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Life (Insurance) After Estate Tax 'Repeal' or 'Reform'

We rarely make predictions—especially those about the future. With the configuration of the House and Senate after the November election, we certainly don't know what changes, if any, the new President will be able to effect with respect to the estate and gift tax. But we can tell you for sure: There will be estate tax repeal (or change). We just can't say when or what specific changes will be made. (See Ronald D. Aucutt's perceptive and well-balanced column, "The Campaign to Repeal the Estate Tax: What a Splendid Little War It Was!," 27 ETPL 493 (Dec 2000).)

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Because we've left ourselves a lot of room, here are our fearless predictions on the impact that change—whatever it is—will have on the use of life insurance in the estate planning process and on planning in general.

Impact of repeal or reform

Life insurance that is sold for the purpose of paying estate taxes is a relatively small percentage of the total life insurance sold in the United States. According to LIMRA, the Life Insurance Marketing and Research Association:

> If survivorship life sales stopped completely *and* were not replaced by other sales, new premium for the industry would likely drop by about 8%, or about $1 billion. The impact on face amount would be smaller—about 4% (or $50 billion)—and the impact on new policies sold would be negligible.

Furthermore, those specializing in the sale of this kind of life insurance—both companies and individual producers—are a smaller percentage yet. It is true that these policies, while fewer in number, are significantly larger in both premium and face amount than the average policies sold. It is also true that the readers of this column see a disproportionate number of these policies used for the benefit of their clients and probably are involved professionally in selling fewer of the more traditional family income replacement products.

Many of the most creative minds and the most successful professionals in the life insurance community are focused on and dedicated to the specialty of estate planning. Huge amounts of resources are devoted to the practice of this specialty. Some of the best life insurance companies (again, the strongest and most innovative) are also committed to this market. Just imagine, if there were no estate taxes, the incredible amount of energy and creativity that could be released and redirected into the marketplace for providing life insurance solutions for families and businesses. We are suggesting that repeal or reform of the estate tax may have positive long-term outcomes to consumers, to insurance professionals, and to the life insurance companies these estate planners represent.

So, as we shift from an emphasis on federal and state death taxes to a focus on ordinary income tax and capital gains, where will life insurance be needed in the future? Clearly, it will continue to be irreplaceable in helping to meet the capital and income needs of the personal/family insurance marketplace. Many Americans are enjoying the highest standard of

living in history. Indeed, more Americans than ever are enjoying a standard of living far beyond anything they ever imagined. Think of how many clients are sending children to private schools, with annual costs approaching—and in some cases equaling or exceeding—those of colleges. The number of million dollar homes and luxury automobiles and affluent lifestyles is staggering. Truly, the level of financial expectation is higher than at any time in recent memory!

But to a great extent, the continuation of this "good life" still depends on someone "winning the bread." Consider the amount of capital necessary to maintain a given level of income, and a standard of living that is often taken for granted. Think about how much capital must be invested to actually, safely, and realistically net—after taxes, brokerage costs, and in some cases trustee's fees—year after year—the monthly income your clients' families have come to need and expect. We submit that too many clients have done far too little to put enough dollars aside, especially in traditional income-only trusts, to adequately maintain the standard of living most clients' families are currently enjoying.

For instance, consider that the yield on a common stock portfolio is currently about 1.2%. Accordingly, in an assumed 60/40 asset mix in today's income-only trusts (with $600,000 invested in equities), the gross yield before taxes, turnover, and trustee's fees would be $7,200. If the remaining $400,000 were invested in bonds (which, of course, provide no chance of growth or inflation protection) and these investments yielded a gross of 5.8%, they would produce about $23,000. The result is a gross total yield of less than $30,500 for every $1 million of capital invested—and probably a lot closer to $25,000 of actual spendable income!

Advisors—all the members of the estate and financial planning team—need to re-focus on the adequacy of the capital set aside to protect our clients' families. We believe that most clients (high net worth and otherwise) have substantial shortfalls of capital reserved in the event of death or disability. In most cases, the only realistic way to assure the capital necessary to produce the income desired is through properly arranged life insurance. So, perhaps with more fervor than ever, we will continue to recommend strategies in which life insurance plays a very important role in estate creation and income replacement for families.

We will see continued reliance on life insurance for the payment of outstanding debts at death and for the funding of special needs trusts. As the most experienced life insurance specialists and the best life insurance companies redirect their energies, we will see new products developed and sold that emphasize tax-advantaged wealth accumulation. Such products will focus on creating supplemental retirement dollars and will be marketed as "Supercharged Roth IRA Look-Alike Plans." The cash values of these plans will provide excellent collateral values and will be the source of substantial emergency funds—all the time to a significant degree protecting assets from creditors and potential litigation.

Once our clients can be certain that their survivors or other intended beneficiaries (such as friends and charities) are adequately provided for, clients will be free to "spend down" all or most of their other assets and enjoy their retirement years without guilt or concern that their children and grandchildren will be left without resources. What really could be better? Continued access to all the values of life insurance while alive and an estate tax-free bequest of assets at death, without all the hassles of Crummey notices, private split-dollar arrangements, and trustees. We envision a time when we can all focus on the incomparable uniqueness of life insurance as a financial planning tool and pay less attention to tax avoidance.

Effect on the business market

Not only will the personal/family life insurance market be revitalized, but the business market for life insurance products is likely to expand significantly. There will be a new emphasis on protecting the business and its owners. Buy-sell agreements will still need to be funded with life insurance dollars. A business owner's death can create a serious hardship not only for his/her family, but also for the business. Buy-sell agreements can establish a fair value for the business, make sure that the business ends up where it should, and provide the dollars to make that happen—for the buyers and ultimately the business owner's family, tomorrow or many years down the road. Only adequate amounts of properly arranged life insurance can fulfill those promises!

Key person life insurance—designed to protect a company when faced with potential financial losses that can occur when a key employee dies—will still be needed as part of any corporate risk management program. Cash value life insurance used for this purpose can also, as a corporate asset, be used as collateral for a loan, provide dollars to finance nonqualified deferred compensation benefits, and/or be available when a business is sold or liquidated.

Of course, life insurance, the vehicle of choice, will continue to be used to fund nonqualified selective employee benefits (often called SERPs, Selective Executive Retirement Plans) and provide the death benefit in DBO (Death Benefit Only) plans in the business market. And lenders will continue to demand that life insurance be used to protect their loans in the event of a premature death. Life insurance will also be needed to pay off "interest only" loans at death.

Future role of life insurance

Last, but certainly not least, a distinction must be made between estate tax planning/funding and estate planning. While it is possible that the former may disappear (our guess is that an immediate total repeal of the estate tax is a very unlikely scenario and that a carefully controlled phase-down of the tax rate and an increase in the unified credit/exemptions is much more likely), the latter will always be with us.

Consider the continuing utility of life insurance. Assume that your client has one child who works in the family business and three children who are not likely ever to enter the business. Estate equalization—using life insurance to make up for the fact that the business represented the bulk of the client's estate and that asset will pass to the child working in the business—will continue to be a vital concern (especially where nonliquid assets are involved).

Charitable planning will continue to be important, and life insurance will be needed to replace those assets redirected from heirs to deserving causes. Suppose, for example, a client would like to make a large lifetime gift of real estate to her favorite charity, the United Cerebral Palsy Association, while she is alive. If she donates $1 million of real estate that otherwise would have passed to her children at her death, the charity receives a certain donation, the client receives a sizeable and immediate deduction, and she can help replace the wealth her chil-

dren would have received with insurance on her life.

Even if estate taxes are eliminated or reduced, there will still be income tax liabilities at death—in essence, capital losses from IRD-type assets, including nonqualified deferred compensation plans, nonqualified stock option plans, and qualified pension and profit-sharing retirement accounts and IRAs. Life insurance can to a great degree be used as a "Section 691 make-up" tool—to make up for the loss in investment power due to the income tax.

Even if there is estate tax repeal or a reduction in tax rates and an increase in credits (all based on estimates of surplus tax revenues made possible by the juggernaut booming economy that already seems to be cooling down considerably), we suggest that it is a good idea to protect clients against a possible restoration of the estate tax or a freeze in the phase-down. Certainly, for most clients, the current proposal for estate tax repeal provides little real tax relief during the next ten years. After all is said and done, there will be life (insurance) after estate tax repeal or reform. However, even in estate tax planning, clients and advisors will want to hedge their bets and ask the following questions:

- Will—and, if so, when will—the estate and gift tax really disappear? Are the future budget estimates accurate or even close? Will the rosy picture of the never-ending growth in federal revenues change during the phase-out or phase-down? Are clients willing to bet their estate plans on politicians' economic predictions? What if surpluses turn to deficits?
- Will—and when will—the estate and gift tax re-appear?
- Will these transfer taxes be replaced by one or more taxes at either the federal or state level?
- What will the states do about inheritance taxes?
- Will clients still be insurable at a later date (they will definitely be older)?
- Will there be fewer planning opportunities with tighter rules and fewer loopholes?
- Will carryover basis and "beyond lifelong" record keeping and accounting for basis and capital gains be found to be impractical or impossible?
- Will the tax obligation actually be more at death, rather than less?
- Could the capital gains marginal rate be increased to 28% or higher?

Be cautious about surrendering policies

Repeal or significant revision of the estate tax, including substantial increases in the unified credit, reductions in the top rates of tax, and meaningful exemptions for various groups such as business owners and farmers, may cause a client—either as insured and owner of his own policy or as grantor of a trust—to consider surrendering an existing life insurance policy that was originally purchased for estate liquidity purposes. We suggest great caution.

Before surrendering any existing coverage, all of the questions above—and perhaps a host of others—should be analyzed very carefully. As advisors, we should help our clients make (if necessary) small mistakes from which they and their families could recover, rather than big mistakes that will severely and permanently adversely affect their personal and business fortunes. Far better, in our opinion, that a person or business have life insurance that is not needed than to need insurance and not have it. At the very least, we suggest clients should hedge their bets by purchasing convertible term insurance and wait and see if they should change it to permanent coverage down the road.

Finally, we would be willing to bet that there are two things in life that are still certain—death and taxes!

We want to express our appreciation to *The Pinnacle Study Group*—a national group of top life insurance professionals—for their input, expertise, and consistent willingness to share ideas. ■