

Estate Planning in Uncertain Times: Advisor-Approved Life Insurance Solutions

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Overview. Except for the field of psychology, by and large, we have learned through decades of education to use a problem-solving approach based on logic. However, in my experience, we often make decisions based on emotion and then justify those decisions with logic. In particular, love and fear, two of the most powerful emotions, seem to dominate the estate planning field. The wealthiest person is a poor estate planning prospect unless he loves someone or something enough to develop a plan to express that love. Unfortunately, uncertainty regarding the future of estate taxes has allowed fear to become the dominant emotion—fear of making a wrong decision; fear of wasting money; fear of feeling foolish; fear that is wrapped in a curious logic that justifies inaction.

The purpose of this paper is to present a general estate planning approach and specific life insurance solutions to address those fears and allow us to help our clients achieve their most heart-felt desires for their families and their communities.

The Federal Estate Tax. For the past ten years, there has been a groundswell of public opinion in favor of repealing the federal estate tax. In the 2000 Presidential election, George W. Bush ran on a platform pledged to make estate tax repeal permanent. After the election, a U.S. Senate majority repealed the estate tax—prospectively, for one year, beginning January 1st, 2010. Under current law as of 2004, the estate tax is scheduled to return in 2011 with a 55% maximum rate and a \$1,000,000 unified credit exemption equivalent, unless Congress changes the law before then.

The estate tax was not repealed “permanently” in 2000 because, at the time, the Byrd Rule required a super-majority of 60 votes to repeal a tax, or to increase spending, permanently. A simple majority could only enact a spending increase or tax cut if it also included an offsetting revenue source or spending reduction. The ten-year provisions of the Byrd Rule required the estate tax to be reinstated in 2011. This Senate rule helped lead to

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balanced budgets and surpluses in the 1990's for the first time after decades of deficits.

Today, the Republican Party, led by President Bush, continues to aggressively pursue permanent estate tax repeal. As the November 2004 elections approached, a majority of Americans erroneously believed they would be subject to an estate tax when they die. An even larger majority believes the so-called "Death Tax" is an unfair tax on assets that have already been taxed during life. Small business associations across America have endorsed estate tax repeal even though most of their members will never pay a penny in estate taxes with the exemptions already in place. With a large majority of Republicans in the House of Representatives and a smaller majority in the Senate, the prospect for permanent repeal seems imminent.

What our concerned clients are thinking. We know that life insurance is the last best tax shelter to help many of our clients achieve their estate planning objectives. But our potential clients are hearing what they want to believe—even if it's wrong. If asked, they tend to express the following thoughts:

- "The estate tax will be permanently repealed."
- "If not, the exemption will eliminate my tax."
- "If not, the estate tax rate will be greatly reduced. It's already down to 45%, isn't it?"
- "I don't want to make a decision until I know what the law will be."
- "I don't want to spend money on life insurance that I don't really need."
- "What part of 'permanent repeal' didn't you understand?"

It is only natural to delay making difficult decisions. It is even more difficult to make complex estate planning decisions that will become irrevocable after our death. And it is often extremely difficult to make decisions that require us to face our own mortality. Consequently, many clients are using the possibility of permanent estate tax repeal as an excuse to delay planning. This is the

emotional environment surrounding the estate planning process today.

What history tells us will happen. Less than a year after I took my first job in the financial planning industry, Congress passed the Employee Retirement Income Security Act of 1974, known as ERISA. As a young man, I saw in ERISA an opportunity to become an instant expert in the field of tax planning, particularly estate tax planning. It didn't matter how old you were, I thought; everyone had to learn the new law. And, as I soon discovered, there would be many new tax laws with planning opportunities awaiting discovery.

As professionals, we are immersed in and live with the reality that the tax laws will change every few years. Sometimes it's a tweak; other times it's a major overhaul; today it's the promise of permanent repeal. More than once, the estate tax has been repealed. Each time, it has been reinstated. There will always be a desire by some group in Congress to change the law. Perhaps our constant exposure to the grist mill of tax legislation has desensitized us to what our clients are seeing and feeling. Knowledge is power and it is time to empower our clients with lessons from history:

- As in the past, death and taxes are still a certainty.

Although cryogenics is a developing industry, to date, all of my clients acknowledge their own deaths are inevitable. They may not want to deal with it, but they will choose to plan now when they see that a pro-active approach gives them control of their future and their legacy.

Taxes have been a part of civilization for thousands of years. The early Christians were advised, "Render unto Caesar what is Caesar's." Every organized government imposes taxes to pay for its operations. Sometimes these taxes are excessive. At other times, our governments seem to be wasteful or inefficient. But, in countries that promote free enterprise, taxes are necessary to provide the governance and infrastructure to protect our freedoms.

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- War, the deficit, and the increasing federal budget will lead to more taxes.

In 2004, the candidates argued about the amount spent to date on the War in Iraq and the cost of ensuring the peace. Whether it was \$120 billion or \$200 billion, as the late Senator Everett Dirksen said in the 1960's regarding deficits, "A billion here; a billion there; pretty soon that's big money." Tax revenues have to pay for our wars and our peace.

Regardless of party affiliation, responsible people are unwilling to accept continuous and increasing federal deficits without taking action. Few people are comfortable with the deficits of recent years. Whether we understand the macro-economic theory behind it, logic tells us that the cost of spending more than we take in eventually will have terrible consequences. Soon, we may choose to pay more in taxes to maintain our security and continue the global "War on Terror" on a balanced budget basis.

Even with tight controls, our federal budget seems to grow every year. Whenever a new administration takes office, or new leadership emerges in Congress, there is pressure to enact programs reflecting the new direction our leaders want to take. For better or worse, the tax code is not just a source of revenue; it is also an instrument of social policy. At some point, gift and estate taxes will return, or perhaps never go away, as a needed source of revenue.

- A "carryover basis" world is unmanageable.

If we die today, most of our assets receive a "step-up" in cost basis equal to fair market value at the date of death. Whether or not they pay an estate tax, the basis step-up allows our families to sell their homes, their businesses, their farms, and their stock portfolios at death without paying any capital gains tax.

In 1976, Congress replaced the "step-up in basis" rules with "carryover basis" rules. For a brief period, estates were subject to both an estate tax and a capital gains tax at death. Accountants, attorneys, investment advisors, trust officers, and advisors anguished over the time, the expense, and the impossibility of accurately determining the cost basis of every asset in each estate. Fortunately, Congress agreed and in 1978 they corrected this problem. However, our institutional memory is too short; the problem returned with the Tax Act of 2000.

Most of our clients don't realize that Congress included a capital gains tax at death in the 2000 tax act, effective 2010, to replace the estate tax. Quite simply, they had to include this new tax in order to justify repealing the estate tax. It's just an estate tax operating under another name and it is just as unworkable now as it was in 1976.

- Any estate tax repeal will be temporary.

Powerful words can be misleading. In the constantly changing world of tax legislation, "permanent" doesn't mean forever. It means "until circumstances change", and they will. Our legislators are constantly balancing fairness and ideals against expedience and economic reality. If Congress repeals the estate tax, they must replace it, sooner or later, with another source of revenue. At some future date, perhaps with the next Congressional session, they may be "forced" to reinstate the estate tax they repealed.

- Many clients will be tricked into paying more transfer taxes because they will not understand that it only takes 51 votes to reinstate the estate tax.

If Congress "permanently" repeals the estate tax, many clients will believe that "permanent" does mean "forever". Convinced that no action is needed, they

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will save legal fees now only to pay much more later. Many current planning options will not be available in a few years. In addition, inaction may cost them the ability to utilize cost effective life insurance solutions as part of their estate plan. When Congress begins its next search for tax revenues and reinstates the estate tax, it will be too late for too many of our clients.

What the estate planning attorney recommends. Fortunately, a consensus is building within the estate planning community. The best advisors want their clients to make informed decisions based on a prudent analysis of the future of estate taxes. Here's what they are telling their clients:

1. Assume the estate tax exemption equivalent will increase to between \$3 million and \$5 million before 2009, but be conservative in your estate tax estimates.

The current law calls for the exemption to be \$3 million per person by 2009. It would be reasonable for it to be increased to that level, or more, now with the inclusion of a cost of living factor to keep from having to revisit the issue every few years. This approach will eliminate 99% of all estate tax returns and still generate significant estate tax revenue from high net worth clients who fail to plan.

2. Expect the maximum estate tax rate to be in the 45% range, but recognize that it could be higher. If it is lower, your planning will just leave a little more for your heirs.

The maximum rate is currently scheduled to reduce 1% per year until it reaches 45%. Most people agree that the scheduled return to 55% is politically unacceptable at this time even though the maximum rate was 70% in the 1980's. An alternative approach might link the rate to any changes in the maximum capital gains tax rate—for most taxpayers, it has ranged from 15% to 28% in recent years. As we get closer to 2010, more

and more people will become aware of the problems associated with a carryover basis regime. This will increase pressure to replace carryover basis taxation with a resumption of the estate tax.

3. Leverage your \$1,000,000 lifetime gift exemption and your \$11,000 annual gift tax exclusions before they are legislated away.

As in the past, the gift tax exclusion is an annual "use it or lose it" proposition. Although some clients are using it to maximum fund \$529 Education Trusts, many more will appreciate the leverage provided by funding irrevocable life insurance trusts. Congress did not increase the lifetime \$1,000,000 gift tax exemption limit in order to discourage tax-free lifetime transfers and retain the option to tax everything either during life or at death.

4. In general, avoid gift taxes, if possible, just in case you die during the short period when there might not be an estate tax.

You can accomplish a lot of planning without paying gift taxes. However, many older clients recognize that gift taxes are approximately 1/3rd less expensive than estate taxes, provided they live three years after the transfer. In addition, they understand the huge advantage of initiating estate tax-free compounding now rather than later. Besides, they don't plan on dying in the one year when there might not be an estate tax. Consequently, they are making the practical decision to proceed with comprehensive estate planning programs even if it may involve paying some gift taxes.

5. Consider life insurance both as a temporary and as a permanent part of your plan.

In most situations, life insurance is one of many tools to consider for your estate plan. It can provide tax-

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free cash while we complete your planning. It can be used to discount your estate tax costs. It may serve as a wealth transfer or wealth replacement vehicle. And, even if there is no estate tax, it will have value as a source of income tax-free cash.

Planning Approaches to help our clients make informed insurance decisions. Many of our most gratifying experiences involve working jointly with advisors and their clients to craft comprehensive plans that utilize life insurance as part of the solution. The professional atmosphere encourages a thorough analysis of planning opportunities to achieve the best results for our clients. Summarized below are some of the ways we have successfully added value to the planning process.

1. **Client-designed policies**—shifting from preparing quotes to managing a unique process with *The Life Insurance Design Questionnaire® (LIDQ)*.

We live in a world of commoditization. Computerization, the Internet, and an increasingly competitive world economy have impacted the shift toward commoditization in the life insurance industry as well as most areas of our economy. It is both normal and reasonable to seek the lowest price for a product or service. Consequently, we often receive requests for a product “quote” instead of an opportunity to add value to the planning process.

In our experience, most life insurance “Requests for Proposal” should ask for a reasonable estimate instead of a quote. For example, if you know the client’s health status and the lowest premium is the primary objective, term insurance can be quoted. However, most other life insurance policies have multiple design features that require an expert understanding of the life insurance industry, its products, and the policy design assumptions. With these policies, an RFP could easily result in each agent quoting a different premium for the same policy! This is both confusing and frustrating to

the client. And, simply selecting the lowest premium may lead to disastrous policy results.

We use *The Life Insurance Design Questionnaire® (LIDQ)* as one of many steps to add value to the insurance planning process. The LIDQ serves several roles. First, it helps us educate the client regarding the many types of insurance products and potential policy design options. Second, with the LIDQ, our client designs his or her desired policy. Third, we use the client’s design specifications to provide reasonable estimates of insurance costs for our clients to choose the company, policy, and plan design that will best meet their objectives. Finally, with trust-owned life insurance, the trustee may use the LIDQ to prepare a life insurance policy management statement in compliance with the Uniform Prudent Investor Act guidelines.

2. **Advisor-approved programs**—Using a *Family Wealth Blueprint™* to coordinate the client-designed policy with the overall estate plan.

In our opinion, many clients do not fully understand and appreciate the significant value provided by each of their advisors—attorney, accountant, investment advisor, trust officer, insurance consultant. For example, from the client’s perspective, there is very little difference in will and trust documents from law firm to law firm or from client to client. They all seem to have the same boilerplate provisions. Unfortunately, if the attorney is forced to plan in a vacuum, this may become a self-fulfilling prophecy. When the attorney is simply providing a commodity, his well-drafted document may do little more than assure proper distribution of assets after providing for full payment of all taxes due and payable.

We have the pleasure of working with many fine advisors who share our passionate desire to provide the highest level of service for their clients. In many cases, they know the client much better than we do.

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In all cases, they have unique abilities and professional skills essential to the design and implementation of a successful plan. With the client's permission, we prefer to work with their advisors to develop our life insurance planning solutions.

We use the *Family Wealth Blueprint*™ and other planning services to help the client's advisors provide comprehensive planning and to coordinate our insurance planning with the overall plan. When the client works with each advisor separately and treats their respective services as commodities, two things can happen. First each advisor's planning is done in a vacuum. Second, the client fails to benefit from the synergy of comprehensive planning. When we plan with the client's advisors instead of simply proposing a life insurance sale, the client receives a number of benefits:

- a. All feasible estate planning techniques, including life insurance, are evaluated in terms of their ability to achieve the client's objectives.
 - b. The role of life insurance, if any, is defined within the overall context of the client's estate plan.
 - c. Each insurance policy is structured within the most appropriate entity.
 - d. The plan includes provisions to efficiently fund the policy with assets, cash flow, income, gifts, or distributions.
 - e. Any recommended insurance is advisor-approved before it is presented to the client for review.
 - f. The client makes an informed and confident decision regarding his plan.
 - g. The implemented insurance program complements the client's estate plan.
3. **Life Insurance that will not pay estate taxes**—maximizing the flexibility of trust-owned life insurance.

The uncertainty regarding estate taxes imposes additional limits on the effectiveness of the traditional

estate planning life insurance sales presentation. This proposal typically includes two basic steps. Step One—calculate the estate tax at the death of the second spouse, surviving spouse, or single client with full utilization of each spouse's estate tax exemption. Step Two—recommend the client purchase an income tax-free policy in an estate tax-free irrevocable trust to pay the estate tax. With this narrow approach, clients often see little benefit to life insurance unless they lack liquidity to pay the tax. Typically, they are not sufficiently motivated to use their income, or transfer assets, to pay for the proposed life insurance.

Today, with the possibility of estate tax repeal, our clients may not see any benefit to life insurance when it is presented for the narrow purpose of providing liquidity for estate taxes. Ben Feldman used to say, "When you walk out, the cash walks in." This remains one of the greatest benefits of life insurance. However, this benefit can do much more than provide for the efficient payment of estate taxes.

We have a marvelous opportunity to help our clients define their legacy and develop solutions tailored to each client's unique concerns and objectives. Whether estate tax planning ranks third, tenth, or even last on their list of major estate planning objectives, with our clients' deepest desires in mind, we can develop life insurance plans that are not dependent on the future of estate taxes. For example, consider the following non-tax insurance planning solutions:

- Life insurance as a wealth transfer device. The prospective repeal of the estate tax will not repeal the gift tax. Life insurance can help our clients maximize the benefit of gift tax-free planning.
- Life insurance as a wealth replacement tool. When a client's plan skips over, or delays distributions to, a generation or designates significant assets for charity, life insurance can efficiently replace those assets for the client's family.

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- Life insurance to fund management trusts. Many irrevocable trusts are established primarily to provide professional management, asset protection, and client-directed distributions for the benefit of the client's family, and secondarily to provide tax-free cash to help discount estate tax costs.
 - Life insurance for the Dynasty Trust. Trust-owned life insurance that utilizes the generation skipping transfer tax exemption can provide estate tax-free asset preservation for multiple generations regardless of future tax law changes.
 - Life insurance to fund a Family Bank Trust. A trust can serve as a Family Bank—encouraging family continuity and individual enterprise with the efficient use of trust assets.
4. **Capitalizing on “Windows of opportunity”.** You may have developed, discovered, or been introduced to a planning idea you want to exploit before the “Window of Opportunity” closes. Before doing so, be certain you will be adhering to the highest ethical standards and acting in the best interest of your clients. For example, consider the consequences of selling a policy linked to an aggressive tax planning idea that doesn't work, is legislated away, triggers a tax audit, or results in litigation:
- You may have harmed, and probably will lose, your client.
 - You may be sued and your insurance or securities license may be at risk.
 - Even if you have not broken any laws, your reputation will be damaged, perhaps permanently.
 - Finally, your actions may cause permanent damage to our industry and its ability to serve the public.
- Creative people are always looking for “windows of opportunity”. In difficult times, it is tempting to cut corners or sell a planning idea that is not in the best interest of our clients. Some apparent “windows of opportunity” will be a little too close to, or perhaps, over the edge. With that as prologue, let's look at several current “windows of opportunity”:
1. Old Split Dollar Agreements. There is a continuing opportunity to provide expert advice to people who have not yet developed an exit strategy for their split dollar plans. Despite 40 years of split dollar plans prior to publication of the final regulations on split dollar arrangements, there are only a few insurance consultants who really understand both the law and the planning options available. In 2002, we developed a *Split Dollar Solutions*™ team to assist advisors and clients.
 2. Life Settlements. You may be able to sell an existing policy to an investor for more than its cash value. In the right situation, the numbers can be compelling, but be very careful. Even if it appears to be in the best interests of your client, there are a number of potential issues, including, but not limited to, confidentiality, insurance limits, whether the life settlement will be treated as the sale of an unregistered security and whether you and your client's assets will be unknowingly at risk for any re-sale to a subsequently dissatisfied investor. Note: your broker-dealer may require any life settlements to be processed as securities transactions with special compliance requirements and the payment of any permissible compensation through the broker-dealer to its registered representatives.
 3. Guaranteed Universal Life (GUL). Many companies are promoting their low guaranteed premium GUL contracts. However, an inflexible contract with zero cash values may not be in your client's best interests. In addition, there is a growing concern that some of these so-called “secondary guarantee” products carry a large, undisclosed, emerging reserve liability that eventually will adversely affect insurance company profit margins and the cost of all life insurance.

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4. **Trust-Owned Life Insurance (TOLI).** At least 44 states have enacted some form of the Uniform Prudent Investor Act. Although it imposes a duty on the trustee to follow a prudent process to analyze, select and manage its investments, most trustees lack the expertise to evaluate TOLI policies from a UPIA point of view. Some states include provisions encouraging trustees to seek the advice of a knowledgeable insurance consultant to fulfill their fiduciary duty. We use the TOLI (Trust Owned Life Insurance) Expert System™ to provide this service to trustees.

5. **Making counter-intuitive recommendations.** It is not always in our clients' best interest to follow trends. For example, studies indicate the average investor under-performs the stock indices because he buys high and sells low in reaction to current trends. With low interest rates and fresh memories of the latest "Bear Market", many investors are looking for guaranteed policies. That may be the easy sale, but not necessarily the best policy for your client.

When interest rates are low, we can help our clients evaluate the benefits of current assumption General Account policies. With the expected return of fixed income rates to their historical levels, our clients will benefit from increased policy values that produce a safer contract and higher death benefits. Until that happens, the use of low interest rates in the compliance illustration should encourage a conservative policy design.

Similarly, while most insurance agents and brokers simply respond to their client's investment fears by following the path of least resistance, we can help our clients make informed decisions regarding whether to use a variable life policy with its Separate Account cash values. The annual payment of life insurance premiums can serve as an effective form of dollar cost averaging. And, logically, the best time to invest is when the market is low but expected to rise over the long haul.

6. **Insurance while you are still insurable.** In an uncertain estate tax climate, the inclination of clients and advisors is to avoid any potentially expensive mistakes by doing nothing. We can educate our advisors regarding the many flexible approaches to insure their clients now while so many factors are in their favor. In addition to all of the normal reasons to consider life insurance, it is important to remind our clients that premiums will only increase as they get older, products currently available are not guaranteed to be available in the future, and the best time to act is while they are still insurable.

We can allay the advisor's concerns regarding uncertainty by developing flexible, trust-owned life insurance plans tailored to each client, such as:

1. Including convertible term insurance as an option.
2. Using a low premium to initiate permanent coverage while waiting for estate planning clarity.
3. Making the cash value equal the premium at a designated age to limit the potential surrender cost to a lost use of money calculation.
4. Utilizing a split dollar plan to defer gifting and recover any premium payments if the insurance is not needed in a few years.
5. Designing a cash value-oriented policy with an increasing death benefit feature "just in case" the client really does want a large tax-free death benefit as he or she approaches life expectancy.
7. Using life insurance before they change the rules. By working with knowledgeable advisors, we can help our clients understand that today is the best of times to complete their estate plans. When Congress reformed the estate tax, with the seductive promise of repeal, it left all our estate planning tools in place. It is in our clients' best interests to select from and implement the best planning tools available now, because, as we have seen, many appropriate and effective techniques will not be available a few years from now.

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Similarly, now is the best time to include an “advisor-approved” life insurance program as part of their estate plan. Future policies may be less flexible or more costly than the excellent policies available today. Life insurance is no exception to legislative attack. The insurance industry is always potentially subject to increased taxation that could adversely affect future insurance policies. In addition, the prospect of increased regulation carries with it the prospect of more policy expenses. And there is no guarantee we will always have the great benefits of tax-deferred cash value

growth combined with income tax-free and, potentially, estate tax-free death benefits.

Summary. Sophisticated clients are comfortable planning in uncertain times when they have the confidence that their advisors are helping them make informed solutions that will stand up to the test of time. We can provide our special expertise to design cost effective and creative “advisor-approved” life insurance solutions that will make sense regardless of the future of estate taxes.