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Don't Let Your Clients' Liquidity Plans Get Trumped

Do you have all the information you need to properly advise your clients regarding their estate-planning life insurance needs?

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Estate tax repeal, if it happens, would leave many wealthy seniors facing an uncertain estate tax future.

Specifically, senior clients who've already purchased life insurance to provide estate tax liquidity may have their existing estate liquidity plans "Trumped" and will need to assess what to do with their life insurance policies. Decisions about currently held life insurance and the purchase of new life insurance will both be impacted by increasing life expectancy and product type.

Do you have all the information you need to properly advise your clients regarding their estate-planning life insurance needs, assuming the estate tax is at least temporarily repealed (an assumption this article will make going forward)?

Estate Tax Liquidity

Several options are available for senior clients with larger estates who are considering purchasing life insurance to provide estate tax liquidity, who've determined that they have a good chance of outliving the temporary estate tax period but are still concerned that they may be needlessly paying high premiums should they die prior to the estate tax repeal sunsetting.

One is to postpone purchasing the life insurance until the estate tax repeal sunsets. The problem with this approach is that it may be 10 years or more until the future of the estate tax is known. The client will be 10 years older, and a lot can happen from a health perspective over the course of that time. Thus, the client may be unable to acquire the coverage in the future when it's needed, or the coverage may be considerably more expensive at that time due to age and health changes. And, even when the temporary estate tax repeal sunsets, there's no guarantee that the outlook for the estate tax will be any more certain than it is now.

A potentially better option that eliminates the risk of a health change and helps ensure that the estate tax liquidity can be obtained cost efficiently is to proceed with the life insurance purchase now, and employ one of the following strategies that provides the client flexibility to adapt when necessary:

1. Purchase convertible term or minimum funded cash value life insurance coverage. If a client is concerned about the possibility of dying during the temporary estate tax repeal period and having needlessly paid large premiums for coverage that's no longer needed, the client could choose to buy 10-year level term insurance (assuming the client isn't too old to qualify for such coverage). Ten-year level term insurance would provide a low-cost solution for purchasing life insurance now but give the client several options should the client determine in 10 years that life insurance is still needed to provide liquidity to pay estate taxes:

- If the insured is in good health and willing to go through the full underwriting process, it may be possible to simply replace the term coverage with cash value coverage with a relatively affordable annual premium.
- If the insured isn't in good health, he could choose to continue the existing term coverage. The low guaranteed level term rates will end, but the insured should be able to continue the coverage at much higher annually increasing premiums.
- If the insured isn't in good health and can't readily obtain affordable new cash value coverage, see if the current term policy can be converted into a cash value policy. This needs to be done before the level term period of the policy expires and, in the case of some life insurance carriers, may need to be elected well before the level term period ends. A downside of converting existing level term coverage is that the cash value products that the insured can convert to generally aren't very competitive.

As an alternative to purchasing a 10-year level term product and converting it, a client could instead choose to purchase a cash value product and imitate a 10-year level term product by paying a minimum premium just sufficient to keep the policy in force through 10 years. At the end of 10 years, if the client decides to maintain the coverage, the client can substantially increase the premiums being paid into the policy. The downside is that the premiums in the future needed to keep the policy in force until death might be significantly higher than if the client had just initially decided to pay a level premium for life. The upside is that the client won't have to worry about a change in health preventing him from qualifying for a new policy or about converting into a potentially uncompetitive term conversation product. This also makes the policy more attractive to institutional investors in the life settlement market if your client decides to sell the policy at a later date.

2. Purchase cash value life insurance using a flexible planning strategy. What if your client could lock in his insurability and purchase the needed life insurance to provide estate tax liquidity, avoid having the proceeds be includible as part of his taxable estate and have the ability to potentially unwind his liquidity planning if it's later determined it isn't needed and get his money back? Too good to be true? It may be possible to accomplish all this in the right circumstances as long as sufficient flexibility is incorporated into the planning. For this to happen, two things are required: (1) the product used must provide enough flexibility that the client could surrender it after 10 years and get most, if not all, of his premiums back. One type of policy that may not provide much flexibility would be a guaranteed universal life policy because the cash surrender value after Year 10 may not be anywhere close to the cumulative premiums paid; and (2) the strategy for handling the policy ownership must provide sufficient flexibility to enable it to be unwound, while at the same time ensuring that the death benefit proceeds of the life insurance won't be included in the insured's estate should the insured die while there's a federal estate tax in effect. Two possible flexible planning strategies are:

- A flexible irrevocable life insurance trust, or ILIT; or
- Have the coverage owned by a family business as part of an entity redemption plan.

Flexible ILIT. A flexible ILIT is just a version of a spousal access trust, so it can only be used by married couples. One spouse is the grantor of the trust, and the other spouse is the beneficiary. It can be used with either a single life policy insuring either spouse or a second-to-die insurance policy insuring both spouses. The key to a flexible ILIT is to use an "independent trustee" and to give that trustee broad discretion to make distributions to the spousal beneficiary for any reason and to the exclusion of any other beneficiaries of the trust.

In the event that the estate tax is permanently repealed or the client's estate is no longer large enough to be subject to the federal estate tax, the independent trustee could potentially exercise his absolute discretion to make distributions from the trust to the spousal beneficiary. If the independent trustee were to distribute all of the trust assets to the spousal beneficiary, this would effectively unwind the ILIT.

Estate liquidity planning using an entity redemption. As an alternative to having the life insurance owned outside the estate by an irrevocable trust, it might be feasible to simply have it owned by the client's family business. If the insured owns the business, then the insured has increased flexibility, because the insured indirectly has control over the business-owned policy.

How is it possible to avoid inclusion of the life insurance in the client's taxable estate if the client is the owner of the business? First, Internal Revenue Code Section 2042, which is the primary IRC section dealing with estate tax inclusion of life insurance proceeds, is inapplicable. It only applies if (1) the insured possesses incidents of ownership in the policy, or (2) the proceeds are payable to the insured's estate.

In this situation, the insured doesn't possess any incidents of ownership (because the policy is owned by the business), and the beneficiary of the policy is the business rather than the insured's estate. The fact that the business is wholly owned or controlled by the insured also doesn't cause estate tax inclusion, because there's case law and IRS guidance indicating that attribution of a business' incidents of ownership only occurs if the life insurance proceeds are NOT payable to or for the benefit of the business. Therefore, there's no direct inclusion of the life insurance proceeds in the insured's estate if the business is the owner and beneficiary of the life insurance policy. But, what about indirect inclusion?

What's clearly includible in the insured's estate is his pro rata share of the value of the business, which may or may not reflect the value of the life insurance proceeds received by the business. This is where the entity redemption comes in to prevent indirect inclusion. Both the U.S. Court of Appeals for the Ninth and Eleventh Circuits have ruled that life insurance proceeds paid to a business don’t increase the value of the business to the extent that they’re offset by an obligation to pay those proceeds to an owner’s estate pursuant to an entity redemption arrangement.

Estate tax repeal, if it happens, would continue to impact the dynamics of estate planning for senior clients, which has already seen considerable changes in recent years due to a substantial increase in the federal estate tax exemption and the enactment of portability.

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