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Planning for Non Bloodline Family Members With Term Life Insurance

By Eric Hieber and Matt Phillips[*]
Winged Keel Group
New York, NY, Washington, D.C., and Richmond, VA

Since the financial crisis in 2008, financial markets have increased dramatically — from December 31, 2008, through December 31, 2020, the S&P 500 experienced annualized growth of 12.54%[1] and the Dow has seen annualized growth of 10.90%.[2] During this same period, the number of American households with at least $1 million of financial assets grew from 4.31 million to 6.98 million — an increase of 2.67 million households or 62%.[3] In addition, the number of American households with at least $50 million in financial assets has ballooned to more than 110,000.[3] This increase in wealth has resulted in a need for more sophisticated planning to preserve assets for future generations. In particular, existing planning often accounts for direct heirs and beneficiaries but does not provide support for non-bloodline family members. Life insurance can be a simple, low-cost solution for this planning issue.

Over time, changes in family dynamics such as divorce or the death of a spouse can put the assets at risk if they are comingled between spouses. Upon the death of one spouse, the surviving spouse may manage the assets poorly or disinherit stepchildren. Or the children that inherit assets may subject the assets to the claims of creditors through poor financial decisions. There are many circumstances that could put the assets at risk.

To help protect family assets and secure them for future generations, many families implement trusts to ensure that family assets pass to direct descendants and protect the assets in the event of unforeseen circumstances such as those summarized above. These ‘‘Bloodline Trusts’’ hold assets for the benefit of direct descendants but often do not provide any beneficiary rights to their spouses. Upon the death of the grantor, the Bloodline Trust assets pass to the grantor's direct descendants. In addition, if the Bloodline Trusts are outside of the Grantor's estate, they have the added benefit of protecting the assets in the trust from estate taxes.[4] While Bloodline Trusts are very effective at keeping assets in the family, there are drawbacks to the technique that should be considered.

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[*] Eric Hieber is a Managing Director of Winged Keel Group. Based in the firm's Richmond and Washington D.C. offices, Eric oversees case design and the management of client relationships. He specializes in structuring customized insurance solutions that assist families and their advisors in their wealth accumulation, wealth transfer, and business succession planning.

Matt Phillips is a Principal of Winged Keel Group, based in the firm's New York office. His focus is on structuring, implementing, and servicing life insurance portfolios that are designed for ultra-affluent families. This includes both traditional life insurance that is used in conjunction with an estate plan, as well as private placement life insurance that is used as part of an inter-generational investment plan.

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[1] Yahoo! Finance (n.d.), S&P 500 Historical Data.

[2] Yahoo! Finance (n.d.), Dow Jones Industrial Average Historical Data.

[3] Statista Research Department, Millionaires in the United States - Statistics & Facts (Jan. 20, 2022).

[3] Statista Research Department, Millionaires in the United States - Statistics & Facts (Jan. 20, 2022).

[4] *See Estate of Leder v. Commissioner*, 89 T.C. 235, 238 (1987) (the Tax Court held ‘‘that the proceeds from the policy are not includable in the gross estate where the decedent did not possess at the time of his death, or at any time in the 3 years preceding his death, any of the incidents of ownership in the policy. . .’’); *Estate of Headrick v. Commissioner*, 93 T.C. 171, 176 (1989) (the issue before the Tax Court was ‘‘whether the proceeds of a life insurance policy purchased by a trust within 3 years of the insured grantor's death must be included in the trustor's gross estate under [I.R.C.] 2035(a).’’).

In particular, if a family member inherits assets and subsequently dies, there may be limited assets to support the lifestyle of the surviving non-bloodline spouse.

Consider an example where John and Marie are married with three young children and Marie inherits significant assets through a bloodline trust. During Marie's lifetime, these assets can be used to support John and the children and maintain their lifestyles. Upon Marie's death, there are often sufficient assets in trust to support the needs of their children, but no provisions to provide support for John. Additionally, running every household expense through a trust with distributions approved by a trustee creates challenging dynamics the family may wish to avoid.

Providing John with a source of funds is an important part of supporting him and the children after Marie's death. Life insurance can be used to provide a lump sum of cash in a cost efficient manner without directly transferring family assets to John and provides the following advantages:

- Guaranteed term life insurance (Term Insurance) is a low cost solution designed to address a temporary need;
- Permanent insurance can be implemented with a flexible structure to meet long term planning needs;
- The insurance benefit is provided to John and the children free of income tax;
- The insurance may be owned in a trust to further protect the assets from frivolous spending and ensure sufficient cash flow over a long period of time; and
- The family assets can remain in trust and protected from estate taxes and claims of creditors.

The sample pricing below illustrates $100 million of Term Insurance for a New Jersey resident (who qualifies for a preferred non-smoker life insurance risk, the second-best classification) at ages 30, 35, 40, 45, and 50 as well as two guaranteed funding durations.[5]

Male		
Age	**10-Year Term Premium**	**20-Year Term Premium**
30	$25,147	$ 43,690
35	$25,590	$ 48,030
40	$40,730	$ 70,010
45	$64,750	$116,590
50	$103,730	$182,564

Female		
Age	**10-Year Term Premium**	**20-Year Term Premium**
30	$19,646	$ 31,760
35	$20,675	$ 38,704
40	$32,630	$ 55,949
45	$52,810	$ 88,310
50	$84,750	$133,140

There are additional benefits of utilizing Term Insurance. If the family dynamics change rendering the Term Insurance unnecessary, the insured has the option of ceasing premium payments and allowing the policy to terminate.[6] Conversely, if there is a desire to provide for the surviving spouse indefinitely, or if there is a separate planning need that does not go away over time, the Term Insurance may be repurposed by taking advantage of the policy's ''conversion option.'' The conversion option allows a policy owner to convert the Term Insurance policy to a permanent insurance policy at the same risk classification the insured qualified for at the time of the initial Term Insurance acquisition, without having to qualify medically.

In some cases, providing for non-bloodline family members is a long term need and the limited duration of Term Insurance may not adequately meet the family's needs. In this situation, permanent insurance may be a more appropriate solution. Many permanent insurance policies offer guaranteed insurance benefits that can generate between a 4% and 5% income tax-free return (7% – 9% taxable equivalent) at the insured's life expectancy (actual results are dependent on a variety of factors including the age of the insured(s) and the underwriting risk classification).[7]

Life insurance is a powerful planning tool that can help secure family assets while providing a source of funds to surviving non-bloodline family members. The combination of a low-cost solution and term conversion options or a flexible permanent product solution provides optionality to utilize the insurance for other purposes over time as unforeseen changes occur in the family dynamics. This flexibility is a critical element to ensure the planning is properly structured to meet long term objectives and gives the insured the comfort that the surviving family members will be taken care of without subjecting their assets to undue risk.

[5] COMPULIFE Software, Inc. is a website which assists individuals in illustrating Term Insurance prices from a number of insurance companies.

[6] Mary Van Keuren, *How to cancel a life insurance policy*, Bankrate (Sept. 27, 2021).

[7] I.R.C. §101(a)(1).

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