Sentinel Trust Company

On Watch

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Does a Wealthy Family Need Life Insurance?

In This Issue:

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Every weekend, I hear radio infomercials about life insurance products (and their cousin, annuities), although those words are not always used. At least once a month, a client will ask whether she needs insurance or a broker will pitch me on a product, seeking access to my clients. It always sounds so compelling, but does a very wealthy family need life insurance?

Traditional Reasons

Historically, there are two reasons to consider insurance. The first is to build wealth, primarily to take care of your loved ones if you happen to get run over by a bus before you have time to accomplish that feat by other means (like working and saving). Since very wealthy families already have enough wealth for those purposes, this reason doesn't apply, although some will buy a little insurance anyway because it makes them feel safer (e.g., in case the rest of their wealth somehow disappears).

Story continued inside.

Life Insurance story continued.

The second traditional reason is to provide liquidity so that your family is not forced to sell the family business or other illiquid asset. We are told that Uncle Sam wants his share a mere nine months after death, so the business will have to be sold at a sacrificial price. But, that's not really true. While liquidity can be a legitimate reason to buy insurance, considering liquidity in a broader context might ease the fear:

> There is little reason to believe that your family will have to panic and sell your business or other illiquid assets shortly after you die. There are two provisions in the tax law to defer the payment of the estate taxes – one that is specific to closely held businesses and can permit a payout over as long as 15 years and a second that merely requires a showing of reasonable cause (e.g., the estate is illiquid) that can defer payout for up to 10 years.

> Your business and/or other assets may be able to generate the cash flow after you die to pay the taxes over this longer time period.

> Perhaps the focus should be on lifetime wealth transfer planning which can substantially reduce estate taxes as a percentage of overall family wealth, potentially decreasing or eliminating the liquidity need.

> Will your family still own the policy when you die? (see below)

A practical question: Are you willing and can you actually buy enough insurance to solve the liquidity problem? I've seen businesses and other assets appreciate substantially over the owner's lifetime, dwarfing the amount of insurance that was purchased to pay the taxes on them.

Estate Planning Benefits

A frequent rationale for a wealthy family to buy insurance is that younger generations will be better off financially. It is illustrated with a projection that shows how much more the kids will have after estate taxes with insurance versus without. Unfortunately, more often than not, the illustration compares apples to oranges. The life insurance side of the comparison looks better after estate taxes because it incorporates estate planning, while the do-nothing side does not. But, the estate planning benefit is not dependent upon buying insurance. The appropriate comparison is:

> Cash gifts to a trust, with the trust investing in life insurance, versus

> Cash gifts to a trust, with the trust investing in something else.

Either way, you get the same estate planning benefit - avoiding estate tax on the gifts and the growth in value of the policy or the trust's other investments. Now we can focus on the real question, "Is life insurance the best investment?"

Insurance Investment Characteristics

Well, if you die in the near term, the answer is clear – buy as much insurance as you possibly can! There is no better investment available. You might beat the system by dying sooner than the actuaries predict but, conversely, some speculate that very wealthy people live longer because of access to the best medical care, diet, etc., making insurance a potentially poor investment.

Let's assume you are going to live to your actuarial life expectancy. Then, the analysis becomes a simple comparison between the investment return on a policy compared to other investment opportunities.

If it is to survive, an insurance company must take the money it receives in premiums, invest it, and then pay agent commissions, costs of doing business and death benefits. Plus, it must make a profit. There are three basic ways that the insurance company can make the policy a good investment for you:

1. Invest your money incredibly successfully, providing a great investment return for you. They might even give you some discretion in how the funds are invested, give you a guaranteed minimum return (in return for keeping some of the upside for themselves), and some other bells and whistles. But, in reality, they typically invest rather conservatively. They do not print money and do not have magical investment abilities.
2. Charge too little – The insurance marketplace is competitive, but if the company is really undercharging for its products, you should run from the company because it may die before you do.
3. A significant number of people cancel their policies before they die – The companies don't talk about this, but they can charge you a smaller premium (or boost your policy's investment return) because they make lots of money by selling policies which expire or are cancelled before they have to pay the benefits.

There are extremely important implications in that last point. Will you keep your policy until you die? Why do so many people cancel their policies? The most common answers are that insurance premiums get too expensive when you get older (especially true for term policies) and whole life products may "blow up" (e.g., due to your longevity or poor investment performance within the policy).

That brings us to the income tax benefits. Insurance proceeds are income tax free. To make your comparison accurate, adjust the other investments' return to reflect that they will be subject to income and/or capital gains tax. For example, if the insurance company projects a 4% return if you hold the policy to life expectancy, you will need to generate a pretax return between 5% and 6.67% (assuming tax rates of 20% and 40% for capital gains and ordinary income, respectively) for your investment fund alternative to equal the insurance proceeds at your death. If the alternative investment is family business stock that will "never" be sold, the potential income tax benefits of the insurance policy become immaterial.

Practical Considerations

Here is a list of things to consider:

- Carefully consider your reasons for buying insurance. Will those reasons change or go away over time? Consider alternative ways to address those needs.
- Treat insurance as an investment and analyze it and the issuer accordingly.
- Determine the duration over which you will need insurance. If the need is relatively short term (e.g., for 10 years to give you time to deal with estate tax issues through other planning), consider term insurance rather than some form of permanent insurance.
- Require your agent to run numerous "policy illustrations" to show what happens to the policy over time with varying investment and other assumptions. Project the policy's performance to at least age 95.
- Carefully address the gift and generation skipping tax considerations involved in premium payments. Tie this analysis to the policy illustrations to determine whether you can tolerate these tax costs if you have to make bigger gifts to the insurance trust to offset poor investment performance.
- Avoid apples-to-oranges comparisons of estate tax savings by using a life insurance trust versus doing no estate planning. Compare investing the premium dollars in other ways within an estate-tax-sheltered trust.

Insurance can play an important financial and psychological role in your overall planning, but don't be rushed into a major purchase without carefully and objectively considering the overall picture and the specifics of the proposed policy.

Family Offices:

A FAMILY OFFICE IS ONE OR MORE EMPLOYEES WHO ARE DEVOTED TO SERVING THE INVESTMENT, ADMINISTRATIVE, AND/OR PERSONAL NEEDS OF A WEALTHY FAMILY.

We often are asked questions about family offices, perhaps because of Sentinel's history as the successor to two single family offices and because we currently serve several dozen families, most of whom have a family office with whom we work closely. Examples include:

- Do I need a family office?
- Whom should I get to run my family office?
- What are the significant advantages and weaknesses to having a family office?
- Is my family office typical?

Only the last question is easy to answer: there are no "typical" family offices.

Family offices range in size from a part-time bookkeeper who helps pay bills to a multi-disciplinary staff of dozens who coordinate investments, accounting, tax preparation, domestic staff, travel and more. A family office may be run in conjunction with a family's operating business, or it can be a stand-alone group.

D. FORT FLOWERS, JR., CFA
Chief Executive Officer

Advantages & Weaknesses

How a family office evolves depends on the history of the family and its businesses; the family's needs; and the experience and expertise of the office's leader. The head of a family office often is a current or former senior officer of the family's operating business or a former partner of a legal or accounting firm who has had a long relationship with the family.

Advantages

Family offices offer a number of advantages to their client families beyond just coordinating their financial lives.

- A family office can provide increased **privacy and confidentiality** of financial dealings, which can help protect family members from unwanted attention.
- The family office can act as a **gatekeeper** that protects family members from unwanted solicitations.
- Services delivered by a family office can be coordinated and **customized** to the individual family members being served.

Weaknesses

Family offices frequently have **limited internal financial and accounting controls** over cash, securities and valuables. Because of the small number of employees, the basics of segregation of duties and dual controls frequently are ignored, often with the excuse that long-time employees are totally trustworthy. Unfortunately, families may find this trust to be misplaced.

Family offices can have difficulties in recruiting and retaining professionals due to lack of career path and possible lack of intellectual challenge. It is extremely hard to build the **breadth of expertise** required to serve all of a family's needs. Families tend to solve this problem by choosing to provide some services in-house (especially in the areas of expertise of the family office head), while outsourcing other tasks to other organizations.

Similarly, it is also difficult to **build depth** behind senior positions, which is required for smooth transitions and succession. Most families find themselves conducting a search and bringing in someone from the outside each time they have a vacancy in a senior position.

Gatekeeper Disadvantage

The gatekeeper advantage mentioned above can be a two-edged sword when the family office acts as an intermediary with outside advisors. Although it typically doesn't happen with family doctors, consider the possible consequences. You are sick (or maybe you don't even know that you are sick, but it's time for your annual physical). Your doctor obviously needs to examine you to obtain both subjective and objective information. A medical procedure also might be necessary. But all of this must be done through your family office. You never see the doctor directly, so he doesn't have the opportunity to identify issues that you don't even know about. Presumably, you would never do this and might dismiss the example as silly. Yet, the filtering effect of a family office on estate planning, investment and other professional matters can deprive both you and the outside professionals of important information needed to identify issues and make the best decisions.

A family office may develop over time as a way for the family to save money. For example, hiring an employee to do your family's taxes might be cheaper than paying an accounting firm to do them. While this may be true, the family office actually may turn out to be more expensive when you consider office space, employee benefits, secretarial support and the like. You might also incur costs or lose opportunities when you rely on a single individual compared to the broader and deeper expertise available from the accounting firm.

How can you craft the best family office?

Use business-like discipline to carefully define the family's needs and consider the advantages and disadvantages of the many alternatives to serve those needs. It may help to seek input from others who have had the experience of creating and serving family offices.

Concierge Medicine

Concierge medicine, a growing trend in the healthcare landscape, arose in response to frustration with the existing system. It is a phenomenon that conjures up images of "old school" medical care: doctors with fewer patients (perhaps 1/4 to 1/3 the typical patient load), taking the time to build personal relationships, making house calls and, in many cases, earning a better living without dealing with insurance and Medicare.

The definition is vague because delivery models vary, from solo or small groups of doctors locally to global networks. Consequently, annual membership fees can range from below $2,500 to $75,000. In exchange, clients get near-immediate appointments, easier and more frequent communication, comprehensive annual physical and wellness plans, and a family physician who really knows the whole family. Visits start on time and last as long as necessary for the doctor to feel comfortable with the service provided. The starting point for all patients is a complete review of all existing health records with an emphasis on finding gaps in care, which leads to the creation of custom treatment plans that are monitored and tweaked over time.

For patients who spend significant amounts of time abroad, international, round-the-clock programs take concierge medicine to a whole new level. These programs offer their members priority access to English-speaking doctors and top specialists worldwide, as well as medically necessitated evacuation out of country to treatment facilities by private transportation.

> Your family may find the cost well worth the increased quality and personalization of care and other benefits offered through these relatively new approaches to medicine.

Concierge models are not a replacement for insurance. Generally membership fees only cover improved access to primary care services. Tests, lab fees, procedures, specialist consultations, and hospital stays are billed by the providers and can be covered by traditional insurance.

IRS guidance is minimal concerning the deductibility of concierge membership fees or the use of tax incentive plans (e.g., flexible spending accounts and health savings accounts) to pay the costs. Since the fee may include non-medical services, you probably cannot use these accounts and insurance companies may not reimburse it. The concierge organization may be able to provide itemized bills for actual medical services provided, which may receive better tax and/or insurance company treatment. Note that paying the membership fee for family members also might be a taxable gift since it may include nonqualified medical expenses. You can seek input from your tax advisor if tax considerations are a concern.

The more global and comprehensive models of concierge medicine are offered through organizations like PinnacleCare, MDVIP and Guardian 24/7, to name a few. Wealthy families may find the cost well worth the increased quality and personalization of care and other benefits offered through these relatively new approaches to medicine.

LISSA GANGJEE, J.D., CFP®
Head of Client Service

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

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