Life Insurance Considerations for Legal and Tax Professionals

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Contents

Introduction

Trusted legal and tax advisors may find that their clients ask about life insurance. This brochure provides an introduction to some common life insurance terms, discusses the basic insurance planning process and explores its use within clients' overall financial strategies.

Buying life insurance is a multifaceted decision for a client: *Which type of policy should I choose? How much coverage and for how long? What premium level fits my budget?* Choosing insurance is not just a financial decision; it can be an emotional decision as well: *How will my spouse pay the mortgage if I die? Will my children be able to go to college? What will happen to my business?*

No one wants to consider his or her own mortality. However, people should not ignore the impact their deaths can have on those they leave behind. By understanding the facts about life insurance, professionals can help their clients make informed choices about how best to financially protect and provide for those who matter most to them.

Basics of Life Insurance

Life insurance is a financial resource that can be used to help protect families in case a spouse dies and businesses in case an owner or a key employee dies. It can also help with planning a financial legacy. It is a contract between a policyholder and an insurance company in which the insurer agrees to pay the contracted amount to the beneficiary or beneficiaries upon the death of the insured.

Policyholders pay premiums to maintain coverage, either over a specified period of time or over their lifetimes. How much premium a policyholder pays depends on the insured's age, gender, occupation, hobbies, tobacco use, medical history, foreign travel or residence, type of policy and coverage amount.

Life Insurance Can Help Protect a Family's Financial Security

Life insurance offers much-needed financial security. It can provide:

- **Funds to cover final expenses –** Proceeds from a life insurance policy can be used to cover funeral expenses, estate-processing fees, outstanding medical bills and other unpaid debts.
- **Income during the readjustment period –** Surviving family members need time, usually two to three years, to adjust financially to the loss of the insured's income. The surviving spouse may need to acquire new skills to rejoin the workforce.
- **Income for the surviving spouse –** Life insurance can provide the surviving spouse financial support for a certain number of years or for life.
- **Income for dependent children –** Funds from a policy can support a policyholder's children until they become financially independent. Life insurance also can provide funds for college or private school education costs, or help meet the financial needs of physically or developmentally disabled children.
- **Funds to pay off the mortgage –** Proceeds from the policy can be used to pay off a mortgage, thereby alleviating some of the financial pressure on the family.

Without life insurance, survivors may have to sell assets, such as a home, to pay expenses. With life insurance, the beneficiaries may have the financial resources they need at the time of the insured's death.

Life Insurance Can Help Individuals with Long-term and Legacy Goals

While the primary purpose of life insurance is financial protection, it can also be used to help accumulate funds to cover long-term financial goals such as the following:

- **Supplemental income for retirement –** A permanent policy's cash value can supplement retirement income received from other sources. Through carefully planned loans and withdrawals, the funds may be received on a nontaxable basis.
- **Building wealth for tax-efficient transfer to heirs –** Life insurance can serve as an estate-planning vehicle, allowing proceeds to be paid directly to beneficiaries, bypassing the probate process. Life insurance can be used as an efficient wealth transfer vehicle because death benefits are generally paid income tax free to beneficiaries.
- **Liquidity for large estates –** For clients with large estates, life insurance can provide liquidity to pay federal and state estate taxes, state inheritance taxes, attorney fees and probate expenses.
- **Business planning –** If a client owns a business, life insurance policies can help protect the business in the event of the client's death. For example, insurance can indemnify a business for the loss of earnings caused by the death of an owner or a key employee. It can also fund a buy/sell agreement between owners of a business, which allows the surviving owner to purchase the deceased owner's portion of the business. Additionally, life insurance can be used to provide executive benefits to key employees and enhance a business's ability to secure credit.
- **Gifts to charity –** Life insurance can provide money for a charity, a religious organization or an educational institution, or it can replace assets bequeathed to charity.

Insurance Planning Steps

The first step is to determine a client's financial goals, whether planning retirement or their estate, and discuss how life insurance may play a role in helping to reach these goals. The client and his or her financial advisor and tax or legal professionals can then complete a needs analysis to determine how much life insurance coverage may be needed to help provide for family or business financial needs based on those goals.

To determine which policy or policies would be appropriate, several factors are considered, including the appropriate coverage amount, the length of time the policy is needed, the premium amount that fits the client's budget, desired flexibility and the client's risk tolerance.

How Much Life Insurance May Be Appropriate?

There's no magic formula for determining how much life insurance to buy, because no two people have the same needs or circumstances. The insurance needs of a single parent can vary greatly from those of someone supporting an elderly parent or those of a business owner planning succession.

Performing a needs analysis can help determine the amount of life insurance that might be appropriate and make informed choices about how to provide for legacy goals or help protect loved ones in the event of an untimely death.

When the primary objective may be time-specific or a non-legacy goal, the following approaches may be considered to help determine the potential amount of insurance to consider:

- ***Multiple of income approach:*** *Calculate seven to 10 times the client's pretax annual salary.*
- ***Needs approach:*** *Estimate the client's family expenses and savings needs over time using the acronym LIFE.*

Use LIFE as a Guide

Add the following together to estimate life insurance needs:

- **L** Liabilities (like mortgage, car loans, credit cards, etc.)
- **I** Income needs for the client's family to replace future salary and cover ongoing living expenses, saving needs and an "emergency" fund
- **F** Final expenses
- **E** Education expenses for the client's child(ren)

Since the key is to have a strategy to provide for the client's family, either approach can provide a solid estimate of potential insurance needs.

Importantly, the LIFE framework does not include any potential legacy goals such as leaving a lump sum to heirs or charity. This objective may be added to LIFE, so the client's total life insurance needs would be "LIFE and legacy."

Planning Tip

Edward Jones financial advisors provide a valuable resource to help analyze insurance needs and options for you and your clients. To learn more, please contact an Edward Jones financial advisor.

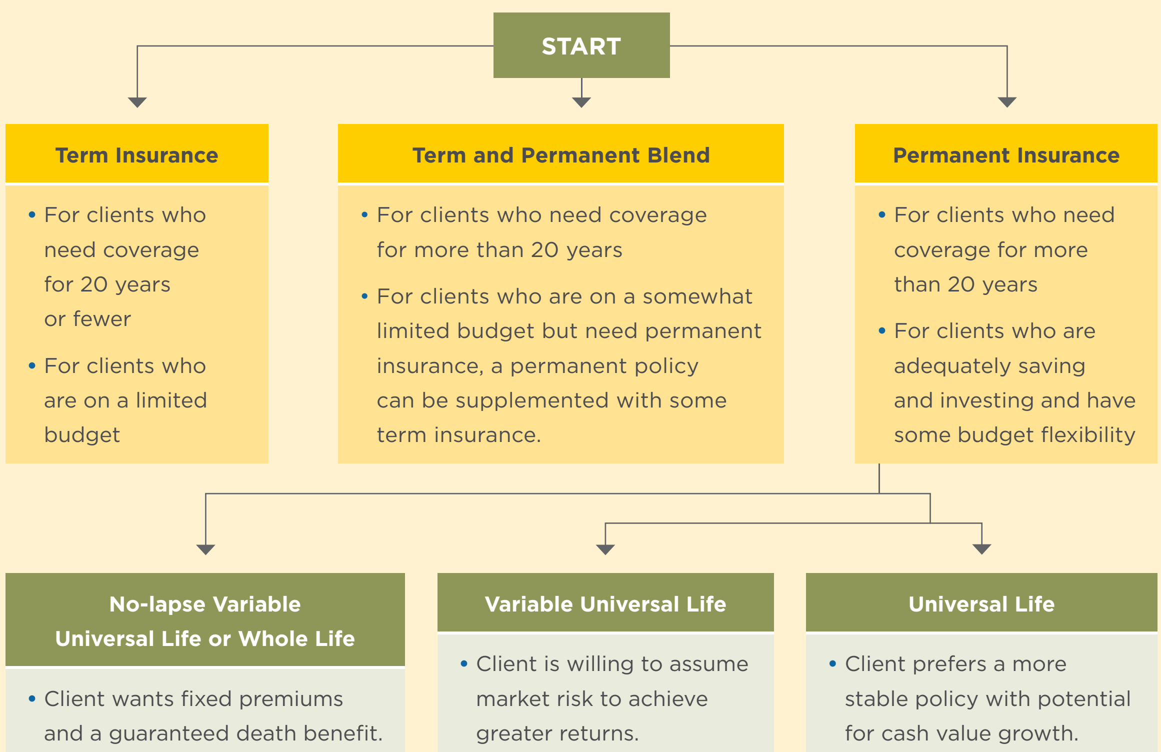
Types of Life Insurance

Life insurance can be divided into two types: term and permanent. Within these two types are subcategories. Clients should choose the policy that best meets their goals based on the amount of time the insurance may be needed. This is not an either/or decision. For example, the LIFE framework may be providing cash for a time-specific need, which may be satisfied with term life insurance, while legacy goals, which may be desired to pay at death regardless of the time period, may be better satisfied by permanent life insurance.

What Type of Life Insurance Is Right for My Client?

Many considerations must be taken into account when determining the appropriate life insurance contract for a client. It is important to fully understand the client's life insurance needs and objectives before recommending any specific type of life insurance policy. The following chart is designed to help determine the right type of life insurance based on a client's potential needs:

Evaluating Life Insurance Options



Term Life Insurance

Term life insurance is the most basic type of life insurance and usually offers an affordable, level premium for a fixed number of years. The insured is covered for a specific term or time frame, such as 10, 15, 20 or 30 years, and benefits are paid only if he or she dies during this time period. If premium payments stop, coverage ceases.

Premiums are based on the insured's age, gender, tobacco use and health, and the coverage amount requested. Premiums on some annually renewable term policies increase with age.

Term insurance is typically purchased by people with short-term life insurance needs (usually 20 years or fewer) or by those with longer-term needs who, for budget reasons, need relatively inexpensive coverage. Many term life insurance policies can be converted to permanent policies issued by the same insurance company without providing additional medical information, but the conversion period may be limited. Consequently, it's important to understand the policy options when purchasing a life insurance contract.

Following are some reasons term insurance may not be the better choice for long-term needs:

- Term insurance may reach a point where the client cannot afford to pay an increasing premium.
- If a term policy is kept long term, the cumulative increasing premiums can exceed the rate the client would have originally paid for a level premium permanent policy.
- If the insured of a level premium term policy outlives the policy's time frame and his or her health has deteriorated, the premium will increase significantly at renewal time. The insured may be unable to purchase a different policy to avoid higher premiums.

A variation of term life insurance is group term life insurance. Generally, group term coverage is available on a guaranteed issue basis (no medical underwriting) through an employer-sponsored, employer-paid plan with limited coverage amounts (usually no more than $50,000 per person) for employee participants. The employer maintains the master policy for the group. State laws generally require that the employer furnish the employee with a certificate of coverage in writing or electronically.

Many group term life plans contain a conversion privilege allowing employees to convert their coverage to an individual universal life policy within 30 days after separation of service due to retirement or departure for employment elsewhere.

Permanent Life Insurance

Permanent life insurance provides protection for the policyholder's entire lifetime rather than a specific time period, as long as premium requirements are met. In addition, permanent insurance builds cash value. These dollars generally are used to pay the higher cost of insurance as a person ages, without increasing the annual premium. The accumulated cash value can be accessed through loans or withdrawals and used to fund future goals, such as college education costs or supplemental retirement income. However, using cash value to cover other expenses could affect the policy's ability to provide for the life insurance need.

Permanent policies also typically enjoy favorable tax treatment because the cash value growth is usually tax-deferred. Individuals and small-business owners typically purchase permanent insurance if they have long-term life insurance needs and can afford premiums that are higher than those of term life.

Types of Permanent Life Insurance

Whole Life Insurance

Whole life is a type of permanent insurance suitable for an individual who wants guarantees in his or her contract. Whole life contracts guarantee minimum cash values, level premiums and death benefits, as long as premiums are paid on time.

Because of the guarantees, for which the insurance company assumes all the risks, whole life carries the highest premium of all types of permanent insurance. This type of policy is also the least flexible. For example, the insured cannot increase his or her coverage within the same contract. All whole life policies are structured to endow, meaning the cash value will equal the policy death benefit at policy maturity, typically at age 95 or 100.

Some whole life insurance policies pay the policyholder an annual dividend representing a return of unused premium. Policy dividends can be taken tax free in cash, applied toward premiums, used to purchase additional paid-up death benefit coverage inside the whole life policy or reinvested inside the policy for interest.

Universal Life Insurance

Universal life is a type of permanent insurance typically more suitable for an individual who wants fewer guarantees and more flexibility. The premium, cash value and death benefit are not guaranteed, even if the premium is paid on time. The policyholder assumes almost all of the risks. Because there are few guarantees in the contract, the premium is lower compared to whole life. The flexibility that was lacking in whole life is available for universal life. For example, increasing or decreasing the face amount of the policy will cause the premiums to increase or decrease accordingly.

Some universal life policies offer what is referred to as an Option A or Option B death benefit. Under Option A, the policyholder chooses a policy that has a level death benefit with a higher cash value. Under Option B, the policyholder can choose a higher death benefit equal to the sum of the policy's face coverage and the policy's cash value.

If the financial condition of the insurance company deteriorates, the expenses it charges against the policy's cash value can increase. Higher expenses can drain the cash value. If this happens, the policy may lapse or premiums may increase.

An insurance company will guarantee payment of only a minimum interest rate on a contract. However, a contract is usually credited by the insurance company with a current-year interest rate based on an intermediate-range bond rate being paid inside the insurance carrier's investment portfolio. Clients should be aware that if the current interest rate being credited decreases, additional premiums may be required to keep the policy in force.

No-lapse Guaranteed Universal Life Insurance

No-lapse guaranteed universal life insurance has the same features as universal life. However, as long as the premium is paid on time, the policy is guaranteed not to lapse. Compared to universal life, this type of no-lapse policy trades off noticeably lower cash value accumulation in exchange for a guaranteed death benefit and guaranteed level premiums.

Variable Life Insurance

Variable whole life and variable universal life are similar to whole life and universal life except that a portion of the annual premium is used to fund cash value growth in variable subaccounts chosen by the client from a predetermined list of stock, bond and mutual fund portfolios. These products are subject to extensive federal and state securities regulations requiring the client to complete a suitability questionnaire and be provided by his or her financial advisor with a current prospectus on the investment history of the variable insurance product being purchased.

Because these products carry market risk, variable life is typically more suitable for clients comfortable with the risks inherent in equities. Variable insurance products may not be as suitable for older clients because of their shorter time horizon and potentially lower ability to handle market risk.

Modified Endowment Contracts

A modified endowment contract (MEC) is not a type of life insurance. Instead, it is a type of policy. MECs are generally single-premium contracts purchased on or after June 21, 1988. However, an MEC can be any policy that has exceeded stated IRS guidelines for the maximum premiums that can be paid during the first seven policy years. Almost all single-premium policies are considered MECs.

During the insured's lifetime, any policy classified as an MEC is treated similarly for tax purposes to an annuity (IRC 7702A). This results in the following:

- Any loans or withdrawals are taxable as ordinary income on a last in, first out (LIFO) basis; i.e., gains above cost basis are taxed first.
- Pledging a cash-rich MEC policy as security for a loan can result in an immediate tax event to the policyholder. A limited exception may apply when the pledge is restricted to the payment of burial or prearranged funeral expenses, but only if the policy's maximum death benefit does not exceed $25,000.
- Withdrawals and loans made prior to age 59½ are usually subject to a 10% federal tax penalty.

Several differences between MECs and annuities are as follows:

- Upon the death of the insured, the MEC policy is still treated as life insurance. This means the death benefit received by a beneficiary such as the surviving spouse is almost always free from income tax. This is different from an annuity where, upon the policyholder's death, any gain in the contract is generally taxable to the beneficiary as ordinary income.
- In life insurance, the person insured is called the "insured." In an annuity, the person insured is called the "annuitant."
- Life insurance is generally purchased for the death benefit. An annuity is purchased to provide a retirement benefit and protection against outliving one's retirement income.

Ownership Considerations

The ownership of life insurance is an important matter. If an individual who is both the owner and the insured of a life insurance policy dies, the death benefit is part of his or her estate. Thus, the death benefit could be subject to estate taxes if the individual's net worth exceeds the federal and/or state exemption amounts.

Incidents of Ownership

The death benefit is included in an estate if the decedent is listed as the owner, was the applicant on a policy on his or her own life, or had certain types of control over the disposition of the policy.

If the insured has certain incidents of ownership in a life insurance policy, it may be includable in his or her estate for estate tax purposes. Incidents of ownership are not limited to actual ownership of the policy and include other ways that the insured or the insured's estate has control over the policy or the right to the economic benefits of the policy. Incidents of ownership include the following:

- The power to name or change the beneficiary
- The right to assign the ownership of the policy to another person or revoke that assignment
- The right to surrender or cancel the policy
- The right to borrow money from the policy or pledge the policy as collateral for a loan

It is important to note that, under IRS rules, should the owner of a life insurance policy transfer ownership within three years before his or her death, the policy's death benefit may be included in the deceased's estate and be subject to estate tax. This rule may not apply when policy ownership is transferred between spouses.

If someone other than the insured owns the policy from the date it is issued, and if the insured does not hold any other incident of ownership in the policy, the death benefit is not included in the insured's estate when he or she dies. Typical examples of owners other than the insured are the insured's adult children or an irrevocable life insurance trust.

Below are some potential pitfalls in having adult children own the insured's life insurance policy:

- If the adult child divorces, the policy ownership or cash value could be awarded to the spouse in a division of property by a state divorce court judge.
- If the adult child declares a Chapter 7 or Chapter 13 bankruptcy, creditors could attach the policy in federal court proceedings where cash values in life insurance contracts are only protected for debtors up to a limited amount.
- If the adult child is sued, the policy might be attached in state civil court proceedings. State laws vary widely regarding the amount of the cash value and death benefit of a policy that may be exempt from creditor claims. In determining whether and to what extent a policy can be protected from creditors, many state laws consider whether the policy is owned by a debtor who is the sole provider

of support for a household or whether substantial premiums are being paid by the debtor to defraud creditors.

- If adult children are under financial strain and decide they need cash, they could access the policy for that cash and thereby cause the coverage to lapse due to excessive loans or withdrawals.

As an alternative, an insurance policy can be owned not by children but by the trustee of an irrevocable trust. An important advantage of naming a trustee as the life insurance policyholder is that the trustee will be better suited to withstand creditor collection challenges in federal or state courts, and can prevent a beneficiary's detrimental use of the policy cash value. Drawbacks to using a trust include the cost of establishing the trust and annual administration fees. Life insurance trusts are discussed in more detail below.

In certain situations, permanent cash value life insurance may be owned by an administrator inside a qualified retirement plan, such as a 401(k). In this situation, the life insurance policy cash value may be exempt from creditor collection efforts, except for certain creditor processes such as IRS tax liens or a qualified domestic relations order entered by a state court in a divorce proceeding.

To determine the best choice for life insurance ownership based on business, personal or estate-planning considerations, a client should discuss the matter with his or her legal and tax advisors.

If a client owns a life insurance policy on a third party, such as a parent, spouse or child, consideration should be given to naming a successor owner, should the client die. By doing so, potential disputes over policy ownership, including lengthy probate proceedings, may be avoided.

It is important to know that when the owner of a life insurance policy is not the insured, only the owner has control of the contract. The insured has no rights in the policy.

Irrevocable Life Insurance Trust

Life insurance may be used to fund an irrevocable life insurance trust (ILIT) where the trust is both the owner and the beneficiary of the policy on the life of the grantor (insured person). An ILIT is an inter vivos trust (one created during the grantor's lifetime) that is structured to be exempt from estate tax. An additional benefit of an ILIT is that the trust receives the death benefit in cash upon the death of the grantor. Often, the grantor's estate must pay estate tax, but holds mostly illiquid assets such as real estate or a small business. The ILIT can purchase assets from the grantor's estate to provide liquidity for the amount of estimated estate taxes due upon the grantor's death.

Almost any type of policy insuring the grantor's life may be used to fund an ILIT, such as life insurance on the life of one person or a survivorship policy on the lives of two people (usually a married couple). Permanent cash value policies with guaranteed level premiums and face coverage amounts can often accomplish the desired purpose of an ILIT.

Although an ILIT can be funded by a term life insurance policy to contain costs, if the insured is likely to outlive the policy's time frame (typically 20 years), it may be more cost-effective over time to fund the ILIT with a permanent policy. After the term has expired, the trust's premium for policy renewal will be significantly higher due to the insured's increased age. Converting to a permanent policy at this later date will result in higher premiums than would be applicable if a permanent policy had been arranged earlier.

It should be noted that the grantor of an ILIT does not have control over the contract and cannot serve as trustee or co-trustee of the ILIT. Instead, the grantor names an individual (who could be the grantor's spouse or other family member), commercial bank or corporate trust company to serve as trustee of the ILIT. The ILIT is then named as owner and beneficiary of the insurance policy, thereby keeping the policy proceeds out of the grantor's taxable estate.

To provide the trust with the necessary funds to pay premiums on a life insurance policy, the grantor may generally gift the annual gift exclusion amount per year per trust beneficiary. Beneficiaries are typically family members or loved ones.

To ensure that the annual gift per beneficiary qualifies for the annual exclusion from gift tax, each trust beneficiary is granted a limited right, called a Crummey right, to withdraw the gift made to the ILIT. Once money is paid into the trust to pay the annual life insurance premiums, the trustee must provide written notice to the beneficiaries of their right to withdraw the gift made on their behalf. In general, beneficiaries are given 30 to 60 days' notice to exercise this right. After this time period has expired, the trustee may pay the life insurance premiums.

The grantor may decide not to use the annual gift exclusion giving his or her beneficiaries Crummey withdrawal powers. Instead, the grantor may utilize his or her ability to make a single gift to the trust up to the maximum federal lifetime exemption to pay for a single-premium policy with a guaranteed death benefit and minimal cash value.

Planning Tip

Many states impose an estate tax on a person's assets after death, an inheritance tax on heirs receiving such assets, or both. In addition, few states follow the federal portability rules whereby a surviving spouse can carry over the portion of the deceased spouse's exemption from estate tax, so married individuals may still need to establish trusts to obtain the benefit of two exemptions under state law. Legal and tax advisors should follow federal and state legislation on this issue closely if assisting clients with one-time gifting concerns.

Cash Loans versus Cash Withdrawals

It is important to understand the consequences of taking a loan versus a withdrawal from a life insurance policy.

Loans

If a policyholder makes a loan against his or her policy and repays the loan during his or her lifetime, the death benefit remains unaffected. If the insured dies while a loan is outstanding, the insurance company subtracts the loan balance plus any unpaid loan interest, dollar for dollar, from the death benefit paid to the beneficiary.

Interest charged on policy loans is calculated in one of two ways, based on life insurance policy provisions:

- A fixed interest rate, not to exceed 8% per annum
- A variable interest rate tied to Moody's Corporate Bond Yield Index, often recalculated on a monthly basis

Most permanent life insurance policies have an automatic loan provision that allows the insurance company to pay premiums from the policy's cash value if the premium is not paid within 30 days after the premium due date. Premium loans are assessed either a fixed or variable loan rate. Premiums paid in this manner over an extended period of time can result in lapse of coverage when the loans and interest exhaust the policy's cash value. In this type of policy lapse situation, excessive unpaid loans and loan interest may cause the policyholder to incur an income tax liability.

The repayment of interest on a policy loan may not be a deductible expense for tax reporting purposes.

Withdrawals

When a substantial withdrawal is made, e.g., a cash withdrawal that exceeds cost basis, it could have a negative tax consequence. Per IRS rules, anytime a cash distribution from a policy results in a reduction of the death benefit within the policy's first 15 years, some portion of the distribution may be subject to income tax.

In most cases, a policyholder is better off taking a loan rather than a withdrawal from his or her insurance policy. A loan can be repaid during the insured's lifetime to prevent a reduction of the death benefit paid at the time of the claim.

Beneficiary Designations

When a client buys life insurance, he or she must name a beneficiary. At the time of purchase, the beneficiary must have an insurable interest. This means that if the insured were to die, the beneficiary would experience a financial loss.

Insurance companies are generally unwilling to agree to a beneficiary designation on a new policy where no insurable interest exists. Once a policy is issued, the owner can change the beneficiary designation to anyone he or she wants without obtaining the approval of the insurance company.

Beneficiary designations can be revocable or irrevocable. The owner can change a revocable beneficiary at any time. An owner cannot remove an irrevocable beneficiary unless the beneficiary consents to such a change in writing.

The insured should also keep in mind that he or she may outlive a named beneficiary, so one or more contingent beneficiaries should be named to provide for this potential event.

Although beneficiaries of life insurance policies are generally entitled to receive the death benefit proceeds gift and income tax free, in some situations, such as the two described below, improper policy ownership and beneficiary designation arrangements can have potentially negative tax consequences to the beneficiaries.

Example One

Joe Smith owns a business. He buys a $3 million life insurance policy on himself with the business owning the policy and paying the premiums. Joe names his wife, Mary Smith, and the couple's three adult children as equal beneficiaries. Upon Joe's death, the policy pays a death benefit of $750,000 to each beneficiary, which subjects the survivors to gift taxes. Because the policy is owned by Joe's business, rather than Joe himself, the IRS may deem the policy premiums as being a taxable gift from the business to Joe's spouse and children.

Example Two

Joe Smith wants to insure his life for $3 million in order to leave a large sum to his oldest son, Jerry. Jerry purchases the policy on his father and is the owner. Jerry wants to be fair to his siblings, so he names himself and his two younger brothers, James and John, as equal beneficiaries on the policy. Upon Joe's death, the $3 million death benefit is paid in equal shares to Jerry, James and John. Because Jerry is the owner of the life insurance policy, however, the IRS may deem that Jerry has made a taxable gift of $2 million to his brothers when the death benefit is paid.

Policy Replacement Considerations

Replacing a permanent life insurance policy with a new one may not be in the policyholder's best interest.

Following are a few issues to consider when replacing permanent life insurance:

- The new insurance company can challenge a death benefit claim that is filed within two years from the date of policy issue. (State guidelines should be reviewed; some states differ regarding this general rule.)
- The insured may lose a lower policy loan interest rate or forfeit other favorable policy provisions, such as those that provide for a premium waiver in the event of disability, an accelerated death benefit for terminal illness or long-term care needs, or an additional purchase option allowing the insured to increase his or her coverage without further medical underwriting.
- The insured may lose important grandfathered rights, such as attractive loan features, including the ability to borrow on a first in, first out basis for a non-MEC policy.
- A new surrender penalty schedule can apply for up to 15 years.
- There may be fewer contractual guarantees, such as the loss of a guaranteed death benefit or guaranteed level premium.

Other factors to consider include the following:

- If the insured is in poor health, he or she may be giving up a contract with a more favorable medical rating. If the existing contract has a medical rating, the insured should probably keep the current contract unless his or her health situation has improved substantially.
- If the existing contract has a very large surrender penalty, other options within the existing policy should be considered before replacement, depending on the client's objectives.

1035 Exchanges

A 1035 exchange enables a policyholder to exchange permanent cash value contracts while deferring any taxable gain. A 1035 exchange can be processed on the following:

- A life insurance policy exchanged for another life insurance policy
- A life insurance policy exchanged for an annuity
- An annuity exchanged for another annuity
- An endowment life contract exchanged for an annuity, if done before the endowment date
- A permanent life insurance policy or annuity for a qualified long-term care insurance policy

A 1035 exchange cannot be processed on the following:

- An annuity to a life insurance policy
- An endowment life contract to any life insurance contract other than another endowment of the same endowment date

In addition, a 1035 exchange can generally occur only if the new and the existing contracts have the same policyholders and insureds (or annuitants in the case of an annuity). For example, a policy owned by Joe Smith with Mary Smith as the insured may be used as a 1035 exchange only for a new policy owned by Joe Smith with Mary Smith as the insured or annuitant.

An exchange of multiple policies to one new policy normally qualifies as a 1035 exchange as long as the policyholder and insured are the same on both the existing and the new contracts and the exchange is initiated at the same time.

Exchanging Single Life Policies for Multiple Life Policies

The exchange of a single-owner, single-insured policy for a first-to-die or second-to-die policy, commonly called a "survivorship life" policy and used for estate-planning purposes, does not qualify as a 1035 exchange because the owner and insured are not the same on both the existing and new contracts.

Exchanging Life Insurance Policies with Loans

It is important to be very careful when considering replacing or exchanging an existing policy with a loan, as doing so could cause tax consequences. If the client's goal is to eliminate the policy loan by exchanging to another life insurance contract or an annuity, the loan amount may have taxable "boot" consequences. In other words, the loan amount could be taxed as ordinary income to the extent of gain represented, i.e., taxed on a LIFO basis.

On life-insurance-to-life-insurance replacements, some insurance companies allow the loan on the existing contract to transfer to the new contract where the outcome results in no taxable event to the policyholder because no gain is recognized. However, the client may end up with a less favorable interest rate on the new policy. Therefore, it is extremely important to consider all consequences before making changes.

If a policyholder uses his or her policy cash value to extinguish a loan as part of a 1035 exchange, the policyholder may recognize taxable gain in purchasing a new policy with no debt. The IRS may not view this 1035 exchange as triggering an income tax event if the loan on the policy being replaced is paid off from outside (non-policy) funds that originate from a savings account, a checking account or some other financial resource.

Gifting Life Insurance Policies with Loans

The IRS may treat the gift of a life insurance policy subject to an outstanding policy loan as part sale and part gift transaction. The value of the loan is treated as consideration received from the donee (the "sale" portion). The net cash surrender value is deemed to be the "gift" portion. If the value of the loan on the date of the gift is less than the donor's basis, the donor will not recognize any gain on the transfer of the policy. However, if the loan balance is greater than basis, gain will be recognized to the extent that the loan exceeds basis.

Company Ratings and State Regulations

A life insurance policy or an annuity is only as secure as the insurance company issuing it. Hundreds of life insurance companies do business in the United States. These life insurance companies are rated on a regular basis for purposes of assessing their financial soundness with respect to maintaining profitability, managing investment assets and retaining cash reserves to pay policy claims and other related liabilities when they become due.

The major financial ratings services for the life insurance industry are A.M. Best, Standard & Poor's, Moody's Investors Service and Weiss Ratings. It is important to remind clients to be aware of any significant changes in the ratings of the insurance companies from which they have purchased some type of insurance product.

State insurance regulations impose strict financial and legal operating requirements on life insurance companies. If a life insurance company cannot meet these requirements because it is under financial distress, a state insurance regulator can step in and suspend its sales operations to issue new policies or liquidate the company in the event of extreme insolvency.

In order to provide some level of financial protection to the general public, each state maintains a life and health guaranty association where insurance companies licensed to do business in that state are charged an assessment for monies held in trust by the State Insurance Director for the benefit of policyholders should any insurance company become insolvent. These guaranty associations provide only minimal protection to policyholders. Maximum benefit limits vary by state, but most states offer at least the following[1]:

- $300,000 maximum coverage for pending life insurance death benefit claims
- $100,000 maximum coverage for life insurance cash surrender or withdrawal values
- $250,000 maximum coverage for present values of annuity benefits, including net cash surrender and withdrawal values
- $300,000 maximum coverage for any combination of the above

[1] National Organization of Life and Health Insurance Guaranty Associations: www.nolhga.com/policyholderinfo/main.cfm/location/questions

Conclusion

Life insurance can fulfill a variety of purposes in helping to protect a family's financial security or funding a legacy goal. It can provide funds to cover final expenses, income during the readjustment period, income for a surviving spouse and dependent children, funds to pay off a mortgage, liquidity for large estates, tax-efficient transfer of wealth to heirs and assistance with business succession concerns.

How Edward Jones Can Help

Edward Jones is committed to helping clients meet their financial goals using a team approach. An Edward Jones financial advisor can walk you and your clients through the process of evaluating the wide range of insurance options we offer and selecting the products that best fit their needs. Working together, we can assist mutual clients in making cost-effective, intelligent choices to address their personal, business and estate-planning needs. To learn more about how this team approach can help you serve your clients' best interests, contact an Edward Jones financial advisor today.

Building a Team of Professionals to Help Provide Solutions for Our Clients

At Edward Jones, we believe that when it comes to financial matters, the value of professional advice cannot be overestimated. In fact, in most situations we recommend that clients assemble a team of professionals to provide guidance regarding their financial affairs: an attorney, a tax professional and a financial advisor.

The legal, accounting and financial services industries are governed by constantly changing complex laws and regulations; by working together as a team, driven by similar philosophies and guiding principles, professionals in a variety of financial fields can use complementary knowledge and skills to assist mutual clients in planning for today's financial and tax challenges.

www.edwardjones.com/teamwork

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