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Life Insurance What Attorneys and Trustees Should Know

By Bruce A. Tannahill and Melisa Seyhun

Bruce A. Tannahill is director of advanced sales for a large mutual life insurance company, a vice-chair of the RPTE CLE Committee, and a Trust & Estates Associate Articles Editor of Probate & Property. Melisa Seyhun is an associate with Schiff Hardin LLP in Chicago, Illinois, a 2019-2021 RPTE Fellow (Trusts and Estates), Vice Chair of the Financial Planning and Risk Management Committee of the RPTE Non-Tax Estate Planning Considerations Group, and Chair of the Communications Sub-Committee of the RPTE Diversity and Inclusion Committee.

Life insurance is a powerful financial tool. It is the only financial product that, if the product requirements are met, promises to pay a specific amount at a specific event—the death of the insured. Like many things, what began as a simple product with two choices has evolved to provide many different options and the flexibility to be used in numerous ways.

This article will cover how life insurance is defined, both judicially and for tax purposes, the different types of life insurance policies available, the income and transfer taxation of life insurance, how life insurance is frequently used, and how life insurance is valued.

What Is Life Insurance?

Before there was a tax law definition of life insurance, there was a common-law definition. In *Helvering v. LeGierse*, 312 U.S. 531 (1941), the Supreme Court held that both risk shifting and risk distribution are required to qualify as life insurance. Risk shifting involves the policy owner transferring his risk of loss from the insured's death to the insurance company, while risk distribution involves the insurance company distributing its risk of having to pay a death benefit among its many insureds by pooling premiums received on the policies.

In 1986, Congress enacted a statutory definition in Internal Revenue Code Section 7702. (All references to a "section" are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.) To qualify for favorable income tax treatment on a life insurance policy, section 7702 requires a life insurance policy to meet one of two actuarial tests. First, the Cash Value Accumulation Test (CVAT) under section 7702(b) limits the amount of cash value that can be accumulated in a policy. Second, the Guideline Premium Test, under section 7702(c), limits the amount of premium paid in relation to the death benefit. Life insurance companies will not issue policies that do not meet one of these two tests. It's important to note that the policy must also meet the common law definition of life insurance.

If a policy fails both tests, the income on the contract is ordinary income to the policy owner each year, even if not withdrawn from the policy. The income on the contract is (1) the increase in net surrender value during the year, plus (2) the cost of life insurance protection during the year, less (3) premiums paid during the year.

Failure to meet either test does not affect the income tax treatment of the death benefit. It is still

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considered to be paid under an insurance contract and not taxable under section 101 unless one of the exceptions to tax-free treatment discussed below applies.

What Are the Risks?

There are inherent risks associated with life insurance, and it's important to understand them.

Credit Risk

There is no FDIC coverage for losses associated with life insurance, though state guaranty funds may cover a portion of losses. When it comes to credit risk, not all carriers are created equally, so carrier ratings play a critical role when choosing a policy.

Investment Risk

Investment risk concerns how any cash value is invested. The cash value for most policies is held in the carrier's general account, and policy owners have no control over the general account. Separate accounts, as the name suggests, are used for variable universal life insurance policies and held separately from the general account of the carrier. The general account is subject to the creditors of the carrier, but the cash value allocated to the separate accounts is owned by the policy owner and isn't subject to the carrier's creditors.

Although the primary purpose of life insurance is to provide a death benefit, some policy owners often also consider permanent life insurance as an investment tool, and some policies, therefore, can be riskier than others. Investment risk tends to be the most often overlooked risk associated with life insurance. Thus, it's important to periodically review and manage existing policies.

Premium Adequacy Risk

Premiums can be fixed or variable. There are universal life policies that can be sold on a "pay what you want, when you want" basis (subject to tax law requirements). It is the policy owner's responsibility to ensure that the policy is in effect at the time of death, meaning that enough premium has been paid into the policy to ensure the policy has more cash value than the expenses charged against the policy. If the policy runs out of cash value, it may lapse, depending on the policy terms.

Term vs. Permanent Policies

There are two general categories of life insurance: term and permanent. *Term* policies provide coverage for a specified period; *permanent* policies last for the life of the insured. The difference between the two is similar to leasing versus buying a car. With a *term* policy, you are paying to lease a policy, much the same way you would lease a car. At the end of the term, you may choose from a few options. You could purchase the car you had been leasing, such as converting a term policy into a permanent policy (though not all policies may offer that option). You could choose to lease a new car (meaning, you decide to purchase a new term policy). Or you could purchase a new car (or, in this case, purchase a permanent policy).

With a *permanent* policy, you've bought the car; you own it. You can pay for it in cash, upfront, as you would with a single-pay permanent policy. Or you could finance the car, and pay over time, such as you would with premium payments on a permanent policy. Once you've paid for the car, or paid-up the policy,

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you can sell the car for cash, use the car as collateral for a loan, or drive it into the ground. In terms of the permanent policy, that means you can withdraw the cash value of the policy, you can borrow on the cash value (even if premiums are still due), or hold onto the policy until the earlier of death of the insured or maturity of the policy. Note that policies that build cash value generally take several years before any cash value is available to withdraw or borrow. There are other options available too, such as life settlements, which are outside the scope of this article.

Types of Term Policies

There are two basic types of term policies—those with a level premium and death benefit for a specific period, known as level term policies, and those that renew annually, known as annually renewable term (ART) policies. At the end of the term for a level term policy, the policy generally becomes an annual renewable term policy, and the premiums may be significantly higher than those paid during the initial term. Many level term policies allow the owner to convert the policy to a permanent policy, at least during the first part of the policy term.

Renewable policies are less common than level policies. Annually renewable policies allow annual renewal without needing to reapply or go through underwriting; however, premiums are recalculated annually, which may be more costly, over time, than a level term policy for the same period. For example, as we age, premiums generally become more expensive. Thus, annual renewable policies are often used to cover short-term insurance needs for the lowest cost. They may also be convertible to a permanent policy.

Types of Permanent Policies

Broadly, there are two types of permanent policies—whole life and universal life, which is broken into four general types of universal life policies. Also, a policy may have elements of both permanent and term policies. These policies, known as blended policies, are frequently used when some permanent coverage is required, but additional coverage is needed for a limited amount of time or to manage the premium amount while providing some permanent coverage.

Whole Life

Whole life policies, also known as ordinary life, have fixed premiums, a guaranteed death benefit, and cash value, assuming the required premiums are paid. The cash value of whole life policies can be withdrawn or borrowed against. If the policy is surrendered, the policy owner will receive the cash value, less any surrender charge or outstanding loan. As discussed above in the section on risks, the cash value of whole life policies is part of the carrier's general account. The cash value is therefore subject to creditors of the carrier.

Universal Life

Unlike whole life policies, universal policies have no scheduled premium payments or required due dates, although the sales illustrations will show the premium payments recommended as part of the sales process. They offer more premium flexibility than whole life policies. The carrier deducts the policy charges from the policy's cash value. This creates the premium adequacy risk discussed earlier. It is the policy owner's responsibility to ensure that the policy is in effect at the time of death, meaning that enough premium has been paid so the policy has sufficient cash value at the time policy expenses are charged. If the cash value is less than the policy charges, the policy will lapse. Generally, carriers will inform the owner of the lapse and provide a grace period of 60 days to pay higher premiums to keep

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the policy in force. Illustrations of these policies typically assume constant account credits, which are not always realistic, so these policies require monitoring and updated illustrations. If the actual interest credited is less than the amount illustrated, additional premiums may be required for the policy to remain in force for the insured's life.

The death benefit of a universal policy can include the face amount or the face amount plus premiums paid or cash value and the death benefit may increase if earnings are sufficient. The cash value accumulated in universal life policies can be surrendered or borrowed, like whole life policies, but they may also be withdrawn. Universal life policies are general account policies.

Indexed Universal Life

Indexed universal life (IUL) policies are a hybrid of traditional universal life policies and variable universal life policies (granting flexibility concerning premiums) but with *some* guarantees regarding policy earnings—providing down-side protection and an upside cap by crediting interest on the return of an equity index, such as the S&P 500. Once a policy owner has selected a particular equity index, it's locked in and cannot be changed, at least for some time.

In indexed policies, any excess earned above the cap is kept by the insurer. In contrast, for traditional universal life policies, the insurer decides how much will be credited to the cash value of the policy, subject to a minimum crediting amount. IULs are also general account policies. Their complexity increases the importance of IUL policy owners regularly monitoring the policy performance and how it compares to the expected performance.

No-Lapse Guarantee Universal Life

No-Lapse Guarantee Universal Life (GUL) policies are a departure from traditional universal life policies because they guarantee a level premium in return for a guaranteed level death benefit if the premiums are paid when due, even if the cash value is reduced to zero. With GULs, you lose the premium flexibility but gain a guaranteed death benefit.

These policies typically don't offer much cash value at any time and restrict access to the cash value. GULs can be referred to as permanent level term policies. Like level term policies, there are fixed annual premiums and death benefits. Like permanent policies, however, they last for the lifetime of the insured if the policy requirements are met. These policies often have very strict requirements to maintain the guaranteed death benefit. These requirements may include always paying the full amount of the premium and paying the premium on or before the due date.

Variable Universal Life

Variable universal life (VUL) policies allow policy owners to allocate premiums into one or more mutual fund-type investments, referred to as subaccounts. By doing so, the investment risk is shifted to the policy owner. They otherwise provide many of the same features of universal life policies, such as flexible premiums. The death benefit may vary to include the face amount or the face amount plus cash value. Unlike the previously described insurance types, VULs are separate account products. Thus, they are not subject to the creditors of the carrier.

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Single Life or Survivorship

Single life and survivorship (or second-to-die) policies are not necessarily different policies from those described above; they describe the number of insureds on the policy.

Most policies cover one insured—we call these single life policies. Survivorship policies cover two insureds, with no death benefit paid until both insureds have died. The insureds do not have to be spouses. If they are not spouses, however, there needs to be some relationship between the insureds that justifies the insurance. Survivorship policies do not require the carrier to make any payment of death benefit proceeds until both insureds have died.

It may be possible to obtain a survivorship policy when one insured is uninsurable. Generally, a survivorship policy premium will be less than the combined premiums for two single life policies on the lives of the insureds. Survivorship policies are often used for estate planning purposes, such as providing liquidity to pay estate taxes or funding a special needs trust.

Modified Endowment Contracts

Congress enacted the modified endowment contract (MEC) rules in 1988 to identify policies purchased primarily as investments that take advantage of the favorable income tax rules for life insurance policy distributions. Section 7702A defines a MEC as a policy in which the cumulative premium paid exceeds the amount required to fully fund the policy in seven level annual payments (the seven-pay test). Withdrawals, distributions, and loans from MECs may be taxable and subject to a 10 percent penalty tax.

Also, certain policy changes result in re-testing. Those changes are certain increases in the death benefit, the increase or addition of certain riders, and a reduction in death benefits – including a reduced face amount or partial surrender. If a policy change, including the payment of additional premiums, will result in a policy becoming a MEC, carriers will normally contact the policy owner to confirm that the policy owner understands that the requested change will result in MEC treatment.

Choosing a Policy and Carrier

Many factors can influence which type of policy to choose, including the purpose of the policy, the features available within a specific policy, and the insurance company's ratings.

Purpose

Death benefit only, cash value not a concern. This is used when a policy is needed as collateral for a loan or a breadwinner wants to provide his family with income replacement if he passes for a certain number of years or until a certain time, such as when the youngest child reaches a certain age. In these situations, term insurance or a guaranteed universal life policy may be the policy of choice. If the goal is to provide estate liquidity, a guaranteed universal life policy will accomplish the client's objective but a term policy may not.

Death benefit and cash value accumulation. A client may want the life insurance coverage death benefit to replace lost income until retirement and then use the cash value to supplement her retirement income. Most buy-sell planning provides for the purchase of an owner's interest either at death or upon a specified lifetime event. A cash value policy provides a death benefit at an owner's death as well as cash value that can be used as part of the payment for a lifetime purchase. An often-overlooked situation where a policy

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with cash value is important is key person coverage. A business is likely to suffer the same loss regardless of whether a key person leaves the business or dies. A policy that offers cash value accumulation can provide the employer with necessary resources, regardless of the reason for the key person's departure.

Cash value accumulation and death benefit. In some situations, the primary focus is on accumulating cash value, and the death benefit is a secondary consideration. Two common situations are when the client's focus is on using the cash value to provide supplemental retirement income with income replacement or estate liquidity as a secondary factor. Businesses that offer nonqualified deferred compensation plans often use life insurance as a way to accumulate cash to meet their obligations under the plans during the participant's life and receive a death benefit that can be used to pay any remaining obligations to the participant's beneficiary, recover some or all of the premiums paid on the policy, and fund deferred compensation obligations to other participants.

Features

In addition to the death benefit and cash value accumulation, policies may offer additional features that may be important. Some are included in the basic policy, but others require the addition of a rider to the policy, often at an additional cost. The riders are subject to limitations and exclusions, which vary with the carrier or the specific rider.

Common riders include:

- Guaranteed insurability rider: Allows the purchase of additional coverage without new underwriting at certain ages or events, such as marriage or the birth of a child.
- Waiver of premium rider: Provides that premiums are waived if the insured becomes totally disabled. Depending on the type of policy and type of rider, the rider may cause the entire premium to be treated as paid or just the policy costs paid. When the entire premium is treated as paid, the cash value continues to grow.
- Long-term care/chronic illness access: This feature allows access to the death benefit if the insured needs long-term care or is chronically ill.
- Transfer of insured rider: This feature can be attractive in business situations. It allows the exchange of a policy for a new policy on a different insured. It reduces first-year policy charges on the new policy, increasing the cash value accumulation. Certain requirements must be met, including underwriting on the new insured and the owner having an insurable interest in the new insured. The transfer does not qualify as a section 1035 exchange because the policies have different insureds. For tax purposes, it is treated as a surrender of the original policy and the purchase of a new policy. Any gain on the original policy will be taxable.

Ratings

A life insurance policy, even a term policy, is intended to last for many years. It's important to consider how likely it will be for the insurance company to have the ability to pay a death benefit at the insured's death. Several rating agencies, including A.M. Best, Moody's, Standard & Poor's, and Fitch, evaluate the claims-paying ability of life insurance companies, based on factors including a company's assets, cash flow, investment mix, and expenses. Each rating agency uses a different approach and has its own scale. When reviewing ratings, it's important to consider the rating agency's description of what each rating means and where the insurer's rating falls in the rating agency's scale. Not all companies are rated by all agencies. Note that these ratings can change rapidly—AIG in the 2008 financial crisis is an example of this. It is prudent to check the credit rating of carriers annually.

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Other Factors

Underwriting criteria. Different insurers may take different underwriting approaches, especially for medical conditions. Some carriers may be more willing to issue policies on insureds with specific types of medical issues over others. For example, Company A may be willing to issue a policy on a proposed insured with skin cancer at its standard rates while another a company would issue a policy only at a substandard rating and significantly higher premium.

Generally, there are three broad classifications: preferred risk, standard risk, and substandard risk. Preferred risk is the most ideal scenario for carriers and will generally offer lower premium rates to policy owners. Insureds that fit in this classification are lower risk for the carrier because they are in good overall health and are nonsmokers. Carriers often have more than one preferred risk category. The substandard risk classification is used for insureds who fail the standard underwriting options. Carriers generally have multiple substandard risk classifications, based on the insured's specific characteristics. Policy owners will pay significantly higher premiums than those with a standard or preferred risk classification. Standard risk fits between preferred and substandard risk, with higher premiums than preferred risk and lower than substandard risk.

Relationship with an agent. A client may have worked with an insurance agent who understands the client's unique situation and needs for several years. The existing relationship may lead to better advice and service than starting with a new agent.

Products offered. Different companies offer different products with different features for those products. For example, some insurers do not offer certain types of products. Choosing a certain type of policy may limit the insurers.

Customer service. An insurer's customer service can be an important factor in evaluating insurers.

Premiums. Cost is almost always a consideration in evaluating a policy and a company. As with almost all other products, it is rarely the only consideration.

Uses of Life Insurance

The primary benefit of life insurance is the death benefit. The death benefit, cash value, and other characteristics of life insurance can be used in many different situations. See the table on page 46 for a summary of different life insurance features and their uses.

Managing Life Insurance Policies

It is certainly tempting to purchase a life insurance policy, file it in your desk, and forget about it. A periodic review of existing policies is critical to ensure the policy continues to meet the needs of the insured and the policy owner. Managing a policy is more important for a permanent policy than for a term policy. For a term policy, the main considerations are whether to continue the policy and, if the policy can be converted to a permanent policy, whether to convert some or all of the policy.

The flexibility of universal life, indexed universal life, and variable universal life policy designs mean that they need to be monitored regularly, similar to how investments are monitored. For these policies, paying the planned premiums may not be sufficient to produce the anticipated results or perhaps to even keep the policy in force for the insured's life expectancy. Without regular monitoring, policy owners may find that

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the policy has not performed as expected and significant additional premiums are necessary to accomplish the anticipated results.

Even though whole life policies offer guarantees, the actual amounts credited to the policy may be less than expected. New policy designs or assumptions may offer a larger death benefit or cash accumulation than a current policy.

Some of the steps to consider in managing a policy include:

- Reviewing the reason the policy was originally purchased and whether that reason still exists. If it does, determine if the death benefit amount is still appropriate or if it needs to be adjusted. A policy that is no longer required for the original purpose may now be needed for a different purpose. When additional coverage is needed, exercising a guaranteed insurability rider to add the needed coverage may be more cost-effective than purchasing a new policy. If a lower amount of coverage would be sufficient, consult an insurance professional or the carrier for options to reduce the coverage.
- When a policy is not currently needed for any purpose, consider if there may be a future need. If there may be, keeping the current policy may be the most economical decision. Age and the insured's health are two crucial factors in determining the premium amount. The insured will never be as young as he was when an existing policy was issued and may never again be as healthy.
- Compare the most recent policy statement with any policy illustration obtained at the time the policy was issued. Things to review include the actual cash value, the crediting rate or rate of return, policy charges (for UL, IUL, and VUL policies) and death benefit compared to the illustration, and whether the policy statement indicates the policy will eventually lapse and, if so, when.
- Obtain an in-force illustration from the carrier showing how the policy is expected to perform based on anticipated future premiums. When reviewing an in-force illustration, things to look for include the future death benefit, future cash value, future policy costs (if available), whether future premiums can be paid from the policy cash value, and whether the policy is projected to lapse. Requesting in-force illustrations with different assumptions on future premiums and crediting rates allows the policy owner to analyze available options.

There are several options for a policy that is no longer needed. The options for a specific policy depend on the type of policy, the death benefit, the amount of cash value (if any), the age and health of the insured, and the carrier. Some common options include surrendering the policy for its cash surrender value, exchanging it for an annuity, exchanging it for a long-term care contract, or potentially selling it to a third-party buyer in a life settlement.

If the policy owner does not want to pay future premiums, there may be options besides letting the policy lapse or surrendering it. These may include exchanging the policy for a paid-up policy or using policy cash value to pay future premiums. The policy owner should consult an agent for the issuing carrier or the carrier itself for information on the options available. Depending on the age and health of the insured and the type of current policy, new policy designs and changes in the mortality table used to calculate the costs and values of a policy may make a new policy more attractive than the existing policy.

Life events can prompt a review of existing coverage and may give rise to additional coverage or exchanging of the existing policy for a more appropriate one. Common events that should lead to a review of life insurance coverage include marriage, divorce, birth or adoption of children, and significant changes in income or assets. Beneficiary designations should be reviewed regularly to ensure that the named beneficiary is still the desired beficiary. Failure to update a beneficiary designation may result in an ex-spouse, parents, or siblings receiving the insurance instead of a current spouse or children.

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Taxation of Life Insurance

Income Taxation

Premiums Are Not Deductible. Section 264 provides that premiums are not tax-deductible if the taxpayer is directly or indirectly a beneficiary of the policy. For businesses, this means that premiums on policies purchased for business purposes, such as key person coverage, buy-sell funding, and deferred compensation funding, cannot be deducted.

Cash Value Increases Are Not Taxable. Under section 72(e), an increase in cash value is not taxable at the time of the increase.

Cost Basis. The cost basis of a policy is the total of the premiums and any other consideration paid less any non-taxable withdrawals.

Distributions from Non-MECs Are Generally Not Taxable. If a policy is not a MEC, a distribution from the policy during the insured's life is not taxable unless the total distributions exceed the investment in the contract.

Gain on Surrender of a Policy Is Taxable. When a policy is surrendered, the taxpayer is subject to tax at ordinary income rates on the difference between the amount received (which may be less than the policy cash value because of surrender charges) and the investment in the contract.

Investment in the Contract. The investment in the contract is similar to the policy's cost basis. Premium charges for disability income, double indemnity, and disability waiver are excluded from the definition of "investment in the contract."

No Loss Deduction If Policy Surrendered for Less Than Basis. The surrender of a policy for less than the cost basis does not generate a deductible loss.

Income Taxation of the Death Benefit

Section 101(a)(1) provides that gross income does not include amounts received under a life insurance contract if such amounts are paid because of the death of the insured. It then sets out three exceptions:

1. Transfers for value (section 101(a)(2));
2. Reportable policy sales (section 101(a)(3)); and
3. Employer-owned life insurance policies not meeting certain requirements (section 101(j)).

If the insured is terminally ill or chronically ill, payments during the insured's life are treated as an accelerated payment of the death benefit under section 101(g). Policies may require a rider for the accelerated death benefit to be available.

Transfer for Value Rule

One of the key benefits of any kind of life insurance is the tax-free death benefit. To discourage the transfer of life insurance policies between parties to reap large tax-free windfalls, Congress enacted the transfer for value rule (section 101(a)(2)), providing the death benefit on a life insurance policy transferred for any kind of material consideration may become partially or fully taxable when the death benefit is paid. In particular, it can be a trap in business planning, especially buy-sells.

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The transfer for value rule applies to the transfer of a life insurance policy or any interest in a policy for cash or other consideration that can be reduced to a monetary value. It does not require an actual transfer of a policy to occur, for example, as in the case of a change of ownership.

Some examples of transfers for value include but are not limited to:

- Creation of a contractual right to receive some or all of proceeds;
- Increase in an interest in a policy funding a cross-purchase agreement resulting from the withdrawal of an owner, i.e., death of partner increases surviving partner's interest in policy from one-third to one-half; and
- Transfer of the policy to a shareholder other than the insured in a corporate liquidation.

When a transfer for value occurs, the amount includible in income is computed as (1) the proceeds received, less (2) consideration paid for the transfer, less (3) premiums or other amounts paid by the transferee. For example, assume Amy sells a $100,000 policy on her life to a third-party $10,000, and no exceptions apply. The buyer pays $5,000 in premiums before Amy dies. The buyer must report $85,000 ($100,000 – ($10,000 + $5,000)) as ordinary income.

Once the rule is violated, without any applicable exceptions, the policy continues to be subject to the transfer for value treatment unless: (1) the income-tax-free treatment of the death benefit is recaptured, (2) a transfer occurred before 2019 that qualified for an exception to the rule, or (3) a gift transfer occurred after 2018 to an insured if no reportable policy sale has occurred.

Transfer for Value Exceptions

When a transfer violates the transfer for value rule, it is important to determine whether one of the exceptions described below apply.

Transfer Results in a Carryover Basis. The transfer results in a carryover basis, in whole or in part. This exception captures transfers to a spouse and may include tax-free reorganizations (subject to the effect of the reportable policy sale rule discussed below).

Transfer to the Insured. A common exception applies in the case of a transfer to the insured or the insured's grantor trust (Rev. Rul. 2007-13, IRB 2007-11).

Business-Related Transfers. Three business-related exceptions can be used in planning for transfers of policies in business planning situations. These are:

4. Transfers to a partnership in which the insured is a partner;
5. Transfers to a corporation in which the insured is a shareholder or officer; and
6. Transfer to a partner of the insured.

Note that there is no exception for a transfer to a co-shareholder of the insured. Some have suggested that the exception is met if the transferee and the insured are both partners in a publicly-traded partnership. If the transferee and insured are both shareholders, an alternative might be to form a partnership (or LLC taxed as a partnership) to rent buildings or equipment to the corporation.

Reportable Policy Sales

The Tax Cuts and Jobs Act of 2017 added section 101(a)(3), which eliminated the transfer for value exceptions if a policy is acquired by a person or entity that does not have a substantial business, family,

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or financial relationship with the insured other than the interest in the policy. This results in the portion of the death benefit that exceeds the consideration and premiums paid by the acquirer to be subject to income tax. The acquirer must also report the acquisition of the policy to the IRS and the insurer.

Also, the same income tax treatment applies to a gift of a policy to a person or entity that does have a substantial business, family, or financial relationship with the insured other than the interest in the policy. But no reporting is required.

Reportable Policy Sales Exceptions. Treas. Reg. § 1.101-1(c) provides the following exceptions to the tax treatment for reportable policy sales:

- Transfer of policy between entities with the same beneficial owners. Each owner's interest in the transferor can't vary by more than 20 percent from his interest in the transferee.
- Transfer between corporations that are members of an affiliated group that file a consolidated tax return for the year of the transfer.
- Indirect acquisitions, or the acquisition of an entity owning a policy if the acquired entity:
- Acquired the interest before January 1, 2019, or
- Acquired the interest in a properly reported reportable policy sale.
- Acquisition of a policy in a section 1035 exchange by an insurance company that issues the policy.
- Acquisition of a policy in a section 1035 exchange if the policy owner has the required relationship with the insured (other than through the policy).
- Indirect acquisition of a policy when a person becomes a C corporation shareholder and less than half of the corporation's assets are life insurance policies immediately before the stock is acquired.

Reporting Reportable Policy Sales. In addition to changing the tax treatment of policies that qualify as reportable policy sales, section 6050Y requires reporting to the IRS, insurer, and seller. The acquirer must file Form 1099-LS with the IRS by February 28 of the year after the acquisition (March 31, if filed electronically). The following information must be reported:

- Name, address, and TIN of buyer,
- Name, address, and TIN of seller,
- Date of sale, and
- Issuer, policy number, and sales price.
- The same information must be provided to the seller and issuer, plus the buyer's name, address, and phone number. The sales price does not have to be provided to the issuer. The statement to the seller is due by February 15 of the calendar year after the sale. The statement to the issuer is due by the later of:
- Twenty calendar days after reportable policy sale, or
- Five calendar days after the end of the state law rescission period, *but*
- No later than January 15 of the calendar year after the sale.

Employer-Owned Life Insurance

The employer-owned life insurance policy rules of section 101(j) were enacted to address "janitor insurance," where large employers purchased life insurance on their employees for the benefit of the employer, with no portion of the proceeds going to the employee's family. For policies issued after August 17, 2006, failure to comply with these rules results in the policy proceeds being included in the employer's income to the extent they exceed premiums and other amounts paid on the policy.

Under these rules, an "employer" is a person engaged in trade or business who is directly or indirectly a policy beneficiary. An "insured" is an employee (including an officer, director, or highly compensated

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employee) of the employer's trade or business or a related person on the date the policy is issued. For survivorship policies, both insureds are considered an "employee" for purposes of the rules on employer-owned life insurance policies.

Complying with the rules requires meeting two requirements—a notice and consent requirement and an exception based on either the insured's status or the use of the insurance proceeds.

Notice and Consent Requirement. To satisfy the notice and consent requirement, before the policy is issued the employee-insured must:

- Be notified in writing that the employer intends to insure the employee's life and the maximum face amount of insurance;
- Provide written consent to be insured and to coverage continued after termination; and
- Be informed in writing that the employer will be a beneficiary, even if the employee is no longer an employee.

A corporation must comply with the notice and consent requirement even for a policy on its sole owner or employee. The IRS stated in Notice 2009-48 that, under the statute, actual knowledge about the policy does not substitute for compliance with these requirements. A policy is deemed issued at the later of the application date, the effective date, and the formal issuance of the policy. Some insurance companies require a notice and consent form to be submitted with any application for a policy to be owned by an employer.

Exception Based on Insured's Status. To qualify for the exception based on the insured's status, the employee:

- Must have been an employee at any time during the 12 months before death; or
- At the time the policy was issued, was:
- A director;
- A highly compensated employee under section 414(q), defined as receiving compensation of more than $130,000 for 2020 or a 5 percent owner;
- A highly compensated employee under section 105(h)(5), defined as one of the five highest-paid officers;
- A shareholder who owns more than 10 percent in value of the employer's stock; or
- One of the highest 35 percent paid of all employees.

Exception for Amounts Paid to Insured's Heirs. This exception is met if amounts are paid to a family member (under section 267(c)(4) of the insured); any individual who is the insured's designated beneficiary under the contract, other than the employer; a trust for family members or designated beneficiary; the insured's estate; or to purchase an interest in the employer from one of the qualifying persons.

Income Taxation of Non-MECs

Cash value accumulation, often referred to as "inside build-up," is not taxable unless it's distributed and the total distributions since the policy was issued exceed the investment in the contract. Dividends, withdrawals, and proceeds from surrendering or selling a policy not received as an annuity reduce the policy owner's investment in the contract. § 72(e)(5)(A), (C). The investment in the contract is determined as (1) total premiums or other consideration paid, less (2) non-taxable amounts previously received. § 72(c)(1), (e)(6). Premiums for disability income, double indemnity, or disability waiver are not included in the taxable premiums or other consideration. For example, Amy receives a $50 dividend on a policy with

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$1,000 investment in the contract. If received in cash, the dividend reduces the investment in the contract to $950. If then used to pay premiums, the investment in the contract increases to $1,000.

Treatment of Dividends from Non-MECs. Whole life policies issued by mutual companies often pay dividends. It's important to note, however, that they are treated differently than dividends paid on stocks. If received in cash or used to pay principal or interest on policy loans, the dividends reduce the investment in the contract. If used to pay premiums or purchase additional insurance ("paid-up additions"), there is no net effect on the investment in the contract. The dividends are treated as received in cash (reducing investment in the contract) and then as a payment of premiums (increasing investment in the contract).

Withdrawals from Non-MECs. When a withdrawal is taken from a policy, it is generally non-taxable up to the investment in the contract. Section 7702(f)(7) provides an exception for withdrawals during the first 15 years of the contract if the withdrawal causes a reduction in the death benefit ("forced-out gain"). In that situation, the gain is considered to be distributed first, followed by the investment in the contract. Section 7702(f)(7) provides additional rules that are based on the type of policy and whether the withdrawal occurs in the first five years or in the sixth through the fifteenth year. Also, the section provides that Treasury regulations are to provide that distributions reducing the cash surrender value two years before a death benefit reduction result in gain recognition. No regulations have been issued, so how this provision is to be applied is unknown. Because of the uncertainty, different carriers may take varying positions on reporting any such distribution as taxable.

Surrenders, Redemptions, or Maturities. When a policy is surrendered, redeemed, or matures, any amount received in excess of the investment in the contract is taxable and treated as ordinary income. § 72(e)(5)(E). For example, Maria surrenders a policy with a cash value of $10,000 and a basis of $7,000. The $3,000 gain is taxable to Maria as ordinary income.

Income Taxation of MECs

The MEC rules apply to policies entered into on or after June 21, 1988. As with non-MECs, the cash value growth of MECs is not taxable unless it is distributed. But distributions from MECs are considered to be income first if there is any gain in the policy. § 72(e)(10). Distributions include loans (including loans used to pay premiums) and the assignment or pledge of the policy. § 72(e)(10). An anti-abuse rule provides that all MECs issued by the same company to the same policy owner in a calendar year are treated as one MEC.

Dividends from MECs. Dividends are not taxable if used to pay premiums or buy additional paid-up insurance; however, they are taxable if received in cash or used to pay loan principal or interest.

Other MEC Tax Rules. The following additional rules apply to MECs:

7. Once a policy is a MEC, MEC rules apply to the current year and all following years. § 7702A(d).
8. Treasury regulations are to provide that a distribution made within two years of failing to meet the seven-pay test is considered made in anticipation of the policy becoming a failure. § 7702A(d). No regulations have been issued, so how this provision is to be applied is unknown. Because of the uncertainty, different carriers may take varying positions on reporting any such distribution as taxable.
9. A section 1035 exchange of a MEC results in the new policy being deemed a MEC.
10. A 10 percent excise tax applies to taxable MEC distributions (section 72(v)) unless one of the following exceptions applies:
11. Distribution occurs after the taxpayer turns 59 ½;

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12. Distributions are attributable to the taxpayer becoming disabled; or
13. Distributions are made as part of a series of substantially equal periodic distributions (similar to section 72(t) distributions).

Section 1035 Exchanges

Section 1035 allows a tax-free transfer of an existing annuity contract, life insurance policy, long-term care policy, or endowment policy for another one policy, without recognizing gain. The intent of section 1035 is to allow a policy owner to purchase a policy that better meets her current needs without current taxation. To qualify for a section 1035 exchange treatment, specific requirements must be met.

Both full and partial section 1035 exchanges are permitted, although some rules will vary by company. Typically, section 1035 exchanges between products within the same company are not reportable for tax purposes as long as the IRS criteria for the exchange are satisfied.

As described below, only specific exchanges are permitted.
- Life insurance policies can be exchanged for:
- Life insurance policy;
- Endowment policy;
- Annuity contract; or
- Qualified long-term care policy.
- Endowment contracts can be exchanged for an endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged; an annuity contract; or a qualified long-term care policy.
- Annuity contracts can be exchanged for an annuity contract or a qualified long-term care policy.
- Qualified long-term care policies can be exchanged for qualified long-term care policies.
- To qualify for tax deferral under section 1035, the insured and policy owner must be the same for the old and new contracts. After the death of one insured on a survivorship policy, the policy can be exchanged for a policy on the surviving insured. Two single life policies on different insureds cannot be exchanged for a survivorship policy covering both insureds. Similarly, a single life policy cannot be exchanged for a survivorship policy covering the insured and another insured.

Receipt of insurance contract plus other property or money (boot). As with section 1031 exchanges, a policy owner who receives other property as part of the exchange must recognize gain to the extent of any cash and the fair market value of other property received.

Exchange of policy with a loan is permitted. A policy loan will not prevent a section 1035 exchange but may result in gain recognition. If some or all of the loan is paid off as part of the section 1035 exchange, the lesser of the policy gain or the amount of the loan will be treated as boot. No boot exists if the new policy has a loan at least equal to the loan on the old policy. Insurers may not allow a loan on the new policy or may impose certain requirements, such as a minimum cash value on the new policy, in addition to the loan. Insurers may also treat the repayment of a loan from policy cash value within a certain time of a section 1035 exchange as boot.

Estate Taxation of Life Insurance

Life insurance proceeds are included in the insured's estate if they are received directly or indirectly by the executor or if the decedent had any incidents of ownership in the policy, even though the proceeds were receivable by other beneficiaries. §§ 2042(1), (2). The estate does not have to be the named beneficiary for

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the proceeds to be considered "received" by the executor. If the proceeds are required to be used to pay for taxes, debts, or other expenses or are used as collateral, they are considered to be received indirectly by the executor. If the policy was community property, the proceeds are community property and only half of the proceeds are included in the estate.

A decedent's incidents of ownership in the policy, whether exercisable alone or in conjunction with any other person, cause the proceeds to be included in the decedent's estate. Incidents of ownership are not limited to technical, legal ownership in the policy. The phrase refers to the rights of the insured or estate to the policy's economic benefits. § 2042(2), Reg. § 20.2042-1(c). The following powers constitute incidents of ownership:

- Power to change the beneficiary;
- Power to surrender or cancel the policy;
- Power to assign the policy or revoke assignment; or
- Power to borrow from the policy.

Policies are often owned by irrevocable trusts to ensure the policy proceeds are not included in the client's estate. Careful drafting is required to avoid incidents of ownership in a trust-owned policy. An insured's power to change beneficial ownership in the policy or the proceeds or the time or manner of enjoyment, alone or in conjunction with another person or persons, such as trustees, will be considered an incident of ownership. The insured does not have to be a trust beneficiary for the proceeds to be included in their estate if sections 2036 or 2038 apply to the trust.

A corporation's incidents of ownership in a policy on an insured who is a sole or controlling shareholder will not be attributed to the insured to the extent that the proceeds are payable to the corporation. The corporation's incidents of ownership will be attributable to the insured if the proceeds are not payable to or for the business, such as being payable to the insured's spouse. § 20.2042-1(c)(6).

Three-year look-back rule. Even if the proceeds are not included in the insured's estate under section 2042, the three-year look-back rule of section 2035 can cause inclusion if the insured makes a gift of the policy within three years of death. This can create a problem if the insured wants to transfer the policy to an irrevocable life insurance trust to avoid estate tax inclusion. Some alternatives to a gift are the purchase of a new policy, including a QTIP provision in the trust in order that any proceeds included in the estate qualify for the marital deduction, purchasing additional insurance for additional estate tax, or selling the policy to the trust for fair market value. This last option requires funding the trust or using a note to pay for the policy as well as determining the policy's fair market value to avoid a partial gift.

Valuing Life Insurance Policies

Although the value of a life insurance policy is important in several different contexts, there is no one valuation criteria that applies to all contexts. The most common situations where valuation plays an important role include gift and estate tax valuation, a transfer from a business or retirement plan to the insured, a transfer from co-business owner to the insured, and a gift of a policy to charity.

Gift and Estate Tax

The gift and estate tax regulations on the valuation of life insurance were last updated in 1974, before level term policies and universal life (or any UL varieties, for that matter) had been developed. Those regulations provide that the value for gift and estate tax purposes is the cost of a comparable policy and guide how to determine the approximate cost of a comparable policy:

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- For a policy in the first year, the value is equal to the premiums paid.
- For a single premium policy or a paid-up policy (where additional premiums will not be required) the value equals the cost of the single premium policy on a person of the same age.
- If a policy has been in force for more than a year with premiums remaining, the value is not readily ascertainable. The regulations provide that the value may be approximated by using the policy's interpolated terminal reserve (ITR) value plus prepaid (unearned) premiums.

See Reg. § 25.2512-6, Reg. § 20.2031-8(a). A policy's reserve value is an actuarial computation based on the insurer's reserve for the policy, with adjustments for prepaid premiums. The ITR adjusts the reserve value for the difference between the reserve value at the beginning of the current policy year and the beginning of the next policy year. Requiring the use of a policy's ITR raises the question of which reserve value should be used.

Types of reserves for a policy include the reserve value used by the insurer for income tax purposes (income tax), the reserve value used to determine compliance with state law requirements (statutory reserve), and a reserve if the expected future costs associated with a policy exceed the expected premiums (premium deficiency reserve). The regulations do not require the use of a specific reserve value. Different insurers may use different types of reserves to determine the ITR or different reserves for different types of policies.

The regulations provide that the values may not be used if a contract's unusual nature means this approximation is not reasonably close to the policy's full value. Unfortunately, the regulations do not define when this might occur or what should be used in its place.

When a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, is filed reporting a gift of a life insurance policy, Form 712, Life Insurance Statement, must be attached. This form requires the insurer to report the policy's value as determined under the gift tax regulation. Before making a gift of a policy, clients should informally ask the insurer what value will be reported on Form 712. If the value is higher than expected, the client and advisors may want to determine whether the gift should be made or whether they should instead take the position that this approximation is not reasonably close to the policy's full value and use a different value.

Transfer from Business or Retirement Plan

Rev. Proc. 2005-25 provides safe harbors for determining the value of policies under sections 79, 83, and 402, including when policies are distributed from qualified and non-qualified plans. It sets out two safe harbors, one for non-variable policies (term, whole life, UL, IUL) and one for variable policies (VUL). Both use ITR plus prepaid premiums as part of the safe harbor. The value is determined as of the date of distribution, transfer, or sale.

Basic Formula

The basic formula under both safe harbors is the greater of:

- The sum of ITR, plus prepaid premiums, plus a pro-rata portion of expected dividends, or
- The product of the PERC (Premiums, Earnings, Reasonable Charges) amount multiplied by the Average Surrender Factor.

PERC for Non-Variable Policies. For non-variable policies, PERC is the total of:

- Premiums paid from the date of issue without reduction for offsetting dividends,

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- Plus dividends used to purchase paid-up additions,
- Plus any other amounts credited to the policy owner for premiums other than dividends used to pay premiums or buy paid-up additions,
- Minus reasonable mortality charges and other reasonable charges actually charged and not expected to be reversed later, and
- Minus any distributions, withdrawals, or partial surrenders.

PERC for Variable Policies. For variable policies, PERC is the total of:
- Premiums paid from the date of issue without reduction for offsetting dividends,
- Plus dividends used to increase policy value, including the purchase of paid-up additions,
- Plus or minus adjustments for investment return and value of subaccounts,
- Minus reasonable mortality charges and other reasonable charges actually charged and not expected to be reversed later, and
- Minus any distributions, withdrawals, or partial surrenders.

Average Surrender Factor. Except when the policy is owned by a qualified plan, the Average Surrender Factor applied to the PERC value is 1.0. This means that for sections 79 and 83, and non-qualified plans policies, no surrender charge is used. For qualified plans, the Average Surrender Value is the unweighted average of applicable surrender factors over 10 years beginning with policy year of distribution or sale. The applicable surrender factor is the greater of 0.70, or a fraction equal to the cash available if the policy is surrendered on the first day of the policy year divided by the PERC amount on the first day of the policy year.

Gift of Policy to Charity

When a policy is being given to charity, a qualified appraisal must be included with the donor's income tax return if the policy's fair market value is more than $5,000. Because the policy is ordinary income property, however, the income tax deduction is limited to the lesser of the policy's fair market value or the donor's basis in the policy.

Other Valuation Options

Other options that may be explored in valuing a policy include obtaining a life settlement quote, the price available on the secondary market price, or a qualified appraisal.

Trustee Considerations

If a policy is owned by an irrevocable trust, there are important considerations for the trustee. Those considerations vary depending on whether the policy is already owned by the trust or whether the trust is acquiring a newly-issued policy.

Trustee of Trusts with Existing Policies. In administering a trust that owns a life insurance policy, a trustee must consider the following:
- Fiduciary duty—The trustee must administer the trust according to the terms of the trust and in the best interests of beneficiaries, including regularly reviewing the performance of existing policies.
- Prudent investments—Unless the trust document relieves the trustee of complying with the applicable Prudent Investor Act, the trustee must manage and monitor the trust investments, including the life insurance policies.
- Payment of premiums—Have the premiums been paid on a timely basis following the terms of the

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policy? Some benefits of policies, such as the guarantee in guaranteed UL policies, require premium payments in strict compliance with policy terms.
- *Crummey* provisions—Have *Crummey* letters been provided to *Crummey* beneficiaries on a timely basis, if required to be in writing in the trust document?
- Policy ownership—Confirm that the carrier's records show that the trust is the owner of the policy by obtaining written documentation from the carrier.
- Suitability—Periodically review the existing policies for suitability in light of the current circumstances and goals.

Trustee of Trusts Acquiring New Policies. When a trust is acquiring a new policy (either a newly issued policy or an in-force policy), the trustee should be actively involved in the process, unless specifically relieved of that responsibility by the trust document. The trustee's review should include:
- Screening for the appropriate life insurance product (suitability);
- Reviewing a complete copy of the policy contract;
- If a newly issued policy is being issued to the trust, reviewing the sales illustration and other sales material;
- If a policy is being transferred to the trust, reviewing a copy of the most recent in-force illustration, showing guaranteed and non-guaranteed values and running to at least age 100, preferably past age 105; and
- Reviewing the carrier's current financials and ratings, as well as past years.

Common Life Insurance Terminology

Terms often used in working with life insurance policies include:
- Insured: Person(s) covered by insurance.
- Carrier: Life insurance issuer.
- Owner: Individual or entity who owns the coverage on insured's life.
- Underwriter: An employee of the life insurance carrier who determines the insured's rating classification, based on a review of medical records and other information.
- Issue Date: Date upon which underwriting is complete, the application is approved, and the policy is put in force.
- Premium: Payment made to carrier to pay for the policy benefits; can be fixed or variable; can be paid once or over a period of time.
- Lapse: Policy coverage lapses due to failure to pay premium, policy charges exceed cash value, or both. Upon a lapse, the death benefit is no longer available. If policy requirements are met, including payment of required premiums and potentially providing proof of insurability, the coverage may be reinstated.
- Cash Value: Applies to permanent policies; the portion of policy that earns dividends, interest, or other earnings and may be available to withdraw or as a source of policy loans.
- Face Amount: Initial amount stated as the policy death benefit. It does not include any additional amounts that may be paid out under special provisions (accidental death, for example) or obtained through policy dividends.
- Death Benefit: Actual amount carrier pays out to beneficiaries. The death benefit is the amount paid to a beneficiary when an insured dies. This may include the face amount plus cash value and premiums paid, under some policies.
- Proceeds: Amount received by beneficiaries at the insured's death, upon surrender of the policy, or at policy maturity.

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An Important Note on Policy Illustrations

A policy illustration is normally used in the process of purchasing a permanent policy. It's important to note that these illustrations are not the policy contract; they are projections. These illustrations depict the growth of the policy cash value, the amount of death benefit available over a period of years, and the end result. Policy illustrations are developed using fixed assumptions. For example, it may show interest at a constant 8 percent, but a policy simply cannot be expected to earn 8 percent year after year, with no fluctuation. In addition, policy expenses can be subject to change.

Thus, it's important to not rely on the initial illustration as a guide to the actual policy performance and to actively manage permanent policies.

Periodically request in-force illustrations, using the same premiums and other assumptions shown in the original illustration, reviewing both guaranteed and nonguaranteed values, and running to at least age 120. Be wary of policies that show investment projections that are too optimistic; ask for more conservative growth assumptions.

Cash Value May Mean Flexibility

Cash value in permanent policies provides more flexibility than term policies, which do not have cash value. Loans and withdrawals from the policy could have a negative effect on the existing policy. Depending on the type of permanent policy, policy owners may withdraw or borrow against the policy cash value. These could affect the death benefit and cash of the policy value and cause the policy to lapse.

The Comdex (Composite Index) score of an insurance company is an attempt to make it easier to compare insurance companies by using the same scale for all insurers. Starting with a company's percentile rank from each rating agency, those rankings are averaged and then placed on a 100-point scale. The higher the score, the better the ranking.

Life Insurance for LGBTQ+

Generally, identifying as an LGBTQ+ person does not affect eligibility for life insurance. But there are two points regarding life insurance for LGBTQ+ insureds to highlight. First, there are now life insurance companies that will provide coverage for those living with HIV/AIDS, a development that was not previously available. Second, for transgender applicants, there may be a question regarding gender. Life insurance applications will ask about the applicant's gender and underwriters will use this information to determine mortality rates with actuarial tables that have traditionally corresponded with one's sex assigned at birth. Although some companies continue to use this model, many others will quote life insurance policies based on one's current gender identification.

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