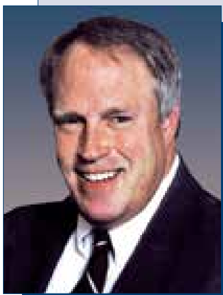

PETER L. McCARTHY

JD, CLU, ChFC, is a senior advanced sales consultant for ING U.S. Insurance Solutions. He has more than 20 years of experience in advanced marketing and practiced law as an estate planning attorney with a large Minneapolis law firm. He earned his JD degree from the University of Miami (FL) School of Law and an MBA from Rollins College.

*McCarthy can be reached by email at **Peter.McCarthy@us.ing.com**.*

Shared Dollar Life Insurance:

How Parents Can Help Their Children Retire

What Will Retirement Look Like for Our Children? If you are like most working people, from time to time you think about retiring. You may wonder what your life will be like and what your standard of living will be. Sometimes you may try to look even further into the future and think about what retirement will look like for your children. Will they be able to retire 20, 30 or 40 years from now? What will their standard of living be?

Retirement planning could be a lot different for our children—possibly a lot harder. The world seems to be changing in profound ways: Competition is increasing. Technology is rapidly transforming many businesses and industries. Good paying jobs are harder to come by and require more skills. The workers and entrepreneurs of the future will need to be intelligent, quick learners who are both skilled and flexible.

A big part of our retirement cash flow will likely come from Social Security and work-based retirement plans (e.g. pension, profit sharing, 401(k), 403(b), HR-10, IRA plans, etc.). Will the same be true for our children when they retire? When we stop to think about their futures, there may be reason to worry. Retiring could be harder for our children for several reasons, including:

- On average they should live longer, so their savings may have to last longer.
- On-going inflation means the cost of living should keep rising.
- Retirement benefits from employers and Social Security payments may be smaller.

To retire comfortably, our children will probably have to be more self-reliant. If they get less from Social Security and company retirement plans, they will need to provide a larger portion of their own retirement income through savings and investing. To have a secure retirement, they will need good financial habits, self-discipline and effective money management skills.

What Big Inheritance?

Because we love and care about them, we want to help. We'd like to leave them a big inheritance to supplement their retirement savings, but we may not be able to. We don't know how much we'll be able to leave them because we don't control some important factors, including:

- How long we live.
- Inflation—how much our cost of living will increase from year to year.
- How well our own qualified and non-qualified investments perform.
- The cost of health care and how much of it we will need.

Life Insurance May Help

Many adult children need life insurance on their own lives. If they are married or have children of their own, they may already own life insurance policies. Often they use term insurance or work-based group term insurance for their life insurance protection because in the short run it is usually less expensive. Cash value life insurance may be less commonly used because it costs more and many adult children need to carefully manage their expenses.

Many adult children who own only term insurance may not be aware of the benefits cash value insurance could provide them in the long term. A well-structured cash value policy may be able to recover some of their premium costs. In addition, policy cash values may be a helpful source of cash during financial emergencies and may also produce supplemental retirement income.

If our children had an additional source of cash to help pay cash value insurance premiums, they could have both death benefit protection for their families and the long term potential for supplemental retirement income.

"A shared dollar life insurance arrangement with cash value insurance on an adult child has several potential advantages..."

Consider a Shared Dollar Life Insurance Arrangement

Most parents want to encourage their children to save for the future. They can give their adult children some strong incentives to do that by helping them develop a retirement game plan. One way to do so is to partner with them in a strategy designed to supplement their retirement savings—shared dollar life insurance.

Many working children participate in their employers' 401(k) retirement plans, which gives them a chance to defer some of their salaries into pre-tax investment accounts with retirement investment options. Many companies match a portion of each employee's salary deferral as an incentive for them to participate in the plan.

Shared dollar life insurance arrangements help parents do something similar. These are arrangements in which parents and their adult children work together to pay for cash value life insurance designed to develop significant cash values over time. The children will usually be the insureds and the policyowners, while the parents will provide some of the premium dollars.

It's easy for adult children to take parental gifts for granted. That's why shared dollar arrangements are structured so the child pays part of the cost and the parents provide the remaining premiums through a "family match." Paying part of the policy premiums can increase both the child's retirement readiness and appreciation for the potential advantages the parents are providing.

Some possible alternatives for the parents' "family match" include:

- Match premium costs 50/50 each year.
- Parents provide funds to pay the premiums for a specified number of years (e.g., 5 to 10 years) and the children pay the premiums thereafter.
- Parents pay a declining percentage of the premiums over time (e.g., 75 percent for years 1 through 3, 50 percent for years 4 through 6, 25 percent for years 7 through 10, and zero thereafter).
- Parents pay the "term insurance" portion and the children pay the balance.

A Two Policy "Combo"

Shared dollar arrangements should be structured to help adult children meet both death benefit protection and cash value accumulation needs. Because death benefit protection needs sometimes decrease with age, in some cases it can be more efficient to use two policies: term insurance for short term death protection needs (those not expected to last more than 20 to 25 years) and cash value insurance for long term death benefit needs and supplemental retirement income. The term insurance policy will end when its death benefits are no longer needed, and the cash value policy will continue.

A "combination approach" using both term and cash value policies sometimes produces a better long term result and can be an effective way to maximize use of premium dollars.

An Alternative: Insuring the Parent

Insurance on adult children isn't the only option. In some cases insuring either or both parents may be a better alternative, especially when a child is uninsurable or the premium cost is high. Death benefits payable at the insured parent's death could provide a substantial retirement income supplement. In this approach either the parent or adult child could own the policy and the premium costs would be shared.

Keep in mind that there may be some drawbacks to insuring a parent rather than an adult child. The amount of insurance protection on a parent may not be enough to adequately protect an adult child's spouse or dependents. Also, when a parent is the insured, the child must wait until the insured parent dies to receive any benefit. Cash values in a policy insuring a parent may not grow to a high enough level to make much of a difference in the child's retirement. When an insured parent lives past normal life expectancy, the children could be retired for many years before death benefits would be paid. Cash values in policies insuring the children are likely to grow more quickly because the child's mortality costs are likely to be lower.

Potential Advantages of Shared Dollar

A shared dollar life insurance arrangement with cash value insurance on an adult child has several potential advantages, including:

• The existence of policy cash values increases the chances the child's life insurance protection will stay in force to protect his/her spouse and family.

• The child may use policy values for both unexpected pre-retirement financial emergencies and supplemental retirement income.

• When parents pay part of the premiums, the child's potential internal rate of return on his portion of the premiums will be higher.

• By paying part of the cost, the children should have a greater appreciation for the benefits that the parents are providing.

Potential Disadvantages

There are also several potential disadvantages, including:

• The life insurance policy may not perform as anticipated or as illustrated.

• The parents may not be able to contribute to the premiums as long as expected.

• The adult child may not be able to contribute his share of the premiums if he becomes unemployed or suffers financial reverses. There needs to be an understanding of what will happen in those situations.

• Cash value distributions may decrease death benefits payable at the child's death.

• If premiums aren't paid in any year, cash values for supplemental retirement and/or policy death benefits would be reduced, or the policy could lapse.

Alternatives to Gifts: Loans or Split Dollar

The shared dollar strategy may be appealing to many parents. Many will like the idea of giving their children a direct incentive to save more for retirement. They should also like the fact that they won't have to pay all policy premiums themselves. Their children can elect to participate at a level that works for them.

Still, some parents may not be comfortable making gifts. They may be worried that someday they may need to use the funds themselves. They may not want to take the chance that they won't have access to their contributions if their circumstances change.

Fortunately, there are premium payment alternatives for parents who want to retain access to their money. Instead of using gifts, parents can pay their share of the premiums through intra-family loans or through a split dollar arrangement. Loans are usually a more flexible option because they can be structured in several different ways and can be more easily customized to fit the family's situation.

Split dollar arrangements are usually more expensive and less flexible. They are legal documents which should be drafted by an attorney. Parents have the most security and control in an endorsement split dollar arrangement in which they own the policy and the death benefit is split.

The parents' estate receives death benefits equal to the greater of the policy cash values or the premiums the parents paid and the child receives the remaining death benefits. If the child is to own the policy, the collateral assignment method can be used, but then another document—a collateral assignment—must be prepared and filed with the insurer to protect the parents' rights.

Two other disadvantages to using split dollar are: (1) The parent is deemed to make an annual gift equal to the economic benefit value of the life insurance protection. (2) The parent owns or controls all the policy's cash values; consequently those cash values aren't available to the insured child for use as supplemental retirement income.

At some point parents may review their financial situation and decide they have enough assets and will no longer need to be able to use the policy cash values. If this happens, they can elect to transfer their interest in the policy to the child by forgiving repayment of the loan or terminating the split dollar arrangement. These will be treated as gifts to the child.

Flexible Premium Payment Options

Each year a new policy premium is due, the parents have the flexibility to choose how much to pay and the form in which they will make the payment. From year to year their contributions can vary in amount and in form. The strategy can be revised to fit their financial circumstances and those of participating children. Each year they do contribute, they can choose whether to make a gift, a loan, or a combination of the two.

Motivating the Children

It's natural to assume that because shared dollar arrangements are designed for the

Decision Checklist for a Shared Dollar Arrangement

Who will be the insured(s)?

What type of life insurance policy(ies) should be used?

How should the strategy be implemented (formal contract, child ownership, parent ownership, ILIT ownership, informal, etc.)?

How large should the policy death benefit be (one policy or term-perm combo)?

How much will the annual premiums be?

How should the premiums be shared (what should the "family match" be)?

From year to year, how should the parents pay their share of the premiums—gifts, loans or combination?

Each year a loan is used, should it be structured as a demand loan or term loan?

When loans are used, what should the interest rate on the loan be?

How should the annual loan interest be handled?

benefit of adult children, they will jump at the opportunity to participate. This may not be the case. In reality, some children may be hesitant to participate. This could be the case for a variety of reasons, including:

- Fear of not having enough discretionary income to pay their share of the premium now or in the future.
- Uncertainty that paying part of the premiums is a good use of their own money.
- Familiarity with other retirement vehicles, but not with life insurance.

Because of concerns like these, it is important that the shared dollar strategy is carefully explained to the children. In particular they need to understand: (1) why the parents want to do this, (2) why they've chosen to use life insurance, (3) the details of the arrangement and (4) how the child, spouse and children stand to benefit. In particular, they need to understand exactly what their risks are and why this strategy is a "good deal" for them. One of the best ways to show how they might benefit is to show them an internal rate of return (IRR) analysis on their share of the premiums.

"Shared dollar arrangements give parents an opportunity to help their adult children without decreasing their own retirement security."

Implementing the Arrangement

Families that are interested in this concept often wonder what they need to do to make it a reality. Shared dollar arrangements can be structured in a variety of ways ranging from formal agreements to informal understandings. They can be customized to fit the goals of those participating. Here are some of the options for putting an arrangement in place:

A Formal Agreement. The parents' attorney draws up a written agreement and it is signed by the parent and the child. The agreement should address all the possible issues, including ownership, premium payments, policy beneficiaries, assignments, cash value access, etc.

Child Ownership. The child could be the policyowner and pay his share of the premiums directly. The parents' share could be provided by gifts or loans to the child; the child's share of the premiums could be added to the parents' contributions and the child could pay the total combined amount to the insurer. If the parent is making loans to the child, the parent could receive a collateral assignment to protect that interest.

Parental Ownership. The parent owns the policy and makes the total premium payment to the insurer. Each child pays his share of the premiums either from personal savings, parental gifts, parental loans or a combination. When a child is the insured, he is the contingent owner of the policy and takes over ownership at the parents' death. This approach allows the parents to control the policy and to be sure the child is paying his share of the premiums.

The Trust Approach. Parent establishes an irrevocable life insurance trust (ILIT) to own and manage the policy. Parent pays part of the premiums as gifts or loans to the trust and the child's portion of the premiums is gifted to the parent who then contributes it to the trust. Having all contributions come to the trust through the parent may prevent the child from being considered a grantor of the trust for income tax purposes. The trustee manages the policy under the terms of the trust and makes distributions as needed to accomplish the trust's objectives. By using an ILIT, the terms of the trust control distributions after the parents' death and protect the death benefits from potential claims from the child's creditors.

A Shared Dollar Arrangement in Action

Suppose Jane and Joe Smith are each 66 years old and want to give their two children, Vince and Violet, some strong incentives to save for retirement. They decide to use shared dollar arrangements.

Vince is married and has two children, while Violet is married with four children. Vince needs $500,000 of death benefit coverage, while Violet needs $800,000 of coverage. Vince will purchase a $300,000 cash value policy and a $200,000, 20-year term policy. Violet will purchase a $300,000 cash value policy and a $500,000, 20-year term policy.

Jane and Joe decide to make a commitment of $5,000 to each of them annually for 10 years. Jane and Joe will review their financial position each year and decide whether to make their $5,000 contributions by gift or by loan. Their annual contributions will go into the cash value insurance policy.

After 10 years have passed, Jane and Joe will decide if they are able to continue making contributions. Vince and Violet each agree to pay the term insurance premiums from their own funds and also to contribute at least $4,000 to their cash value policy. They can contribute more if they wish. If either Vince or Violet is unable to pay their share of the premiums in any year, Jane and Joe have the flexibility to lend that child his share of the premium.

Because of their parents' generosity, Vince and Violet will have adequate life insurance protection for their young families, as well as the potential to build significant cash values for potential supplemental retirement income. Exactly how much supplemental retirement income will be generated depends on how the cash value policies perform over time. Vince and Violet both understand that the annual $5,000 subsidy from their parents effectively gives them a

50 percent "discount" in the cost of their coverage. They also understand they have the option of increasing their premium contribution in future years if their finances permit.

Conclusion

Shared dollar arrangements give parents an opportunity to help their adult children without decreasing their own retirement security. Shared dollar arrangements are a flexible way for parents to work with their children to create a unique retirement income supplement. From year to year parents have the flexibility to change how they structure their share of the funding and they can position their contributions so they can get them back should they be needed.

The "family match" component of a shared dollar arrangement gives children strong incentives to participate and potentially realize a good internal rate of return on the funds they contribute.

Shared dollar arrangements can be useful strategies that allow parents to help their children protect their families and build funds for retirement.

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