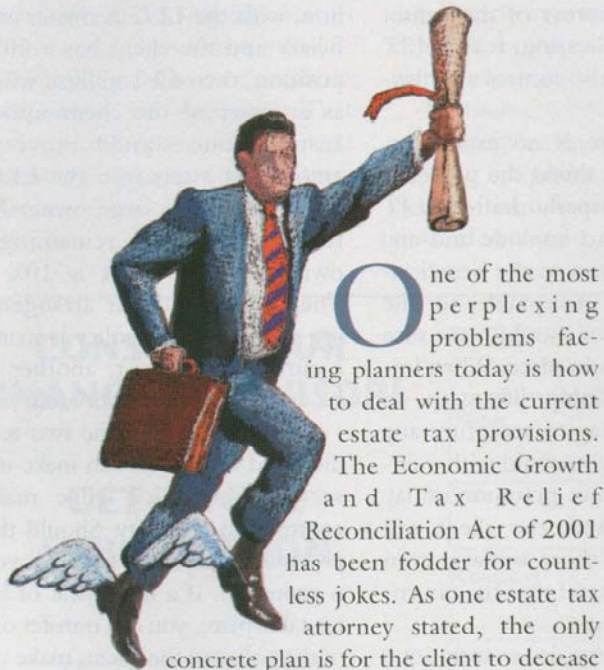


Survivorship Life And The "Sunset" Provision

How to insure asset protection in an uncertain future.

By Joseph W. Maczuga



One of the most perplexing problems facing planners today is how to deal with the current estate tax provisions. The Economic Growth and Tax Relief Reconciliation Act of 2001 has been fodder for countless jokes. As one estate tax attorney stated, the only concrete plan is for the client to decessate in 2010. As we all know, the controversial sunset provision reverses all of the act's changes in 2011 by restoring the tax rules in effect before enactment of the law. Hence, while the act totally repeals estate taxes in 2010, any client who survives beyond December 31, 2010, will again face an erosion of up to 60% of their taxable estate.

So what is your bet? Over the decades, the estate tax has been repealed four times and reinstated three times. Therefore, the historical odds are four to three that the current law will be changed before the 2011 dilemma gets to our table. In addition, we will have had two Presidential elections and four Congressional turnovers prior to the 2011 debacle. This increases the chance for change before the 2010 repeal. Even as we work, some in Congress have hinted at repeal now due to increasing federal deficits. If the law stays as it is, we revert right back to the beginning in 2011. If the law is changed for a permanent repeal, how is that to be handled? I firmly believe that the two most important elements in any form of plan design are those of control and flexibility.

Regardless of how things play out, the fact is that the client (heirs) will be facing asset erosion by estate taxes or asset transfer taxes. If, against all odds, the estate tax is repealed in its entirety, the offset for revenue generation to Uncle Sam is that the heirs lose their advantage of a "step-up" basis on transferred assets. Therefore, considerable taxes will be due on the gain of these assets as they pass to the heirs. (Of course, if the market keeps its downward slope, this may not be a problem.) The point is that in either case, whether we take the right or the left fork in the road, insurance proceeds provide the cheapest way to recover or protect assets.

The experienced advisor will consider three aspects to this dilemma:

- (1) The Client. What is the personality of the client? What are the objectives? Is there an openness to relinquish control of assets? A willingness to invest time and money to achieve goals?
- (2) The Plan. Does it provide for maximum flexibility and control? Is it confusing? Who benefits if it is enacted? What are the economic and emotional costs? What trusts or entities are best deployed?
- (3) The Product. What style of life insurance should be integrated into the plan?

Survivorship Life

Survivorship life is a great wealth accumulation builder as the actuarial costs are unbelievably cheap when underwriting two lives. Over the years, survivorship life, or last-to-die, policies have become increasingly popular for estate tax planning objectives as well. Such integration is not without a basis due to those low actuarial costs and the benefits if one of the parties is not particularly healthy. However, some elements of caution need to be examined.

At the introduction of these joint life policies, there were no provisions of protection to the parties should the policy no longer be needed as issued (joint insureds) or in the event of a divorce. The issuing companies would not split the policy and provide the individual an exchange of coverage without

undergoing new underwriting qualifications. If one or both of the insured had a change in health/insurability, too bad. As time went by and the carriers found that this was a gregarious oversight, they offered riders at an additional charge for such conversions, based on stipulated events. Therefore, older policies need to be examined to make sure the client has the required flexibility and control in this issue.

Another element of consideration is policy style. Should a fixed Survivorship Universal Life (SUL) policy be chosen, stabilizing the capital and return with fixed guarantees, or is Survivorship Variable Universal Life (SVUL) a better bet due to the market potential of invested assets? Our experience, in light of the past two years of market performance (or nonperformance) is that there has been a leaning toward SUL. Survivorship Universal Life guarantees the cash-value principal as general assets of the underwriting company and a minimum rate guarantee, usually stated at 3% to 3.5%. Current interest rates are running 5.75% to 7.1%. Other advisors point out that this is an opportune time to edge into the market and thus prefer SVUL.

Variable Universal Life

Although primary concentration is focused on the "return" side of the equation, the most important factor is often overlooked—that of cost structure. As more astute advisors are starting to acknowledge, illustrations of policy projections are flimsy at best. Studies have also shown that with VUL, illustrated annual premiums to endow or hit a targeted future cash value have over a 50% chance of failure.

This would hold true for SVUL as well, which means that most policies illustrated will not accomplish the objective. In fact, one company that always appears to be the most competitive admits to using a lapsed-based premium structure which opens the high probability that premiums will double or triple after five years.

Coordinating the "plan" with product implementation is essential. The use of survivorship life usually indicates that the assets and the plan are structured to have the major estate tax liability hit at the last death of those insured. But

herein lies the problem: From where will the tax liability come, estate tax or asset transfer tax? What will that liability be? In addition, how should the death benefit proceeds be kept out of the estate? Or will it even be necessary?

The standard method of choice in keeping the death benefit proceeds out of the estate is through the use of an irrevocable life insurance trust, or ILIT. However, it is important that we understand that it is third-party ownership that accomplished this goal, and that the ILIT is only one of the options available. In the context of the sunset problem we are addressing, is the ILIT the best option for the control and flexibility we need?

After all, if there is no estate tax, there is no need to shield the proceeds of the policy. A properly drafted ILIT will have a trigger to implode and any assets will trickle down to the beneficiaries. This may be acceptable to the client, and the advisor should make sure such a mechanism is in place. When implementing survivorship life with an ILIT, there is no way to recapture any cash-value assets as you could with a single-life approach. Since premium outlay can not be recovered, the client will have to commit to those outlays, even though they understand that the tax environment may change.

Premium recovery is a technique that can be utilized with a split-dollar arrangement if single-life policies are used with one spouse advancing the premium on the other spouse's policy. With a survivorship policy, both spouses are involved and the technique is no longer available.

What about other options? The use of a family split-dollar arrangement may give us the full control and flexibility we are seeking. By having the children as owners and beneficiaries, the parents can advance the premiums with this arrangement, keeping control of the cash values while the death benefit stays out of the estate. Survivorship life can be very applicable to this strategy.

A similar arrangement with a family LLC could also prove to be advantageous if properly structured. The common structure of a family LLC is to create the entity, have the clients transfer a fair amount of assets into the enti-

ty, then gift a percentage of ownership to others (usually children, grandchildren, and sometimes trusts). The problem here is that the client has an initial high percentage of ownership in the entity, say 70% to 85%, with the objective of gifting ownership every year until the client has a 2% to 5% equity position.

This will not work when used in conjunction with a premium-recovery technique because there will be a pro-rata assessment of the death benefit going back into the client's estate. For example, if the death benefit is \$3 million, with the LLC as owner and beneficiary and the client has a 70% equity position, then \$2.1 million will be filed as an asset of the client upon death. Instead, one should move a small amount of assets into the LLC at the onset and gift a large ownership position so that the remaining equity owned by the client is 10% or less. Then the split-dollar arrangement using a survivorship policy is workable. If a current LLC exist, another one can be created for this approach.

The advantage of the two techniques discussed is that you can make use of the survivorship policy while maintaining control and flexibility. Should the sunset provision fall upon us in 2011, your client is protected. If a full repeal of the estate tax takes place, you can transfer ownership of the policy to the client, make use of the cash value, or surrender the policy and recapture premium outlay. The advisor/planner must be careful to employ the services of qualified legal and tax counsel in either of these techniques, just as you would when suggesting an ILIT.

In order to allow for maximum control and flexibility, I recommend the use of a fee-based no-load survivorship universal life policy or a low-load survivorship variable policy. These products allow for increased latitude in premium outlay control. For example, using a sample case where we have a male aged 60 and a female aged 57, both standard non-smokers, with a need for a \$3 million policy, the minimum first year premium with a popular and competitive UL commissioned policy is \$4,437. The minimum for the no-load UL with Southland is \$232.

This would allow the advisor to plan an annual increasing premium for the

client with minimum outlay until 2010 to see what direction the estate tax takes. This is ideal if the client prefers the use of an ILIT.

If the variable product is desired, the same element of advantage occurs. The minimum first year premium of a commission SVUL product is \$11,250, whereas the minimum for the low-load SVUL with Ameritas is \$3,322.

Using optional third-party ownership strategies, you can maximize the capital leverage much better with the fee-based policies. A "target" premium (paying full loads and commissions) of \$35,010 in the first year with a commission SVUL product will lapse in the second year if no additional monies are deposited. That same first year deposit into the low-load SVUL illustrates 10 years of continuance. This affords a great safety net should things change.

Many of my clients have preferred a seven-pay premium approach, making one deposit that, in this case, would be \$173,258. I use an increasing death benefit option that pays face amount plus cash value. There are no surrender charges and the client controls the cash value, which at the end of the first year is \$180,289, a gain of \$7,000. In addition, the projected cash value in 9 years (2011) is \$299,934. This high liquidity without surrender charges keeps the client whole from the first year and throughout the period in question, giving the client control and a sense of comfort, as opposed to the anxiety of future uncertainty.

In summary, I feel that if both spouses are healthy, the first plan of choice is a single life policy on the income producer with estate tax planning coordination. However, if the spouse has some

health problems, or the client and/or attorney are structuring their estate plan with survivorship life in mind, then you need to suggest concepts and products that provide maximum control and flexibility. In my experience, the fee-based policies allow that design and reduce the potential of extensive, complex and sometimes questionable designs that place the client in harm's way. Look at surrender charges and liquidity of cash value on the basis that the estate tax climate can change at any time from now until 2011. If you do not plan for flexibility, the sun may set on your relationship with your client. ☺

Joseph W. Maczuga, executive director of the Fee Planners Network, may be reached at (888) 854-0931. The organization's Web site is at www.feeplannersnetwork.com.

▶▶ 1000403444 Enter to save and share at www.inklinkmobile.com

CONSULT YOUR FINANCIAL ADVISOR!

GET A FREE SUBSCRIPTION

Yes! Send me a free subscription to *Financial Advisor* magazine

No, thank you

Complete this form and fax back to:
(732) 450-8877 or subscribe online
at www.fa-mag.com

FINANCIAL ADVISOR

Signature		Date	
Name			
Title			
Company			
Address			
City	State	Zip	
Phone	Fax		
E-mail			

Do you personally recommend or sell investments or provide investment advice? Yes No

Which of the following best describes your primary business activity? (check one)

- (1) Financial Planning/Advisor (2) Securities Broker
 (6) Registered Investment Advisor (RIA)
 (3) Accounting (4) Insurance
 (5) Banking (9) Other _____

What is your income source? (check one)

- (A) Commission only (B) Fee only (C) Fee & commission

What are your total assets under management?

- (1) Under \$1 million (2) \$1 million - \$9.9 million
 (3) \$10 million - \$24.9 million (4) \$25 million - \$49.9 million
 (5) \$50 million - \$100 million (6) Over \$100 million

All questions must be answered to qualify for free subscription. Publisher reserves the right to reject unqualified applications.