Mary Vandenack provides the transcript from Legal Visionaries podcast on Life Insurance in Estate Planning.

TRANSCRIPT:

Mary: On today's episode, my guest is Eryka Morehead. Eryka is the President and CEO of Collaborative Planning Group, Inc., an organization that she founded. Collaborative Planning consults with clients in regard to life, disability and long-term planning. I asked Eryka to participate in this episode to discuss life insurance in estate planning. Eryka is also going to join me for some additional episodes. We're going to do an episode on long-term care insurance and long-term care planning, and we're also going to go into some of the topics that we find really interesting and have an episode on split dollar and discuss one of the cases that's been really interesting in the industry recently for life insurance providers and for estate planners. And we're going to also discuss premium financing and some really interesting strategies in that arena. Thanks for joining me today, Eryka.

Eryka: Thanks, Mary. I'm excited to be here.

Mary: So one of the things I've learned that there's a lot of different types of life insurance. While you and I routinely work with life insurance, can you take just a minute to explain what exactly is life insurance and how does it work?

Eryka: Yeah, so life insurance is a contract between a policy holder and an insurance company. And the policy, I'm going to lightly use the word guarantees because a lot of things have changed in the life insurance world this day, but theoretically, the contract guarantees that if a client pays premiums or a specific sum of money over a period of time, that there would then be a death benefit provided by the insurance company that would pay out upon their death.

Mary: So, there are a lot of different types of insurance. Can you give just a summary of the major categories of insurance types?

Eryka: Yeah, so they really boiled down into two different categories. There's term insurance, which would fall into more temporary type of coverage. It's set to be there for a certain duration of time. For example, it might be a 10-year term or a 20-year term. The other category would be permanent insurance coverage, and these are contracts, whole life insurance policies or universal life insurance policies that are designed to be there throughout the duration of the insured's entire life. In that category of universal life, you'll hear things like variable life insurance, indexed life insurance, current assumption, universal life insurance, and those really just depend on the crediting method that's being used inside those contracts.

Mary: So, can we just break down one thing that a lot of times when I'm talking with clients about life insurance they really don't understand? And that is if you pay a dollar of premium, so let's talk about your traditional old guard whole life rather than all the other variations of the permanent insurance for a minute. Now I always break it down into the dollar that you spend, it breaks down into different factors what it's paying for. And when you're buying the term life insurance, you're basically just buying death benefit. But when you're buying the traditional whole life, the premium dollar goes into three different categories as I understand it. And the other thing you could maybe speak to is how that works and why sometimes you'll have a policy that you think is permanent. So, what I tell clients is make sure you have somebody review your insurance because what you think is permanent or you think is paid up isn't necessarily going to be there when you need to. And part of that, I think that it would help people to just understand what their dollar is going towards in that premium.

Eryka: Yes, no one likes surprises, at least those kinds of surprises. So, within whole life insurance, it's a little bit of a big black box. On whole life insurance, you're not going to get a statement that shows you exactly what the premium load was or what the deductions were for mortality or expense or administrative charges.

Mary: So, wait, so those are the three categories, right?

Eryka: Correct.

Mary: So, mortality and that means the death benefit. So, if you buy a $100,000 face value policy, the part of my premium dollar that's going to mortality is supporting that a $100,000 death benefit?

Eryka: Yes.

Mary: Okay. And then administrative expenses was the other one.

Eryka: And then you're going to have premium loads. So, every time you make a premium payment to an insurance company, typically there's a load, a percentage, might be 3%, 5%, 7%, they're different at every carrier. That's that premium expense load that's coming off of the top. So you've got three categories of expenses, you've got your mortality, your administrative expense charges, and then you have your premium loads that you'll see coming out of those policies.

Mary: And those amounts can vary from time to time during the term of the policy, if I understand that correctly. And so, when you talk about you're, again, I'm just going to stay with the traditional guaranteed whole life type policy, there's a guarantee that expenses will never go above a certain percentage. Is that how that works?

Eryka: So actually, in whole life insurance, the change in mortality or any of those expenses and charges, that risk is actually held by the insurance company. So, because, by pure definition, whole life insurance is a contractually guaranteed, there's guaranteed cash value, there's guaranteed death benefit so long as the premiums are paid. So, where you would see maybe some surprises in a whole life ledger if you showed up 20 years later and said, "Wait a minute, what did this ledger look like originally when the policy was issued and why has it deviated?" The biggest factor you're going to see, assuming the client paid the premiums all of those years is just the difference in the dividend crediting performance. So for example, 20 years ago, if the insurance company was crediting an 8% dividend, but last year they were only crediting a 5% dividend, that is going to change the growth of the death benefit and the growth of the cash value. But very rarely with a whole life policy are you going to find a negative surprise where a client has paid their premium all of these years and there isn't a death benefit. It will be there in a whole life contract.

Mary: So, what if they get told, okay, we're a little short on cash, and they said, "Well, you can let the premiums get paid out at cash value."

Eryka: Yes, you can, but here's the danger. Oftentimes people think I'm just not going to pay the premium. Well, when an application is initially submitted, there's a little box that the agent has to check, do you want an automatic loan provision, an automatic premium loan if a policy premium payment is not paid, yes or no? So, depending on whether that box was or was not checked on the application will dictate what happens when the client doesn't make a premium payment. So if that automatic premium loan provision is enforced on the contract, that's where you'll see people stop making premium payments. And next thing we know, 10 years later, we've amassed a large loan on a life insurance policy that was unexpected. So anytime someone says, "I can't make a premium payment, or I don't want to make premium payments anymore," with whole life insurance, you have to be very proactive about the how. How are you not going to make those premium payments? You can do a reduced paid-up contract. There are an assortment of dividend elections you can make. Maybe you could have the dividend cover the premium, or you could surrender paid up additions inside of the whole life contract to take care of that premium. If you don't proactively submit that form and that change to the insurance company, you may find yourself in a lapse situation or an automatic loan situation.

Mary: And so what would you say, because that's one of the things as a practitioner and early in my career I understood almost nothing about life insurance except that you should have life insurance. I'm being a little facetious but not entirely. And then I started to have clients, particularly at a certain age, that all of a sudden, their policies didn't have what they thought. They thought they had a policy that was going to pay $100,000. It wasn't going to pay that. So what is the step or what's the action that clients should be taking to make sure that doesn't happen?

Eryka: So, on whole life, if you're not going to make a premium payment, you need to reach out to the insurance company and you need to ask them, "What are the various ways, what could my policy do right now? How could I move forward not paying premium?" And have them run the various illustrations so they can run dividends taking care of premium. Okay, maybe we see that doesn't work. Surrendering paid up additions to take care of the premium, maybe that'll get you by for 10 years. You can run those options to see what the impact is going to be on the cash value and the death benefit moving forward. And if someone says, "I don't want to continue to pay at all," they could always look for a contractually reduced paid up option on whole life insurance. Indexed universal life is a separate story.

Mary: Yeah, no, I picked one to try and make it simple because I think it's a really complex topic.

Eryka: It is.

Mary: And with all the different types of insurance... So once upon a time you basically had your traditional whole life and term and now we've got all these other different types of products out there as well. So I just picked what I thought was the easiest of those to illustrate really what I would say and extrapolate to the other types of insurance is you need to pay close attention to your insurance policies because the other one, even with the term, what I see is sometimes I'll have clients don't understand, so they think it's renewable term, but they got this great deal where they bought a million bucks, they're paying a really reasonable premium. The 10-year term comes, and they're caught very off guard when they find out that the amount they're going to have to pay to continue that term policy is a huge amount. And so that's, to me, something I just really encourage people to understand insurance or at least understand enough to ask the right questions. And what you're saying is really on a regular basis to the extent you have insurance, you should have it looked at, have illustrations run showing you what does this look like if I do this? What does this look like? And do that regularly. Is that a fair statement?

Eryka: Absolutely. Absolutely. I would say on the universal life policies, it's very critical to be keeping an eye on those policies because the risk of that mortality expense charges the admin charging the performance of the contract on those, that's actually held by the policy holder, not by the insurance company. And we're seeing in today's market, more and more of those built in contractual guarantees on both the permanent products, the universal life specifically, and the term products are being stripped away. So you talk about back in the old days of insurance, term life insurance used to come with all these contractual provisions for conversion in exchange. And as the market's trying to be super competitive and offer insurance for the least amount of cash flow possible, they're stripping out a lot of these writers that are now add backs. Well, as a consumer, how do you know what you want to add back to your term contract if you don't even know what's available? So, making sure that you're asking upfront, even if it is that 10-year term or that 20-year term. The term length typically refers to the level premium funding period, not necessarily the duration of the contract. So, to your point, it might go to an annually renewable term option after. Some contracts, though, if they're 20 years, they're 20 years and they're done. It all depends on the carrier and the policy that you're looking at.

Mary: We are going to take a brief break from our episode for a word from one of our sponsors.

Mary: Okay, let's continue our episode. In a comment that you made that I think is really important is that there are so many different types of insurance, and they change constantly. And sometimes, and I've worked with you on this because it's like, okay, I know that the industry changes constantly and the products evolve constantly, but I don't have time to keep track of all of that and don't have a life insurance license. So, I'll call you up and say, "I have this client with X insurance, what can we do? Is there a better product that they can switch to?" Sometimes the answer is yes, sometimes no. But the importance, again, is actually paying attention to the life insurance, not just putting the insurance in place thinking it's going to be there but realizing that the products do change. So, it's almost like managing your funds in the stock market or anywhere else, is there should be somebody paying attention to it with some type of closeness. And proactively, if you're not getting a call from your advisor, call them and ask.

Eryka: Yes. And I think it's important to realize, I tell my staff this all the time, there are no synonyms in insurance. If you say one word meaning something very similarly related and you ask that word to an insurance company, you're going to get back. So, if you say, "Hey, I want to look at a dividend offset versus surrendering paid up additions," well if someone just called in and said, "I want to stop making premium payments on my whole life," there are a bunch of different ways to do that. So as long as you keep in mind that when you're asking questions to your agent or you're asking questions to the insurance company, word choice is very specific. So sometimes broaden your questions, how could I go about not making premium payments because there's actually six different ways to do it, for example. So just if you remember that, there are no synonyms in insurance and every word has a very specific meaning.

Mary: And so then following that up with questions and so what are the consequences of each of those six options and what does this look like? Which also comes back to the objectives that you have the insurance for in the first place, which can change over time, and we can talk about that in more detail. But one of the things we were going to at least talk about today was how people and why people use life insurance in estate planning because there's a lot of different reasons for life insurance and we've used the strategies in a lot of areas, but I wanted to talk about that. So, what is the most common use for the average person?

Eryka: So, most people initially purchasing life insurance are frequently looking for term insurance for a temporary reason. That might be income replacement, protecting their family, might be a large business loan or real estate loan that they've taken out and they want to make sure that that debt is taken care of. So that conversion privilege I mentioned for term insurance, especially if it's somebody who's expecting to grow and amass some wealth, can be very important later on. Very frequently we will find people who started out with term needing lots of death benefit for as low as cash flow as they could get the coverage for. But now as their balance sheet is growing as they're accumulating wealth; we are in a situation where we almost need to repurpose that insurance from temporary needs to more permanent needs. And those permanent needs would be things like estate liquidity. So, if we have an agricultural family or we have someone with closely held business interests and they really want to make sure that their estate can stay together, that those assets, that company can successfully pass to the next generation. If we have taxes, we need to be concerned about, life insurance can be a very efficient tool to infuse some liquidity into that situation.

Mary: And so we're going to do a more detailed episode at some point in the future on uses of life insurance and business planning, but I was hoping you could just give us an overview of how insurance is used for the business owner. One of those, you mentioned already, agricultural ownership, but there are varieties of different types of businesses. What are some uses in that context?

Eryka: So anytime we're working with a business owner, we have to look through and analyze their situation through three different lenses. Business owners are typically taking some form of money, maybe salary, dividends, distributions, what have you, out of the business to fund their personal balance sheet. And so from that standpoint, we need to make sure that that cash flow to the family is protected if they were to pass away or even get disabled prematurely. Oftentimes business owners are functioning as a key employee inside their business as well. So, we need to make sure we understand if that business owner passed away, do we have a potential loss of revenue associated with them being removed for the equation or possibly an increase in expenses associated with the business. In either case, that's going to put negative cash flow pressures on the business, which unfortunately happens right before a buy sell agreement, or some contract may be prompting a sale.

Mary: So an example would be, so I own a business or a good portion of the business and I'm the CEO of the business and so I become suddenly disabled. What happens to that business is they're out their CEO and they may have to pay out for the ownership of the shares at the same time, correct?

Eryka: Right.

Mary: And so the life insurance can be a solution to support, give them a cash flow to pay that as opposed to all of a sudden we've lost this key person, we have to figure out how to replace the key person. In the meantime, possibly depending on the business type, the revenues could drop off as a result of you're missing that key person, you're trying to figure out how to function due to a sudden death or disability. And so that's usually held within the company in those contexts.

Eryka: Key employee coverage is typically held in the company and that can be key employee disability insurance or life insurance. We want to just make sure we understand the economic impact to the business if the owner as a key employee or oftentimes we identify other key employees whose premature death or disability would have a negative impact on the cash flow of the business. And we can typically, depending on the carrier, ensure their life for anywhere between eight to 10 times their earnings. So, if you've got a key employee making a $100,000 a year at its maximum, the business can maybe own about a million dollars of coverage on that particular key employee to infuse some liquidity to help replace them and offset any lost revenue associated with them.

Mary: So really any company might ensure a key employee, whether an owner or not. Sometimes if they're one and the same, we add a little level of complexity and you're going down the path of the buy sell. So, it's really common, particularly in closely held companies, but in a lot of different situations that we're going to have an agreement if an owner who is also an employee and maybe not but dies or becomes disabled is going to get bought out. So how does the life insurance work in the buy sell context? Is that different?

Eryka: Yeah, so that's the third lens. So, we've got them personally, we've got the key employee coverage and then we have how are we going to find the buy sell? Because as we know, the legal agreement, the buy sell agreement, oftentimes is obligating someone to transact when one of those triggering events happens. And so, making sure that whoever that is that is going to be required or have an option to transact clearly knows how they're going to be able to fund that obligation or that option that was inside of the buy sell agreement. So, life insurance can be a very useful tool for that. Now the structure of the life insurance, whether we have it owned in the business to fund a stock redemption agreement or whether we have that owned outside of the business through an insurance LLC or owned by the other partners to fund a cross purchase agreement, all obviously gets dictated by part of the plan, but I cannot stress enough how important the ownership, the beneficiary and the payer all being coordinated and intentional to make sure we don't create a surprise tax that no one was planning for.

Mary: And that's important on every life insurance policy. And my thought process, I've seen some really interesting where you create irrevocable trust and then the insurance policy, which is intended to be in the trust is titled in somebody else's name. So, I would just say that's a great point, but you have tax consequences, or the money just doesn't get where you're expecting it to be able to go as well. So, you mentioned agriculture briefly earlier, and we live in an agricultural state. And it's interesting just because I'm here and I do some stuff at national levels, I get regularly reached out to on agricultural issues and it's renewed my interest in terms of it because it's just a whole interesting arena. But can you speak to a little bit how insurance is used in the agricultural world?

Eryka: And insurance is very important in the agricultural world because people who choose to make their living in the world of agriculture, they have to amass massive balance sheets. There's not a lot of occupations out there where you have to have a lot of assets, a very large balance sheet just to be able to get up and go to work every day and produce an income. For me, for example, I need a laptop and a cell phone and I'm pretty much set and a couple grand and that's all that needs to be on my balance sheet to get up and go to work every day and produce my income. So with agriculture, not only is the value of the land super critical, but so is access. It's very hard for families oftentimes to be able to even purchase and acquire enough ground to be able to farm or raise livestock. And so that liquidity that comes from life insurance to help fund other expenses, take care of other risks, pay off debt and handle taxes in those illiquid estates where it is crucial that those assets are able to be held in intact to transition to the next generation.

Mary: Or just sometimes survival before they get to that point, right?

Eryka: Yes.

Mary: Liquidity matters in a lot of other types of businesses too. Do you have some other examples?

Eryka: All sorts of fun examples.

Mary: It's my favorite thing about talking to you. You always have great stories.

Eryka: I always have stories. Yes. So, life insurance can absolutely be there for what I'd call more of a needs-based play. So, in a very illiquid estate where maybe we're leveraged for the land in an agricultural position or we're leveraged from our livestock and it would be very hard to get additional leverage to completely buy out everything we need to fund that liquidity event that we need to have happen. With other closely held businesses, not only can it be important if there's no active market for you to go exchange or sell shares of your business on, if you want that business to stay together, we've got to have a way to have access to capital to fund those things. In addition to that, life insurance can oftentimes just be an efficiency calculation. Sometimes we have estates that have liquidity. They have significant amounts of outside investment of their closely held business interests. But by funding some of those things on a tax-free basis, both income tax-free and estate tax-free, because we have the proper trust and ownership structure, can be a very powerful efficiency tool as part of their overall plan.

Mary: I think that's a really great point that actually gets underutilized a little bit in the estate planning process. You mentioned that life insurance is often used as an estate tax reduction strategy, that's a variety of ways. One of those is the irrevocable life insurance trust. Can you explain that a little bit?

Eryka: Yeah. So the trust is a great way to safely own the life insurance policy. If you were to just have a child, for example, be the owner of that life insurance policy, there's a lot of things that could go on in that child's world, even an adult child's world that could put that policy in jeopardy. So, by using a trust, whether that's an ILIT or irrevocable trust, it allows the family to have a safe place to keep and warehouse that policy until the time that it is needed. Now those policies when they're in those trusts can be funded a variety of ways. We will have clients use their annual exclusions, gifting the required premium amounts. They can sell policies to a trust that was maybe previously seeded with cash or other assets. We've also had times where clients will own the policy inside of a trust that also owns other income producing assets. So we're not worried about how we're going to get the funds into the trust to fund the policy.

Mary: And I'm just going to footnote what you said about the importance of trust generally. It's true not just with life insurance but in general because, to your point, beneficiaries, their lives change. You don't know what's going to happen. They might get in a bad marital situation, they might get in a life-altering injury, they might develop a disability, they might get sued. We have clients in high liability businesses and the trust arrangement in general just gives you the ability to consider the various circumstances that arise that you might not if you just land the proceeds in their estate. I've one` too many times, seen somebody get the proceeds of a life insurance policy and the next day a lawsuit gets filed against them or that's the day the spouse leaves or something like that. So, let's talk about the blended family because I think sometimes insurance has particular value in the estate planning realm when you have a blended family with assets going in different directions. You have any thoughts on that?

Eryka: Yes. So on the blended family situation, especially if both parties are coming to the table with a prenuptial agreement, life insurance can be a very great way to make sure that the spouse, any stepchildren or any children of the second marriage are taken care of to the extent that the family determines is appropriate while still being able to keep maybe more of the family branch assets available to the children of that family branch. We also see that very commonly in situations where maybe one party coming to the marriage, they come from a family of wealth, maybe they're going to be a beneficiary of that trust, but very rarely is their spouse named as an additional beneficiary. If anything, it's their children. And so oftentimes we will use life insurance to make sure that the spouse is going to be adequately taken care of because if the family is counting on as part of their own financial plan assets coming from that trust, it's oftentimes missed that while that spouse is maybe raising those children, they will have access to some of the funds of the trust. But beyond that, they're really not accounted for in that trust planning.

Mary: And another topic that you and I both love is the concept of split-dollar insurance. And it's beyond the scope of our discussion today. And we're going to do another episode where we're just going to talk about split-dollar generally, but we are both familiar with the case that came out in 2022. It's the Levine case that was a win for the taxpayer in utilizing split-dollar, which those of us practicing in the area are really happy to see that. Can you talk about split-dollar just briefly?

Eryka: Yeah. Split-dollar is a very helpful tool, oftentimes used between an employer and employee or in an estate case between generations where it allows us essentially to separate ownership or control of the cash value of the policy from the death benefit of the policy. And so that particular case was incredibly important because it's the first time that the courts have ruled in favor in all accounts of the taxpayer. The structure, though, of that case really helped create a great blueprint for advisors moving forward on how to set up these types of plans. Just to name a couple significant points, in that particular case, the trust owned the policy from the onset. That was critical. Frequently we see people, "Well, we're going to apply for it this way, and then later after we get the policy issued, we're going to transfer it over here." I'm not sure if that would've resulted in the same favorable treatment at the end in that case if that's what had happened. Where here, the policy was owned at the onset in the trust and her wishes and intentions were incredibly well-documented. The IRS is always concerned as this some tax avoidance scheme. And so, her intentions wanting the policies to be for the benefit to create a legacy for her grandchildren was an incredibly important component to this case as well.

Mary: And it's fun, we've been talking about that case since it came down. I was recently at Heckerling, which is the Annual Institute on the tax issues, and I think some great people gather there. And I'd have to think, I feel terrible I don't recall who presented on that issue this year. I think it was brought up in several of the sessions actually, but one commentator specifically mentioned that every practitioner in this area should read this case in terms of look at this as how to do things right. Do you have any last thoughts on this topic today, Eryka?

Eryka: I think you said it best earlier when you said life insurance is a very underutilized tool in the estate planning arena. I do also think a very important takeaway is we think of life insurance as a contract that offers guarantees, but just knowing that we have to review those policies frequently because more and more of those guarantees aren't quite embedded in the policies the way maybe we think they were or they used to be.

Mary: Well, as we reach the end of our episode, I want to thank our sponsors Interactive Legal, Carson Private Client and Foster Group. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.