Creative Uses of Second-to-Die Life Insurance

By Joel Kabaker and Michael Altman

Joel Kabaker and Michael Altman discuss the use of second-to-die life insurance policies in estate planning, especially in situations where one party may be uninsurable and in situations designed to address the liquidation of joint business ventures.

John and Robert McCoy were partners and brothers. Like clockwork, for 20 years, McCoy Aerospace grossed $10 million annually. Their products included the fuel lines used in mid-air tanker refueling. John suddenly died. By prior agreement, Robert paid $5 million to John's estate to buy out his interest in the company. Then the Persian Gulf War began. Those fuel lines manufactured by McCoy Aerospace were a critical link in America's airborne supply bridge to the Mideast. McCoy Aerospace sales shot up to $30 million. Two years after his brother John's death, Robert sold the company for $45 million. John's heirs were understandably upset at having received just $5 million for their share of a company valued at $45 million a relatively short time later. From that point, relations between the two surviving factions of the McCoy family slid downhill fast.

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Making Families Whole

Why do so many family-owned businesses fail and create discord among the families when an owner dies? Follow the money. It's usually distributed unequally, contrary to the owner's intent.

Keeping settlements fair and preserving the estate's valuable assets are certainly two parts of the estate planner's job. The challenge comes when we toss in the variables of life: the uncertain planning horizon the estate plan must cover, indeterminate business value when partners die and how to cope with one partner becoming uninsurable if the plan will use insurance proceeds to pay taxes or to make one estate/owner whole.

There is a solution. It involves the creative use of an insurance product that's been around for years: survivors insurance, dual life or more commonly, second-to-die insurance. Use of second-to-die insurance for this particular purpose balances wealth distribution between the estates of businesses with multiple owners once the trustee(s) sells the company.

Objectives of the Second-to-Die Tool

We need sufficient liquidity in the estate to pay estate taxes. Second-to-die insurance provides that liquidity when dealing with multiple owners of a substantial company. Further, it eliminates the impact of uncertainties such as the firm's future value or when an owner will die.

The second objective is to equalize the windfall proceeds from the business sale among the families with an interest in the owners' estates. This is perhaps

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the best way second-to-die insurance preserves family harmony. A third is to buy out siblings if not all children plan on staying in the business. Certainly, it gets more complicated when one or more business owners cannot be insured. Nevertheless, that's when using second-to-die coverage becomes the most useful.

Applications of Second-to-Die Insurance

Simply stated, a second-to-die life insurance policy insures two lives under one policy. Because the insurance companies spread their risk over two people, the premiums are typically less expensive as a percentage of benefits paid out than for single life coverage (*see* sidebar).

The most common use of second-to-die insurance is with a husband and wife. When the second spouse dies, the benefits paid by the second-to-die policy offset the estate tax liability to the children and heirs. Second-to-die insurance is best employed in estates whose value exceeds $2 million. Consider it also if the estate is comprised mostly of real estate, business interests or other illiquid assets. This strategy allows survivors to retain assets they otherwise might have been forced to sell at a disadvantageous time. This application of second-to-die coverage ensures the estate's assets go to the intended heirs rather than being liquidated to pay expenses and other probate costs.

Uses for Second-to-Die Coverage in Businesses

Most privately held companies or partnerships with two or more related owners have debated how to fairly divide the company among the families involved when one of the principals dies. In the case of a rapidly growing company such as McCoy Aerospace with two related owners, when one dies and the company is later sold, the surviving owner's family gets a huge windfall in which the first deceased's family doesn't participate.

Estate planners and insurance professionals alike often attempt to solve the problem with individual life insurance policies on all the business owners. Apart from being expensive, that can work if none of life's variables occur. But what happens if one of the owners is uninsurable for whatever reason? Even many insurance professionals would say there's nothing that can be done. This is not true. Second-to-die insurance solves the problem of uninsurability and fulfills the objectives stated earlier.

Mechanics of the Transaction

There are two housekeeping objectives associated with employing a second to die policy. First, keep the insurance proceeds out of the taxable estate of the second insured to die. Second, avoid the three-year contemplation of death rule. We can accomplish both objectives by creating an irrevocable life insurance trust that we establish *before* signing any life insurance applications or submitting to any medical examinations.

Alternatively, contemplation of death issues can also be resolved by doubling the insurance benefits during the first three years in order to pay the estate tax if the policy unfortunately remains in the estate. There's only a minimal charge for this. Doing so allows the insurance company to begin medical underwriting immediately and communicating with the client's medical team in advance of the trust agreement being executed. However, ideally, the insurance policy remains outside the estate to avoid confiscatory taxation.

Use of a substitute application allows the underwriting process to formally begin. However, the insurance is not included in the estate because the owner in the substitute application is the insurance trust. Both approaches accomplish the same thing—keeping the insurance policy out of the estate.

Some practitioners want to determine the insurance cost to see if a second-to-die insurance strategy even makes sense before creating an insurance trust. There's a way to accomplish this: Provide the insured's full medical records to the insurance agent. Then ask the insurance underwriter for an informal opinion

Life Insurance Premiums As a Percentage of Total Benefits*

Insured age	Single life Premium as % of benefits	Survivor life Premium as % of benefits
50	1.0%	0.72%
60	1.8%	1.25%
70	3.0%	2.1%

On policies with multi-million dollar benefits, the differences are significant.

* Percentages assume preferred, non-smoking rates.

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on the individual's insurability. Use this information to determine the terms of the policy—premiums and benefits. If the cost and benefit fail to accomplish the estate plan's goals, then there is no reason to establish the insurance trust in the first place.

The Payout Process of Second-to-Die Insurance

The irrevocable life insurance trust purchases the insurance policy, naming itself as owner, applicant and beneficiary. When the second insured dies, the second-to-die policy pays the insurance death benefit, passing the proceeds directly to the insurance trust. These funds provide the liquidity to pay taxes owed.

Additionally, a business owner previously denied life insurance coverage, may be approved for a second-to-die policy with someone—most likely a family member—with whom there is an insurable interest. After all, two lives are insured instead of one, with the benefit not paid until death of the second insured.

Practical Application: Simple Case with One Owner

Suppose that Leon is the sole owner of a retail store chain that grosses $25 million annually. Leon is just 52 years old, but was denied a regular life insurance policy because of poor health. What can he do so his estate avoids paying a substantial portion of the corpus in taxes? Also, how can he see that his heirs aren't forced to sell a part of the company at a potentially disadvantageous time? The answer is to insure someone else who can stand in Leon's uninsurable shoes. This person must be someone in whom Leon has an insurable interest.

The answer comes in the form of assistance from Leon's 78-year-old father who is in excellent health and *is* insurable. The two apply for a second-to-die policy covering both Leon and his father. Since the insurance company is able to spread its risk over two lives, the application is accepted. The death benefits are approximately equal to the estimated estate taxes due on inheritance of the business when Leon dies. What happens next?

Scenario 1: Leon Dies First. If Leon were to die first, there is no insurance benefit paid yet since the policy is for the second-to-die of the two insured parties—Leon's father, since Leon himself predeceased Dad. In the interim, Leon's estate owes tax on the transfer of the company to Leon's heirs. One option is to take out a loan, pay the tax owed and then repay the loan with insurance proceeds on the Father's death. Often, such loans are interest only and use the business assets themselves as security.

Alternatively and in conjunction, Leon's estate may employ Code Sec. 6166, *Deferral Options,* to treat a portion of the tax liability. This section is intended for use by closely held businesses provided:

- the business interest accounts for at least 35 percent of the adjusted gross estate; and
- the decedent was either a sole proprietor or the enterprise had less than 45 partners or stockholders.

If Leon's company meets these standards, then up to a maximum of $552,000 in estate taxes attributable to transfer of the business interest may be deferred up to four years, paying interest only at the rate of two percent. After that, for a maximum of 10 years, the estate can pay annual installments of interest and principal.

On death of the father, the tax-free proceeds from the second-to-die policy may be used to pay off the loans (the $552,000 owed the IRS and the loan taken to pay any additional tax owed over this amount). The estate is made whole without invading its corpus or having to sell a part of the company at a possibly inopportune time.

Scenario 2: Leon Outlives His Father. Say that Leon's father is the first to go. As before, there is no insurance benefit paid since the policy is for the second-to-die of the two insured parties—that would be Leon in this scenario. Neither, however, is any estate tax due since there is no transfer of assets. Leon was, and still is, sole owner of his retail store chain. When Leon does succumb, the second-to-die insurance benefits paid on his death are used to pay the estate taxes when ownership of the company transfers. No loan is required as was the case in Scenario 1 above. Neither is the estate's corpus invaded or is a part of the company sold just to pay estate taxes.

Practical Application: More Complicated Case with Two Owners

John and Robert McCoy, whom we discussed earlier, have positioned their McCoy Aerospace to enter a period of explosive growth. Assume both brothers are just 56 years old and in excellent health. The two purchased single life policies on each of them with a $5 million death benefit and a second-to-die policy on them both with a benefit of $35 million—an amount they estimate the company will be worth at the end of McCoy Aerospace's anticipated growth period.

The purpose of the single life policies is to allow one brother to buy out the other's interest in

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the company on his demise. The second-to-die policy provides an instrument to equalize the cash flow to both estates and the two brother's families after final sale of the company. Here's how it works:

1. Assume that John McCoy dies just as the period of rapid growth begins. At that time, the company is still worth just $10 million.
2. By prior agreement Robert McCoy buys out his brother John's estate's interest in the company for the amount of the single life insurance proceeds, $5 million. At this point, John's heirs feel they have received their fair share of McCoy Aerospace present value.
3. Robert McCoy now works the (former) two partners' growth plan and, as expected, the company prospers quickly.
4. Within two years, Robert dies, leaving a company whose value is now $45 million. The trustee of Robert's estate sells the company for that amount. John's heirs now believe that their deceased father did indeed contribute to the company's increased value before he died and that they should receive their fair share of this windfall. Harsh family discord follows—to put it mildly. The disharmony is proportional to the $40 million difference in the value either side has received so far. John's side feels they were robbed of something that was rightfully theirs since their father was co-architect of the growth plan and Uncle Robert was merely the caretaker who happened to be around while it happened. Robert's side believes their dad was really the brains behind the company who worked the growth plan, turning mere thoughts and ideas into economic reality. This family enmity is clearly not what both brothers planned when they undertook their insurance policy strategy. Here is one solution.

5. The remaining two insurance polices pay off: The single life policy on Robert McCoy pays deceased brother John's estate $5 million and the second-to-die policy pays $35 million to John's estate.

6. Before their deaths, John and Robert instructed their respective estate trustees to distribute whatever monies were necessary to maintain fairness and harmony between both families. However, John's heirs have now received a total of $45 million ($5 million from buy-out by Robert on John's death plus $5 million single life benefit from Robert's death and the $35 million benefit from the second-to-die policy). Robert's estate receives all of the $45 million proceeds from sale of McCoy Aerospace. Family proceeds are now balanced as the two brothers had planned before

Table 1 – Summary of Funds Distribution: Rising Fortunes

	John	Robert	Total
Ownership of McCoy Aerospace	$5MM	$5MM	$10MM
Single life payout to Robert on John's death. Used to buy John's interest in the company.	$5MM	$0	$5MM
Ownership of McCoy Aerospace	$0	$10MM	$10MM
Robert dies: Single life distribution	$5	0	$5MM
Second-to-die distribution	$35MM	$0	$35MM
Trustee sells McCoy Aerospace	$0	$45MM	($45MM)
Total funds received	$45MM	$45MM	$0

Table 2 – Summary of Funds Distribution: Declining Fortunes

	John	Robert	Total
Ownership of McCoy Aerospace	$5MM	$5MM	$10MM
Single life payout on John's death to Robert, used to buy out John's estate's interest in the company.	$5MM	$0	$5MM
Ownership of McCoy Aerospace	$0	$10MM	$10MM
Robert dies: Single life distribution	$5MM	$0MM	$5MM
Second-to-die distribution	$35MM	$0	$35MM
Trustee sells McCoy Aerospace	$0	$4MM	($4MM)
Trustees balance distribution to both estates	($20.5MM)	$20.5MM	($41MM)
Total funds received	$24.5MM	$24.5MM	$0

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either died. The second-to-die insurance strategy worked at restoring family harmony.

Certainly, the trustees of both estates could have adjusted the monies paid to both estates since the company did indeed prosper during Robert's tenure. The point is, because the second-to-die insurance worked, the trustees had the funds to distribute equitably between the families to maintain harmony and fairness of distribution in accordance with both brothers' wishes.

What If the Company Declines?

Just as company fortunes may improve after the death of one owner, they may also decline. For such companies, buy-out of the interest owned by the deceased owner's estate is worth more than the surviving partner's at a later time. What is the fair solution to this scenario?

Following the same fact set as used above for McCoy Aerospace, Robert McCoy uses the $5 million single-life policy to buy out his brother John's interest in the company on his death. At that point the company is worth $10 million. However, if their plans to position the company for explosive growth don't work out, it seems that *John's* estate enjoys the windfall by receiving the $5 million buy-out for a company whose value has dropped from $10 million to $4 million in just two years. When Robert dies and the estate's trustee sells the company for that amount, Robert's family comes up way short. Certainly, this does nothing to ease tensions between the two brothers' families. Of course, John's side may claim that Robert was incompetent. Therefore, his heirs don't deserve an equal share of what the company was once worth with benefit of John's watchful guidance.

However, if both partners—while living—intended to give their respective families an equal share after their deaths and to eliminate family discord due to unequal distribution, then second-to-die insurance could also save the day if the company's fortunes decline. The estate planning attorneys must take great care in drafting the trust to provide the trustees with sufficient discretion to achieve the owners' goals on their demise. Here is how it is done:

1. Robert bought out John's interest at John's death two years ago using proceeds from John's single life insurance policy for $5 million. During those two years, the company's value has fallen to only $4 million.
2. Robert dies. The two remaining insurance polices pay off: The single life policy on Robert pays John's estate $5 million and the second-to-die policy pays $35 million to John's estate. At this point, John's estate has $45 million: $5 million from buy-out of John's interest in the company, $5 million from Robert's single life insurance benefits and $35 million from the second-to-die policy paid on Robert's demise. Robert's estate, of course, has 100-percent ownership of McCoy Aerospace, now worth about $4 million. This one-sided distribution of wealth is clearly not what both partners intended. Family discord ramps up to a level never before seen. John's family feels they deserve the $45 million since Robert obviously ran the company into the ground.
3. However, the trustees of both estates were instructed before either brother's death to distribute whatever monies are necessary to maintain fairness and harmony between both families. This instruction gives the trustee of John's estate the authority and obligation to balance the distribution. There is about $49 million in play ($45 million from the insurance proceeds and Robert's buy-out of John's interest plus $4 million from the company's sale). The two estates' trustees may elect to simply split the available funds, giving $24.5 million to each estate. Alternatively, they may negotiate some other mutually agreeable settlement.

Of course, with this much money at stake, no matter what both trustees agree to, someone will complain. John's trustee could have discounted or eliminated entirely the monies paid to Robert's estate since the company did indeed remain stable during John's tenure. The point is, again the second-to-die insurance provided the funds to distribute equitably between the families to maintain harmony and fairness of distribution.

Certainly, both families would have been better off had the company prospered according to plan. However, it's difficult to feel too sorry for a family receiving over $24 million.

Selling the Concept to the Insurance Company

Most insurance companies are used to viewing second-to-die insurance as used between two spouses. The intent is that any estate taxes payable by the next

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generation come out of insurance proceeds rather than the estate's corpus. The departure from this custom comes when using second-to-die insurance to balance distributions between company owners, as with the McCoy brothers, or to provide insurance benefits for someone who is uninsurable. Often, applications for second-to-die policies have different results than applications for single life policies.

The explanation of the intent to the insurance company turns on insurable interest. The insurance agent must persuade the insurance company the beneficiary has a greater interest in the insured being alive than deceased. For family members, this presumption is usually automatic and presents no real issue. As in the case of the McCoys, there is also an underlying business reason for using second-to-die insurance for both owners. Once the underwriters understand the two insureds are business partners as well as brothers and the insurance is for estate balancing purposes, any questions are usually resolved. Though use of second-to-die insurance for the purposes described here is out of the norm, once explained, the insurance companies usually understand the role of the policy in accomplishing the owner's goals.

Indications That Second-to-Die Coverage Is Applicable

Situations and facts vary widely when strategizing the components that go into thoughtful estate plans. It's like putting the pieces of a jigsaw puzzle together. Each has its place in the whole, but each must fit with the others. Here are the indicators we think flag how second-to-die insurance could be applicable to particular situations:

Business Ownership Structure

The most common business applications for second-to-die insurance are with family-owned companies where the owners are somehow related. Ownership could be among siblings, parents and children, uncles and other second-tier relatives. Family ownership puts to rest any issues of insurable interest. It further provides trustees with the funds necessary to settle family acrimony caused by an unbalanced distribution of funds.

However, ownership doesn't necessarily have to be limited to just two owners. Though more complicated, the strategy of having multiple insureds for estate balancing purposes where a company is concerned may be appropriate in certain instances. The driving criteria are:

- What is the owners' intent for distribution of the company's value on their demise?
- How should the estates deal with uncertainties such as when the partners will die, who will die first and what is the company value at that time?
- The risk of illiquidity and forcing a disadvantageous asset sale to raise money for expenses

A more sophisticated insurance strategy could work between unrelated owners, so long as an insurable interest is established that makes either insured worth more to the other alive than dead.

Owner's Insurability

If there is one unhealthy owner of the business, a second-to-die insurance policy can often fill the breach that a single life policy cannot. Here, the purpose of the second-to-die policy is to lay off the risk of insurance on someone else.

Estate and Company Size

The minimum estate value must be at least $2 million to make tax liability a consideration. Estates with values lower than that generally don't pay federal estate taxes. Companies that are (or will be) part of the estate can be any size. However, if the company is illiquid (as most are) or if its assets consist largely of real property whose forced sale could be economically disastrous, then second-to-die insurance may provide a solution regardless of size.

Another point related to size is the company's growth potential. This injects one of life's uncertainties into the equation. Companies expected to have a change in their fortunes—either for the good or not—may require a balancing of the overall value on demise of the partners. Second-to-die insurance gives the estate trustees the resources to balance distribution according to the partners' wishes.

Multiple Marriages

When dealing with multiple marriages, ex-spouses and step-children avoid at all costs:

- children needing to ask a step-parent for money; and
- a step-parent having to ask children for money.

Children often assist their natural parents and *vice versa*. However, having to help parents and children from other marriages often creates conflict and anxiety.

Second-to-die insurance prevents this by providing a death benefit after the children's parents die.

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However, second-to-die insurance is usually used to benefit natural children rather than step children. This is particularly important if there is a large age difference between husband and second wife. Always consider life expectancy and the timing of when the insurance proceeds will be needed.

Analyzing Proposed Policies

After including a second-to-die insurance strategy into the estate plan, how can we make sure the policy does what it's supposed to? Many trust that to the insurance agent; however, there are some simple things non–insurance professionals can do to determine if a proposed second-to-die policy accomplishes what the estate plan intends.

Understand the Illustrations

Look at the illustration for the proposed second-to-die policy. Illustrations work with three variables: (1) the premium, (2) cash surrender value, and (3) death benefits. They compute one variable based on assumptions for the other two. The result is usually both a guaranteed and a nonguaranteed rate. The guaranteed rate is the worst case scenario with the lowest interest rates and credits to the policy and the highest mortality payout expenses. This is the performance the carrier has promised. From this, you can readily see the premiums, cash surrender value and death benefits of the policy. Ask, even under the worst case scenario, does this policy provide the funds to accomplish our intent?

Next, review the assumptions the carrier used to compute the illustration. These should match the age, sex and underwriting health status of the prospective insureds. If they don't, there is an error somewhere and the illustration is invalid for your purposes.

Evaluate the Insurance Carrier

Few trusted advisors would recommend an insurance carrier with questionable financial stability. Depending on how often you need it, the Vital Signs report (*www.lifelinkpro.com,* by fee subscription) provides ratings of all insurance carriers by the major rating services (A.M. Best, Standard & Poor's, Moody's, Fitch and Weiss). Determine if a carrier is losing money in either operating results or its investment portfolio (or both areas). Such losses are a possible warning sign of problems in future policy performance. Since the objective of the second-to-die strategy is to insure two lives, the insurance carrier must be stable for a longer time horizon.

Some illustrations provide two nonguaranteed columns in their illustration instead of just one. This usually pegs interest credits halfway between the guaranteed and the current/nonguaranteed assumptions. This second nonguaranteed projection doesn't identify the most likely case. It's just a halfway point in the interest rate projections, nothing more. The mortality charge assumptions do not usually change for either of these nonguaranteed illustrations.

Capability of the Insurance Professional

Competence of the insurance representative providing expert advice is critical when considering a second-to-die strategy. Be sure the representative has these minimum qualifications:

1. Their background and experience specifically includes second-to-die insurance used in various estate planning strategies.
2. They use a specific set of qualifications for the insurance carriers they employ for second-to-die applications. Identify these qualifications and be sure you agree that they do indeed filter out those carriers not as financially stable as required rather than simply pay the highest commission rates.
3. If medical issues are a factor, be sure they understand how to deal with them and what they will mean to the insurance strategy under consideration.
4. The insurance professional should be respected by and be able to work with any other advisors you bring into the mix on behalf of your client.

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Request an Inforce Reprojection

Once the second-to-die policy is purchased and in place, the job is not finished. As time goes on, it's always a good idea to ask the insurer for an *inforce reprojection*. This shows any changes in credits or charges the carrier has declared for the next policy year. Carriers don't normally issue inforce reprojections unless requested. Watch for:

- unanticipated premium increases;
- changes to interest rate credits; and
- changes in mortality and other expenses.

Changes in any of these will alter the benefits and premiums (if the benefits are to be constant). Such deviations will affect how well the second-to-die insurance strategy continues doing its job.

Vanishing Premiums

Some clients balk at paying premiums. The insurance industry counters with illustrations showing "vanishing" premiums. This doesn't mean the second-to-die policy is paid. It simply means the policy cash value and earnings cover the premium so it *appears* to vanish in later years. However, during periods of declining investment portfolio performance and of rising mortality expense, premiums that once vanished have a nasty habit of returning. Be aware of this and communicate the potential of having to write a check to pay the premiums to the client.

Understanding the Words

All insurance policy illustrations come with a narrative summary. Go through it completely. Be sure to check for any missing pages. The narrative summary includes these sections:

- **Policy description, terms and features.** This section provides an overview of the policy's main elements. Read it to be certain the premiums and benefits are what you thought.
- **Underwriting discussion.** This section contains the policy's benefits, premiums and tax information. Again, the premiums and benefits must match the prior section and your original understanding.
- **Column definitions and key terms.** Ensure the definitions match your own understanding. If they don't, then ask the agent. Don't table the discussion until you are satisfied the definitions and terms match the second-to-die policy intent.
- **Signatures page.** This page includes a numeric summary of the illustration in five- and 10-year increments. The policy applicant signs a statement affirming their understanding the nonguaranteed elements are subject to change. The insurance agent also signs, saying he or she has explained that the nonguaranteed elements are subject to change.

Conclusions

Second-to-die insurance is one of the creative products that the estate planning industry can use to achieve clients' financial goals. Future creative uses of insurance to accomplish very specific financial goals where one or more unknowns may affect the outcome will likely separate the industry leaders from the rest.

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