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Life Insurance: Decision-Making After September 11th and EGTRRA

"Some companies are reported to be experiencing an increase in sales activity. Apparently, individuals who previously ignored the value of life insurance, disability insurance, or estate planning in general are reconsidering their personal financial risks in light of September 11."[1]

What life insurance is really all about

Sometimes, it takes a cataclysmic event to provide the prospective we need to really see things clearly. The horrific events of September 11th were just that—an awe-full, terribly harsh lesson in reality.

We were brutally reminded by the events of that day and by those that have followed that no individual—regardless of age, health, gender, or occupation—is exempt from unexpected death. We learned—if we didn't already fully understand—that none of us is "safe" and none of us has a "lease on life."

As doctors all too often distance themselves from the death and dying of their patients, we estate planners sometimes forget that death and dying are the biological center of our own professional existence. This is particularly true of those of us who advise our clients regarding whether or not to purchase life insurance, and the amount of insurance they should purchase. All too often, we attempt to reduce their decision-making process to dollars and sense, and take shelter ourselves by trying to reduce our assistance in their life insurance purchase to emotion-numbing numbers and matrix-oriented financial analysis.

There is no way we will ever measure the number of hearts broken or the true scope of the human devastation that survivors would suffer on and after September 11th. *And only those individuals* and businesses who will have to do with less or do without—the survivors of those killed that day—will ever know if those murdered had "adequate" life insurance.

True, the unprecedented generosity of millions of Americans—sharing to some small extent the survivors' pain, frustrated by the inability to physically help on a person-to-person basis, and caring for others because we are essentially a nation of decent, compassionate, giving people—will (hopefully) mean that most, if not all, of the families of those who died that day will not lack the financial *means for basic food, clothing, and* shelter. But have we planners learned a lesson from that day about the importance to our own clients—and our own families—of adequate amounts of business and personal life insurance? Do we have a better appreciation of why it is more important to be sure an adequate amount of insurance is in force on the lives of breadwinners, estate owners, and business builders than to wait until we are certain that the premiums are the lowest available, or that the cash values are the highest possible, or that insurance is arranged as carefully as possible to minimize taxes? Have we learned something about the urgency and significance of action when it comes to the purchase of life insurance (as well as other forms of insurance)?

Of course, we planners have a responsibility to help clients find policies with an efficient premium structure, with the highest possi-

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ble cash values and the best possible contractual provisions from sound and ethical insurers. We need to be sure the policy is arranged so as to minimize taxes and maximize the probability that the proceeds will go to the right person at the right time and in the right manner. All these elements are a crucial part of the equation and of the decision-making role each member of the estate planning team should play. But absent sufficient capital and its consequent income-producing power, the well-drafted wills, trusts, and other documents we insist our clients have can provide little financial security for those whom planning is most often intended to benefit.

We estate planners need to approach the subject of life insurance in both a more professional and humanistic manner, to truly apply and adopt a multi-disciplinary approach, and to re-examine and perhaps re-align our priorities with respect to the importance of insurance in the estate planning process. We must now give a much higher priority to assuring that our clients have adequate amounts of life insurance!

The insurance community will pass the test

Within days after the terrorist attack, Tillinghast-Towers Perrin released a special report that stated, "All sectors of the insurance industry, including property/casualty, life/health and reinsurance, are certain to be severely affected by the terrorist attack on the World Trade Center and the Pentagon, as well as the airplane crash in Pennsylvania." But the report quickly concluded that, "While our industry will be severely tested, it will survive and in large measure perform well. Massive numbers of people and businesses will receive their policy benefits. The industry has already mobilized substantial resources to begin the claims settlement process and put money in people's hands." The conservative nature of life insurance companies will now be a distinct advantage. Their financial strength should offer comfort during these uncertain times. While the financial markets have sustained a severe impact, life insurance companies should be able to manage the resulting risks through careful, prudent, and sensitive action.

In spite of this, the long-term availability, cost, and contractual features of life insurance are likely to be affected adversely. Towers Perrin estimated the overall insurance loss at between $30 billion and $58 billion, and characterized it as "the largest single-event loss in history." But the report was quick to note that, "The life insurance sector will be much less directly affected than the property/casualty sector. The greatest long-term impact in the life sector may be for those involved in variable products, as the equities market continues to drop. This may cause more insurers to rethink and re-price guarantees they offer on variable products. In the future, insurers will seek to finance and spread the risk from large loss of life in a concentrated time and place. This is certain to impact adversely on the cost of life insurance." This suggests that advisors must give a great deal of thought to the potential adverse implications of any suggestion that a client cancel or reduce presently held coverage, particularly life insurance contracts with significant insurer guarantees. Planners should also consider that the present environment for purchasing life insurance with favorable rates and terms may be better than in the future.

Current impact on underwriting and claims

Currently, it appears that most insurers and reinsurers are assessing the situation on a day-to-day basis. We've seen no actual decisions to deny coverage or withdraw any products. Nor have we noted any insurers or reinsurers insisting on a terrorist or war exclusion or military risk clause. Nevertheless, some insurance companies have been carefully reviewing the applications of U.S. citizens traveling abroad with respect to length of stay, place, etc., but currently there are no set parameters being used.

The life insurance community responded strongly, positively, and fairly with respect to victims of the September 11th atrocity. Insurance companies made the claims process as easy and equitable as possible.[2] Claimants were asked to provide whatever documentation they could to prove that the insured was (1) on the plane, (2) at work, (3) in the building, or (4) a rescue worker, etc. Official airline passenger lists, a letter from an employer, and an affidavit created by the New York Department of Insurance, or a Presumption of Death Certificate issued by the State of New York, etc. were all accepted. Our sources indicate that insurers have examined whatever documentation was provided, and have been approv-

1 Our thanks to Tillinghast-Towers Perrin, which provides actuarial and management consulting to financial services companies, for furnishing us with the firm's very useful special report, "The September 11th Terrorist Attack: The Impact on the Insurance Industry." This report is available at http://www.leimbergservices.com. Once logged in, go to the Finance and Markets Tab and click on Report # 98.

2 For an excellent resource, see insurance consultant. J. J. MacNab's http://deathandtaxes.com/main.htm. Look under Insurance Company Contact Information.

ing claims and disbursing death benefits in a timely manner.

Insurers have not considered the attack to be an Act of War. Although some Accidental Death Benefit Riders or Waiver of Premium Riders contain a War Exclusion Clause, no insurer to our knowledge has invoked it to deny a claim, and few (if any) insurance contracts issued since the early 1960s have War Exclusion Clauses.

It is our understanding that insurers are handling death claims resulting from the New York and Washington terrorist acts on September 11th as "accidental," and therefore, if applicable, beneficiaries will receive the additional accidental death benefit.

It is likely, though, that insurers will reserve the right to provide future benefits based on the policy or policy riders in force at the time of claim, including the application of any war exclusions. Consequently, military or terrorist actions could affect the decisions made regarding future contractual provisions, underwriting and acceptance of risk, and claims.

Again, this all suggests to us that the best time to purchase life insurance—if not purchased already—is now.

After EGTRRA: New ground rules and new trends

Estate planning techniques using life insurance, complicated strategies, and taxable gift giving were virtually non-existent in the first eight months of 2001 as clients and advisors sat on the sidelines trying to determine how the estate tax controversy in Congress was going to be resolved. However, conversations between clients and their advisors are starting again.

The dust is settling. EGTRRA is law. Estate taxes will be repealed in 2010—maybe. Life insurance companies, practitioners, and clients are trying to navigate uncertain waters as they try to implement solutions that "match up" with the absurdities of the new law.

How will life insurance be used to solve the many planning problems that the new Tax Act has created? Some trends are starting to develop, and we are confident that we will see many new and creative approaches over the next several months and years. The balance of our column discusses the trends that are emerging and the direction practitioners and insurance companies are heading. This is the first wave of innovation. There will be plenty more to follow.

Now that the reality has set in, advisors need to make recommendations. Should we recommend temporary (term) or permanent insurance? Should we continue to use irrevocable life insurance trusts (ILITs)? If so, how should they be drafted? Are there other viable alternatives? Should we use the insurers of the past, the companies that we've always used, or should we search for creative new approaches adopted by progressive insurers to deal with the inherent uncertainties of the new law?

There are many possibilities. This commentary may raise more questions than answers, and there is little we can be sure of at this point, except for this: Advisors must no longer take any insurance-related decision for granted and must now re-check all assumptions.

Three major issues

Creativity, energy, and focus are being directed in three areas. First, planners and advisors must tackle the question of term insurance vs. permanent insurance. Second, professionals must examine and understand the recent contractual changes in existing life insurance policies. Third, we need to revisit the drafting approaches necessary to keep the death benefit proceeds *out of the insured's taxable estate*, yet retain access to substantial cash values—in contemplation of an exit strategy.

Term vs. permanent insurance

On a conceptual basis, without endlessly crunching numbers, term insurance seems like the logical remedy for solving the temporary problem of estate taxes over the next several years. There are, however, three problems with choosing term insurance.

Uncertainty regarding the estate tax. The first and most glaring problem is that we really don't know—and no professional can be certain—whether the estate tax liquidity problem is temporary, will diminish, and is certain to disappear (if and when the tax is in fact repealed). No one can guess the probability that repeal will ever occur or that our clients will live long enough or that repeal itself will not be repealed. And if repeal does become a reality, how will the carryover basis regime and its consequent capital gains tax affect our clients' survivors' liquidity needs? What level of cash liability will carryover basis create for our clients' estates?

Cost. We can cover the risk of estate tax with term insurance over the next nine or ten years. But what happens if clients discover a need—or more importantly, a want—for life insurance post-estate tax "repeal"? The bottom line is that we have guaranteed convertibility (hopefully, we have used a quality life insurance company with quality permanent products, instead of the "cheapest"

term insurance carrier), but the premium cost to convert to permanent insurance can be prohibitive ten years from now.

The reality of 'needs and wants.' The third problem is much less obvious. Clients tend to stay very focused on the problem they are trying to solve today (e.g., estate liquidity, a less expensive way to fund the tax liability). In our experience, though, we have found that the "need" for life insurance very often doesn't disappear, but merely changes and in many cases (for the more successful—or less successful—client) grows over time.

For example, many young and middle-age couples buy term insurance for income replacement and capital creation needs while they are raising families. At the time of purchase, they intend to drop their life insurance when they retire, because they assume that the children will then be grown and self-sufficient. Couples expect to have accumulated sufficient capital, and assume there won't be any need to continue their life insurance coverage. Ever hear of "boomerang children"—those that come back? Ever hear of a stock investment that didn't go up? Interestingly, we don't see people actually dropping their coverage when they retire. In fact, we see many clients who are very upset that they are losing group life insurance benefits, particularly when they are told the cost of replacing that coverage.

In real life, needs don't disappear. They change. Needs change when clients see their choices in pension payouts between "Life Only" and "Joint and Survivor" options. Needs change when clients see their children struggling and when they hold their grandchildren in their arms. Needs change when they want to cover a new mortgage on a vacation home or achieve other financial goals.

So, in the end, advisors can crunch the numbers and analyze the hard facts for hours. That is the science of financial and estate planning. The art of financial and estate planning, however, deals as much with "wants" as with "needs." Good estate and life insurance planning consists of implementing solutions today in the context of what clients may very well "want" in the future. That is the art. That is the reality.

It is very difficult to take a client through all the possible scenarios and explore all the reasons why he/she might someday have permanent needs and wants. Time is one problem. Focus and perspective are even more of a problem. But the real problem is that most individuals have difficulty imagining themselves ten, 20, or 30 years down the road. Typically, an individual, particularly a younger client, hasn't seen enough to appreciate what a seasoned estate planner may know. Usually, the client buys for the reasons he/she thinks are most important today. However, the experienced practitioner knows that there are many reasons why insurance coverage—perhaps even increased coverage—will be crucial in the future.

Emergence and importance of 'exit strategies'

Clients are purchasing life insurance for "today's reasons." If that means to them a better way to fund estate tax liability and if they think there is a very good chance that estate taxes are going to disappear forever, then we have to deal with potential exit strategies. Exit strategies are developing on two fronts. First, we are seeing contractual changes in new policies that are being issued. Second, we are seeing more creative and flexible drafting techniques.

Let's focus first on the former. Transamerica, among other companies, has introduced its new "Sunset Option" in response to EGTRRA's "sunset provision." This new option is available with certain policies issued after 7/7/01. Understanding that clients and advisors are going to be aggressively seeking exit strategies due to the uncertainties created by the 2001 Tax Act, Transamerica has cleverly addressed the issue by eliminating the surrender charges on specific policies in 2010 if estate tax repeal becomes permanent.

Obviously, the policy does not have to be surrendered if there is permanent repeal of the estate tax. The policy could be continued as a source of funds to pay the new capital gains tax or as an extremely competitive wealth transfer vehicle. If surrender is considered as an exit strategy, the investment and tax assumptions would be important in measuring the cost of the permanent policy vs. buying term insurance and investing the difference.

Another example of contractual changes and guarantees facilitating an exit strategy has been adopted by Manulife Financial, which is offering "Estate Tax Advantage 2010." This provision, unlike the Transamerica contract, is not dependent on repeal of the estate tax. Manulife isolates two variables—current assumptions and guarantees—in its universal life insurance policy, and focuses on interest rates and cost of insurance charges. Essentially, this insurer is using the minimum guaranteed interest rates and is willing to guarantee the policyowner's current cost of insurance charges over the first ten years of the policy. Manulife then runs its illus-

tration software to determine the premium necessary (based on paying the premium in all years) to endow the contract at maturity using current assumptions.

For example, assume the annual premium to accomplish the goal is $10,000. Over a projected ten-year period, the cash outlay would be $100,000. If, instead, the client pays the $100,000 (in most cases at a discounted rate) over one, two, three, or four years, Manulife guarantees that at the at the end of the tenth year, the net cash surrender value will be equal to the premium paid—at least $100,000. The bottom line: This policy will guarantee that a client's cash surrender value will equal premiums paid after just ten years. Therefore, there is a "zero net cost"; and the time value of money approach would measure the lost opportunity of investing elsewhere while enjoying the insurance protection. The payment of the premiums over the shorter period will also improve long-term performance by reducing total premium outlay and will actually have the potential to lower the premiums from the 11th year forward.

Manulife is marketing this solution as "The Can't Lose Solution: Guarantee for the Short Term and Performance for the Long Term," "Take the Fed Out of the Equation," and "A Full Money-Back Guarantee." As with all contractual provisions and policy changes, Manulife requires state approval and, thus, the contract is not currently available in all states.

Transamerica and Manulife represent just two approaches. There are and will be many more.

Drafting and planning strategies

Numerous drafting and planning strategies are being used to respond to the vagaries of the 2001 Tax Act. Again, these techniques should be considered primarily as exit or access strategies that are intended to make the irrevocable life insurance trust more flexible and give clients more control. Estate planners' dual goals are to (1) assure that life insurance is removed from, or never included in, the taxable estate and (2) simultaneously provide more access for clients to the values inherent in the life insurance they purchase.

Practitioners are taking three approaches to achieve these objectives: "private split-dollar," "Survivorship Stand-By Trusts," and "Spousal Support ILITs." Private split-dollar will be covered in detail in our upcoming column on the anticipated Regulations covering traditional, equity, and reverse split-dollar. Currently, private split-dollar arrangements are intended to assure that: (1) the policy death benefit is kept out of the insured's estate and is therefore estate tax-free, (2) gift taxes are minimized in cases involving large premiums and a limited number of beneficiaries, (3) the party that outlays the bulk of the premiums will be reimbursed, and (4) the remaining cash value will benefit the beneficiaries.

Survivorship Stand-By Trusts

An interesting alternative is the Survivorship Stand-By Trust. This vehicle would be most appropriate for clients who potentially have lifetime income needs and would like the cash value of the policy to be available for supplemental retirement funds. While clients have a taxable estate today and may not have a taxable estate in 2010, clients want to retain as much control and flexibility as possible. That is especially true if there is permanent estate tax repeal. The Survivorship Stand-By Trust is intended to allow clients indirect access to policy cash values during lifetime yet exclude the death benefit from their taxable estates.

The spouse with the anticipated shorter life expectancy applies for and is named owner of a survivorship policy. A Survivorship Stand-By Trust is created as a testamentary trust that will become effective upon the policyowner's death. The trust will be the contingent owner and beneficiary of the policy. The trust will assume ownership of the policy upon the death of the policyowner spouse (presumably the first to die). With ownership established in this manner, premiums are not gifts and, during the lifetime of the policyowner, there is total control of the policy and its cash value. If the surviving spouse is neither trustee nor beneficiary of the Survivorship Stand-By Trust, she will have no incidents of ownership and the policy proceeds should be excluded from her estate.

If the non-owner spouse predeceases the policyowner spouse, the policyowner can transfer the policy to an existing Survivorship Stand-By Trust or during lifetime to an irrevocable life insurance trust. The transfer of the policy will be a taxable gift. In the case of a simultaneous death, it is presumed that the policyowner predeceases the non-owner spouse. This technique is intended to achieve the following:

- Total control over the policy and trust during the owner's lifetime.
- Income tax-free access to cash values during the owner's lifetime.
- Income tax-free death benefits to the trust.
- Avoidance of gift taxes during the owner's lifetime.

- Potential exclusion of death benefits from the taxable estate.

Penn Mutual, Nationwide, and other life insurance companies have been promoting this technique, and can provide assistance and specimen documents for attorneys.

Spousal Support Trusts

In order to deal with the tremendous amount of uncertainty created by the 2001 Tax Act and to provide maximum flexibility for clients, many advisors are considering the use of what is sometimes referred to as a Spousal Support ILIT (SSI) or Spousal Support Trust (SST). The SSI/SST is a technique designed to be highly flexible and to achieve the goals of keeping the insurance proceeds out of the taxable estate while providing the opportunity for clients to use substantial cash values to supplement retirement income or to be available in the event of permanent estate tax repeal.

The SSI/SST is an ILIT created by the insured-grantor spouse to provide financial security for the grantor's spouse and/or children. The objective is to exclude the assets in this trust from the insured's estate—as well as the estate of the insured-grantor's spouse—yet provide some access to the policy cash values during the couple's lifetime in the event of an emergency, opportunity, or major change in the transfer tax law.

The SSI/SST is named owner and beneficiary of a permanent policy on the grantor's life. A trusted family member, friend, advisor, or corporate fiduciary is named trustee.[3] Premiums could be funded in various ways, including a gift from the grantor, a loan from the grantor, or a splitting of dollars or loan from another entity such as a trust, LLC, or FLP. If the grantor makes gifts to the trust, the insured's spouse and children would be given Crummey withdrawal powers to maximize the benefit of the available annual gift tax exclusions. Timely notices would be provided to all power holders, giving them a realistically adequate amount of time to make a withdrawal of each year's gifts to the trust.

The trust instrument would specifically authorize the trust to purchase and maintain insurance on the life of the grantor (and others with an insurable interest on the grantor's life). After the period for exercising the Crummey withdrawal power expires, the trustees purchase and pay premiums on a policy insuring the grantor.

The SSI/SST (unlike the traditional irrevocable life insurance trust) allows distributions to the grantor's spouse and children for their health, education, maintenance, and support during the insured-grantor's lifetime. This provides an effective (albeit indirect) way for the couple to access the policy's cash values through interest-bearing loans or even policy withdrawals.

At the insured-grantor's death, the policy proceeds would be payable to the trust to provide income to the trust beneficiaries. The trust can also lend money to, or purchase assets from, the insured's estate to provide liquidity.[4]

Conclusion

At this time, there are few perfect answers. There is uncertainty in the estate planning community regarding the new Tax Act and the solutions that should be implemented. We all need to re-check the assumptions we are using. What we thought might be a term insurance solution actually might turn out to be a permanent insurance solution—or vice versa. We need to be alert every day for new innovations in the insurance and legal marketplaces—or rely on someone who is familiar with those changes. We can't simply rely on drafting trusts the way we used to; we are not driving our grandfather's Oldsmobile, and we can't use his trusts either.

What we can be sure of is that most of our clients and many of their businesses or practices need life insurance and that the single most important—and urgent—step we advisors must take is to assure that they have "adequate amounts"[5] of life insurance as quickly as possible.

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[3] If the spouse is named sole trustee, it is probable that the proceeds would be included in his/her estate. More aggressive planners might consider naming the uninsured spouse as co-trustee and providing that she may not make any decisions as trustee with respect to the life insurance.

[4] Of course, the terms of the trust should not require the trustee either to loan to, or purchase assets from the estate because this would cause the proceeds to be estate tax includable under Section 2042.

[5] The term "adequate amount"—when followed by the words "of life insurance"—is certain to arouse both high emotion as well as great intellectual searching. There are literally hundreds of articles on how to determine the appropriate amount of coverage. Ironically, the people who can best judge what is "adequate" (i.e., the insured's survivors or other intended beneficiaries) are almost never brought into the decision-making process. Practitioners are directed to the American Bar Association's *The Lawyer's Guide to Insurance*, by Ben G. Baldwin (1-800-285-2221); RIA's *Tax Planning With Life Insurance*, by Zaritsky and Leimberg (1-800-950-3055); and National Underwriter's *The Tools and Techniques of Life Insurance Planning*, by Leimberg and Doyle (1-800-543-0874).