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The New Politics of Planning

2017 Life Insurance Planning

Why this could be a strong year despite uncertainty in the tax law

by Mark Peterson

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Along with the combined Trump administration and the Republican-led Congress comes uncertainty and change in our tax laws. Both the Trump administration and the Republican tax platform include a proposed repeal of the estate and gift tax along with significant decreases in both corporate and individual tax rates. This raises the question: how should these looming changes and this time of uncertainty affect life insurance planning in 2017? Should clients just wait a few years to see what happens?

As everyone knows, change is constant. It is good to remind clients of this fact, as well as the fact that it is doubtful long-term certainty will ever exist. That's why it's vital to act now to preserve insurability and pricing rather than take a "wait and see" approach. One accident or the onset of an illness could forever change a client's ability to purchase the protection that life insurance affords.

Successful planners will view 2017 as a time of opportunity and therefore, will focus on the following:

#1: Flexibility is key

While flexibility in planning has been important for several years, it is now more important than ever. Historically, the estate tax has been repealed only to be reinstated a short time later and there's little reason to believe this won't happen again. While planning in 2017, it's crucial to keep this in mind and help clients prepare for this possibility.

Always recommend to clients that they work with their attorneys to draft flexibility in their documents. For example, by building in provisions in trust documents – such as the power of substitution over assets in a grantor trust, granting powers of appointment, or giving the trustee the option to allocate assets to charity – you preserve flexibility to adjust the plan at a future time based on the then-current tax environment. Be sure, however, to tell clients to consult with a qualified tax expert when considering their own situation.

#2: An estate tax repeal does not eliminate estate planning

Clients may have shared that they care less about tax and more about maintaining control over their assets (i.e., being responsible stewards of their money, motivating and preserving the independence of their heirs, planning philanthropic gifts, and minimizing family conflicts). If the estate tax is in fact repealed, go back to basics and focus conversations with clients on identifying which of these areas are important to them, and then show them how life insurance can meet these needs and solve problems in these areas.

In addition, estate equalization is a common non-tax area of concern for clients. You've likely had clients with one child active in the family business and another child pursuing interests in other areas. Life insurance is a great way to preserve the integrity of a family business while treating the children equally in terms of the value of the inheritance received. Even with the repeal of the estate tax, these strategies remain a powerful solution to equalizing estates.

#3: A federal estate tax repeal does not necessarily mean a repeal of state estate taxes

Over the past 15 years, many states have decoupled their estate tax from the federal estate tax, and there is no reason to believe this trend will not continue. While some states have chosen to forego the estate tax, others have tried to maintain revenue from this source by adjusting their estate and gift tax laws to keep up with the rapidly changing federal laws.

If the estate tax is repealed, it will be interesting to see how the states react and if they make further amendments to their laws. Regardless of the exact changes made, clients will need professional guidance and assistance to understand the differences between the federal tax laws and the state estate and gift laws, and to identify planning opportunities created by these differences.

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#4: Instead of estate-tax planning, focus on basis planning

One area of consensus among tax planners is that there will be a greater focus on basis planning if the estate tax is repealed. With the elimination of the estate tax comes an expectation that the step-up in basis will be eliminated.

But the question remains: under the new tax regime, will death be considered a redemption and trigger capital gains or ordinary income tax? If this occurs, an estate would owe tax on the difference between the decedent's basis and the fair market value of his or her property at the date of death. If this does not occur, the heir(s) presumably would receive a carryover basis from the deceased and would pay tax on the difference between the sales price and the basis on the date the heir disposed of the asset.

Life insurance is taxed unlike any other asset. As death benefits generally are income-tax-free under current IRS regulations, neither the client nor his executor or heirs typically pay tax on the difference between the premiums paid (the basis) and the proceeds at death. Thus, if ownership of the life insurance is structured in a tax-efficient manner, both income tax and estate taxation may be avoided. This type of planning may provide a unique opportunity for life insurance sales under the new tax regime.

Let's look at an example. If a client purchased a piece of real estate for $250,000, and real estate prices grew at 5 percent per year, in 30 years the property would have a value of a little over a million dollars. If the client died in year 30 and his heir sold the property, his heir would owe capital gains tax on the difference of $750,000 ($1,000,000 sales price less basis of $250,000). Given an assumption that the capital gains tax rate is reduced to 15 percent, the tax owed would be $112,500.

However, if a client purchased, at age 45, a 30-year term life insurance policy with a $1 million death benefit, and died 30 years later when he was 75, he would have paid approximately $70,000 in premium for the million-dollar death benefit, but his beneficiary would not owe any tax on the death proceeds. He would have saved $112,500 in capital gains tax.

Please note that this hypothetical example is for illustrative purposes only. It's not an actual case and is intended solely to depict how the life insurance product features might work. It does not reflect the value of any specific policy.

#5: Income tax deferral and management are still important

If the individual and trust tax rates are lowered as expected, clients still will be looking for opportunities for tax deferral and tax management. Several strategies will still be viable, such as buying life insurance in a trust. The tax benefits of life insurance, such as tax-free accumulation and federal income-tax-free death benefit, still will be appealing whether the client is paying tax at a high rate or a low rate.

#6: Life insurance can help solve non-tax planning needs

As stated above, this is a good time to go back to the basics of why people buy life insurance. Life insurance solves innumerable non-tax planning needs. 2017 is a great year to revisit existing clients to learn about any key changes that have occurred in their lives – such as divorce, remarriage or childbirth – and to determine how to update their estate plan to accommodate these changes.

With today's more complex modern families, clients may have children from prior marriages, life partners, new spouses, etc. They can no longer just avoid estate planning and rely on the laws of intestacy to take care of the ones they love. For example, life insurance is an excellent vehicle to provide for a new spouse while preserving assets of a prior marriage for the children of that estate. By leveraging life insurance, you have the potential to help clients minimize conflicts among their blended families.

Life insurance owned by a trust still is a wonderful way to pass wealth to the next generation. The terms of the trust can provide flexibility and protect the heir from a number of problems, such as difficult marriages, substance abuse or mismanagement of money. The design of the trust can provide flexibility, liquidity and creditor protection.

#7: Life insurance planning for businesses

The Trump administration and Congress both have announced that they intend to make significant cuts in business tax rates. As a result of not having to pay these additional taxes, companies will have more cash available to invest in life insurance and business planning strategies. This year may be an excellent time to meet with business clients and discuss their planning needs.

In 2017, the tax environment may be uncertain and rapidly changing. However, this will only create new opportunities to serve clients' needs. In addition to going back to basics and looking for ways to help clients meet their non-tax objectives, focus on staying optimistic and capitalizing on the unique tax aspects of life insurance to help clients navigate the new opportunities. ❖

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