
Life insurance/ long-term care hybrid


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Life insurance trustees should pay close attention to the Uniform Prudent Investor Act

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Dramatic tax changes eminent for 2013

The Tax Relief, Unemployment Insurance and Reauthorization and Job Creation Act of 2010 (the "2010 Tax Act") provided favorable, but temporary, federal gift, estate and generation-skipping transfer (GST) tax provisions. The key transfer tax items in the 2010 Tax Act were just two-year fixes that continue through the end of this year.

2010 Tax Act changes included:

- Exemptions increased to $5,000,000 ($10,000,000 for married couples) for gift, estate and GST taxes. These exemptions were inflation adjusted for 2012 to $5,120,000 ($10,240,000 for married couples).
- The top estate tax rate and gift and GST tax rates were reduced to 35%.
- Exemption portability – the executor of a decedent can elect to provide the surviving spouse with the decedent's unused estate tax exclusion amount.

Lifetime transfers

In 2011, the gift tax and generation-skipping tax (GST) exemptions were raised to $5,000,000. The increase in the gift tax and GST tax exemptions from $1 million to $5 million represented a 500% increase and significantly increased lifetime wealth transfer planning opportunities. With the 2012 inflation adjustment, individuals can now give away $5.12 million ($10.24 million per married couple) without incurring gift or generation-skipping transfer tax. Such gifts can defer transfer taxes for multiple generations, if made to properly structured trusts. Further, if the trust is a "grantor trust," the donor pays the trust's income taxes without making additional taxable gifts, which, in a rising income tax environment, may produce additional tax savings. These gifts can be further leveraged within the trust through the purchase of life insurance.

The GST provisions are not fully unified with the estate and gift tax provisions. The remaining GST exemption may vary materially from the unused balance of the federal gift/estate tax exemption amount, even though these exemptions are set at $5,120,000 for 2012. For example, outright lifetime taxable gifts to children during 2012 – or outright bequests to children upon a death in 2012 – would count against the $5,120,000 individual federal gift/estate tax exemption, but would not exhaust any of the $5,120,000 GST exemption. Conversely, gifts that are excludable for federal gift tax purposes and thus are not "taxable gifts" for federal gift or estate tax purposes, such as annual exclusion gifts to many generation-skipping trusts, may count against the GST exemption.

Transfers at death

For a death occurring in 2012, an estate comprised of up to $5,120,000 ($10.24 million potentially for a married couple) in assets will be exempt for federal estate tax purposes. Additionally, the top federal estate tax rate is down to 35%. The federal estate tax exemption amount generally is reduced by lifetime taxable gifts. So, if an individual passes away in 2012 and has utilized all of his/her individual lifetime federal gift tax exemption amount, there would be no remaining federal estate tax exemption amount available. All assets in such decedent's gross estate for federal estate tax purposes would, as a general rule, be subject to a 35% federal estate tax except to the extent the marital deduction, charitable deduction, or some other federal estate tax deduction applies.

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A smarter alternative: life insurance/long-term care hybrid

The number of Americans age 65 and older is expected to increase from 40 million to more than 71 million by 2030. Statistics show at least 70 percent of this aging population will require some form of long-term care services.

The need for a consumer solution has only gotten stronger as traditional, individual long-term care policy sales decline and premiums for those products increase. The result has been the rapid growth of hybrid life/long-term care policies. Available since the late 1980s, these policies have seen dramatic sales growth over the past decade because they enable consumers to maintain control of their assets, while offering benefits whether or not long-term care is needed.

A hybrid life/long-term care policy operates as a universal life insurance policy with long-term care benefits and helps clients leverage assets so they get more for their long-term care dollar. A hybrid policy may be more appealing to consumers because the premium paid will not be lost if the insured dies without utilizing long-term care coverage. If the long-term care benefits are not used, the beneficiary receives a life insurance payment. Policyholders can feel confident that they have benefits regardless of whether they need long-term care because their policy offers the following options:

- Tax-advantaged long-term care benefits
- Income tax-free death benefit
- Potential for full future premium refund with some products

The ideal candidate for a hybrid life/long-term care policy is, first and foremost, someone who understands the need to plan for long-term care but is cautious in committing to paying for traditional long-term care insurance. It also usually is someone close to, or preparing for, retirement that already has his or her retirement plan largely in place. The characteristics of a hybrid product may be more attractive than traditional long-term care insurance as they meet the multiple financial and estate needs of many consumers. These policies often are purchased with a single premium, but also can be designed with ongoing annual premiums. Consumers who have no need for life insurance, or who do not have sufficient retirement assets, may be better off with a traditional long-term care policy.

With a sound hybrid life insurance/long-term care policy in hand, clients can use a portion of the savings they have already set aside to get much more for their long-term care dollars and immediately increase the protection for the rest of their portfolio assets.

August 2012 Applicable Federal Rates

	Annual	Semi-annual	Quarterly	Monthly
Short-term	0.25%	0.25%	0.25%	0.25%
Mid-term	0.88%	0.88%	0.88%	0.88%
Long-term	2.23%	2.22%	2.21%	2.21%

The Section 7520* rate is 1.0%.

2013 tax changes

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Portability of unused federal estate tax exemption

The lower rates and higher exemption amounts are not the only potentially favorable gift and estate tax provisions set forth in the 2010 Tax Act. The "portability" provisions were made law for the first time in the 2010 Tax Act. Under these provisions, to the extent the taxable estate for federal estate tax purposes of the first spouse to die is less than the federal estate tax exemption amount, that first deceased spouse's unused portion of the federal estate tax exemption amount ("DSUEA") can potentially carry over and be available for use by the surviving spouse's estate on top of the surviving spouse's own federal estate tax exemption amount, subject to limits imposed by the new legislation.

Assume that an individual's husband died in 2011 having made no taxable gifts and possessed a $5,000,000 taxable estate. The husband's estate files an estate tax return on a timely basis, which permits his wife to use his DSUEA. As of the date of her husband's death, the wife has made no taxable gifts. Thereafter, she does not have to pay taxes on the first $10,120,000 of her assets (her $5,120,000 basic exclusion amount plus the $5,000,000 DSUEA "inherited" from her husband), which she may use for lifetime gifts made prior to year-end 2012 or for transfers at death if she dies prior to year-end 2012.

Looking ahead to January 1, 2013, the gift tax, GST and estate tax exemptions will all decrease to $1 million without legislative action. Top transfer tax rates are scheduled to increase back to 55%. While some or all of the 2010 Tax Act provisions may be extended, the remainder of 2012 provides a measure of certainty for making sizable lifetime gifts that could disappear when the ball drops in

Life insurance trustees should pay close attention to the Uniform Prudent Investor Act

Trustees generally have a fiduciary duty to invest and manage trust assets as a prudent investor would. This includes not just traditional investment assets, but other frequently overlooked assets, such as life insurance.

The Uniform Prudent Investor Act, adopted in some version by most states, provides that:
"[A] trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule . . . A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."

Trustees who breach this duty may be liable for monetary damages to the trust beneficiaries.

A key responsibility of the trustee is to have a disciplined investment process that seeks the greatest return for the least amount of risk. To help minimize potential trustee liability with respect to trust-owned life insurance, it is advisable to develop an investment policy statement (IPS) for the purpose of documenting the process.

At a minimum, the IPS should cover:

- Duties and responsibilities of the trustee with respect to trust owned life insurance
- The purpose of the coverage
- Type of coverage to be held by the trust, based on the designated risk tolerance
- Premium level of adherence, based on grantor's gifting limitations

In addition, a key component of an IPS is a commitment to regularly review each policy owned by the trust. It is likely that something has changed since the life insurance was purchased. It is the trustee's responsibility to ensure that the life insurance is performing as expected and is providing the best possible benefit for the trust beneficiaries.

Reasons for regular policy reviews

- Policies may not be performing as projected due to market downturns over the past few years, or historically low interest rates.
- Policies may be at risk of lapsing, leaving the trust beneficiaries with nothing and the trustee with a potential liability for failing to properly monitor the policies.
- Grantors may have to make larger premium gifts than expected to keep the policies in force, which could possibly exceed the available annual gift exclusions.
- Newer products may be available that might be more cost-efficient or offer better guarantees.
- It may be possible to pay a lower premium for the same coverage, or obtain more coverage for the same premium.
- Underwriting changes may have occurred. What once was considered rated for underwriting purposes might be considered standard today and require lower premiums.
- Improved health or lifestyle changes may have occurred, providing the potential for better underwriting offers and lower premiums.
- The amount of life insurance needed might have changed, making current coverage amounts insufficient or unneeded.
- Changes in insurer financial ratings could put the policy at risk because the company backing it is at risk.

A policy review is part of an ongoing assessment of trust owned life insurance. JMB Insurance can assist with the analysis of existing life insurance to determine if it is appropriate for the needs of the trust beneficiaries and whether the type and performance of the life insurance aligns with the goals of the trust.

Helpful Links

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IRS – Index of Applicable Federal Rates

Each month, the IRS provides rates for federal income tax and other planning purposes.

Quick benefit calculator

The calculators will show your retirement benefits as well as disability and survivor benefit amounts on your record if you should become disabled or die today.

Detailed benefit calculator

The Office of the Actuary, Social Security Administration, produces a Social Security Benefit Calculator. It produces the Social Security benefit for an old-age, survivor, or disability claim, given the characteristics of a particular worker (such as birth date, past earnings, and type of benefit). It also produces the "primary insurance amount" (PIA), "maximum family benefit," the actuarial reduction or increment factor (for early or delayed retirement), and the monthly benefit amount (MBA).

CPI inflation calculator

The CPI inflation calculator allows you to quickly calculate the value of either current or past dollar amounts relative to inflation.

For more information, please contact your Account Executive, or:

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