Using Universal Life Insurance with Secondary Guarantees for Estate Taxes

As things stand in early 2007, estate and generation skipping (GST) taxes will be repealed in 2010 and reinstated in 2011. And given that Democrats now have control of the House and the Senate, experts are predicting that the permanent repeal of the estate tax is unlikely in the next two years.

At present, for 2007 and 2008, the estate tax exemption is $2 million per person, rising to $3.5 million in 2009, repealed in 2010, and then the tax returns in 2011 with an exemption of $1 million. Given existing laws, experts suggest that using life insurance to pay for potential estate taxes is a very viable solution.

According to industry reports, the number one product sold for estate liquidity today is universal life with a secondary guarantee. In short, this is a policy whereby insurers guarantee the insurance benefit on a universal life insurance policy even if the cash value in the policy goes to zero. This is known as a “secondary guarantee.” The policy owner agrees to pay a premium which is often less than a whole life insurance premium and if the policy owner keeps-up payments, the policy’s death benefit is guaranteed to age 100.

Policies with secondary guarantees are often used for estate planning where the crucial component is a guarantee of the death benefit and cash value build-up is secondary.

Survivorship life insurance (also called joint and survivor life insurance or second-to-die life insurance) can also be used for estate planning to create the cash liquidity to pay the estate taxes. However, in order for the insurance death benefit to avoid both income and estate tax, the policy must be set-up properly within an Irrevocable Life Insurance Trust (ILIT).

So what in general is universal life, what are its advantages and disadvantages, and when should it be used? According to Tools and Techniques of Life Insurance Planning, universal life – which was first introduced in the late 1970s -- is often referred to as a “flexible premium,” “current assumption,” “adjustable-death-benefit” type of cash value policy. It’s flexible premium because the policy owner can pay whatever premium they wish within a given range and adjust later as needed. Policy owners can even skip premium payments provided there’s enough cash value in the policy to cover policy charges. It’s called a current assumption because current interest rates and current mortality and expense charges are used to determine the cash value of the policy. And it’s called an adjustable death benefit because the policy owner can lower the death benefit at anytime and can raise it with evidence of insurability.

Given this flexibility, universal life is a useful product should a person’s estate tax liability rise or fall with the Congressional tides. Typically, a universal life is best suited for long-term coverage needs; while a non-renewable term policy will generally be more cost-effective for short-term needs. Generally, however, such policies work best when flexibility is needed and policy owners need to reconfigure their premiums or death benefits.

According to some planners, the biggest advantage of using guaranteed universal life is this: The policy owner pays the least expensive premiums to guarantee a lifetime death benefit. The policy owner can also adjust the premium. If, for instance, there’s enough cash value to cover the mortality charges, the policy owner could even skip premium payments.

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However, caution should be followed in skipping or delaying payments on these contracts since the "guarantees" could be impacted. Even premiums received during the grace period could affect the accumulated values and "guarantees." Policies differ on this and need to be reviewed before any change is to be made.

The policy is also transparent – the policy illustrations and annual reports break out and report each element of the policy, such as premium, death benefit, interest credits, mortality charges, expenses and cash value, separately.

Universal life policies also offer two death benefit options, one that is similar to a traditional whole life policy and one that is like a traditional whole life policy with a term rider. The first, a level death benefit; the latter, an increasing death benefit.

When selecting a universal life policy, it's especially important to consider the amount credited to cash values. The prospective policy owner should know how the insurer determines the amount credited to cash values. The amount credited to cash values depends on the expenses charged against the policy, the mortality charges assessed against the policy, net investment yield earned by the insurer on its portfolio investments and the method used to allocate interest to various blocks of policies.

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