The ABCs of Business Life Insurance

Our business is a third generation family business providing independent life insurance consulting and sales services to family and closely-held businesses for over 75 years. We have had the privilege to work with two, three and four generations of family business clients.

Our focus is assisting family businesses to lower the risks associated with the death of an owner or key employee. For **business protection purposes**, most business life insurance needs can best be met with high quality term insurance that includes the right contractual provisions. (More on this statement later.)

Very seldom do we see a good use for cash value life insurance to meet a business protection need. If the insured is young and healthy, or the corporation needs a cash reserve, cash value life insurance can work. It can also work for death benefit recovery with a large enough pool of insured executives – usually larger businesses than our client base. (The reasons to avoid permanent, cash value life insurance for business protection purposes are identified later in this report.)

WHAT ARE THE DIFFERENT KINDS OF LIFE INSURANCE?

For this report, we have to provide some basic life insurance terminology. This report is not intended to be an analysis of the many possible life insurance policy designs. In summary, all life insurance policy designs can be placed in two clearly understandable categories:

<u>Temporary Life Insurance – "If I Die During a Period of Time"</u>
This is any policy designed to provide protection for a period of time and then end, usually by age 80 or younger (maybe much younger). The cost of insurance is low because the insurance company prices the policy based upon the likelihood that the insured will outlive the policy. Temporary life insurance is like auto insurance. You buy it for the year and hope you do not use it.

The most common, but not only, example is term life insurance. It is most commonly available with a level premium for 10, 15, 20 or 30 years. The older the insured's age at the **end** of the level premium period, the higher the level premium. For example, a healthy 40 year old could be insured with a level premium to age 50, 55, 60 or 70. (The significance of the level premium duration will be discussed later in this report.)

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One very important term life insurance contractual provision is guaranteed convertibility. It allows for the conversion of the temporary term policy to more permanent life insurance **with no health questions asked.**

When this contractual provision is worded correctly, with a high quality life insurance company, it provides a cost effective extension beyond the original term insurance level premium period (10, 15, 20 or 30 years) if the insured's health has changed making them no longer insurable cost effectively, if at all.

The future flexibility offered by this guaranteed convertibility contractual provision is one of the most important considerations in the purchase of term life insurance. Yet, it is very seldom discussed by life insurance advisors and even less frequently understood by clients.

Way too often, term life insurance is purchased on price alone – "cheap term insurance." **If you want high quality term insurance, this guaranteed convertibility contractual provision has to be considered.** It is even more important because some, but thankfully not all, insurance companies are pulling back to offer less client protection in this contractual provision.

<u>Permanent Life Insurance – "When I Die"</u>

Permanent life insurance is a policy designed to continue for the insured's lifetime to pay a death benefit. It can be a whole life, universal life, or variable life insurance policy. The policy should be with a quality, financially strong life insurance company.

As an aside, permanent life insurance policies need to be monitored every one to two years in our current low interest rate environment. **An in-force illustration projecting the policy forward every year until either policy maturity or policy lapse is one tool to monitor permanent life insurance policies.** Low interest rates can reduce the interest earnings in the policy or the policy dividends. Over time, this can lead to increased premium outlay or the possible premature termination of the policy. If the policy could lapse before the insured dies, it is no longer a permanent policy. It has become a high premium temporary policy.

When permanent life insurance is used in family business planning, or estate planning, the policy death benefit usually has an important function in the overall planning. Therefore, it is especially important that permanent life insurance policies remain permanent. The policy should continue well beyond the insured's age 100, whenever possible, so there is not a risk that the insured will outlive the life insurance policy.

WHAT ARE THE MOST COMMON REASONS FOR BUSINESS PROTECTION LIFE INSURANCE?

Properly structured life insurance can provide after tax cash to the beneficiary (often the business) in the event of the insured's death. Business protection life insurance is used most often for two fundamental purposes:

1. To provide cash to offset liabilities or contingent liabilities.

2. To provide cash to offset increased business costs and/or lost profitability resulting from the insured's death, especially when the individual is integral to the business' success and hard to replace (a key person).

Liability Protection

This could be actual business debt liabilities, including debts that are personally guaranteed. It is our understanding that loans are automatically in default at a guarantor's death. This makes the loan technically callable. Or, the guarantee could remain in place, holding the insured's estate open or passing on to estate beneficiaries. Having cash, from life insurance proceeds, to pay down or pay off debt can be very valuable if an owner/key employee dies.

Contingent Liabilities

There are situations where no liability exists today but could exist tomorrow if a family business owner dies. If the business has a buyout agreement for company ownership, it may include a mandatory buyout at death. This provision means that the deceased owner's family will have cash rather than continuing business ownership with its associated risks and responsibilities. The surviving owner(s) will have control, the risks, and the potential rewards associated with continuing the business. No one knows when death will occur, and properly designed life insurance provides after tax cash to fund some or all of this contingent liability.

Another example is estate taxes. While the business owner is living, no estate taxes are payable. However, at an owner's death (or the second death of an owner and spouse), an estate tax may be payable. Properly structured life insurance can help provide after tax cash to fund this potential liability, especially if family business ownership makes the owner's estate illiquid. (More on this subject later.)

Key Person Life Insurance

It is common to insure key business leaders to fund the cost of locating and recruiting a capable replacement, as well as to fund potential declines in family business profitability during this unexpected transition. Examples of possible key employees include: the business leaders; the business visionary; and employees with unique financial skills, hard-to-find technological expertise, industry or sales contacts, or the financial resources to guarantee business obligations. This need for business key person life insurance is especially acute if the family business does not have much depth in any of these key roles.

WHAT ARE THE FOUR MOST COMMON
BUSINESS PROTECTION LIFE INSURANCE MISTAKES?

1) **Inadequate term life insurance protection**, especially to fund liabilities and contingent liabilities: How often does the value of your business change? We see family and closely-held businesses that have not updated their buyout life insurance in 10-15 years even though the value of the business has increased significantly.

Also, business owners very seldom incorporate personal guarantees of business debt into their business protection life insurance planning. Ideally, in anticipation of upcoming debt negotiations, the following should occur:

- The business owner/guarantor should complete an insurance physical exam, without cost or obligation, to make sure he/she is insurable.

- Negotiate with the lender the amount or percentage of debt that needs to be repaid at the guarantor's death, and include in the debt documents that with this payment at death, the estate of the guarantor will be released from this guarantee.

- Implement the needed term life insurance with an assignment or other legal arrangement to make sure the death benefit is used to pay down the debt.

2) **An incorrect duration for the business protection life insurance:** Examples include permanent life insurance when the business protection need is temporary. Also, remember the level premium term durations of 10, 15, 20 or 30 years. Often the business term insurance need is longer than the level premium period remaining in the term life insurance policy. When this mismatch is identified, and if the insured is insurable, it is best to rewrite the business term life insurance to the appropriate duration. The premium will be higher because the insured is covered to an older age. However, if the insured's health changes and the family business waits until the end of the level premium period in the current term policy to try to make coverage duration corrections, new insurance may not be available or it may be much more expensive.

3) **Poor quality term life insurance:** Term life insurance is a valuable contract to pay a large benefit if the insured dies. We want our family and closely-held business clients to have **as much future flexibility as possible** within this contract because this business protection life insurance could be important for the owner-insured's estate planning in the future.

This centers on the guaranteed convertibility contractual provision in the term policy. Poor quality term insurance may be guaranteed convertible for a period less than the level premium duration (such as only the first 10 years of a 20-year level premium). Usually, the conversion of term insurance to more permanent life insurance does not become an issue until the level premium period is about to end. If this contractual provision has ended, the policyowner has no "Plan B" for the policy and all future flexibility is lost.

Furthermore, many term insurance policies have contractual language allowing the insurance company to require that the guaranteed conversion be to a "special" policy for this purpose. The premium may be two to three times higher than the premium available to a new consumer, making the conversion policy very expensive and negating much or all of the future flexibility.

These issues are almost never discussed with clients in the purchase of term insurance. Quality term insurance can often be purchased as cost effectively as the "cheap" policies. **Purchasing the right term insurance is very important.**

4) **Business-owned life insurance no longer needed in the business:** We see business-owned life insurance that was purchased on a business owner's life years ago to fund a buyout agreement or debt obligation that has been paid off. This business-owned life insurance could increase the value of the business at the owner's death with negative estate and/or income tax consequences. An analysis should be done to see if the life insurance can be removed from the business or replaced outside of the business to be more tax efficient for the business owner's family.

A WORD ABOUT ESTATE PLANNING LIFE INSURANCE

The owners of a family business may have a future estate tax liability. If the family business and its related assets are a large share of the estate value, and the goal is to keep the business intact and in the family (usually the case), there may be a need for cash at death to help pay this estate tax liability.

Properly designed life insurance can be structured to be outside of the estate, resulting in cash at death that is both income and estate tax free. Most commonly, estate planning life insurance is permanent life insurance, and our comment earlier about making sure that permanent life insurance remains permanent is especially true in family business estate planning situations.

However, term life insurance may be used for estate planning as well. As an example, one of our family business clients purchased 20-year term insurance owned in trusts outside of the estate to provide needed estate tax liquidity in the event of an owner's death. At that time, the family felt that the business was likely to be sold within 10-20 years,

Circumstances change. That is why future flexibility is so important. About 15 years into the 20-year level term policies, the family concluded that they will not be selling the business. The existing **high quality** term insurance policies were converted to very cost effective permanent life insurance **with no health questions asked**.

WHAT ARE THE THREE REASONS WE AVOID PERMANENT LIFE INSURANCE FOR BUSINESS PROTECTION NEEDS?

Permanent life insurance (whole life, universal life or variable life insurance) is characterized by a higher premium to fund a policy designed to continue for the insured's lifetime and pay a death benefit. This higher premium usually results in a policy reserve or cash value that is an asset to the policyowner, often the family business. The three reasons we avoid permanent life insurance most of the time for business protection needs are:

1) Most business owners or key leaders leave the company between age 60 and 75, negating the need for business protection beyond that time. The result is a shorter duration business life insurance need that can be funded with a much lower premium, often with term insurance. It costs much less to insure someone to age 75 "if they die" than to insure them to age 100+ to pay a death benefit "when they die." However, if the business protection is a lifetime need, then the business should purchase permanent life insurance.

2) Cash value in a permanent life insurance policy is sometimes described as a "valuable business asset." It can be, but the rate of return on premiums paid, calculated over a long time, is usually very modest. It has been our experience that our successful family business clients can usually deploy their cash reserves more effectively in the operation of their business. The exception is the business that wants this separated cash reserve for a reason that makes the lower rate of return an acceptable tradeoff.

3) Most of our clients want to minimize their cash outlay for all insurance to maximize their discretionary cash flow in their business. For the life insurance to be permanent and have significant cash value, it is important to set aside these large premium payments every year. It is possible to skip permanent insurance premiums and borrow or withdraw cash value, but that will reduce the cash reserve and the rate of cash value growth net of costs.

Occasionally, the structure of cash value life insurance premium payments every year is beneficial for the business. More often, our clients tell us the permanent life insurance premiums are too high for too long, and too little rate of return.

CONCLUSION

We hope this discussion of the various uses and policy designs for business life insurance is helpful. If you have questions about the best ways to protect your family and business against the risk of premature death, or about the effectiveness of existing business life insurance policies, please contact us at 608-231-2700 or info@zimdars.com .