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That Life Insurance Policy May Be Worth More Than You Think!

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By Donald O. Jansen

I. SCOPE OF ARTICLE AND INTRODUCTION

In all types of transfers of life insurance policies, it is very important to know the value of the policy. Gift and generation skipping tax valuations arise in transfers to family members and irrevocable trusts. Value for income tax purposes is important with regard to sales of policies and transfers resulting in compensation or dividends to an employee or shareholder buy sell agreements or transfer to a partnership, corporation or LLC of which the insured is a partner, shareholder or member. Valuation can also be important for estate tax purposes when the deceased owner is not the surviving insured.

The problem is that valuation rules for income tax purposes differ in important ways from valuation for transfer tax purposes. In many cases, valuation of policies involve rules of thumb with many exceptions and no bright line valuation test.

The valuation rules often depend upon the type of life insurance policy that is involved in the transfer. Thus this outline will start with a basic primer of life insurance policies followed by an examination of the gift GST, estate and income tax valuation rules in that order.

II. TYPE OF LIFE INSURANCE POLICIES PRIMER

A. TERM POLICIES

1. Annual Renewable Term.

a. This is a pure death benefit without cash value. The policy is renewable annually without proof of insurability. The premium increases each year with age based on underwriting classification. These policies normally have a right to convert to permanent life insurance without proof of insurability.

b. This type of policy is best for short term needs for a younger person – income replacement or debt retirement in case of an early death of the insured. It is often used as a decreasing term rider to a whole life policy (blended insurance) to keep death benefit high at lower cost in the early years until the term is replaced by paid up additions or replaced by permanent coverage with increased premiums.

2. Level Term Insurance.

a. The carrier guarantees a fixed term premium over a period of time in blocks of five years up to 30 years depending on the age of the insured. Since the premium is fixed, it is generally higher than an annual renewable term premium in the early years of the level term. These policies usually have a conversion to permanent life insurance feature without proof of insurability. Even if renewable at the end of the term, the premium for the renewed policy will be significantly higher.

b. The advantage of a level term policy is that the premium is fixed for a number of years and not an annual renewable term premium subject to current carrier cost and mortality experience.

3. Group Term Insurance.

a. This employer provided insurance is available to a group of employees without proof of insurability. The first $50,000 of employer provided coverage is income tax free to the employee. Any excess coverage is generally taxed to the employee using the Table I rates in the regulations.

b. A problem is that the coverage terminates upon the employee's severance from employment. Although there is a conversion to permanent insurance right upon employee severance from employment, the conversion policy premium will be very high.

B. PERMANENT INSURANCE

1. Whole Life Policies. This type of policy has the most carrier guarantees but has more expensive premiums than universal life.

a. The premium is fixed for the life of the insured and the death benefit is guaranteed if the premiums are paid (either by the owner, policy dividends or cash value loans). A minimum cash value growth is also guaranteed. The cash value growth is low in the initial policy years in order for the carrier to recover its front-end expenses in case the policy owner surrenders the policy or lets it lapse.

b. Thus the carrier assumes the mortality , investment return (for the guaranteed cash value), expense and lapse risks of the policy. As a result, in setting the premium, the carrier makes very conservative estimates in determining the risks. If the policy performance exceeds the conservative estimates, the cash values may exceed the guarantee and mutual carriers may pay dividends and the stock carriers may credit for larger policies, additional interest to the

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