SOLID ROCK WEALTH MANAGEMENT

WealthGuide

Life Insurance: An Effective Estate Planning Tool for the Agricultural Family

An Educational Resource From
Solid Rock Wealth Management

By Christopher Nolt, LUTCF

Introduction

Life insurance, particularly Survivorship Life insurance, can be an effective estate planning tool for the agricultural family. This Wealth Guide will educate you about life insurance and illustrate how it can be used to accomplish various objectives of an agricultural family.

Uses of Life Insurance

Life insurance can serve a number of purposes for the agricultural family. Besides providing for the continuation of income in the event of a breadwinner's death, life insurance can:

- Provide cash for the payment of debts, funeral expense, probate fees, medical expenses, estate taxes, etc. Having cash to pay these expenses may prevent heirs from being forced to sell assets in order to pay these costs.
- Provide cash to children who are not inheriting a family farm/ranch as a means of equalizing inheritance with a child or children who are inheriting a family farm/ranch.
- Provide cash for funding a buy-sell agreement between business partners/shareholders. Life insurance proceeds are used to buy-out the deceased partner's share of a business.
- Provide cash for wealth replacement to heirs when a Charitable Remainder Trust is used to avoid tax on the sale of farm/ranch property.

Types of Life Insurance

There are two basic types of life insurance: 1. Term insurance and 2. Permanent insurance.

Term Insurance

Term insurance is simple and straight-forward. You pay a specified premium for a specified amount of coverage for a specified period of time. You can purchase annual renewable term insurance where your premium increases each year or you can purchase term insurance where your premiums are locked in for a specified number of years.

The main advantage of term insurance is that it is lower cost than permanent insurance. The main disadvantage is that it can only be renewed for a limited amount of time and it becomes very costly at older ages.

Permanent Insurance

Permanent insurance combines an insurance protection component and a cash accumulation component. The main advantage of permanent insurance is that it can provide coverage for the duration of your life with premiums that may remain stable over the life of the policy. Part of the premium for permanent life insurance covers the insurance cost and part of the premium builds cash value on a tax-deferred basis. Cash value is money you may borrow against or withdraw for various needs. If sufficient cash values are available, it can also be used to pay premiums on the policy.

Types of Permanent Insurance

There are six main categories of permanent life insurance:

1. Whole Life
2. Universal Life
3. Variable Life
4. Variable Universal Life
5. Single Premium Life
6. Survivorship Life

Deciding on the type of permanent life insurance to buy can be confusing. Whole life is a more rigid type of contract but offers the stability of premiums and death benefit guarantees many want. Whole Life insurance usually has a set premium and face amount while Universal and Variable Life offer the flexibility to increase or decrease coverage amounts and premiums. Variable Life allows a person to invest in stocks and bonds through a wide variety of separate accounts similar to mutual funds.

Make sure you understand all the terms of a policy (not just the agent's promises of returns) before you buy it. If your agent cannot explain these to your satisfaction, shop elsewhere.

Single Premium Life

Single-premium life is a type of life insurance in which a lump sum of money is paid into the policy in return for a death benefit that is guaranteed to remain paid-up until you die. Single premium life is offered in all types of permanent life insurance policies.

Survivorship Life

Also known as Second-to-Die Life insurance, Survivorship life insurance is a type of policy that insures two lives under one policy with the death benefit paid out on the second death. Survivorship life insurance is commonly used for estate planning purposes because in the case of a married couple, estate taxes are typically not due until the second spouse's death. Survivorship life insurance is less costly that a single life policy. If one spouse doesn't qualify for life insurance due to health conditions, a Survivorship Life insurance policy can typically be purchased if the other spouse is healthy.

Term Life vs. Permanent Life

Deciding whether to buy term or permanent life insurance can depend on several factors such as your age, income, purpose for buying insurance, amount of coverage required and length of time the coverage is needed. For young families with limited income, term insurance is often the best solution because a sufficient amount of coverage can be purchased for a much lower premium than permanent insurance. When used as a solution for estate and succession planning, permanent insurance is usually a better solution because term insurance can only be renewed for a limited period of time.

In some instances, a combination of both term and permanent policies may be the best solution. Additionally, while term life insurance may be a starting point for some because of their financial situation and needs, some term policies can be converted to a permanent policy any time prior to a certain age without evidence of inusrability. So, if your goal is to obtain permanent life insurance, but you cannot afford it financially, you may consider obtaining the term coverage now and converting to a permanent policy later.

Buying life insurance as an investment

Many insurance agents promote buying life insurance as an investment. One of the advantages they proclaim is the ability to accumulate money on a tax-deferred basis and to take money out tax-free through policy loans.

Permanent life insurance policies typically have high fees. Despite the tax benefits, life insurance is not a good retirement investment in my opinion. If you need life insurance for a temporary period of time, a more prudent approach may be to buy term insurance and invest instead in portfolio of low cost mutual funds, ideally in a qualified retirement plan such as an IRA or SEP. While I don't believe in buying life insurance as an investment, I do believe permanent life insurance is a valuable financial tool. Many of the wealthiest people I know own permanent life insurance.

How much life insurance should I purchase?

The amount of insurance a person should purchase depends on a variety of circumstances and there are a variety of formulas you can use. For survivor income purposes, it usually advised to purchase enough coverage to provide cash to cover final expenses, the payment of debt, the funding of college expenses and the continuation of family income at a level similar to when the breadwinner was alive. A common rule of thumb is to purchase five to ten times a person's annual income. Everyone's situation is different so it is best to carefully calculate what your actual needs are.

For estate planning purposes, an amount of insurance is often purchased with an attempt to provide enough cash so that a family can pay for some or all of the financial expenses at death so heirs are not forced to sell property to cover these expenses. Some of the financial expenses at death can include:

1. Federal estate taxes
2. Federal and state income taxes
3. Probate and administrative costs
4. Medical expenses
5. Payment of maturing debts
6. Maintenance and welfare of family
7. Payment of specific cash bequests
8. Funds to continue operation of family business

For estate equalization purposes, life insurance is purchased to provide cash to heirs who are not inheriting the family farm/ranch. This amount can be determined a number of different ways. Here are two of those ways:

1. Provide an amount of cash equivalent to the current value of the farm/ranch or the projected value at the estimated date of death.

2. Provide an amount of cash that, if invested, will generate an annual income equivalent to the net income the ranch is generating. For example: Let's assume Bob and Joan have a son name Scott who is going to inherit the family ranch and the ranch is Bob and Joan's entire net worth. They also have a daughter Ann who they would like to provide an inheritance to in the form of life insurance. If the farm generates an annual net income of $100,000, the amount of insurance Bob and Joan may choose to purchase would provide a sum of money that if invested, would generate $100,000 of income for Sue. Assuming Sue could invest money and earn a 5% return, Bob and Joan would need to purchase $2,000,000 of life insurance ($100,000 divided by 5%).

Choosing a life insurance company

There are many life insurance companies to choose from. It is helpful to work with an agent that is able to shop among multiple companies. Not all companies have the same rates and not all companies treat health conditions the same. This is why it is helpful to compare proposals from several companies. To get accurate quotes, you should complete a health questionnaire ahead of time so that all quotes are based on your health history.

You should also choose a company that is financially strong. Multiple rating agencies evaluate the financial strength of insurance companies and assign ratings based on the company's evaluation. These rating agencies include: A.M. Best, Duff & Phelps, Moody's, Standard & Poors and Weiss Research. These agencies don't all use the same rating classifications so make sure you understand how each company's ratings rank from good to bad.

Claims and Settlement Options

To receive proceeds from an insurance company when an insured person dies, beneficiaries must submit a claim from to the insurance company along with a certified copy of the death certificate. Beneficiaries can choose among different methods for receiving life insurance proceeds. The different methods are called settlement options.

The simplest method is a lump sum payment of the value of the policy. Beneficiaries can also choose to leave the entire proceeds with the insurance company and collect interest, retaining the right to withdraw principal funds at any time. There are also a range of options that pay benefits over specified time periods or the entire life of the beneficiary.

Before getting locked into a settlement option with an insurance company, you should explore all your options with a reputable financial advisor.

Parties to a life insurance policy

There are three parties to a life insurance policy:

1. **The owner.** The owner is the person or entity that controls the policy. The ownership of life insurance affects the tax treatment of the death benefit.
2. **The insured.** The person whose life is insured under the policy.
3. **The beneficiary.** The person(s) or entity that will receive the proceeds of the policy upon the death of the insured.

Beneficiary designations

Who you designate as beneficiaries of life insurance policies is a very important consideration. You need to make sure that the beneficiary designations you select are coordinated with your overall estate plan because beneficiary designations override a will. If you name your estate as beneficiary of your life insurance, your will controls the disposition of your life insurance proceeds. However, if life insurance is paid to an insured's estate, it is needlessly subjected to probate costs and to the claims of the insured's creditors. When a person is named as a beneficiary, the proceeds are payable directly to that person and avoid probate.

If you have minor children, it is often a good idea to have a family trust as the primary beneficiary of your policy. If you designate minor children as beneficiaries and you die while they are still minors, an insurance company will require that a court-appointed conservator be assigned to manage the money until the child reaches the age of majority, typically age 18 or 21 depending on the state. When children reach the age of majority they will then receive their share of the life insurance proceeds.

With a family trust as the beneficiary, parents can name a trustee to manage the proceeds of the policy and stipulate when their children are to receive their money. For example, a trust may stipulate that a child receives 25% when they turn age 21, 25% when they turn age 25, 25% when they turn age 30 and 25% when they turn age 35. While the children are still minors, the trustee may be directed on how to invest the proceeds with provisions allowing them to use the income generated from the investments to care for the children.

Because family and financial situations frequently change, it is a good idea to review your beneficiary designations and your life insurance coverage on a regular basis. It is also important to make sure that contingent beneficiaries are listed in addition to primary beneficiaries.

Ownership of life insurance

There are ownership dilemmas associated with life insurance, which impact whether or not the life insurance proceeds are included in an estate. The IRS states that if a person has any "incidents of ownership" in a life insurance policy, the proceeds will be included in their estate at death. Incidents of ownership can include the right to borrow on a policy's cash value, to change the policy's beneficiary, to change a settlement option, and the right to change the dividend selection.

While it is true that life insurance proceeds are usually received income tax-free, they are not estate tax-free. Many people don't realize the proceeds from their life insurance will be included in their estate. If you have purchased life insurance as a means of paying estate taxes but you own the life insurance policy, the IRS may end up receiving a large portion of the proceeds.

There are two primary means of keeping life insured's proceeds from being included in your estate. The first is to have an adult child or children own the policy. The second (and preferred) method is to have the policy owned in an Irrevocable Life Insurance Trust.

Irrevocable Life Insurance Trust (ILIT)

An ILIT is a type of trust designed to own life insurance. There are three good reasons to utilize an ILIT. The first is for estate tax considerations, the second is for concern of leaving a large sum of money unsupervised to a minor or an irresponsible adult, and lastly for asset protection concerns.

If an ILIT is structured properly, the death benefits paid to the trust will be free from inclusion in the gross estate of the insured.

If the insured has beneficiaries that are minors or adults that aren't good with money, it might be wise to set up an ILIT with the trust as beneficiary. This appoints a trustee to act as a supervisor for the trust and distribute the assets per the terms of the trust documents as per the grantor's wishes.

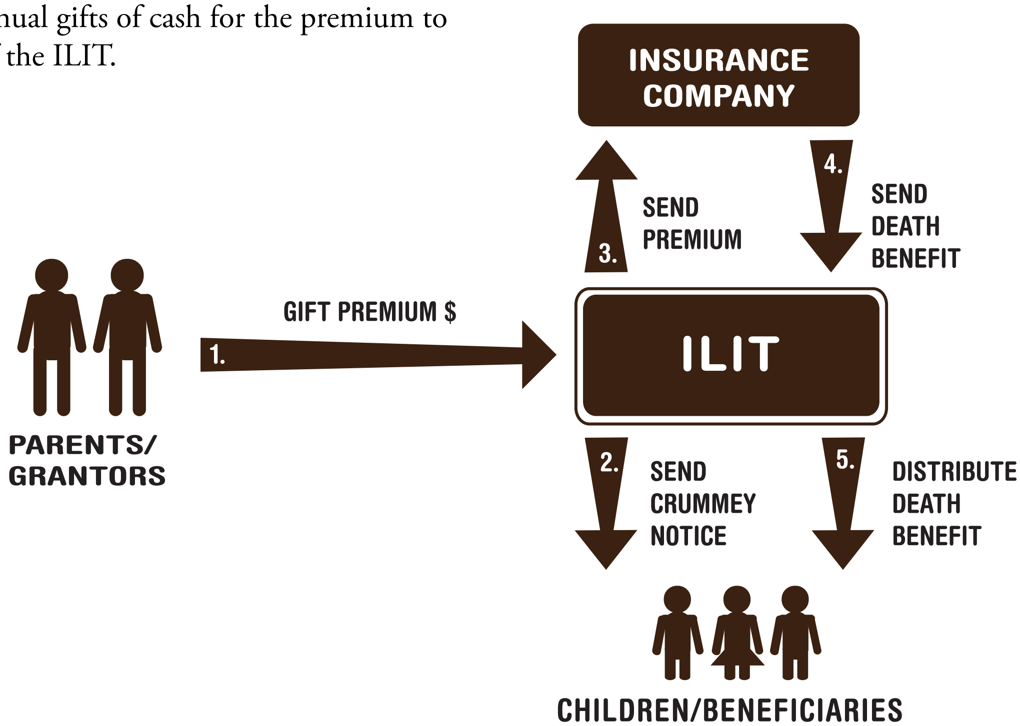
An ILIT can also provide asset protection. ILITs are not considered to be owned by the beneficiaries. This makes it difficult for courts or creditors to access the assets in the ILIT.

How an ILIT works

1. With the help of an estate planning attorney, you the Grantor(s)/Insured(s) establish an ILIT and name a trustee, other than yourself, to manage the ILIT. You make annual gifts of cash for the premium to the trustee of the ILIT.
2. Upon receipt of cash gift, the trustee sends the beneficiaries of the ILIT an annual "Crummey Notice/ Letter" which gives the beneficiaries the right to use the cash. This qualifies the gift as a "present interest" gift. The annual gift exclusion amount per person in 2013 is $14,000.
3. The trustee makes annual premium payments to the insurance company.
4. Upon death of insured (or second insured if an Survivorship Life insurance policy is used) the insurance company sends death proceeds to the ILIT.
5. The trustee collects the funds, pays estate taxes and other expenses and then distributes money to the beneficiaries you have named in the ILIT.

Life insurance trust assets are excluded from estate tax only when the following conditions are met:

1. The ILIT must own the policy.
2. The ILIT must be the beneficiary of the policy.
3. The insured may not retain any incidents of ownership in the policy.
4. The ILIT must be irrevocable.
5. The ILIT must be established during the insured's lifetime.
6. The trustee is not allowed to use ILIT assets for the benefit of the estate.



Children as owners of a life insurance policy

Another method that may enable life insurance proceeds to be excluded from your estate is to have your adult children own the policies. Under this arrangement, you could gift an amount each year to your child or children to cover the annual premium and they would pay the premium themselves. Some potential problems with this arrangement are:

1. Your child or children control the policy and could make changes that aren't consistent with your desires.
2. If one of your children is involved in a divorce, their spouse could claim that the policy is community property.
3. If one of your children precedes you in death, your child's disposition of the interest in the policy to his or her spouse, for example, might not be the same as what you would have wanted. For example, in this event you may have provided that your grandchildren receive the benefit.

Transferring ownership of an existing life insurance policy

You can transfer an existing life insurance policy into an ILIT. However, if you die within three years of transferring the policy, the proceeds will be included in your estate. This three year look-back rule was enacted by the IRS to prevent transfers of assets in contemplation of death. This means that any asset (life insurance policy or other) that is transferred to another person within three years of death will automatically be included in the decedent's estate for tax purposes.

If you transfer an existing life insurance policy to an ILIT or a child, which is the same thing as changing the ownership of the policy, it is considered to be a gift. The value of the gift is the replacement cost of the policy at the time of the transfer. Under current gift tax rules, if you transfer a policy with a present value of more than $14,000 (in 2013) per donee to another person, gift taxes will be assessed on the amount above $14,000. However, the gift tax won't have to be paid until your death. Keep in mind that if your estate is above the estate exemption amount at the time of death, the amount of gift tax will be far less than the amount of estate tax that would be due if your policy remained in your name and in your estate. This is because the policy proceeds are always considerably more than the value of the policy while the insured is alive.

The mechanics of transferring ownership

You can give away ownership of your life insurance policy by signing a simple document, called an "assignment" or a "transfer." To do this, notify the insurance company and use its form. There's normally no charge to make the change. Also, you usually have to change the policy itself to specify that the insured is no longer the owner.

After the policy is transferred, the new owner should make any premium payments due. If you make payments, the IRS might contend that you're keeping an "incident of ownership" and include the proceeds in your estate.

Life insurance and a Charitable Remainder Trust

Life insurance is often used in conjunction with a Charitable Remainder Trust (CRT). A CRT is commonly used to avoid taxes on the sale of a farm or ranch and provide lifetime income to the donors. Because the remaining assets left in the trust at the donor's death pass to charity, donors often purchase life insurance to replace the value of the assets for their children. When used in conjunction with a charitable remainder trust, an ILIT is often referred to as a wealth replacement trust.

Equalizing inheritance among on and off farm heirs

A common dilemma among agricultural families is how to be fair to both on and off farm heirs. The assets of a farm/ranch typically represent the vast majority of an agricultural family's net worth, leaving little if any assets to pass to the off farm heirs. As a way to equalize inheritance, parents often purchase life insurance for the benefit of the off-farm heirs.

Sometimes, parents will pass the farm/ranch equally to all of their children and let them "figure things out". This is typically a recipe for disaster because the off farm children will often want their value of the farm/ranch after their parents are gone. Because the on farm child usually can't afford to buy out his siblings share of the farm/ranch, he or she will be forced to sell. This often results in bitter feelings among the siblings.

In the example below, we will examine a common scenario among agricultural families and show several solutions of how life insurance can be used to help the family achieve their financial goals.

Using life insurance to equalize an inheritance

John and Mary own a ranch valued at $8 million in central Montana. They are both age 65 and have three children, Steve, Mark and Sue. Besides the ranch assets, they have savings and investments of $200,000. The ranch generates an average annual income of $150,000. In addition to the ranch income, John and Mary receive a total of $23,000 per year from social security.

John and Mary's son Steve has lived and worked on the ranch his entire life. They pay Steve an annual salary of $30,000. Mark and Sue have other careers and are not interested in coming back to the ranch.

Upon their death, John and Mary would like to pass the ranch to Steve and provide Mark and Sue with an inheritance equal to half of the current value of the ranch divided equally between them. John and Mary meet with their advisory team to explore their options for providing Mark and Sue with $4 million.

Option 1: Save

The family estimates John and Mary's joint life expectancy to be 20 years. Assuming they could earn an average annual return of 6% on an investment, they calculate they would need to save over $110,000 per year for 20 years to come up with $4 million to leave Mark and Sue.

Option one won't work.

Option 2: Borrow

They call their local bank and Farm Credit Services representative to see how much it would cost for Steve to borrow $4,000,000. Using a fixed interest rate of 6% and a term of 20 years, Steve's monthly payment would be $26,398.23. Over 20 years, his payments would total $6,335,575.

Option two won't work.

Option 3: Insure

The family obtains quotes on a $4 million Survivorship Life insurance policy on John and Mary's life. Based on standard ratings, the annual premium would be $60,000. The family concludes that using life insurance to equalize the estate is the best option. Three potential solutions are presented involving life insurance:

Solution 1:

John and Mary establish an Irrevocable Life Insurance Trust and purchase a $4,000,000 Survivorship Life insurance policy with the ILIT as owner and beneficiary of the life insurance policy. John and Mary name their two off-farm children, Mark and Sue as beneficiaries of the ILIT. When John and Mary pass on, Steve inherits the ranch and Mark and Sue split the $4 million life insurance proceeds 50/50.

Solution 2:

John and Mary, in their wills/living trust, provide for a distribution of a one-half interest in the ranch to Steve, and a one-quarter interest each to Mark and Sue. During their lifetimes, they have Steve, Mark and Sue execute a binding cross-purchase agreement whereby Steve agrees to buy-out, at fair market value, the one-quarter interests ($1 million each) that will be distributed to Mark and Sue. Steve then purchases a $2 million Survivorship Life insurance policy on John and Mary. If he needs additional funds to pay the premiums on the policy, the ranch may be in a position to increase his salary or bonus additional money to him on an annual basis. Upon the second to die of John and Mary, Steve uses the death benefit to acquire their interest, per the cross-purchase agreement.

Solution 3:

The family determines they cannot afford the $60,000 annual life insurance premium. To come up with the money to pay the annual premium, they decide to sell a lesser productive portion of their land valued at $1 million through a Charitable Remainder Trust (CRT) and use the annual income from the CRT to pay the annual life insurance premium.

Because the CRT is a tax-exempt entity, it will not have to pay capital gain tax on the sale. Assuming they net $1 million from the sale of land and select a 6% payout in the CRT, they will receive approximately $60,000 per year from the CRT. They will use this income to pay the annual life insurance premiums.

Conclusion

Life insurance can be a valuable tool for the agricultural family. Purchasing the right type of life insurance policy and structuring it in a way that maximizes benefits for your family requires the help of an experienced life insurance agent. Because the rates and treatment of health conditions vary among insurance companies, it is wise to obtain proposals from multiple highly rated insurance companies.

While term insurance is often the best solution for many life insurance needs, permanent insurance is typically the best solution for estate planning. Having money available to pay estate taxes or to equalize an inheritance requires the policy to be in force at death. Term insurance may not be suitable for estate planning because the policies can only be renewed for a limited length of time.

Survivorship Life insurance, also known as Second-To-Die Life insurance, is a type of permanent life insurance policy that insures two lives under one policy with the proceeds payable upon the death of the second insured person. This is often the preferred type of policy for estate planning.

The ownership of life insurance determines whether or not the proceeds will be included in your estate for estate tax purposes. To have your life insurance proceeds excluded from your taxable estate, you should either have your children own the policy or, preferably, have the policy owned in an Irrevocable Life Insurance Trust (ILIT). To properly structure a life insurance policy in an ILIT, it is wise to use the services of an experienced estate planning attorney.

Beware of agents selling life insurance as an investment and make sure you understand all the terms of a policy before purchasing it.

Chris Nolt is the owner of Solid Rock Wealth Management, Inc. and Solid Rock Realty Advisors, LLC, with offices in Bozeman, Montana and Fountain Hills, Arizona. Solid Rock Wealth Management and Solid Rock Realty Advisors specialize in working with families who are selling a farm/ranch or other business and transitioning into retirement. We help our clients to save tax on the sale and to create passive income from sale proceeds. We employ a comprehensive planning approach with a team of financial professionals, which addresses retirement planning, investment planning, estate planning, tax planning, charitable giving and risk management. Our wealth preservation strategies are designed to help our clients reduce taxes increase retirement income and maximize the amount of wealth they pass on to their heirs and favorite charitable organizations.

Solid Rock Wealth Management

Solid Rock Wealth Management is an independent, fee-only registered investment adviser. We offer globally diversified portfolios of no-load, low-cost institutional asset class mutual funds and exchange traded funds. Are portfolios are diversified among as many as 15 asset classes and market sectors and are comprised of holdings in roughly 12,000 companies in 45 different countries. Our model portfolios range from conservative (100% fixed income) to aggressive (100% equities) and are designed to achieve optimal returns for your level of risk tolerance.

Solid Rock Realty Advisors

Solid Rock Realty Advisors assists investors who are seeking secure income producing real estate investments. We specialize in office buildings leased to the U.S. Federal Government and primarily work with investors who are purchasing properties through a 1031 tax-deferred exchange. These fee-simple real estate properties offer long-term leases guaranteed by the full faith and credit of the U.S. government with competitive cap rates and professional property management.

Chris Nolt, LUTCF

Chris grew up in Lewistown, Montana. He received a Bachelors degree in business from Montana State University in 1987 and entered the financial services industry in 1989. Working on ranches throughout his high school and college days, Chris gained a deep respect for the work ethic and character of the agricultural family. Having seen the effects from a lack of good financial planning among the agricultural community, Chris determined to help these families make smart decisions with their money so they could preserve the wealth they worked so hard to create. For over 25 years, Chris has been helping farm and ranch families to reduce taxes, invest wisely and preserve their wealth. Chris has earned the designations of Certified Retirement Financial Advisor and Life Underwriter Training Council Fellow.

For more information or to request other Wealth Guides, call 406-582-1264 or send an email to: chris@solidrockwealth.com

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