Life Insurance as an Asset Class: A Predictable Asset for Unpredictable Times

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A Predictable Asset for Unpredictable Times

When most of us die, we want to leave our remaining assets to our families. Wealth transfer planning is the process of intentionally transferring the assets we've built during our lifetimes to those we love with the least amount of loss and delay. This planning isn't something we do for ourselves; we do it for those we care about. It is both an act of love and one of the responsibilities of being a family leader.

A "Patchwork" of Assets

Most of us build our wealth one asset at a time over many years. We acquire new assets to make our own lives better. We usually don't stop to think how they will fit into our wealth transfer plans. For example, when we open an IRA account, we want it to help us be financially secure during retirement; we are much less concerned with how much of it will be available to our children to spend. Consequently, most of us own a "patchwork" of different assets that weren't acquired to efficiently pass on our wealth to those we love. When we die, our assets are subjected to a variety of different costs and problems when they are transferred. As a result, part of our wealth may be lost and won't be passed on to our families.

An effective wealth transfer plan looks closely at our assets and considers different strategies to help us avoid losses and keep as much value as possible in the family. It manages our assets in a coordinated plan that maximizes what we will pass on to our loved ones.

Assets Are All Different

Deciding which assets to pass on to our families can be complicated. That's because when it comes to transferring our wealth, assets are different. Some assets pass on less than the value we might expect because they are burdened by extra taxes, costs, commissions or management fees. Annuities, IRAs and tax-qualified accounts suffer from this disadvantage. Other assets can be problematic because their value isn't stable. Their value changes over time with market performance. For example, real estate and stock investments fluctuate with the performance of their respective markets. A good wealth transfer plan looks at our "patchwork" of assets and decides which ones should be transferred, which ones we should consume during life, and which ones should be repositioned into new assets that pass on wealth more efficiently.

Growth Isn't Guaranteed

The value of many of our assets changes over time. When we acquire an asset, we usually expect that it will become more valuable through the years. Often this is true, but not always. Sometimes asset values go down instead of up. In wealth transfer planning, what matters is an asset's value on the day it is transferred. For example, the value of our homes or investment real estate may be high today, but could lose value around the time of our death. The same possibility exists with equity investments we may own personally or inside our IRAs or other tax-qualified accounts. An ill-timed recession or market downturn could result in a significant reduction in its value when it is passed on at death. The financial security of surviving family members could be jeopardized.

Recovering Losses Can Be Difficult

Once an asset loses value, it can be hard to recover. To recover lost value, the asset will have to earn a higher after-tax return. For example, suppose you have a $1,000,000 stock portfolio that loses 20% of its value; now it is only worth $800,000. In order to recover the lost $200,000 and get back to $1,000,000, the portfolio will have to grow by 25% net after taxes ($200,000 is 25% of $800,000) to get back to $1,000,000. It can be difficult to earn a higher net after-tax return when the market is weak and investment performance is volatile.

Avoiding "Problem Assets"

In wealth transfer planning it's always tempting to take the path of least resistance. That usually means adopting a plan that takes whatever assets remain at death and divides them equally among family members. Although a plan like this is easy to implement, it seldom is financially efficient. It increases the likelihood that some of your hard-earned wealth will be paid to outsiders through unnecessary taxes, costs and fees. As a result some of your hard-earned wealth will be wasted and your family will receive less.

Adopting an efficient plan can take a bit of time and effort. If you want to maximize what you pass on, you will need to invest a bit of yourself. You will want to look at your assets and decide which ones are best suited to your goals. In analyzing your assets, it may help to consider the characteristics you want the assets you transfer to have:

- **Predictable Value** – The asset's date of death value is known in advance with relative certainty.
- **Value Not Directly Linked to Market Performance** – Asset value at death is relatively stable and is not directly influenced by the performance of any particular market.
- **Liquidity** – The asset is easily converted into cash at death and is not reduced by commissions, transfer costs or management fees.
- **Growth/Leverage** – The asset's date of death value will likely exceed the costs of acquiring and maintaining it.
- **Growth is Income Tax Free** – Asset growth is income tax free when distributed at death.
- **Easily Divisible** – The value of the asset after death can be easily divided among several family members with little delay or controversy.
- **Avoids Probate** – The asset can be immediately delivered to those entitled to receive it without the costs and delays of probate.
- **May Avoid Estate Taxes** – The asset may be owned in a manner that avoids federal estate taxes.
- **Subject to Governmental Oversight** – The asset, the sales person and the selling company must all meet established regulatory standards designed to protect consumers.

How Does Your "Patchwork" Measure Up?

How many of these features are in the assets you have today and are most likely to pass on? Evaluating your assets with these features in mind can be a good indicator of how efficient your current wealth transfer plan is. If an evaluation shows your plan lacking, then it may make sense to reposition some assets into others that may be more reliable and efficient.

Life Insurance May Help

You may want to consider life insurance in your wealth transfer plan. Well-to-do families often use life insurance as part of their wealth transfer planning because it has a unique combination of potential advantages:

- **Predictable Value** – Policy can be structured to pay a known death benefit amount when the insured dies.
- **Death Benefit Value Not Linked to Market Performance** – Policy may be structured so that the death benefit is a fixed amount which is known in advance.
- **Liquidity** – Death benefits are paid in cash when the insured dies; generally no taxes, costs, commissions or fees are subtracted.
- **Growth / Leverage** – Premiums paid for death benefit protection may provide a reasonable rate of return through life expectancy.
- **Federal Income Tax Free Payment** – Policy death benefits (including amount in excess of premiums) are generally federal income tax free under IRC Section 101.
- **May Avoid Estate Taxes** – Ownership of the policy may be structured to avoid federal estate taxes.
- **Avoids Probate** – Death benefits may be structured to be paid directly to the beneficiaries without the costs and delays that often impact assets distributed through probate.

A Versatile Estate Planning Tool

The potential advantages of life insurance may make it quite useful in your wealth transfer plan. Traditionally, life insurance has often been used to provide liquidity to the beneficiaries to pay off debts, pay income and estate taxes, to equalize the inheritances of different children and to create a family legacy. Its ability to produce a generally known income tax-free death benefit at the insured's death may add a valuable element of predictability to your estate plan. Life insurance may be very helpful in a number of common estate planning situations:

Freeing Assets for Investment Flexibility

If you have endured investment losses, you may be tempted to invest aggressively to get back to where you were. But you don't want to throw good money after bad. If you can be sure you've created a secure financial base for your family, you may feel good about being more aggressive to take advantage of buying opportunities. Death benefit proceeds from life insurance may be able to provide the secure financial base you want to protect your family. If your aggressive investment choices don't work out as hoped, then your family may still have the income tax-free life insurance death benefits for financial security. If your new investments do come through, then the life insurance coverage can provide an additional inheritance.

Enhancing Financial Security for Dependent Spouses and Children

If you have a dependent spouse or special needs children, you know you need to leave behind enough money so they can be financially secure for the rest of their lives. Investment losses may have reduced the amount of capital you are able to pass on at death. There may now be a gap between the amount you need to pass on and the amount currently available. If you aren't sure there's a gap between the available capital and the amount that will be needed, you can use life insurance death benefits to create a margin for safety.

Leaving a Predictable Minimum Family Legacy

You may want to make sure you pass on at least a minimum sum to your children and grandchildren. For example, suppose a parent wishes to leave a legacy of $250,000 to each of his/her four children. If he/she can qualify for $1,000,000 of death benefit coverage and can afford the premium payments so the policy is in force at death and he/she does not live beyond the policy's term or maturity date, then as equal beneficiaries the children will each receive $250,000 of usually income tax-free death benefits. If other assets remain at death, they can add to this legacy or they can be distributed elsewhere. Life insurance can provide the base legacy and any remaining assets can supplement it.

Simplifying a Wealth Transfer Plan with Multiple Goals

You may want to spread your assets among several different groups of heirs/beneficiaries. Life insurance may make it easier to accomplish different goals. Suppose you want to leave $500,000 to your grandchildren to pay for their college educations, $200,000 to the American Cancer Society for research, with the rest of your estate to be divided equally among your children. You want to leave a significant amount to your children, but you're not sure there will be much left for them after the other two distributions. Life insurance may help. A policy insuring you for $700,000 can have beneficiary designations which divide the death benefit into $500,000 to be held in trust for your grandchildren and $200,000 for the American Cancer Society. Because the total premiums will be less than the $700,000 death benefit, there should be a larger estate to divide among your children.

Potential Risks

No wealth transfer strategy or product is appropriate for every person every time. Here are some of the potential risks that should be considered before using life insurance:

- **Coverage may not be available or may be expensive -** Insurance companies assess the relative health of proposed insureds in deciding whether to issue a policy and in determining the premium amount. If you are not in good health, premiums may be too expensive, or coverage may not be available.
- **The insurer may not be able to pay the death benefit -** If the insurance company isn't financially strong or well managed, it may go out of business and be unable to pay the death benefit.
- **You may not be able to pay the premium -** If your finances change, you may not be able to pay the premiums as required and the policy could lapse. If sufficient cash isn't available, it may have to be borrowed or other assets may have to be sold or otherwise converted into cash to pay the premium.

Conclusion

You've worked hard to earn and protect the assets that make up your estate. You want to pass those that remain at your death to your family. An efficient wealth transfer plan is an act of love. To transfer your wealth efficiently and with as little waste as possible, you need to consider the taxes, costs and problems your assets will trigger during the transfer process and implement strategies to minimize them. Life insurance may be able to help. Using life insurance as one of the components of your plan could increase how much you transfer to your family and improve your plan's financial efficiency. Consult with your financial professional to see if life insurance can help you do a better job of meeting your wealth transfer goals.

Want to hear more? Call your ING Financial Professional.

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