over the exempt amount (currently \$50,000), the imputed cost of coverage exceeding the exempt amount generally must be included in the employee's taxable income.

The base group term benefit may not be adequate to meet client needs. While clients may be able to elect supplemental coverage at an additional cost, they could consider purchasing an individually owned term policy to help address overall insurance needs and provide continuous coverage in case the client changes jobs or separates from service for other reasons.

Many group term life plans contain a conversion privilege allowing employees to convert their coverage to an individual universal life policy within 30 days after separation of service due to retirement or a move to another employer.

Permanent life insurance

Permanent life insurance provides protection for the policyholder's entire lifetime rather than a specific time period, as long as premium requirements are met. In addition, some types of permanent insurance can build cash value. These dollars generally are used to pay the higher cost of insurance as a person ages, without increasing the annual premium. The accumulated cash value may be accessed through loans or withdrawals. However, clients should not consider their insurance policy to be a primary source of liquidity because using cash value to cover other expenses could affect the policy's ability to provide for the life insurance need.

Permanent policies also often enjoy favorable tax treatment because the cash value growth is usually tax deferred. Individuals and small-business owners typically purchase permanent insurance if they have long-term life insurance needs and can afford premiums that are higher than those of term life.

Types of permanent life insurance

Whole life insurance

Whole life is a type of permanent insurance suitable for an individual who wants guarantees in the contract. Whole life contracts guarantee minimum cash values, level premiums and death benefits, provided premiums are paid on time.

Because of the guarantees, for which the insurance company assumes all the risks, whole life generally carries the highest premium of all types of permanent insurance. This type of policy is also the least flexible. For example, the insured cannot increase coverage within the same contract. All whole life policies are structured to endow, which means the cash value will equal the policy death benefit at policy maturity, typically at age 95 or 100.

Some whole life insurance policies pay the policyholder an annual dividend representing a return of unused premium. Policy dividends can generally be taken in cash free of federal income tax, applied toward premiums, used to purchase additional paid-up death benefit coverage inside the whole life policy or reinvested inside the policy for interest.

Universal life insurance

Universal life is a type of permanent insurance typically more suitable for

an individual who wants more flexibility and lower premium payments compared to whole life, though the policyholder assumes more risk. The amount of cash value, which is not guaranteed, depends on the premium payments made by the client and the earned interest rates, which are generally consistent with fixed income returns, subject to a guaranteed minimum rate. The policyholder has the flexibility to increase or decrease future premium payments, but in exchange for this flexibility, the death benefit is typically not guaranteed. Increasing or decreasing the face amount of the policy will cause the premiums to increase or decrease accordingly.

Some universal life policies offer what is referred to as an Option A or Option B death benefit. Under Option A, the policyholder chooses a policy that has a level death benefit with a higher cash value. Under Option B, the policyholder can choose a higher death benefit equal to the sum of the policy's face coverage and the policy's cash value.

If the financial condition of the insurance company deteriorates, the expenses it charges against the policy's cash value can increase. Higher expenses can drain the cash value. If this happens, the policy may lapse or premiums may increase.

An insurance company will guarantee payment of only a minimum interest rate on an insurance contract. However, a contract is usually credited by the insurance company with a current-year interest rate based on an intermediate-range bond rate being paid inside the insurance carrier's investment portfolio. Clients should be aware that if the current interest rate being credited decreases, additional premiums may be required to keep the policy in force.

Guaranteed universal life (GUL) insurance

GUL insurance has the same features as universal life. However, if the premium is paid on time, the policy is guaranteed not to lapse. Compared to universal life, this type of policy generally offers no to low cash value accumulation in exchange for a guaranteed death benefit and guaranteed level premiums.

Variable life insurance

Variable whole life and variable universal life are similar to whole life and universal life, except that a portion of the annual premium is invested in variable subaccounts chosen by the client from a predetermined list of stock and bond fund portfolios. Variable life insurance is typically the most flexible type of permanent insurance, and because of the investment performance potential, premium requirements are typically moderate. The death benefit and premiums are flexible, and there is potential to accumulate cash value. However, the death benefit, premium and cash value are affected by the performance of the subaccounts. If the subaccounts perform well, there is potential for growth in the policy's cash value. There is also downside risk that the subaccounts could underperform projections, creating a situation in which the policy owner will have to make up the difference in performance by paying additional premiums or reducing the death benefit, or risk the policy lapsing before maturity.

Variable insurance products are subject to extensive federal and state securities regulations requiring the client to complete a suitability questionnaire and receive a current prospectus on the product from his or her financial advisor before purchasing the policy.

Because these products carry market risk, variable life insurance is typically more suitable for clients who are comfortable with the risks inherent in investing in equities. Some variable universal life policies offer riders that guarantee the death benefit for the client's lifetime (to age 100 or later). Variable insurance products may not be as suitable for older clients who may have less ability to accept the investment risk because of their shorter investment time horizon.

Guaranteed variable universal life (GVUL) insurance

Similar to variable life insurance, GVUL insurance offers the potential to accumulate cash value depending on the performance of the variable subaccounts. However, similar to GUL, if the guaranteed level premiums are paid on time, the policy is guaranteed not to lapse.

Individuals considering a variable universal life insurance policy may prefer adding the guarantee when their primary purpose for the policy is protecting financial goals in the event of their death, if they have a lower risk tolerance or if they want less required ongoing oversight of the policy. Individuals requiring flexibility with the premium, unable to afford the additional cost of the guarantee or seeking to use life insurance as a vehicle for saving for retirement (known as a life insurance retirement plan strategy) will likely be better served by a variable universal life policy (without a guarantee).

However, it is worth bearing in mind that a variable life policy without a guarantee should be monitored over time to ensure the underlying subaccounts are performing as expected, as additional premiums may be required to keep the policy in force if the subaccounts underperform expectations.

Individuals looking for a guaranteed death benefit may want to compare GUL and GVUL policies, weighing the benefits of the ability to potentially generate cash value with a GVUL versus any difference in premiums.

Modified endowment contracts (MECs)

MECs are generally any insurance policies entered on or after June 21, 1988, that have exceeded stated IRS guidelines for the maximum premiums that can be paid during the first seven policy years. Almost all single-premium policies are considered MECs.

During the insured's lifetime, any policies classified as MECs are treated similarly to an annuity for tax purposes. This may result in the following:

- Any loans or withdrawals are taxable as ordinary income on a last-in, first-out basis (i.e., gains above cost basis are taxed first).
- Pledging a cash-rich MEC policy as security for a loan can result in an immediate tax event for the policyholder. A limited exception may apply when the pledge is restricted to the payment of

burial or prearranged funeral expenses, but only if the policy's maximum death benefit does not exceed \$25,000.

- Withdrawals and loans made prior to age 59½ are usually subject to a 10% federal tax penalty.

The differences between MECs and annuities include:

- Upon the death of the insured, the MEC policy is still treated as life insurance. This means the death benefit received by a beneficiary, such as the surviving spouse/partner, is usually free from income tax. This is different from an annuity, where any gain in the contract is generally taxable to the beneficiary as ordinary income upon the policyholder's death.
- For life insurance, the person insured is called the "insured." In an annuity contract, the person insured is called the "annuitant."
- Life insurance is generally purchased for the death benefit. An annuity is purchased to provide a retirement benefit and protection against outliving one's retirement income.

Considerations when owning life insurance

A policyholder may need to make several decisions about the policy over time, including naming the policy's owner and beneficiary. Because life insurance is typically a long-term holding, clients should periodically review their policy's performance and the financial health of the insurance company. In addition, though some clients may consider accessing the cash value of their permanent insurance policy for income, they should first understand the impact and trade-offs of taking loans or withdrawals, and how these decisions may affect the life insurance benefits of the policy. Clients should consult with their tax, legal and financial advisors to ensure they have evaluated costs, tax consequences and differences in policy features before deciding whether to replace an existing insurance policy.

Ownership of life insurance is an important matter. If an individual who is both the owner and the insured of a life insurance policy dies, the death benefit is part of the estate for federal estate tax purposes. Thus, the death benefit could be subject to estate tax if the individual's net worth exceeds the federal or state exemption amounts.

Incidents of ownership

The death benefit is generally included in an estate if the decedent is listed as the policy owner or had certain types of control over the disposition of the policy.

If the insured has certain incidents of ownership in a life insurance policy, the death benefit may be included in their estate for estate tax purposes. Incidents of ownership are not limited to actual ownership of the policy and may include other ways that the insured or the insured's estate has control over the policy or the right to the economic benefits of the policy, such as:

- The power to name or change the beneficiary
- The right to assign the ownership of the policy to another person or revoke that assignment
- The right to surrender or cancel the policy
- The right to borrow money from the policy or pledge the policy as collateral for a loan

It is important to note that, under IRS rules, should the owner of a life insurance policy transfer ownership within three years before their death, the policy's death benefit may be included in the deceased's estate and be subject to estate tax. This rule may not apply when policy ownership is transferred between spouses/partners.

If someone other than the insured owns the policy from the date it is issued, and if the insured does not hold any other incident of ownership in the policy, the death benefit is generally not included in the insured's estate when they die. Typical examples of owners other than the insured are the insured's adult children or an irrevocable life insurance trust.

Potential drawbacks to having adult children own the insured's life insurance policy include:

- If the adult child divorces, the policy ownership or cash value could be awarded to the spouse/partner in a division of property by a state divorce court judge.
- If the adult child declares a Chapter 7 or Chapter 13 bankruptcy, creditors could attach the policy in federal court proceedings where cash values in life insurance contracts are only protected for debtors up to a limited amount.
- If the adult child is sued, the policy might be attached in state civil court proceedings. State laws vary widely regarding the amount of the cash value and death benefit of a policy that may be exempt from creditor claims.
- If adult children are under financial strain, they could access the policy to obtain cash. Excessive loans or withdrawals could cause the coverage to lapse, undermining the insured's original goal for taking out the policy.

As an alternative, an insurance policy can be owned not by children but by an irrevocable trust. An important advantage of naming a trust as the life insurance policyholder is that the trust may be better suited to withstand creditor collection challenges in federal or state courts and can prevent

a beneficiary's detrimental use of the policy cash value. Drawbacks to using a trust include the cost of establishing the trust and annual administration fees. Irrevocable life insurance trusts (ILITs) are discussed in more detail below.

In certain situations, permanent cash value life insurance may be owned by an administrator inside a qualified retirement plan, such as a 401(k) plan. In this situation, the life insurance policy cash value may be exempt from creditor collection efforts, except for certain creditor processes such as IRS tax liens or a qualified domestic relations order entered by a state court in a divorce proceeding. Potential disadvantages include limits placed on the amount of insurance coverage and the inclusion of the insurance policy in the plan participant's estate if he or she dies before retirement.

If a client owns a life insurance policy on a third party, such as a parent, spouse/partner or child, consideration should be given to naming a successor owner, in case the client should die. By doing so, potential disputes over policy ownership, including possibly lengthy probate proceedings, may be avoided.

It is important to know that when the owner of a life insurance policy is not the insured, only the owner has control of the contract. The insured has no rights in the policy. For instance, if a policy owner who is also the insured makes an absolute assignment of the insurance policy to a bank as collateral for a loan, all ownership rights are transferred to the bank. The original policy owner remains the insured, and the bank (the new policy owner) typically has the right to change beneficiaries, often to itself, and could receive the death benefit after the insured's death.

To determine the best choice for life insurance ownership based on business, personal or estate-planning considerations, a client should discuss the matter with their legal and tax advisors.

Irrevocable life insurance trust (ILIT)

Life insurance may be used to fund an irrevocable life insurance trust where the trust is both the owner and the beneficiary of the policy on the life of the grantor (insured person). An ILIT is an inter vivos trust (one created during the grantor's lifetime) that is structured to be exempt from estate tax. It should be noted that the grantor of an ILIT does not have control over the insurance contract and cannot serve as trustee or co-trustee of the ILIT. Instead, the grantor names an individual (such as the grantor's spouse/partner or other family member), commercial bank or professional trustee to serve as trustee of the ILIT. The ILIT purchases and is named as the beneficiary of the insurance policy, thereby keeping the policy proceeds out of the grantor's taxable estate.

A key benefit of an ILIT is that the trust receives the death benefit in cash upon the death of the grantor, generally keeping these dollars separate from the gross estate. The trust document will typically include provisions for how the death benefit proceeds can be used, such as paying a lump sum or income stream to the beneficiaries. If the grantor's estate must pay estate tax but holds mostly illiquid assets, such as real estate or a small business, the ILIT may be allowed to purchase those assets from the estate or loan money to the estate to provide liquidity for the amount of estimated estate tax due upon the grantor's death.

Almost any type of policy insuring the grantor's life may be used to fund an ILIT, though some types may be more appropriate for the specific circumstances and goals of the grantor. Life insurance on the life of one person or a survivorship policy on the lives of two people (usually a married couple) can be used. Permanent cash value policies with guaranteed level premiums and face coverage amounts can often accomplish the desired purpose of an ILIT.

Although an ILIT can be funded by a term life insurance policy to contain costs, if the insured is likely to outlive the policy's time frame (typically 20 years), it may be more cost-effective over time to fund the ILIT with a permanent policy. After the term has expired, the trust's premium for policy renewal will likely be significantly higher due to the insured's increased age. Converting to a permanent policy at this later date will likely result in higher premiums than would be required if a permanent policy had been arranged earlier.

To provide the trust with the necessary funds to pay annual premiums on a life insurance policy, the grantor can make annual gifts to the trust. These gifts are generally in an amount that is equal to or less than the annual gift tax exclusion amounts for the trust beneficiaries.

Beneficiaries are typically family members or loved ones.

To ensure the annual gift per beneficiary is considered a present-interest gift and therefore qualifies for the annual exclusion from gift tax, each trust beneficiary is granted a limited right in the trust document, called a Crummey right, to withdraw a proportionate amount of the gift made to the ILIT. Once money is paid into the trust to pay the annual life insurance premiums, the trustee will provide written notice to the beneficiaries of their right to withdraw the gift made on their behalf. In general, beneficiaries are usually given 30 to 60 days to exercise this right. However, the beneficiaries will typically decline to withdraw, instead leaving the money in trust. After this time period has expired, the trustee may pay the life insurance premiums to keep the policy in force. The grantor may decide not to use this technique. For instance, the grantor may instead choose to make a single gift to the trust, using the federal lifetime gift tax exemption, to pay for a single-premium policy.

An ILIT should be carefully drafted by an experienced estate planning attorney to ensure it fulfills the client's objectives and meets the complex legal and tax requirements.

Planning tip

Many states impose an estate tax on a person's assets after death, an inheritance tax on heirs receiving such assets, or both. In addition, few states follow the federal portability rules whereby a surviving spouse/partner can carry over the unused portion of the deceased spouse/partner's exemption from estate tax, so married individuals may still need to establish trusts to obtain the benefit of two exemptions under state law. Legal and tax advisors should closely follow federal and state legislation on this issue if assisting clients with one-time gifting concerns.

Beneficiary designations

When clients buy life insurance, they must name one or more beneficiaries. At the time of purchase, the beneficiary must have an insurable interest, meaning if the insured were to die, the beneficiary would experience a financial loss.

Insurance companies are generally unwilling to agree to a beneficiary designation on a new policy in which no insurable interest exists. Once a policy is issued, the owner can change the beneficiary designation to anyone without obtaining the approval of the insurance company.

Beneficiary designations can be revocable or irrevocable. The owner can change a revocable beneficiary at any time. An owner may only be able to remove an irrevocable beneficiary in limited circumstances, if at all.

Insureds should also keep in mind that they may outlive a named beneficiary, so one or more contingent beneficiaries should also be named.

Beneficiaries of life insurance policies are generally entitled to receive the death benefit proceeds free of federal gift and income taxes. However, in some situations, such as the two described below, improper policy ownership and beneficiary designation arrangements can have potentially negative tax consequences for the beneficiaries.

Example 1: Gift tax

Joe Smith wants to insure his life to leave a large sum to his oldest son, Jerry. Jerry purchases the policy on his father and is the owner. Jerry wants to be fair to his siblings, so he names himself and his two younger brothers, James and John, as equal beneficiaries on the policy. Upon Joe's death, the death benefit is paid in equal shares to Jerry, James and John. Because Jerry is the owner of the life insurance policy, however, the IRS may deem that Jerry has made a taxable gift to his brothers when the death benefit is paid.

Example 2: Income tax

Mary Brown owns a \$500,000 insurance policy on her life. She sells it to her friend Tina Williams for \$200,000. Tina pays premiums over the next eight years that total \$40,000. Mary dies and the death benefits are paid to Tina. Under the transfer-for-value rule, if a life insurance policy is transferred to another, the amount of the death benefit received in excess of the sum of the amount of consideration paid and any premiums paid by the transferee after the transfer is income to the transferee. Tina may be required to include \$260,000 in income (\$500,000 minus the sum of \$200,000 initial consideration paid and \$40,000 in post-transfer premiums).

Cash loans versus cash withdrawals

It is important to understand the consequences of taking a loan versus a withdrawal from a permanent life insurance policy.

Loans

If a policyholder takes a loan against the policy and repays the loan during their lifetime, the death benefit remains unaffected. If instead the insured dies while a loan is outstanding, the insurance company subtracts the loan balance plus any unpaid loan interest, dollar for dollar, from the death benefit paid to the beneficiary.

Interest charged on policy loans is generally calculated in one of two ways, based on life insurance policy provisions:

- A fixed interest rate, not to exceed 8% per annum
- A variable interest rate tied to Moody's Corporate Bond Yield Index, often recalculated on a monthly basis

Most permanent life insurance policies have an automatic loan provision that allows the insurance company to pay premiums from the policy's cash value if the premium is not paid within 30 days after the premium due date. Premium loans are assessed either a fixed or variable loan rate. Premiums paid in this manner over an extended period can result in lapse of coverage when the loans and interest exhaust the policy's cash value. In this type of policy lapse situation, excessive unpaid loans and loan interest may cause the policyholder to incur an income tax liability.

The repayment of interest on a policy loan may not be a deductible expense for tax reporting purposes.

Withdrawals

A substantial withdrawal could have a negative tax consequence. If a cash distribution from a policy results in a reduction of the death benefit within the policy's first 15 years, some portion of the distribution may be subject to income tax. Generally, a withdrawal that exceeds the client's cost basis (total premiums paid into the policy) will be considered taxable income.

Cash value withdrawals may result in the policy owner paying higher premiums to maintain the same amount of death benefit. If the higher premiums aren't paid, the policy could lapse.

If the primary goal is to maintain the death benefit, a policyholder is typically better off taking a loan rather than a withdrawal from the insurance policy. A loan can be repaid during the insured's lifetime to prevent a reduction of the death benefit paid at the time of the claim. However, if the intention is to use the policy to supplement retirement income or other income needs, a withdrawal may be more appropriate.

Ways to accelerate death benefits

Some life insurance companies offer accelerated death benefit riders that allow an insured person diagnosed with a terminal illness to access a portion of the policy's death benefit. (Life expectancy, for this purpose, is defined by the insurance company and is usually a period of 24 months or fewer.)

A percentage of the policy's death benefit will be paid to the policy owner and may not be treated as taxable income. The life insurance carrier will deduct the accelerated death benefit payments from the policy's face coverage for any benefit later paid to a designated beneficiary.

If the client's policy doesn't have this rider, they may consider selling the policy via a viatical settlement or life settlement. While selling the insurance policy to a third party

can generate cash for the client, the client will receive less than the face coverage amount, and the sale could cause tax consequences. Before giving up their ownership rights, clients should carefully review their insurance policies and all available options with their financial advisor and team of professionals. If clients no longer need the death benefit and are seeking an immediate source of cash, another option could be a 1035 exchange to an annuity.

Policy replacement considerations

There are several reasons why someone might want to replace their current life insurance policy with a new one. If clients own term insurance, they may be able to reduce premiums, increase the amount of insurance or extend the period for coverage by buying new term insurance. The client will likely have to pass a medical exam to purchase a new policy.

In some cases, a client may be able to convert an existing term policy into permanent life insurance. Having a policy with a large death benefit for income replacement may be less important after children grow up and the mortgage is paid down, so some clients may want to consider converting their term policies to smaller permanent policies.

Deciding whether to replace a permanent life insurance policy requires more analysis. There can be advantages, such as the opportunity to receive a higher death benefit, pay a lower premium or change the policy type or features. However, a thorough comparison of the current and future policies may show that replacement is not in the policyholder's best interest.

The following are some issues that could arise when replacing permanent life insurance:

- Initial costs to purchase a new policy can be high. The client may pay a commission, and the new insurance company incurs underwriting costs to issue the policy. These expenses aren't charged separately, but instead go against the cash value in the contract, which leaves less money available for withdrawals, if needed.
- The new insurance company may be able to challenge a death benefit claim that is filed within two years from the date of policy issue. (Some states differ regarding this rule, so state guidelines should be reviewed.)

- The insured may lose a lower policy loan interest rate or forfeit other favorable policy provisions, such as those that provide for a premium waiver in the event of disability, an accelerated death benefit for terminal illness or long-term care needs, or an additional purchase option allowing the insured to increase coverage without further medical underwriting.
- The insured may lose important grandfathered rights, such as attractive loan features, including the ability to borrow on a first-in, first-out basis for a non-MEC policy.
- A new surrender penalty schedule can apply for up to 15 years.
- There may be fewer contractual guarantees, such as the loss of a guaranteed death benefit or guaranteed level premium.

Other factors to consider include:

- If the insured is in poor health, they may be giving up a contract with a more favorable medical rating. If the existing contract has a medical rating, it may be advantageous for the insured to keep the current contract unless their health situation has improved substantially.
- If the existing contract has a very large surrender penalty, other options within the existing policy should be considered before replacement, depending on the client's objectives.

Because the decision to replace or exchange a life insurance policy is complex and involves many considerations, it is important for the client to work with their full team of professionals when considering such an action.

1035 exchanges

A 1035 exchange enables a policyholder to exchange permanent cash value contracts while deferring any taxable gain. A 1035 exchange can generally be processed on the following:

- A life insurance policy exchanged for another life insurance policy
- A life insurance policy exchanged for an annuity
- An annuity exchanged for another annuity
- An endowment life contract exchanged for an annuity, if done before the endowment date
- A permanent life insurance policy or annuity exchanged for a hybrid life insurance policy

A 1035 exchange generally cannot be processed on the following:

- An annuity to a life insurance policy
- An endowment life contract to any life insurance contract other than another endowment of the same endowment date

In addition, a 1035 exchange can generally occur only if the new and the existing contracts have the same policyholders and insureds (or annuitants in the case of an annuity). For example, a policy owned by Joe Smith with Mary Smith as the insured may be used as a 1035 exchange only for a new policy owned by Joe Smith with Mary Smith as the insured or annuitant.

An exchange of multiple policies to one new policy normally qualifies as a 1035 exchange if the policyholder and insured are the same on both the existing and the new contracts, and the exchange for all policies is initiated at the same time.

Exchanging single-life policies for multiple-life policies

The exchange of a single-owner, single-insured policy for a first-to-die or second-to-die policy, commonly called a “survivorship life” policy and used for estate-planning purposes, does not qualify as a 1035 exchange because the owner and insured are not the same on both the existing and new contracts.

Exchanging life insurance policies with loans

It is important to be very careful when considering replacing or exchanging an existing policy with a loan, as doing so could cause tax consequences. If the client’s goal is to eliminate the policy loan by exchanging to another life insurance contract or an annuity, the loan amount may have taxable “boot” consequences. In other words, the loan amount could be taxed as ordinary income to the extent of gain represented.

On life-insurance-to-life-insurance replacements, some insurance companies allow the loan on the existing contract to transfer to the new contract, where the outcome results in no taxable event to the policyholder because no gain is recognized. However, the client may end up with a less

favorable interest rate on the new policy. Therefore, it is extremely important to consider all consequences before making changes.

If a policyholder uses the policy’s cash value to extinguish a loan as part of a 1035 exchange, the policyholder may recognize taxable gain in purchasing a new policy with no debt. The IRS may not view this 1035 exchange as triggering an income tax event if the loan on the policy being replaced is paid off from outside (non-policy) funds that originate from a savings account, a checking account or some other financial resource.

Gifting life insurance policies with loans

The IRS may treat the gift of a life insurance policy subject to an outstanding policy loan as part sale and part gift transaction. The value of the loan may be treated as consideration received from the donee (the “sale” portion). The net cash surrender value may be deemed the “gift” portion. If the value of the loan on the date of the gift is less than the donor’s basis, the donor may not recognize any gain on the transfer of the policy. However, if the loan balance is greater than basis, gain may be recognized to the extent that the loan exceeds basis.

Company ratings and state regulations

A life insurance policy or an annuity is only as secure as the insurance company issuing it. Hundreds of life insurance companies do business in the United States. These companies are rated on a regular basis to assess their financial soundness with respect to maintaining profitability, managing investment assets and retaining cash reserves to pay policy claims and other related liabilities when they become due.

Among the major financial ratings services for the life insurance industry are A.M. Best, Standard & Poor's, Fitch, Moody's Investors Service and Weiss Ratings. It is important to remind clients to be aware of any significant changes in the ratings of the insurance companies from which they have purchased some type of insurance product.

State insurance regulations impose financial and legal operating requirements on life insurance companies. If a life insurance company cannot meet these requirements because it is under financial distress, a state insurance regulator can step in and suspend the company's ability to issue new policies, or liquidate the company in the event of extreme insolvency.

To provide some level of financial protection to the general public, each state maintains a life and health guaranty association that requires membership of insurance companies licensed to do business in that state. The state guaranty association charges an assessment to the member companies for the benefit of policyholders should any insurance company become insolvent. If an insurance company goes out of business, these guaranty associations, which vary by state, generally provide only minimal protection to policyholders, which may not match the policy value.

Conclusion

Life insurance can help clients address a variety of risks or gaps in their overall financial strategies. It can help provide for a family's financial future, protect what a client has worked for, fund a legacy or assist with business succession concerns. The client's life stage and unique goals will determine the type and amount of life insurance needed. Because the client's needs may change over time, it is important to periodically review the quality and performance of life insurance policies, and to consider a number of factors before taking loans or withdrawals, or before replacing or selling a policy.

How Edward Jones can help

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Building a team of professionals to help provide solutions for our clients

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The legal, accounting and financial services industries are governed by complex, constantly changing laws and regulations. By working together as a team, driven by similar philosophies and guiding principles, we can use complementary knowledge and skills to assist mutual clients in planning for today's financial, tax, legal and estate-planning challenges.

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