Dealin[illegible]RRA's Impac[illegible]urance Professional's Practice

EGTRRA is law (sort of): Now what? The authors explain how life insurance specialists and other estate planning professionals can adapt their practices to take advantage of the opportunities presented by the changes in and challenges of the 2001 Tax Act.

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George Orwell would be proud. Even though the government missed his 1984 date, when the President signed EGTRRA (the "Economic Growth and Tax Relief Reconciliation Act of 2001") into law on 6/7/01, Congress had prospectively created a planned retroactive rewriting of the short-lived future past. What clients must live and die with is "back-ended estate tax reduction" and "wait and see" "maybe-someday" estate tax repeal. The way the sunset provision is drafted, we can't even be absolutely sure we will not have to send back the $300 or $600 rebate checks we get.

But regardless of how absurd, frivolous, or irresponsible it was to enact a law that has a built-in 365-day estate tax repeal[1] and that may or may not return hundreds of sections of law to where they were almost a decade prior to its automatic expiration date (assuring both confusion and uncertainty), it *is* law. Those who advise about life insurance matters need to learn it, and understand its implications and how to deal with it.

What life insurance advisors and agents should be doing

Re-position. A planner's publicly-known specialization and peer-acknowledged strength in a single professional area can command an "expertise premium." But when that strength is concentrated too narrowly in one segment of the tax law, there is an increased downside risk of technical obsolescence. Post-EGTRRA lethargy with regard to estate liquidity planning may trigger a downturn in demand for professional services and products—whether or not that complacency is founded on reality or common sense.

True, the "flying pig of repeal" is, at least at this moment, just that—a hope that should be counted on only by those who are certain they will die in the year 2010. (Although, if you believe in this tax law and its promised repeal, you should also believe that on midnight of 12/31/10, that repeal will go the way of Cinderella's coach and horsemen.) True, the drop in federal estate tax rates is only 1% per year. True, the credit equivalent is increased only slightly between now and 2010. And so *in any case, clients will still need significant amounts of liquidity until 2010.*

But in spite of these truths, it is also true that in the decade ahead, the likelihood is that far fewer individuals will need life insurance to provide liquidity to pay federal estate tax than in the past, and those who do will need more mod-

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est amounts. The "mass affluent" and many of the "core affluent" have already been, or will be, removed from the reach of the federal estate tax. Thus, it makes strategic sense for insurance specialists to begin to re-direct energy in order to expand the extensive knowledge skills necessary to succeed in broader categories of estate and business planning. If you haven't already, now is the time to increase expertise in business, retirement, employee benefits, and financial planning—and think beyond providing insurance merely to meet federal estate tax liquidity needs.

Plan to plan ahead. You may not be able to see all the forces of change. But if you schedule time for an annual or semi-annual strategy meeting, many of the forces of change can be seen years ahead of when they arrive.

Whether they can be seen or not, they will arrive—and they will have an impact on your professional life. Create a game plan to deal with a change in tax law that could severely affect or have an adverse impact on the major area in which you practice. Don't allow yourself to become comfortable with, or dependent on, one set of tax rules—no matter how "solid" or "consumer oriented" they may seem. There are no "bullet-proof" protective Code sections. Demands on the federal fisc and changes in political priorities or parties can result in sudden, unexpected, and mass changes—even where sacred cows are concerned.

Train your mindset to expect change. Tax law is no longer a once-every-15-years or once-every-seven-years phenomenon. And it is no longer the product of years of deliberation. Tax law is now more of an expression of political direction and will. This means it's not only subject to change—substantially—every time the balance of power in Washington changes; it also means tax law *will* change! In a recent taped interview for *Keeping Current*, Lee Slavutin encouraged a strong willingness to embrace change. Develop an "early warning" system that helps you keep your ear to the ground for what's coming.

Remember that there's much, much more. Life insurance planning should *never* be totally dependent on, or driven by, tax planning. Life insurance (and in many cases, permanent coverage) was needed before this new law—and will be necessary after it—for: (1) buy-sell planning; (2) nonqualified deferred compensation; (3) death-benefit-only plans; (4) payment of debts; (5) maintaining the survivors' standard of living; (6) equalizing inheritances; (7) key employee coverage; (8) wealth replacement in a charitable giving context; (9) replacement of income taxes on receipt of IRD (income in respect of a decedent) items such as IRAs, 401(k)s, and pensions; (10) federal estate taxes; (11) state death taxes; (12) reducing or eliminating second marriage conflict by providing separately-owned life insurance for the second spouse and for children of the first marriage; and (13) meeting capital gains and IRD income tax needs. (Ironically, as long as Code Section 101(a) remains in place, income-tax-free life insurance is the only asset that can pay the tax on ultra-large IRD items without itself triggering a tax, because other assets would have to be sold and gain realized to net sufficient cash.) Under EGTRRA, life insurance will become even more popular as a tool to replace the wealth removed from a person's estate by income taxes, particularly income taxes on the largest single asset most clients have—their IRAs (and 401(k)s and pensions).

As noted attorney Jonathan Blattmachr has said, "Life insurance is the *only* asset that is certain to work in a time of great uncertainty!" He's right! Under current law, only life insurance—with certainty—provides income-tax-deferred growth (assuming a non-modified endowment contract), as well as an income-tax-free death benefit (assuming no transfer for value), and can be arranged to be both federal and state death-tax-free. It is the *only* asset that can provide estate liquidity if there is an estate tax, and income tax liquidity if there is a capital gains tax (due to repeal of the step-up in basis and the implementation of carryover basis at death). Consider how many of the "mass affluent" have a large portion of their liquid holdings in tax-favored retirement and 401(k) accounts.

Do a better job interviewing the client.[2] The key to the success of the insurance advisor/agent/MDP practitioner of the future is the same as it *should* have been in the past: a more in-depth knowledge of his or her client's (and the client's family's and favorite charity's) problems, needs, circumstances, objectives, and desires. This requires that we learn and use better interviewing techniques. You need to ask

[1] Author and commentator Lee Shepard recently quoted economist Paul Krugman, writing in The New York Times, who called this new law the "Throw Momma From The Train Act of 2001," hinting there might be a spate of elderly fatal accidents just before the end of 2010. (The New York Times, 5/30/01, p. A23.)

[2] See Leimberg and Gibbons, "Seven Skill Sets Required by the 21st Century Life Insurance Specialist," 27 ETPL 438 (Nov 2000).

more questions and better questions. You need to ask those questions more skillfully.

You need a systematic approach to analyzing and using information, and reassembling it into understandable solutions to problems the client perceives are real and have both importance and urgency. We must sharpen both our questioning and listening skills. We've got to design a more efficient approach that will help us identify needs, establish an order of needs, and give first priority to those things the client feels are most essential.

Build more flexibility into plan design. Emphasize financial and personal objectives other than saving taxes. Tax saving has become a moving target. There's no question in the authors' minds that in the long run—to the extent possible and reasonable—Congress will move to reduce the overall level of tax burden on citizens and businesses. And it will aggressively act to eliminate "bleeding edge" tax-oriented schemes involving hypertechnical interpretations of the tax law.

For planners, the future lies in helping clients achieve financial security and attain personal economic goals, rather than helping them merely save taxes. Cookie-cutter approaches to planning are passé. The word "irrevocable" should be used more carefully and less often—and should be found more frequently in combination with the words, "here are your options" and "escape valves." Practitioners should depend less on preconceived package sales or sales advice, and focus more on in-depth interviews and gaining greater knowledge of the prospective client and client's family and business.

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Review everything. If you haven't checked, how do you know? The new tax law demands that all of your estate planning clients review their situations. In a few cases, premium reduction or policy repositioning may be appropriate. Check to see how soon the client's insurance policies—under current assumptions—can reasonably be expected to become self-sustaining. Should a policy be replaced or converted? To what kind of policy? If term insurance is appropriate for a particular client, what kind of term best meets his or her needs?

Create a 'new and improved' policy suitability guideline. More than ever, planners must "match the product to the problem"—and the needs, circumstances, and objectives of the parties as well as make sure the "forms match the facts."

Market conduct issues associated with appropriateness and flexibility will become a major item in an era of rapidly changing estate and generation-skipping tax law. Set up a checklist and quality control system for determining the suitability of a particular policy (or more properly a portfolio of policies) that best meets a client's (and/or client's business') needs and circumstances. Also create a policy preservation letter that explains the pros and cons of making changes in a volatile tax and economic environment. Monitor more carefully the cost/benefit ratio of various types of policies.

Clients must adjust their ability to handle and live with changing circumstances. This flexibility is now paramount and must be considered in policy selection. Can the client quickly and painlessly increase or decrease premium outlays and death benefits to match changing liquidity and other needs over time? This suggests the need for highly flexible products as well as careful documentation. Insurance advisors must therefore establish and maintain more sophisticated information filing and retrieval systems that can easily and rapidly pinpoint clients whose insurance portfolios may need review.

Communicate more often and more selectively. Make a personal call to your top 20 clients and their other advisors to discuss the implications of the new law. Place a memo about the new law on your website and, by e-mail, invite your clients to learn more. Send letters and prepare a newsletter that describes the new law and its ramifications.

Here's what to advise clients:

Clients who do not need to plan. Tell your wealthy clients that if they can—and are willing to—schedule their deaths in 2010, they need not plan for estate liquidity. Also tell them that if they do manage to die during the 365-day window, their executors may still need large amounts of cash to pay—among other expenses—income tax! The day estate taxes die, carryover basis and its accompanying income tax liquidity needs will be born. And the burden of carryover basis will be shouldered by many more estates than were ever affected by the estate tax. Remind clients who are expecting to die in 2010 that they can't live too long.

Remind current and prospective clients of the law's uncertainty. Seriously, no responsible advisor could tell a client to rely on repeal. It's like playing roulette; unless a wealthy client is certain that he or she will die during one of the 365 days starting on 1/1/10 and ending at midnight on December 31 of that year, the client will continue to have a liquidity problem and will continue to need tax planning as well as all the other aspects of estate planning. It is therefore essential that clients be warned that the availability of any of the future benefits of this law is subject to substantial uncertainty.

There is no guarantee or certainty that estate tax repeal will ever happen. There are many good reasons to expect that repeal will never occur. The odds are high that after 2010, the estate tax will be reinstated (if not "frozen" before then). After all, it is a "vampire tax"; it's been dead and has dug itself up three times already. The tax that might be repealed in 2010 was the fourth re-enactment. At the least, clients should be told, "Hedge your bets." Even the client counting on repeal would be wise to have options in case he or she is wrong. So a "What if you are wrong?" insurance policy may be in order.

Compare risks for the client. The worst risk of purchasing and maintaining a policy for estate liquidity purposes (assuming full and permanent repeal actually occurs) is that the client's family will have more financial security—and more income and wealth—than otherwise.

Remind clients that insurance remains the best game in town. Variable life insurance, for instance, is a Code-sanctioned shelter that mimics a mutual fund.

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Yet, because of Section 101, insurance is the only leveraged asset not affected adversely by a carryover basis regime. The wealthier the client is and the higher his or her bracket, the more appealing the tax-deferred (perhaps forever) build-up of insurance is.

Potential malpractice to recommend replacing permanent with term insurance of less than life expectancy. Certainly, in our opinion, advising a client—based on the 2001 Tax Act—to cancel a policy purchased for estate liquidity or to replace it with a policy that lasts for a period that could be shorter than the client's lifetime could be considered malpractice.

Cancellation of a policy and a repurchase of insurance years later can be both expensive and risky. Someone who cancels insurance, and years later has to replace it, does so at a terrible cost (even if he or she is insurable)—at preferred or standard rates—at that time. At best, rates may be significantly higher because of increased age, and a new incontestable period must be met.

Consider permanent policies into which term can be converted. Prospective clients who are in less than preferred-risk health should—even if purchasing term insurance—think very carefully about the permanent insurance policies into which the term could be converted.

Compare term insurance vs. permanent, assuming a nine- or ten-year holding. Term insurance premiums paid between now and 2010 are a certain non-recoverable total cost, coupled with a lost opportunity to invest the premiums elsewhere. Premiums paid on permanent coverage may be a wiser move if total policy values at that time equal or exceed cumulative outlays—as many will. So even if estate tax repeal does occur, the client will have maximum flexibility through a properly funded and structured permanent policy. The results are as follows:

- If the client concludes that life insurance is the most efficient and cost-effective way to transfer wealth, the mechanism is in place to accomplish that goal no matter when death occurs.
- If it is appropriate, the client can choose to continue funding the policy at the highest levels allowable to accumulate tax-advantaged wealth within the policy.
- If estate tax repeal becomes a reality and remains in the law, and if there is no other reason to continue the coverage, the client could surrender the policy for its cash value. In most cases, if the policy has been held for ten or more years, the client will have achieved a competitive rate of return for the investment risk taken, and at worst the coverage will have cost the *use* of the client's money—rather than the money itself.
- If the client is in poor health, he or she may want to retain the policy (if for no other reason than to enrich his or her family), or sell the policy as part of a lifetime settlement.
- If the client desires continued coverage at the same level, he

or she could elect the "extended term" option of the contract's non-forfeiture feature.

- If the client desires coverage for life, but wants to pay no further premiums, the policy could be placed on the "reduced-paid up" option.
- Split up the policy into two or more contracts and then select more than one of the above.
- Distribute the policy intact (or split it up and then distribute it) to the beneficiary(ies).

Planners should expect to see insurers respond to this confusing and difficult new law with a variety of strategies to help eliminate client risk and encourage immediate coverage. At least one company now offers a policy that can be surrendered in 2010 without surrender charge—if the estate tax repeal actually occurs. (However, this "no surrender charge" endorsement applies only to full surrenders and only for surrenders in 2010.)

Permanent coverage will often be the most cost-effective way to hedge a client's bets that estate tax repeal will happen someday. And, of course, if the client is wrong and repeal never occurs or is only for one year, the policy can be continued indefinitely.

Typical tax tools and techniques still work but may need to be tweaked. Clients should continue to fully use their annual exclusions, credits, and valuation discounts. They should continue to use tools and techniques such as marital and nonmarital (bypass) trusts (and review the formulas of those trusts already in their wills). Short-term GRATs, QPRTs, SCINs, intentionally defective grantor trusts, and private annuities are all alive and well.

Trust protectors, independent trustees, and the use of special powers should be considered for every new life insurance trust.

It is essential that more flexibility than ever be added to irrevocable life insurance trusts (ILITs). "Either/or," "toggle-switch," and "exploding" life insurance trusts take into account both the estate tax repeal and retention scenarios, and enable a legal "switch to be thrown" on a "wait-and-see" approach, depending on what scenario actually occurs. These mechanisms would empower one or more parties to a dispositive plan to modify, disclaim, or even collapse life insurance (and other) trusts.

Trust protectors, independent trustees, and the use of special powers should be considered for every new life insurance trust. For example, if an ILIT holds insurance only on the life of one spouse and the other spouse is not a beneficiary of the trust, the non-insured spouse can be named as trustee and given powers to make distributions to herself/himself for "HEMS" (health, education, maintenance, and support) as well as a special (limited) power to appoint (distribute) the trust's assets to the couple's children, grandchildren, or anyone other than the trustee, her estate, or the creditors of either. Of course, if the trust holds a second-to-die (survivorship) type policy, neither spouse should hold a power or have any interest in the trust. But an independent trustee or trust protector could safely be given the right and power to terminate the trust and distribute the trust's assets to its beneficiaries should the estate tax ever actually be repealed permanently.

Additional guidance for practitioners

Don't fight the convinced client. If you have a prospective client who is convinced he or she will live beyond 2009 and who strongly believes that repeal will both occur and be made permanent, it is essential that you ask more questions and listen more carefully than ever before. Arguing (beyond saying, "You should hedge your bets and retain your flexibility and options") may be both futile and counterproductive.

Investigate needs other than liquidity. According to Charles Ratner, National Director of Personal Insurance Counseling for Ernst & Young LLP, you should put more emphasis on investigating other areas of need. He suggests: First, satisfy and solve the federal and state tax liquidity need until 2010. Second, focus on and meet the needs relating to business ownership succession, key employee recruiting, retaining, retiring, and rewarding, as well as other needs (such as key employee "economic shock absorber" coverage). Concentrate on and emphasize how a client's business can be used to attain his or her personal financial planning objectives. Third, find out if the client has decided on a way to provide financial security for his spouse—independent of the family business. Talk about how a client can "harvest" a lifetime of work efforts from the business (perhaps through a qualified retirement plan or maybe through a sell-out to employees via an ESOP).

Discuss the importance of developing diversification and a source of financial security outside the family business. Consider the

common desire to equalize inheritances among children even though one child will inherit and run the business while another may never work in it or draw financial security from it. Explain how this objective can be accomplished. Asset protection issues and philanthropic interests should also be covered—perhaps more deeply than in the past.

Wealthy and ultra-wealthy clients will be more interested than ever in the insurance-leveraged dynasty trust concept. Why? Because it's the safest, most certain way to be sure that, no matter what Congress does or does not do, a given amount of wealth, income, and financial security is in the hands of future generations and can never be reached by creditors (including the IRS) of the client.

Finally, be sure the client understands that if and when federal estate tax liquidity needs end, other needs—possibly unpredictable now—could surface. For instance, business financing may require insurance on the client, the key person in a business. Will a bank lend the necessary cash without the insurance? What if the client is uninsurable—or no longer insurable at standard rates—at that time?

If estate tax repeal does occur and lasts, so does carryover basis with consequent income tax ramifications. This has some very serious implications for a buy-sell plan. For example, assume there are two co-shareholders, a $20 million business, and equal interests. Under prior law, at the death of a shareholder, the sale of a $10 million interest triggered no income tax event because it typically received a step-up in basis. If the $10 million interest passed to the surviving spouse, it generated no estate tax. Now, a sale of the same interest may trigger a significant income tax, which in turn can generate a very large and immediate need for liquidity. Income tax law doesn't allow Section 6166-type deferrals.

One last time. Help clients with more modest estates develop a plan that is relatively simple—a plan that to some degree hedges a client's bets if he's wrong, doesn't require the payment of any significant gift tax, and is as flexible as possible. Do both a "best case" and a "worst case" estate tax scenario. And most importantly, be sure—very sure—that the most basic need of all has been met—the need to reproduce the income level necessary to generate the food, clothing, shelter, and education standards the client wants his or her survivors to have.

All too often, we forget to review what the family's current standard of living actually costs, and how much capital would realistically be needed to replicate it at the death of one or both parents.[3] And we also forget to talk about life insurance as a way to give clients permission to enjoy more of their own capital while they are alive. We need to tell a client: "After this policy is in force in your family's trust, that alone will provide financial security for them forever (as long as premiums are paid and the policy remains in force). So now, every dollar you have (aside from amounts needed to pay premiums) can be used and enjoyed—by you—while you are alive. And you have 'permission' to take greater business and investment risks as well." In essence, this "freedom from worry—freedom to spend or take a risk" approach is for many individuals "an estate plan in a can."

Practice Notes

It makes strategic sense for insurance specialists to begin to re-direct energy in order to expand the extensive knowledge skills necessary to succeed in broader categories of estate and business planning. If you haven't already, now is the time to increase expertise in business, retirement, employee benefits, and financial planning—and to think beyond providing insurance merely to meet federal estate tax liquidity needs.

The bottom line

Success as a life insurance advisor is directly related to the ability to help others see, as well as solve, their problems. Although the new law has solved some problems—and some people's problems, it has created and compounded problems for others. Many people are confused, misinformed, or underinformed. They are seeking sound, objective, and practical advice about life insurance and how it legitimately fits into their estate plan. These problems are opportunities for those planners, advisors, and agents who are willing to learn and realistically and creatively deal with change. ■

[3] See Leimberg and Gibbons, "Prop. Regs. on the Definition of Trust Income: The Best Thing for Life Insurance Planning Since Sliced Bread!," 28 ETPL 231 (May 2001).