WEALTH COUNCIL INSIGHTS EDUCATION SERIES: ASSET PROTECTION AND INSURANCE

PART 4 – LIFE INSURANCE CATEGORIES, CONSIDERATIONS AND STRATEGIES

In this final installment of our four-part series focused on Asset Protection and Insurance Planning for Wealth Preservation, we will explore the common considerations and strategies involved in comprehensive life insurance planning, including the benefits of an Irrevocable Life Insurance Trust (ILIT).

LIFE INSURANCE CATEGORIES AND CHARACTERISTICS

The most common categories of life insurance are Term Life, Whole Life, Universal Life and Variable Life.

There are several common purposes for life insurance, and individual circumstances and priorities will dictate the type of life insurance strategy selected. Following are the most common categories of life insurance and each category's characteristics:

I. **Term Life Insurance** – Term life insurance covers the insured for a fixed term and will pay the stated death benefit to the named beneficiaries if the insured dies during the term of the policy. If the insured outlives the term, the policy no longer provides any economic benefit to the insured or beneficiaries. Because there is no cash value or investment component, term life insurance is also called "pure" life insurance and is often the least expensive option that allows the insured to purchase the greatest amount of death benefit coverage for the lowest premium amount.

Term life insurance is well suited for those who need life insurance coverage for a specific period of time or for a specific purpose, such as for debt repayment or income replacement. Working parents with minor children often purchase enough term life insurance to provide for the current and future needs of their children, including higher education expenses. The amount purchased and the length of the policy term will depend upon a variety of factors, including income, financial resources, ages of children and annual spending needs.

II. **Whole Life Insurance** – Whole life insurance is designed to provide permanent coverage at a fixed amount for the entire duration of the insured's life. In addition to providing a permanent death benefit, whole life policies also contain a cash value account that increases in value as premiums are paid and interest is earned. Premium payments are generally level, but there are also options to "pay up" a whole life policy with limited-pay or single-pay premium options. Because of the guarantees of the permanent death benefit, fixed premium amount and a minimum guaranteed rate of return on cash value, whole life policies tend to be the most expensive option for obtaining life insurance.

The cash value component of whole life insurance may be invested, and dividends may be paid to the policyholder. Typically, any dividends paid are treated as a return of premium and are therefore not subject to income tax.

Additionally, if a policyholder decides that he or she no longer needs the whole life policy, the policy can be surrendered, and the cash value will be paid out to the policyholder. The surrendered cash value can also be used

to purchase a paid-up term or whole life policy with a lower death benefit.

III. **Universal Life Insurance** – Universal life insurance is also designed to provide permanent coverage. However, the hallmark of a universal life policy is flexibility. The death benefit and premium amounts are flexible, allowing the insured to decide how much to pay in premium or to not pay the premium in a given year and allow the built-up cash value to cover the premium payment. With this flexibility comes the risk that premiums will increase in the future to account for higher mortality cost as one ages, and the cash value built up inside of the policy might not be adequate to cover these higher premium costs. The death benefit also fluctuates based on the premiums paid. Because a universal life policy does not have the same level of guarantee as a whole life policy in terms of fixed premium and death benefit, these policies are generally less expensive than whole life insurance.

Universal life insurance is well suited for those who want permanent coverage but prefer flexibility with premium payments and death benefit amounts.

IV. **Variable Life Insurance** – Variable life insurance is a subset of whole life and universal life and is designed to provide permanent coverage while allowing the insured to control the investment of the cash value account. Because the insured controls the investment of cash value, the cash value does not earn a guaranteed minimum rate of return and might decline. If the cash value account declines significantly, the death benefit might decrease or the policyholder might be required to make an elevated contribution to the policy to maintain the same level of death benefit. Any increase in the cash value account due to the policyholder's investment selections accretes to the policyholder.

LOANS, INCOME TAXES AND ESTATE TAXES

Loans

A policyholder will oftentimes have the option to borrow against the accumulated cash value of a whole, universal or variable life insurance policy. Typically, the loan proceeds are treated as a return of premiums and are therefore not subject to income tax consequence. If the policyholder dies while a loan is outstanding, the death benefit and/or cash value will be reduced to satisfy the remaining balance of the loan and will result in less proceeds flowing to beneficiaries.

Income Taxes

When an insured dies, the death benefit is not subject to income tax when distributed to the beneficiaries. Additionally, any cash value that is paid to beneficiaries upon death is income tax free. Cash value that is distributed prior to death will be subject to income tax to the extent that the cash value distributed exceeds the amount of premiums paid into the policy.

Estate Taxes

If a life insurance policy is owned by a decedent, the death benefit is included in the decedent's gross estate and may be subject to estate tax depending on the size of the estate. For those with a gross estate that exceeds the federal gift and estate tax exemption, any life insurance death benefit paid into the estate will be subject to a 40% estate tax before being distributed to beneficiaries.[1] To prevent the erosion of the death benefit due to estate tax, an Irrevocable Life Insurance Trust (ILIT) or a Spousal Lifetime Access Trust (SLAT) can be established to own the policy and control the distribution of the proceeds.

IRREVOCABLE LIFE INSURANCE TRUST

An ILIT is an irrevocable trust that is primarily designed to serve as the owner and beneficiary of one or more life insurance policies insuring the life of the grantor. To escape estate tax under an ILIT strategy, the grantor must relinquish control over the life insurance policy for it to be excluded from his or her gross estate. The primary advantage of utilizing an ILIT is the removal of the death benefit from the grantor's gross estate, which allows a greater percentage of the death benefit to flow to the intended beneficiaries.

> *"A primary consideration and potential challenge to the implementation of a successful ILIT strategy is determining how to fund the annual premium payments."*

In addition to estate tax savings benefits, ILITs provide asset protection advantages by shielding assets from the creditors of the ILIT beneficiaries and the creditors of the grantor. By paying the death benefit into the trust as opposed to outright to the beneficiaries, an ILIT allows a grantor to stipulate how and when the life insurance death benefit is distributed to beneficiaries. This allows the grantor to secure asset protection for children, grandchildren and future generations. An ILIT may also be designed so that the proceeds from any life insurance policy are made available as a source of liquidity to pay any estate tax owed.

A primary consideration and potential challenge to the implementation of a successful ILIT strategy is determining how to fund the annual premium payments. The grantor cannot simply make the annual premium payments on behalf of the ILIT, because to do so would trigger gift tax consequences. A widely-used strategy to fund premium payments involves the grantor transferring cash to the ILIT and using the annual exclusion to avoid making a taxable gift. In 2024, the annual exclusion amount is $18,000 per recipient. If a grantor's available annual exclusion gifting amount is inadequate to cover the entire premium, a portion of the grantor's lifetime exemption or a loan from the grantor can be used to fund the difference.

CONCLUSION

Strategic life insurance planning plays a key role in a comprehensive estate and financial plan. An ILIT can be an excellent strategy for the mitigation and funding of federal estate tax, the protection and preservation of assets and the enhanced transfer of wealth to future generations; these

strategies are most effective when carefully considered and planned in advance.

Your Oxford Team works alongside you with trusted specialists to select and implement tailored life insurance strategies that are in line with your overall estate and financial plan.

[1]The gift and estate tax exemption and the GST exemption are $13,610,000 in 2024. The exemptions are slated to return to $5,000,000 (indexed for inflation) as of December 31, 2025, unless modified or extended by Congress.

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ABOUT THE SERIES

In the Wealth Council Insights Education Series, we endeavor to deconstruct some of the complexities that exist around many commonly utilized estate and financial planning concepts in order to provide you and your family with the basic knowledge needed to better understand and create a blueprint for your overall wealth enhancement needs.