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The Continuing Need for Life Insurance to Meet the Client's Business and Estate Planning Objectives

In this issue we discuss how life insurance will continue to play a prominent role in meeting our client's needs in business planning, executive benefits, retirement planning, estate planning and funding income replacement.

This article reflects the law established under the Act. Among other changes, the Act permanently establishes an exemption amount of $5,000,000 ($5,250,000 as adjusted for inflation in 2013) per person for gift, estate and generation skipping transfer tax (together referred to as "transfer tax") purposes, establishes a maximum transfer tax rate of 40% and provides for permanent portability of the estate tax exemption between spouses.[1]

The passage of tax legislation often creates planning opportunities for many taxpayers and this is especially true with the American Taxpayer Relief Act of 2012. The fact that these changes are not subject to an automatic sunset provision finally eliminates some of the uncertainty that has made estate planning difficult for the last 10 years and has resulted in many taxpayers taking a wait-and-see approach to estate planning. The new Act presents tremendous planning opportunities and should prompt clients to act now to take control of their estates.

[1] Future changes in transfer tax exemption amounts and transfer tax rates may impact the appropriateness of any transfer tax planning strategy or product sale. Clients need to understand that tax law is always subject to interpretation and legislative change. MetLife and its affiliates do not provide tax advice and therefore clients must speak with their qualified legal and tax counsel regarding their current estate plan and what planning options are available and appropriate.

I. Introduction

Even with the exemption amount for gift, estate and generation skipping transfer tax purposes increasing to $5.25 million per person ($10.5 million per married couple) in 2013, life insurance will continue to be an important tool in helping a client achieve his or her estate and business planning objectives. The focus for most clients, however, will change - from one of creating liquidity to pay estate taxes and replacing property lost to taxes to funding the legacy a client wants to leave his or her family and community. Too often taxes drive the planning process. This is planning by default since the resulting legacy is defined simply by whatever is left after taxes. Legacy planning should be driven by the client's objectives. However, for this to occur the client's objectives cannot be assumed but rather they must be clearly identified.

Financial Independence

A client should start with his or her own financial independence. Before a client can have the freedom to define the legacy he or she wants to leave, the client must be comfortable that the standard of living for both the client and his or her spouse will be maintained under even the worst case scenario.

Family Legacy

Once a client is comfortable that his or her financial well-being is protected, the client can focus on his or her family legacy. It is important that this legacy be well defined because it involves the transfer of a value system in addition to the assets themselves. Accordingly, a client often expresses concern regarding the impact an inheritance will have on his or her family. These concerns must be addressed when determining the manner in which the assets will be distributed to the heirs.

Social Capital

It is not uncommon to find that a client, if given the opportunity, wants to leave a charitable legacy. However, the client cannot become committed to a charitable legacy unless there is first sufficient personal financial capital to fund both the financial well-being of the client and his or her family legacy. Once these objectives have been met, the client has the freedom to allocate any excess capital to fund a charitable legacy. This capital is referred to as social capital. It includes government-directed social capital and self-directed social capital. Assets allocated to the payment of taxes constitute government-directed social capital as opposed to property donated to charity which constitutes self-directed social capital. Charitable planning is aimed at giving the client and his or her family more control over the disposition of social capital.

Cash value life insurance can be an efficient way to fund these legacies especially where they are to be funded upon the client's death. The tax deferred accumulation of cash value coupled with the income tax free death proceeds (the proceeds are estate tax free when the policy is owned by a properly formed irrevocable life insurance trust) can generally generate a reasonable after-tax return even at life expectancy when premium payments are compared to the policy death benefit.[2] Life insurance can also be viewed as a hedge against the client's premature death. This approach can change the psychology of the sale from a negative to a positive. The client no longer sees life insurance as being synonymous with estate taxes but rather it is now positively associated with the creation of a legacy for his or her family and community.

While the design of the plan may change, the central role of using life insurance to solve complex problems will continue. The key to planning with life insurance in today's environment is to develop a plan which permits the client to take control, to the extent possible and yet still retain flexibility for life's changing circumstances. It may be helpful to look more closely at the specific uses of life insurance in the estate and business planning process, and how life insurance can be used to meet a client's objectives.

[2] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec.101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable.   Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

II. Needs for Life Insurance in 2013 and Thereafter

1. Individually Owned Life insurance

The permanent increase in the exemption amount for estate tax purposes may make the personal ownership of life insurance more attractive to many of our current estate planning clients. Many more clients will be able to personally own their own life insurance, enjoy the tax deferral of the accumulating cash values* and retain access to the cash values without concern that such control will create negative estate tax consequences.[3] Furthermore, when properly structured, this access to cash value will not trigger an income tax if effected through partial surrenders to basis and/or policy loans. However, surrenders and loans will reduce both the cash value and the death benefit and interest will be charged on policy loans.[4] The death benefits will pass to their heirs free of at least federal estate tax if the client's taxable estate is less than $5,250,000 in 2013 (and as this amount is adjusted for inflation in future years). This will only enhance the use of life insurance to fund a client's legacy. Clients, with the help of their tax and legal advisors, should be sure to give thought to long term planning objectives.

In addition to the tax benefits, life insurance may be an attractive asset to own for creditor protection purposes. In several states, the cash value and the death benefit are afforded some protection from the insured's creditors.[5]

2. Spousal/Survivor Income

Remembering that a definition of estate planning is the orderly disposition of assets to the intended heirs, the issues of providing adequate survivor income and treating children equally or equitably cannot be overlooked. These issues drive home the point that the key to evaluating the need for insurance as part of a client's overall plan is the client's objectives.

Even without the higher exemption amounts, clients have been reluctant to make the lifetime gifts that are critical to many estate plans. A client wants to know that

[3] Cash value accumulations are not guaranteed. Moreover, investments in a variable life policy are subject to market risk including the loss of principal. Dividends in a whole life policy are not guaranteed and may vary depending upon mortality risk, investment risk and expense risk.

[4] Tax-favored distributions assume that the life insurance policy is properly structured, is not a modified endowment contract (MEC), and distributions are made up to the cost basis and policy loans thereafter. Loans and withdrawals will decrease the cash value and death benefit. If the policy has not performed as expected and to avoid a policy lapse, distributions may need to be reduced, stopped and/or premium payments may need to be resumed. Should the policy lapse or be surrendered prior to the death of the insured, there may be tax consequences.

[5] Creditor protection laws vary dependant upon governing federal and state law. Individuals should be sure to confer with their independent tax and legal advisors regarding how applicable laws apply to their particular situation.

he or she has accumulated enough wealth to live comfortably in retirement. The client wants to know that if he or she dies the spouse will have enough income to maintain a certain standard of living.

One of the major points that should be emphasized is that the key to planning with life insurance will be flexibility. Even with so-called permanency, we do not truly know what the exemption amount will be when the client dies. While many of the same needs and objectives for clients will still apply regardless of the level of the exemption amount, some needs are clearly the result of the estate tax. Many clients may be reluctant to commit to funding for an estate tax need. However, a properly designed irrevocable life insurance trust can still serve as the cornerstone of an effective estate plan. Clients should consider using single life products inside these trusts since the death benefit can help meet a myriad of needs such as support for the surviving spouse, business continuity and estate equalization.

In light of the increased estate tax exemption, life insurance funding may change over time. Traditionally, producers have made certain assumptions regarding the client, calculated the client's projected estate settlement costs and then recommended that the client purchase the maximum amount of death benefit to meet that projected need. The goal was often to minimize the premiums paid for a set amount of life insurance, given that the policy was often placed in an irrevocable trust, outside the direct reach of the insured(s).

There are several shortcomings with this traditional approach. First, it will continue to be extremely difficult to accurately predict the amount of estate settlement costs. Given the uncertainty regarding the future estate tax laws, the uncertainty as to what will be the future growth in the client's estate and the uncertainty as to how effective estate tax planning techniques will be in reducing these projected costs, the initial amount of life insurance purchased will often be far more or far less than the client's actual need. A second disadvantage in this approach is that in funding for the maximum death benefit, the client is sacrificing cash value buildup and may be jeopardizing the underlying viability of the policy. This emphasis on death benefit will often result in the underfunding of the policy and the policy's early termination. These policy lapses lead some prospective clients and their advisors to perceive life insurance as a poor or instance, many attorneys are reluctant to allocate the precious GST exemption to a life insurance trust in the fear that this GST amount will have been wasted if the policy terminates.

It may prove more attractive to view life insurance funding as nothing more than a tax-advantaged sinking fund. Rather than minimally funding the policy, a better approach may be to heavily fund the whole life or variable life policy, up to the modified endowment contract (MEC) limits. The most efficient cash value policy, if there is a significant chance that the insured will live beyond life expectancy, is one that provides the minimum initial death benefit, but the maximum cash value.

While this policy will provide a lower death benefit initially, it will ultimately provide a greater death benefit at older ages. The higher cash value during life will also provide more flexibility to make changes in the event the policy is no longer performing. This substantial funding approach works well with a type of irrevocable trust known as a spousal lifetime access trust (SLAT). These trusts may address the concerns of uncertainty in future estate tax law and spousal income by allowing the trustee to make distributions from the trust to the non-grantor spouse not only after the insured grantor dies, but also while he or she still lives.

By allowing the trustee to make distributions of trust principal and income to the insured's spouse in accord with the terms of the trust, the SLAT addresses the spouse's concern of having access to the trust funds in case of emergency or in case unforeseen income needs arise in the future. To this end, while the insured is alive, it is possible for the trustee to take withdrawals or loans from a life insurance policy to make distributions to the spouse. Distributions may or may not be income taxable depending on how the policy is structured. If the policy remains in force in the trust at the insured's death, then death proceeds will, of course, provide spousal survivor income after the death of the insured. The fact that the proceeds are in a trust, rather than paid outright to the spouse, will be consistent with the objectives of many clients.

The SLAT addresses the flexibility concern in that it allows the insured's spouse access to the trust assets (including any life insurance cash values) through trust distributions in some circumstances. While the trust assets may not be reached by the insured/grantor, the trust can provide income or principal distributions to the grantor's spouse. This option will also allow the spouse – in his or her capacity as trustee – to access policy values subject to an ascertainable standard, increase or decrease the insurance coverage, or make other changes to the policy as new legislation alters tax law or as the couple's circumstances change.

We note that there is very little guidance that specifically addresses the tax treatment of SLATs, and as with other ILITs, please note that an improperly drafted SLAT or improper administration can cause estate tax inclusion of trust assets and policy death benefits in the estate of the insured, the spouse, or both.

3. Estate Equalization

Related to the survivor income issue is the issue of estate equalization. Does the client want to treat the children equally or equitably? When does the client want the children to inherit his or her wealth? There may be situations where a client wants to leave a specific asset to one child and that asset represents a significant portion of the estate. Insurance can be a simple way to equalize the inheritances. There may be situations, perhaps in a second marriage, where the client needs to balance survivor income needs (e.g., providing income through use of a QTIP Trust) with the timing of distributions to the children (e.g., children of first marriage receive the trust assets at the time of the second death). Again, insurance can be a simple and effective way of solving the problem.

The family business owner is, perhaps, the best example of a client who must address the survivor income and estate equalization issues. If the client's objective is to keep the business in the family then there are likely to be at least three additional objectives: control of the business should pass to the children who are active in the business, the financial needs of the spouse should be provided for separate and apart from the business, and the children who are not active in the business will need to be treated fairly.

If the business is bequeathed to a US citizen surviving spouse, the transfer should qualify for the marital deduction. However, if the spouse is not active in the business, problems are likely to arise. Control probably should shift to the active children upon the business owner's death. The easiest solution is simply to bequeath the business interest to the active children. This assumes that there are sufficient non-business assets to maintain the surviving spouse's standard of living. If this is not the case then there may be a need for life insurance. In addition, federal and/or state estate taxes may be due upon the transfer. Life insurance can be owned by the active children and used to pay these taxes. Alternatively, the business owner may want the active children to purchase the business and have the proceeds pass to the spouse to provide survivor income.

Once the surviving spouse's needs are met, there still remains the objective of treating the children who are inactive in the business fairly. Generally, the business should not be used to equalize the estate with the inactive children. Non-business assets should be used. Treating the children fairly or equitably does not necessarily mean that the inactive children receive assets of equal value. Again, it is the client's objectives that should control how the planning is accomplished.

4. Legacy Planning

As stated earlier, the $5,250,000 estate tax exemption in 2013 (and as adjusted for inflation in future years) makes it easier to fund the client's legacy with life insurance. The use of an irrevocable life insurance trust may not be necessary for many of our estate planning clients today. It will be important to have a strategy available that will permit the transfer of the insurance policy from the taxable estate (without subjecting the death process to the three-year rule) should the client's taxable estate ever exceed the exemption amount. There may be added gift and generations-skipping tax costs and other expenses involved in transferring a policy to an irrevocable trust after issuance if circumstances change.

This means that the client can maintain access to the policy's cash value for his or her own needs and still create a substantial death benefit to meet the needs of his or her family and/or community. In the typical hierarchy of needs, a client wants to make sure that his or her needs and the needs of the spouse are met. Then the client needs to make a decision as to how much wealth he or she wants to leave the children. Often, the decision is that the children need not inherit all the wealth. A client may have reached the point in the estate and business planning process that the objective is to leave a legacy. That legacy may be for grandchildren and great-grandchildren, or that legacy may be for a favorite charity or charities.

Life insurance has been proven to be an effective way in helping the client provide for his or her legacy. It not only provides reassurance but it can actually liberate the client to enjoy life and to spend his or her other assets during life knowing that the legacy for his or her heirs has been properly funded. A popular way to make a legacy to grandchildren and great-grandchildren is a generation skipping trust. A generation skipping trust often provides that at the death of the client the assets shall remain in trust, with income and principal being available to the children at the trustee's discretion. After the children die the assets remain in trust for the benefit of the grandchildren or even succeeding generations. The length of the trust is limited in many states by either the rule against perpetuities or a uniform statutory rule of 90 years. Certain states, such as Alaska and Delaware, have adopted statutes that effectively do away with any limit on the term of the trust.

The death proceeds are received by the trustee income tax-free, estate tax-free and generation-skipping tax-free so long as the GST exemptions were properly allocated to the premiums. While the proceeds remain in the trust, they will continue to be available to the beneficiaries for future generations without any transfer taxes. The trust assets will also remain sheltered from the creditors of the beneficiaries, including the spouses of the beneficiaries in the event of divorce.

In funding a generation skipping trust today, it is important to avoid the generation skipping tax. The generation skipping tax is a tax in addition to the gift and estate tax and is intended to tax transfers that skip generations and are therefore not subject to the estate tax when the children of the grantor die. The tax can apply to property in a generation skipping trust when distributions are made to "skip persons" (e.g., grandchildren), or when all "non-skip persons" (e.g., children) die.

The new law currently provides for a $5.25 million exemption for gift, estate and generation skipping tax purposes for 2013, and this amount is indexed for inflation. The exemption may be used during life or at death. In order to maximize the benefit of the exemption, lifetime gifts of appreciating assets are often made into the generation skipping trust. Life insurance can provide significant leverage especially when there is a substantial difference between the cumulative premiums and the face amount of the policy. The benefits made possible with life insurance can be further enhanced by using second-to-die insurance and, where, appropriate, through the use of split dollar life insurance arrangements.

5. Charitable Giving

Once a client is comfortable that he or she has satisfied personal needs, and once the decision has been made as to the size of the family legacy, a client may wish to leave a charitable legacy. The payment of the estate tax is largely voluntary in that the current law allows for an unlimited charitable deduction. This unlimited deduction is consistent with the underlying theoretical basis for the estate tax—the redistribution of wealth. If wealth is voluntarily redistributed to a qualified charitable organization, there is no tax.

Zero Tax Plan

Even very wealthy clients may be able to avoid paying estate taxes. First they should identify the legacy they wish to leave to their families. For many of these clients their family legacy can be funded by gifts and bequests that are sheltered from gift and estate tax by the annual exclusion and by the applicable exclusion amounts. These gifts can be leveraged by purchasing life insurance owned outside their estates. The remaining assets stay under the client's control where they are available to fund the financial independence of the client and his or her spouse. No estate tax will be paid on these assets because they will pass to a qualified charity upon the death of the surviving spouse. This approach becomes even more attractive under the new law with the increase in the amount that can be transferred during life free of gift tax and generation skipping transfer tax to $5,250,000 in 2013(and as adjusted for inflation in future years).

Funding a Charitable Legacy

A life insurance policy can also be used to fund a charitable legacy. One simple way is for a qualified charity to be the owner and beneficiary of a policy on the life of a donor. If the donor contributes cash to the charity to pay for the premium he or she will be eligible for a charitable income tax deduction. At the donor's death the charity can receive a substantial legacy.

In order for a life insurance policy to be considered valid, it must meet the insurable interest rules in the state in which it is issued. Most states have enacted laws giving a charitable organization an insurable interest in a donor’s life. However, before creating a charitable plan using life insurance, state law should be considered.

Charitable Remainder Trust

Another common way to use life insurance in conjunction with a charitable legacy is combining an irrevocable insurance trust with a charitable remainder trust. A gift to a charitable remainder trust is a split-interest gift. The donor usually retains the right to receive the income for life or the joint lives of the donor and spouse, and upon death the charity receives the remainder interest. The donor typically makes a gift of appreciated property to the trust, the trust then sells the appreciated property with no tax consequences, and the donor is eligible for a current income tax deduction equal to the present value of the remainder interest. Although a charitable remainder trust is itself exempt from income tax and, therefore, pays no tax on any of its taxable income, the annuity payments made to the non-charitable beneficiaries carry out taxable income that is subject to tax at the beneficiary level. The irrevocable life insurance trust is often used to replace the assets left to charity so the family legacy is not reduced.

Individual Ownership

Clients may also wish to maintain control over the policy and simply name the charity as the beneficiary. If the donor owns the policy and merely names the charity as a beneficiary, no income tax deduction is available for the payment of premiums since this is not a completed gift. Upon the donor’s death, the value of the policy will be included in the donor’s estate, but the entire portion of death proceeds paid to charity will qualify for the estate tax charitable deduction. [6]

6. “Stretch” IRAs

While IRAs are attractive as wealth accumulation vehicles, they are not generally looked upon as attractive wealth transfer vehicles. Under current law, qualified plans are subject to income tax and possibly state and federal estate taxes at the death of the participant or the participant’s spouse. Although an income tax deduction is allowed for the estate taxes paid that are attributable to the IRA under IRC Sec.691(c), it is still possible that more than half of the plan balance may be lost to taxes. Fortunately, with proper planning the income tax can be deferred by delaying distributions for as long as possible.

[6] IRC Sec. 2042(2), 2055, Comm. v. Pupin, 107 F.2d. 745 (2nd Cir. 1939)

A popular technique is the “stretch” IRA. The concept is to structure the client’s qualified assets to allow for the minimum distribution possible. It is best suited for clients who have income from sources other than the qualified plan. The general rule for qualified plans and the rule for IRAs is that distributions must begin in the year following the year the taxpayer attains the age of 70 ½. Under this approach distributions are delayed as long as possible and at age 70 ½ the required minimum distribution is paid to the taxpayer. While the taxpayer is free to take more than the required minimum distribution, he or she must take at least the minimum or be subject to an excise tax equal to 50% of the amount the distribution falls short of that which is required. [7]

An example of a stretch IRA is as follows: a client has accumulated a large balance in his qualified plan. He designates his spouse as beneficiary of the plan. At age 70½ he begins to take the required minimum distributions. The client dies at age 75. The spouse, then age 74, rolls over the balance into her own IRA and designates her 45-year-old son as the beneficiary. No income or estate tax is due at the client’s death. The spouse takes the new required minimum distribution over her life. At the spouse’s subsequent death, the son is allowed to take distributions over his own remaining life expectancy. The potential benefit of this technique is that the family may accumulate more wealth due to the tax-deferred growth within the IRA, despite the fact that distributions are subject to income tax. Estate taxes may be due at the spouse’s death. The key is to have sufficient liquid assets, typically life insurance owned by an irrevocable trust. The death proceeds can be distributed to the IRA beneficiaries in order to enable them to pay the estate tax attributable to the IRA balance so that the IRA itself is not depleted. Even if no estate taxes are due, life insurance can be used to provide an immediate source of liquidity to the IRA beneficiaries so that they will have less need for liquidity and that hopefully that will allow the IRA distributions to be stretched out as long as possible.

Portability is a helpful tool where a large portion of the estate is held in qualified assets. Before portability, if the decedent did not have enough nonretirement assets to fully fund the credit shelter trust, there was a tradeoff between the income tax benefits of leaving the IRA to the spouse and the potential estate tax benefits of leaving some or all of the IRA to the credit shelter trust or to or in trust for the children.

Portability largely solves this problem. The IRA owner can designate the spouse as the beneficiary of the IRA. At the participant’s death the spouse can utilize a spousal rollover and name new beneficiaries to achieve a longer stretch-out. Except with respect to the income and growth on the exempt amount during the spouse’s lifetime, the estate tax benefit of the credit shelter is preserved as portability allows the IRA owner’s unused estate tax exempt amount to be transferred to the spouse.

[7] IRC Sec. 4974(a); Treas. Reg. Sec. 54.4874-1

7. Qualified Plans

Contributions to qualified plans are generally deductible from the employer's perspective, not currently taxable to the employees and the assets in the plan grow tax-deferred. As a result, qualified plans can offer substantial opportunities for wealth accumulation. In fact, a client's qualified plan often represents one of the client's largest single assets. A qualified plan, whether a defined benefit plan, defined contribution plan or profit sharing plan, may own life insurance on the life of the plan participant subject to certain limitations, based on both the type of plan and the type of policy owned by the plan.

Qualified plan assets may be used to purchase life insurance provided certain conditions are met including: 1) the plan document specifically authorizes the purchase of life insurance on the person to be insured; and 2) the life insurance death benefits are incidental to the plan's primary purpose of providing retirement benefits. Adherence to the incidental benefits tests as proscribed by the IRS results in a limit on the amount of life insurance that may be held in a qualified plan. As such, dependant upon an individual's planning goals, additional life insurance may need to be purchased outside of the plan. A policy held inside a qualified plan is included in the participant's taxable estate and a portion of the policy proceeds may be taxable for income tax purposes as well.

The qualified plan affords the opportunity to purchase the life insurance with tax deductible dollars or with money already contributed to the plan. Now, with the estate tax exemption amount at $5.25 million in 2013, (and as adjusted for inflation in future years) it may become popular again to own life insurance inside a qualified plan. For many of our clients, qualified plans will serve a dual role. They will act as wealth transfer vehicles in addition to their traditional role of funding retirement needs. Pre-tax dollars will be used to purchase life insurance inside the plan. The pure insurance portion of the death benefit will be used to fund the client's legacy while the cash value, along with the remaining side fund will be used to fund his or her retirement needs. This permanent increase exemption amount will only enhance this design as it may shelter more of the pure insurance death benefit from estate taxes.

If the plan does own life insurance on the plan participant, the participant must recognize income annually on the value of the pure "at risk" component of the insurance (generally, the death benefit in excess of the cash value). The value of that component is generally measured by the lower of the government's "Table 2001" rates or the insurer's Yearly Renewable Term (YRT) rates. Since, at the insured's death, the plan beneficiary receives the at-risk component, the beneficiary receives a lump sum, income tax-free benefit.

A qualified plan generally provides retirement income for the plan participant and his or her spouse. However, recognizing the benefits of tax-deferred growth, it is often desirable to take the minimum distribution required from the plan or, if the beneficiary of the plan is the surviving spouse, upon the death of the participant, to roll over the balance into an IRA and continue to defer taking distributions. By creating a separate nonqualified fund to meet expenses, the income tax-free death benefit from the life insurance can help in meeting a stretch IRA objective.

Life insurance is generally purchased within a qualified plan for the purpose of providing retirement income in the event of the participant's premature death. However, it also provides wealth accumulation and an income tax free death benefit. The plan incurs the cost of the insurance, and at a subsequent date transfers the policy to the insured. The insured recognizes income based on the fair market value of the policy, less his or her income tax basis in the policy. The insured could then gift the policy into the irrevocable trust, and assuming he or she survives three years, the proceeds would be excluded from his or her estate for federal estate tax purposes.[8] Alternatively, the insured might purchase the policy from the qualified plan, leaving the full value in the plan, and then make the gift of the life insurance policy. If the insured wishes to eliminate the three-year rule concern, the insured could gift cash into a "defective" grantor irrevocable trust, and then have the trust purchase the policy for its fair market value from the plan.

8. Nonqualified Deferred Compensation Plans

Life insurance will continue to be an attractive funding vehicle for nonqualified deferred compensation benefits. Despite all the benefits of qualified plans, there are inherent limitations. The law is structured to ensure that qualified plans do not discriminate against rank and file employees. As a result, they sometimes "discriminate" against the highly compensated employee due to limitations on the amount of money that can be contributed to a plan.

A nonqualified plan can be used to supplement a highly compensated employee's income after retirement. Nonqualified plans are also used by employers to attract and retain key employees. In its simplest form, a nonqualified plan is a written contract between the employer and employee whereby the employer promises to pay to the employee on a date certain a designated amount, or an amount based on "earnings" on the amounts contributed to the plan. The plan may be "supplemental" in that the employer promises additional compensation, it may be a "true" deferred compensation plan where the employee defers a portion of his or her salary or bonus, or it may be a

[8] Where a donor gives away or releases any incident of ownership in a life insurance policy, the entire death benefit will be pulled back into his/her taxable gross estate if death occurs within three years of making the transfer. IRC § 2035.

combination of both. The plan may incorporate a vesting schedule or may require the employee to stay employed until retirement or forfeit all benefits. Properly structured, the employee recognizes no income, and the employer receives no deduction, until payments are actually received. IRC § 409A sets forth specific rules regarding deferred compensation arrangements. It is important to confer with your independent tax and legal advisors to ensure applicable deferred compensation arrangements fully comply with § 409A. Arrangements that are not in compliance are subject to significant income tax consequences, penalties and interest.

In order to avoid potentially adverse consequences under both the tax law and ERISA, a nonqualified plan must be both "unfunded" and it must discriminate. That is, the plan can only be offered to a select group of highly compensated employees or management. A plan is unfunded if the employee has no specific right or interest in any asset that is being used by the employer to meet his or her obligations under the plan; more specifically, the promise is not secured in any way. Corporate or business owned life insurance is an ideal asset to informally fund a nonqualified plan because the cash value not only grows tax deferred but, when properly structured, the employer can access the cash value without triggering a taxable event by surrendering cash values to basis or by borrowing against the cash value of the policy.[9,10] The death benefit may be used to provide a pre-retirement death benefit, to meet any obligations to the surviving heirs or in some cases to help the employer recoup its costs.

9. Split Dollar Life Insurance Plans

Split dollar is a selective benefit that is typically used to provide both needed death benefit protection and, in some situations, to help accumulate wealth. Split dollar is simply a way to split the cost and the benefits, both the cash value and the death benefit, of a life insurance policy. Under a typical endorsement split dollar plan, the business is the owner of a policy and the business endorses all or a portion of the pure death benefit to the executive's designated beneficiary. The business pays the premium and owns the policy's cash value. The executive recognizes income on the "economic benefit" (i.e., the value of the pure at-risk term insurance amount). The economic benefit is generally measured by the lower of the government's Table 2001 rates or the insurer's YRT rates. The

[9] To ensure that the death proceeds of an employer-owned policy retain income tax favorable characterization, it is essential to comply with the requirements of Internal Revenue Code Section 101(j).

[10] Tax-favored distributions assume that the life insurance policy is properly structured, is not a modified endowment contract (MEC), and distributions are made up to the cost basis and policy loans thereafter. Loans and withdrawals will decrease the cash value and death benefit. If the policy has not performed as expected and to avoid a policy lapse, distributions may need to be reduced, stopped and/or premium payments may need to be resumed. Should the policy lapse or be surrendered prior to the death of the insured, there may be tax consequences.

policy's cash value can be used to benefit the executive by having it informally fund a supplemental executive retirement plan (SERP).

Split dollar can also be used in conjunction with an irrevocable life insurance trust to allow the business to help pay for a personal estate planning need, and to provide gift tax leverage for the insured. The planning idea is for the irrevocable trust to own the life insurance and to enter into a split dollar agreement with the business. Typically, the corporation pays the entire premium and retains a collateral assignment interest in all of the cash values.

The value of the insurance protection (i.e., the economic benefit) is taxable income to the employee. The economic benefit is also deemed a gift from the employee to the trust and this gift is also generally measured by the lower of the Table 2001 rates or the insurer's YRT rates, rather than the entire premium. For example, assume the client is a male, age 45 and he executed an irrevocable trust with three beneficiaries. Further assume the trust purchased a $5 million life insurance policy on his life with an annual premium of $50,000. The economic benefit based on the Table 2001 rates at age 45 is $7,650. This would allow the gift to fit comfortably within the annual gift tax exclusion, thereby preserving the client's applicable exclusion. It is important to note that the economic benefit increases each year and continues, even if no additional premiums are needed to maintain the policy. Therefore, it is important to create a plan to exit from the split dollar arrangement at some future time.

10. Buy-Sell Agreements

Family Business

The permanent increase in the estate and gift tax exemption amount ($5,250,000 in 2013 and as adjusted for inflation in future years) will make it less costly to transfer the business to the next generation. However, these tax changes will not create the additional assets that in many cases will be needed to provide for the surviving spouse's well being and to treat the children equitably regardless of whether they are active or inactive in the business. Accordingly, the need for life insurance will shift from one of paying taxes to one of providing additional assets to provide for the surviving spouse and children who are not active in the business. For the owner of a closely-held business, the insurance trust can be used to shift control of the business when the goal is for the children to take over the business. The death proceeds can be used to purchase control of the business from the business owner's estate. Control of the business can remain with the trustee until those children who want to participate in the family business are identified. The cash from the sale can be used to provide support to the surviving spouse or to equalize the estate with the children who are not active in the business.

One technique in lieu of an irrevocable trust that may be considered is a bona fide family partnership. If a family limited partnership were created for a valid business purpose, such as to manage real estate or investments, the client can serve as general partner and control the partnership decisions. If the partnership were to own life insurance on the life of that general partner, the death proceeds would be available to benefit the surviving partners. During the life of the general partner, he or she effectively has control over the policy. In general, the insurance will be included indirectly in the estate to the extent of his or her interest in the partnership, which may increase in value due to the policy death benefit it receives.

Non-Family Business

Life insurance will continue to be needed to fund business continuity plans between unrelated owners of closely held businesses. The business owner leaves to chance whether or not his or her family members will receive fair value for the business interest if life insurance is not used to fund the agreement. When dealing with unrelated business owners, the focus of a business continuity plan should be on preserving the full fair market value of the business for the benefit of the family. The use of a properly funded buy-sell agreement can help accomplish this objective.

A buy-sell agreement is generally drafted to require the transfer of a business interest upon a triggering event. Death is the most obvious event; however, disability, involuntary alienation and termination of employment can also be triggering events. The agreement is usually drafted as either a redemption agreement or a cross-purchase agreement.

A redemption agreement is used if the business is to purchase the ownership interest. Redemption agreements are fairly easy to administer and if insurance is used to fund the obligation there needs to be only one policy per business owner. The insurance is owned by and payable to the business. If the business owner dies, the business uses the insurance proceeds to pay the owner's estate for the stock. The estate has no income tax consequences because the estate receives a step-up in basis for the stock, typically to the date of death value, although alternate valuation can be elected. If the business is a "C" corporation the surviving shareholders will not receive a step-up in basis. The surviving shareholders will therefore have to recognize additional capital gains if they later sell their stock.

If the business is an "S" corporation, the surviving shareholders will enjoy at least a partial step-up in basis to the extent the shareholders are allocated a portion of the life insurance proceeds payable to the corporation to fund the redemption. The life insurance is allocated to all the shareholders, including the deceased shareholder, on a per share per day basis. [11]If the business is a partnership or a limited liability company, the surviving partners or members can enjoy a complete step-up in basis to the extent of the life insurance funding the agreement. This can be accomplished by providing in the partnership agreement for a special allocation of the death proceeds to the capital accounts of only the surviving partners or members.

An alternative to the redemption agreement is the cross-purchase agreement. A cross-purchase agreement provides that the surviving owners purchase the business interest. The surviving owners enjoy a full step-up in basis for income tax purposes. A cross-purchase agreement can also be funded with life insurance because life insurance provides the assurance that the heirs of the deceased owner will be paid, and that the heirs will not have to rely on the continued success of the business to pay any outstanding balance.

11. Key Person Insurance

The business need for insurance on key employees will remain even with the increased exemption amount. Business owners will still need to consider what will happen if a key person dies. That key person could be the client, his or her partner or a key employee. Will the business be able to continue without the key person and for how long? Life insurance can be used to provide funds to the business and the surviving owners until the key person can be replaced. It will be easier to recommend that the business be the owner and beneficiary of the life insurance since estate taxes will no longer be a primary consideration for most estates.

If the possibility of an estate tax or if protection against future creditors is a concern, the parties may consider having the key person life insurance owned by and made by to an irrevocable life insurance trust. The trustee could be given express authority to lend monies to the business after the grantor's death. The grantor should also consider including an exculpatory clause in the trust which would absolve the trustee of liability if the loan should not be repaid.

In a family-owned business where the decision has been made to keep the business in the family, the non-family key employee may be even more important. To better ensure the continued services of the key person, it may be prudent to combine key person life insurance protection with a selective benefit like the previously discussed deferred compensation plan.

[11] IRC Sec. 1366(a)(1)(A) and Sec. 1367 (a)(1)(A)

III. Conclusion

Even for those estates that are no longer subject to the estate tax, the wealth accumulation and retirement issues using qualified and nonqualified plans still apply. In addition, the survivor income, estate equalization issues and the business continuation issues will still apply for many clients. The proper approach to the estate and business planning process will not change. The process still needs to be driven by the client's objectives.

- Does the client have sufficient wealth to live comfortably for the rest of his or her life?
- Will the surviving spouse be able to maintain that standard of living if the client dies?
- How much of a legacy does the client want to leave to children and grandchildren? When?
- What is the best way to leave those assets to children/grandchildren in order to minimize transfer taxes and insulate those assets from creditors?
- Who should inherit or take over the business? the vacation house?
- How should the business be transferred?
- How should the children who are not active in the business be treated – equally or equitably?
- How much of a legacy does the client want to leave to charity?

These are the questions that will still need to be answered. The answers to these questions will largely determine the extent life insurance will play a role. The attention given in the media to the increased estate and gift tax exemptions provides an opportunity to discuss with your clients the proper uses of life insurance as part of the estate and business planning process. Proper planning should not cease just because the gift and estate tax exemptions have increased. Planning today will need to focus on the client's many planning objectives for which life insurance is often the ideal funding vehicle.

The 2012 Act has created a favorable planning environment for lifetime gift and insurance planning. The cloud of doubt and uncertainty has finally been lifted after years of not knowing what to expect. Clients may now be motivated to take action and provide some certainty to their estate and business plans.

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