# Life Insurance After the 2001 Tax Act: Lease, Buy, or Replace?

This article examines the need for life insurance after the 2001 Tax Act, and includes a discussion of term vs. permanent insurance, guidelines for selecting the proper coverage, and strategies for handling existing policies.

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In the January issue of *Estate Planning*,[1] we discussed what planners should be thinking, talking about, and doing with respect to the purchase of life insurance—after the 2001 Tax Act. Our friend, Charles L. Ratner, National Director of Personal Insurance Counseling and Managing Director, The Ernst & Young Center for Family Wealth Planning at Ernst & Young LLP,[2] was kind enough to share some additional thoughts and more specific details on this topic. Here are some comments in Q&A format on this most important topic.

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### Evaluating the need for life insurance after the 2001 Tax Act

*Leimberg/Gibbons:* Much has been written about the steps clients might want to consider in light of the effect of the new tax law on their estate plans. In some cases, changes to wills and trusts may be in order. In other cases, thoughts about strategic wealth transfer planning with GRATs or intrafamily sales may have to be revisited in light of the phased-in changes in estate and gift tax thresholds and rates. But what about the life insurance that clients own or were considering buying for estate tax liquidity? How should clients evaluate their need for life insurance after the new tax law? How should they reevaluate the policies they already own?

*Ratner:* It's probably fair to say that clients' views about the need for life insurance to pay estate taxes will depend in great part on how they view the future of estate taxes. Assuming that clients are not absolutely certain that they will die *in 2010 when the estate tax is* scheduled to be repealed, they might take one of two approaches to the need for life insurance as part of their estate tax planning.

First, individuals may believe that estate taxes really will be repealed permanently after 2010, if not before. If that's their opinion, they may see no reason to fiddle around with the law's sunrises and sunsets. These clients probably won't be inclined to make significant transfers of property solely to reduce their taxable estate. What's more, these individuals probably won't be inclined to buy so-called "permanent insurance" to cover estate tax liabilities, and they may wish to reassess the plan of insurance they have in place for that purpose. Of course, these clients will likely want to hedge that view by assuring that their estate has the necessary liquidity, just in case.

A second view might be that estate taxes will not be repealed, although the estate tax exemptions may be much higher after 2010 or so. People who have this view are likely to have a set of planning and insurance guidelines that are different from those held by people who share the prior view. The planning guidelines of this second group include hedging against the possibility of being wrong about repeal by retaining the utmost flexibility, and paying no gift tax in connection with transfers of property to lower generations.

### Is term insurance appropriate for this need?

*Leimberg/Gibbons:* How do you evaluate the appropriateness of a new purchase of life insurance?

*Ratner:* Let's start with term insurance. Regardless of which viewpoint clients may hold, the initial and perhaps not inappropriate reaction to how to address the need for estate tax liquidity is term insurance, particularly ten-year level premium convertible term insurance. However, we should take a moment to challenge that initial reaction. True, there is no question that the pure term insurance approach offers a low guaranteed outlay for ten years. There is also no question that if the clients wish to make all or part of the coverage permanent, they can do so by converting the desired amount of term insurance to cash value insurance. The conversion would be done at the clients' then attained age, but without medical underwriting.

*Leimberg/Gibbons:* Are there reasonable arguments against using all term insurance when estates are comprised primarily of business and real estate interests?

*Ratner:* Yes. First, if one assumes that the estate tax is not going to be repealed, there is a *permanent* need for liquidity to pay estate taxes. The urgency of the need may be mitigated by a Section 6166 deferral or the existence of some nonbusiness assets that could be sold to raise cash to pay taxes. Life insurance could obviously play an important role at that crucial time, giving the estate valuable flexibility and the ability to buy time cheaply.

Even though the term product will be convertible, we have no idea of the kind and quality of products to which it will be convertible ten years from now. We do know that many cash value products available today are very cost-effective for the buyer. Whether these efficient policies will be available at the attained age of term conversion is a matter of conjecture.

The owner of a flexible premium cash value policy can increase the premiums and thereby (eventually) increase the death benefit under the policy without evidence of insurability. This cannot be done with term insurance.

No form of life insurance is an estate plan in and of itself, particularly if one objective of that plan is to reduce the taxable estate. The primary way that an individual can reduce his or her taxable estate is by making transfers of property to the next generation(s). If that individual is willing to begin those transfers sooner rather than later, term insurance acts as a hedge to provide cover for the time it takes to complete those transfers. On the other hand, if that individual is not willing to start those transfers (or is not willing to transfer meaningful amounts of assets), then term insurance just postpones the day of reckoning of how to preserve the estate for the next generation. If it does nothing else, cash value insurance takes some of the pressure off the individual by giving him or her the flexibility to decide when and how to fashion the plan for his or her children's inheritance.

### Guidelines for choosing term insurance

*Leimberg/Gibbons:* Let's assume that, in spite of your warnings about the drawbacks of a term insurance approach to estate planning, a client insists on using only term. What guidance would you give such a client?

*Ratner:* There is a cost of waiting, a cost associated with postponing the purchase of cash value insurance for a meaningful length of time. Nevertheless, some people with taxable estates will choose term insurance. If they do, they still need a strategy for selecting the term products. Suppose that a client has decided that he is going to buy $5 million of ten-year convertible term insurance as a hedge for the liquidity to pay estate taxes. The client has also determined that, if he were to convert the term insurance to a cash value product, he would prefer to buy variable universal life (VUL) because of its flexibility with respect to premiums and investment of the cash value.

These assumptions are important, because they establish the basis for a legitimate discussion about the underlying premise for the selection of the term product(s). Everyone would agree that

[1] See Leimberg and Gibbons, "Insurance Trends and Topics; Life Insurance: Decision-Making After September 11th and EGTRRA," 29 ETPL 36 (Jan. 2002).

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the term coverage should be acquired from one or more carriers with strong ratings and competitive term pricing. But that said, some would give priority to pricing, meaning that they would recommend buying as much coverage as possible at the lowest available rates, even if that results in concentrating the coverage with only one carrier. Diversification for the sake of traditional risk management would not be a priority, nor would diversification for the sake of having a wider choice of competitive products upon conversion.

It may be wise, however, to be prepared to sacrifice some pricing, if necessary, to spread a client's insurance among more than one carrier. The concerns are: (1) there are no guarantees with respect to a carrier's ongoing strength and solvency; (2) there is no assurance that ten years from now, a carrier's cash value products will be competitive; and (3) the client may not be quite as healthy later as he is today.

So prudence suggests that we run two parallel courses. One course is to identify the "cheapest" ten-year term products. That's easy. The other course is to identify the carriers whose VUL products, here and now, are the products the client would purchase. That's not so easy. Once the client identifies those VUL carriers, he will look at the carriers' ten-year term products and compare the pricing and conversion features with the products in the first set, which are the products selected solely on the basis of price. The client should examine carefully the convertibility feature of all the respective products.

Is the term policy convertible to *all* of the carrier's cash value products or just to certain of those products? The more closely the client looks, the more he may find that the conversion features of many products are ambiguous and inconsistent with other published material or what the client may have understood. For example, the client might see that the term product is convertible to only "low premium" cash value products, or is convertible to any product of *that* carrier, but the VUL is offered by a sister company that has a similar name but is not the same company. The client may need assurance that the term is convertible to a VUL policy designed in accordance with the client's specifications.

Another common finding is that the client is told that the highly competitive term products of Company A are seamlessly convertible to the highly competitive VUL products of Company A's parent, Company B. However, the client can't find any indication of that in Company A's policy. So, the client has to get it in writing from Company B. Of course, the letter from the parent company will be only so much grist for the shredder if the parent sells the subsidiary a few years from now.

The client should next verify how long the conversion feature is valid. This can be a trap for the unwary. Not every ten-year term policy is convertible without evidence of insurability for ten years. And will the conversion (without evidence) be done at the same underwriting classification as the term policy for the entire amount of the new policy?

Eventually, the client will have all the information he needs...the carriers, the pricing, the conversion features, the letters of representation about convertibility from the appropriate carriers, etc. He can then merge the two lists. If price is the final arbiter, then go with the cheapest and hope for the best—meaning that the client will take his chances in the marketplace when and if he wants to convert. Those chances/risks include, but are not limited to, the risk that the client is not as healthy a few years from now and the risk that the attractive term carrier is no longer owned by the parent with the attractive VUL product. The client will buy as much of the coverage at the cheapest rate possible, even at the cost of diversification, which means that he is assuming the added risks that the carrier(s) he chooses, subsidiary or parent, aren't the strong companies they are today or that their products at the time of conversion are any good.

If the other philosophy prevails, the client won't take those chances. First, he will sacrifice some pricing to spread the insurance among more than one carrier. Second, he will buy as much as he can from the parent company, meaning that he will buy the term from the same carrier that offers the attractive VUL. The client will remove from the list the carriers that have competitive VUL but very expensive term, as well as the carriers that have very competitive term but not so attractive VUL. In the end, the client will have coverage that might have an average cost 10% higher than the "cheap term portfolio," but preserves the client's options for seamless conversion to the types of products from the types of carriers the client will want when the time comes.

**How to select permanent coverage**

*Leimberg/Gibbons:* What factors are important if permanent coverage is to be used? Can you provide readers with a checklist?

*Ratner:* If a client is going to purchase cash value insurance for estate tax liquidity, he should compare the features of various types of policies in order to select one that enables him to acquire the needed coverage in a way that also comports with his view of the planning environment. Among other features that the client will want to compare are the following:

***Premium flexibility.*** With certain policies, the premium for $5 million of insurance is determined by the insurance company. Other policies give the client the ability to determine the premium within certain guidelines. These "flexible premium" policies may be suitable if the client would like to start with a relatively low premium and then, if the planning environment suggests that the insurance need is indeed going to be permanent, increase the premium to the amount necessary to make the policy run permanently under reasonable assumptions.

***Flexibility to reduce the death benefit.*** The client will want to know whether he would be able to reduce the death benefit if and when he no longer needs the entire amount of coverage. This flexibility would be helpful if, for example, the estate tax thresholds and rates are revised in a way that decreases the projected tax on the client's estate. Or, the client might make substantial transfers of assets to the children, thereby reducing his taxable estate and, correspondingly, the insurance he will need for liquidity.

### Keep, drop, reduce, or increase currently-owned coverage?

*Leimberg/Gibbons:* Let's talk about currently-owned life insurance. What process do you use in evaluating existing policies?

*Ratner:* If a client already owns life insurance, perhaps in an irrevocable life insurance trust (ILIT) designed to exclude the proceeds from the client's taxable estate, he or she might want to ask these questions:

First, based on the client's view of the estate tax landscape, does he still need the insurance? Clearly, the estate tax is not going away for eight more years, if it ever does. So it is highly likely that the client will want to keep the insurance in place. But, as the client ponders this question, he should consider that most people who bought life insurance to pay estate taxes under the "old law" probably had several additional needs for liquidity beyond estate taxes.

For example, even in the absence of estate taxes, a business owner who wishes to pass that business to a child involved in the business may need capital to provide income for his or her surviving spouse, independent of the business. What's more, that business owner may want to use life insurance to roughly equalize inheritances between children who will not take over the business and those who will. Finally, even an individual who will no longer consider estate-planning oriented transfers of property to children may want to keep the insurance in


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place so as to assure an inheritance for the children.

Second, assuming the client concludes that he still needs (or wants to keep) the *amount* of insurance, is the existing policy appropriate for the client's needs? If not, should it be replaced or, where possible, simply managed differently? Let's address these questions by exploring a typical scenario.

Assume that Mary's ILIT has owned a whole life policy for several years. The policy has a fixed premium. Dividends are used to purchase paid-up additions that increase the death benefit. The insurance company's most recent "inforce" illustration projects that several more premiums will be required before the policy is self-sufficient.

Mary would like to maintain the current amount of insurance. However, in light of the recent tax law changes, she believes that it is no longer necessary to build an increasing death benefit. Furthermore, in light of the lower yields she is receiving on her investments, she wouldn't mind being able to reduce the gifts she has to make to the trust each year for premiums.

The trustee explains to her that he could instruct the insurance company to change the dividend option from buying paid-up additions to reducing the premium. Under that second option, the insurer will apply the dividend to the premium and "bill" the policyowner for the net difference. Use of this dividend option will stop the growth of the death benefit. It will also decrease Mary's annual outlay, although premiums will be required for many more years than would have been the case if she had been willing to pay full premiums until the policy was self-sufficient. Still, the dividend will eventually exceed the premium, at which juncture the trustee can have the dividend pay the full premium and apply the excess dividend to purchase paid-up additions.

Mary acknowledges the good insight of the trustee, but asks him to explore alternatives to the whole life policy, alternatives that might enable her to maintain the existing coverage but significantly reduce her outlay now. The trustee might look at exchanging the whole life policy for a whole life/term blend, universal life, or variable universal life policy. Let's assume that Mary has indicated that she's not interested in having the trustee "worry" about the investment of the cash value. So variable life is out.

Whenever we talk about life insurance policy exchanges, we must distinguish between the "internal replacement" and the "external replacement." An internal replacement involves the exchange of a policy within the same carrier. For example, the policyowner might exchange a whole life policy for a universal life policy issued by the same insurer. In the case of an external exchange, the policyowner moves the business to a new carrier. The trustee should find out if the existing carrier offers an internal exchange program whereby he can exchange the existing policy for a new policy from that company on an advantageous basis. The trustee might find that the exchange can be done without full medical underwriting, and that the commission on the new product may be reduced or eliminated and the sales loads and other policy costs may be reduced or eliminated.

***Leimberg/Gibbons:*** How and why can an exchange from whole life to a whole life/term blend or universal life policy make sense here?

***Ratner:*** The whole life policy uses a fixed premium that is determined by the carrier to be sufficient to endow at guaranteed (and very conservative) levels for mortality, expenses, and interest. The dividends reflect the difference between the insurer's current experience in those areas and the conservative guarantees. However, with the whole life/term blend and the universal life policy, the trustee can select the premium and determine the balance between coverage at the guarantees and at current experience. Because in this case, cash value growth for its own sake is not important to the trustee, he will simply look to maintain the death benefit at the lowest prudent outlay.

The design of the potential new policies will have considerable bearing on the merits of the exchange. For example, the whole life/term blend may be designed with a minimum amount of base whole life and a substantial amount of term, with additional premium or a paid-up additions rider. The death benefit of the universal life policy may be comprised of a relatively low amount of base and a large amount of term rider. These policy designs can make the products even more competitive than they otherwise might be.

Here's another advantage the new products will enjoy. The trustee will be rolling over a substantial amount of cash value from the current policy. The infusion of the large up-front premium will "jump start" the new policy. In the case of the whole life/term blend, much of that initial premium will

## ADDENDUM—LIFE INSURANCE, FOREIGN TRAVEL, AND INSURABILITY ISSUES

In our January 2002 column, "Life Insurance: Decision-Making After September 11th and EGTRRA" (see 29 ETPL 36), we discussed some of the issues relevant to advising clients about the purchase of life insurance in today's climate. One topic we'd like to amplify is foreign travel and its impact on insurability. On all applications for life insurance, there has long been a question regarding foreign travel. But as current events illustrate all too dramatically, long-term foreign travel and residency in foreign countries are, more than ever, an important life insurance underwriting consideration.

Currently, for obvious reasons, travelers to global "hot spots" (such as Pakistan, India, Egypt, Iraq, Israel, South Africa, Colombia, and Peru) may encounter insurability difficulties when applying for life insurance. And if insurance is applied for during a time when the State Department issues travel advisories, life insurance companies take notice and—as they should—react accordingly. Nevertheless, there are ways to alleviate the problem. First and foremost, an experienced insurance professional should solicit a number of companies for the best offers. There are almost always reputable and sound insurers, who, at any given time, may decide for competitive or policy reasons to offer favorable insurance coverage to someone traveling to a "hot spot" area even when other insurers will not.

Planners should also remember that the expected length of a proposed insured's visit will be a very important factor. It is often quite possible to obtain insurance—even when one is traveling to countries on the "watch list"—if the travel will be less than 14 days. Longer visits involve far greater exposure and are accordingly much more difficult to insure. By Stephan R. Leimberg and Albert E. Gibbons.

go directly to paid-up additions. The ongoing premium necessary to service the whole life component, to give the dividends time to grow and to give the paid-up additions time to displace the term component, will probably be very small. Indeed, at a given dividend scale, the trustee might see that the ongoing premium is so small that it can actually be paid by the dividend. In that situation, the trustee will not even have to pay ongoing premiums.

In the case of the universal life policy, the large up-front premium will bolster the cash value, thereby reducing the net amount at risk, which is the difference between the policy's face amount and the cash value. Here again, the trustee may find that at reasonable assumptions for interest and costs-of-insurance, the rolled cash value may be adequate to support the death benefit until the client's age 100.

***Leimberg/Gibbons:*** So what's the basis for a decision?

***Ratner:*** The trustee should now compare the illustrations: the whole life against the whole life/term blend against the universal life. He will first determine whether the blend offers superior performance and suitability characteristics to the universal life or vice versa, and will then compare the winner of that round to the whole life. If, and only if, the blend or the universal life will credibly generate an appreciably greater death benefit and internal rate of return than the whole life, not just at the outset but also at and beyond life expectancy, then the exchange will make sense.

If Mary and the trustee were to explore a variable universal life policy, they would essentially conduct the same exercise. The key would be to illustrate the variable policy at a sufficiently conservative gross return to maintain its death benefit under periods of market weakness.

***Actual offers.*** The decision between a term insurance and/or permanent insurance policy and the selection of which insurer to do business with are much more difficult than a mere ledger/illustration decision. Often, an important, or even the deciding, factor after all other criteria have been considered is the insurability of the client—and the consequent premium—as determined by the insurers' actual underwriting offers. Terminology among companies is not consistent. It is common for companies to use terms such as super-preferred, preferred best, preferred, ultra preferred, etc. The independent insurance professional should be seeking (simultaneously) the very best offers, and ratings should never be accepted—even for clients who are known to be ill or impaired—without additional investigation into alternative sources of coverage. Ledgers/illustrations should be compared again after all underwriting offers have been received. ■