
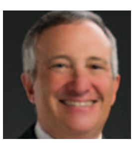

By **Melvin A. Warshaw**

Life Insurance as an Asset Class

A flexible and multi-faceted tool for wealth preservation

Flexibility is a key component of estate planning. Despite the permanence of the American Taxpayer Relief Act of 2012 (ATRA), wealth planning has never been more complicated than it is today. It's highly recommended to devise estate plans tailored to a client's specific asset type and value, residence and tax profile to incorporate maximum flexibility. The bottom line is that no estate plan can perfectly envision a client's asset mix at death. Inserting life insurance into this chaos can deliver greater certainty and liquidity at a time when it's needed most.

Effect of ATRA

Rather than continuing the tradition of giving away assets during life using the applicable exclusion amount ($5.34 million in 2014, adjusted for inflation), many taxpayers are now encouraged to preserve this amount. Most taxpayers have assets below this amount, and their primary death-time federal tax objective is to maximize basis step-up in personally held assets. For those very affluent taxpayers whose assets far exceed this amount, their federal tax objectives are to preserve any remaining applicable exclusion amount for basis step-up at death, while maximizing estate freeze transactions during life that minimize and leverage taxable gifts. The permanent, unified, high, inflation-adjusted and portable lifetime applicable exclusion amount will exempt all but the wealthiest 1 percent from gift, estate and generation-skipping transfer (GST) tax.

Income tax planning is the new estate planning. In states with no state estate tax but high state income taxes (for example, California), the overall recurring annual income tax burden exceeds the overall future estate tax cost. In high tax states with both a state estate and income tax (for example, New York), the spread between overall income and estate taxes has diminished. Federal estate tax rates declined under ATRA, and the future applicable exclusion amount may reach $6.5 million by 2024 with normal inflation. Adoption of the 3.8 percent Medicare tax on net investment income as part of the Affordable Care Act, coupled with ATRA's increased top income tax brackets (39.6 percent on taxable income above $400,000) and phase-out of itemized deductions and personal exemptions, increased the combined top regular income tax rate in California and New York to above 52 percent. The top federal rate on long-term capital gains and qualified dividends has increased by 60 percent to 23.8 percent.

Non-estate tax planning, including business continuation planning, retirement planning, asset protection planning and ensuring the right individuals receive the right assets at the right time, has become more important.

The estate planner is now charged with managing a client's tax basis to maximize the basis step-up at death. The planner must identify the nature of a client's assets, future appreciation potential and disposition plans with a view to how basis step-up impacts specific assets. Creator-owned intellectual property (copyrights, patents and trademarks), negative basis commercial real estate and artwork—all illiquid assets—will benefit most from basis step-up. Income in respect of a decedent (IRD) items, such as individual retirement accounts, qualified plan accounts and variable annuities, receive no or limited basis step-up.

In certain situations, the best strategy may be to force estate inclusion at a lower generation (by having the trustee or protector grant a general power of

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appointment to younger, less wealthy beneficiaries) if income tax savings outweigh transfer tax costs.

State tax planning is now vital and varies depending on state of residence. In community property states (for example, California), at the first spouse's death, the surviving spouse receives a full basis step-up for both inherited assets and the survivor's half share of community property held with the deceased spouse. High state income tax and no state estate tax suggest less lifetime wealth transfer planning. In separate property states with high state income and estate taxes, more lifetime wealth transfer planning may be appropriate. In separate property states without any state estate or income tax (for example, Florida), basis step-up is increasingly relevant.

Life insurance can ensure completion of a successful freeze.

A Versatile Tool

The versatility of life insurance as both a wealth accumulation and wealth transfer asset makes it an integral tool in the current estate-planning world. Investors may be more comfortable in taking added investment risk with other assets knowing a life insurance death benefit is providing a secure financial base. Life insurance may ensure a basic legacy for children and grandchildren, with other assets, if available, to top off an inheritance or give to charity. In wealthy families, life insurance may enable a minimum amount of illiquid family business or investment assets to pass to family members through leveraged gifts, such as sales. Life insurance may be useful in second marriages to provide for a surviving spouse, while children from the prior marriage could receive other assets.

Traditional Life Insurance

Traditional (non-private placement) life insurance has certain characteristics that are compatible with the new estate-planning paradigm. Most clients own a patchwork of different assets that weren't acquired to efficiently pass on. Most asset values change over time. Some decline in value. Life insurance contains unique attributes that will smooth out different asset mixes held during life and at death.

Predicable value. Except for cash, the future value of other assets is unknown. Through guaranteed death benefit products (that is, no-lapse guarantee), the future value of a life policy at death is certain (subject to carrier solvency). Owning an asset with a known death benefit amount when the insured dies is advantageous when all other future asset values are unknown.

Cost guaranteed. No-lapse products fix the premium during the insured's lifetime. Costs of other assets (including non-guaranteed life products) will vary based on inflation and market trends.

Federal gift tax cost/leverage on trust-owned policy. When a policy is trust-owned (for example, an irrevocable life insurance trust) to avoid estate tax, the gift (and GST) tax cost can be leveraged through a split-dollar plan or applicable federal rate loan. *Crummey* notices can be used to preserve the taxpayer's applicable exclusion amount. No other asset has such favorable lifetime gift (and GST) tax leverage features.

Future value not linked to market performance. Guaranteed (no-lapse) products shift the investment risk to the carrier, which invests primarily in corporate bonds and medium duration Treasuries. The death benefit isn't tied directly to one particular volatile market. Stocks, bonds and alternative investments, as well as real estate, all are tied to market performance.

Liquidity. The death benefit is paid in cash at death and isn't reduced by commissions, transfer costs or other fees. It's the only asset correlated to death-time liquidity needs. The benefit is paid shortly after death. Traded assets take time and money to convert to cash. Some assets, such as real estate or an interest in a private business, may be very hard to convert to cash at death in a timely manner.

Leverage. Premiums paid for death benefit protection typically provide significant leverage through life expectancy. Due to the income tax-free death benefit paid on the policy, the internal rate of return (IRR) on the premium to death benefit coverage compares favorably to other taxable assets.

Lifetime tax-free growth in cash value. There's no federal or state income tax or 3.8 percent Medicare tax imposed on the lifetime growth in cash value inside the policy. In a variable policy, the owner can periodically

switch investment options without tax by changing subaccounts. Except for annuities and retirement plan assets, no other personally owned assets offer both tax-free returns and a tax-free rebalancing (switching) of invested assets.

Internal Revenue Code Section 1035 like-kind exchange. An IRC Section 1035 exchange allows a taxpayer to trade an existing life insurance policy for a new policy (or annuity) without an immediate income tax. Otherwise, the surrender of one policy and the purchase of another with the sale proceeds would result in income to the extent the cash surrender value exceeds the owner's basis in the existing policy. It's possible for a policy owner to switch to a different product type altogether (among whole life, universal life (UL), no-lapse and variable) on a tax-free basis, if circumstances and risk tolerance change. Investment, trade or business real estate can be exchanged tax-free and certain tax-free corporate stock reorganizations can be undertaken but are more complicated involving many parties. Other investment assets can't be exchanged tax-free.

Tax-free access to cash value (non-modified endowment contract (MEC)). If the policy is structured as a non-MEC at issuance, the owner will be able to access the cash value tax-free. Through managed cash withdrawals up to policy basis and loans beyond basis, policy distributions won't be taxable. Special products, such as variable, indexed UL or cash accumulation UL, can be purchased. Under certain circumstances, taxpayers can access liquidity in publicly traded securities through a margin loan. Other assets present greater cash liquidity challenges.

Income tax-free death benefit. Assuming there's been no lifetime transfer for valuable consideration of a policy, the death benefit will be paid income tax-free. This situation is equivalent to a basis step-up at death because the death benefit amount in excess of cash value is paid income tax-free. Income tax-free treatment of the death benefit is accorded to both individually owned and trust-owned life insurance.

May avoid transfer tax. Through ownership by an ILIT or spousal lifetime access trust (SLAT), the policy death benefit may immediately avoid federal and state estate tax and GST tax. No other asset offers this immediate estate tax advantage. Only future appreciation can be removed gradually from a gross estate through an estate freeze of other assets. Life insurance can ensure completion of a successful freeze.

Indirect control of trust-owned policy. The insured indirectly controls the asset by his willingness to make future contributions (or the lack thereof) to fund the policy. The insured's willingness to undergo a medical exam determines whether a policy can be restructured in a Section 1035 exchange. If an ILIT or SLAT includes a power of substitution, the insured may be able to personally acquire the policy in exchange for cash.

Easily divisible. As policies are increasingly owned by individuals, the insured can easily divide the benefits among multiple beneficiaries through a beneficiary designation form filed with the carrier. ILITs and SLATs will continue to be designated as beneficiary of trust-owned policies.

There's no need to have an ILIT own the policy to prevent estate tax.

Asset protection. Individually owned policies may be accorded some asset protection under applicable state law. Trust-owned policies held in an ILIT or SLAT are also protected from the beneficiaries' creditors, based on the spendthrift provision in the trust document.

Avoid probate. The death benefit is, generally, paid directly to the designated beneficiary, thereby avoiding probate and the claims of a decedent's creditors.

Comparison to Other Investments

Here's how life insurance compares with other types of investments.

Mutual funds. High income individuals invested in mutual funds will be impacted by higher federal income tax rates and the 3.8 percent Medicare surtax. Mutual funds often make annual (taxable) distributions and turn over their portfolio periodically, which may result in imposition of higher income, capital gains and Medicare taxes. Unlike life insurance, rebalancing may create taxable income, and the investor has no control over recognition of gain or loss. The owner of a life insurance policy has complete control over recognition of income/gain and tax-free rebalancing.

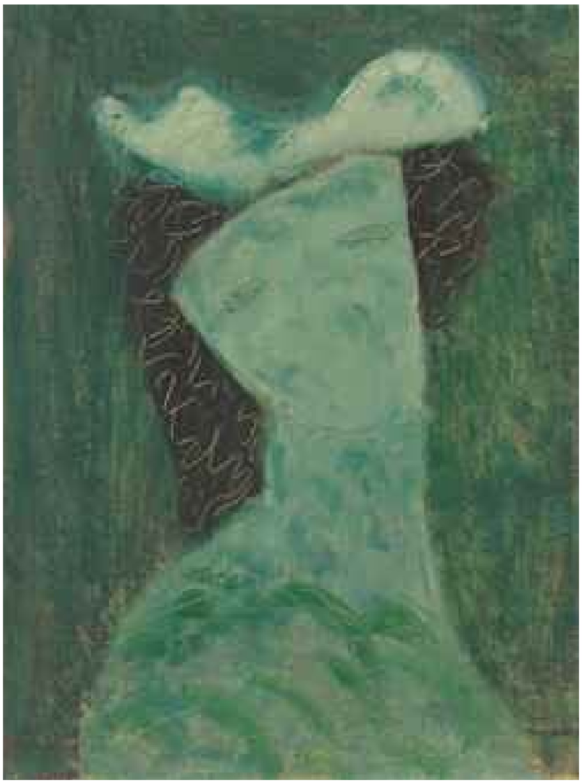
Municipal bonds. Higher income tax and the Medicare tax make tax-free municipal bonds more attractive. Conservative yields of 3 percent to 4 percent will produce after-tax returns of 6 percent to 8 percent for investors in high tax states, such as California and New York. Chasing higher yields carries some definite risk to bondholders, as the financial risk of default by issuers, such as Puerto Rico and Detroit, has stirred this market.

Rental real estate. Rental incomes from passive activities and sales of investment real estate are subject to the 3.8 percent Medicare tax as well as higher rates. It may be impossible for investors to become so involved in the management of the real estate to transform the income or gain into a trade or business.

Master limited partnership (MLP). An MLP is a flow-through limited partnership that's publicly traded and often invests in energy production. It offers tax incentives, such as deduction of intangible drilling costs, and initial distributions to investors are treated as return of capital. K-1s are issued, but above-market yields and tax-deferred benefits make them an appropriate investment consideration in the new income tax world. Any income or gain passed through to affluent limited partners will be subject to Medicare tax and higher tax rates.

IRA and 401(k) plans. For most investors, the easiest way to reduce income tax and take advantage of tax-deferred income is to contribute to employer-sponsored 401(k) plans and, possibly, personal IRAs. Though employee contributions to 401(k) plans aren't deductible (but are excluded from income), investment growth is tax deferred. For those facing estate tax or trying to maximize basis step-up at death, this is a difficult estate asset to manage.

Life insurance. As a pure asset, life insurance is more expensive than other assets. But, life insurance offers, in one asset, considerable tax advantages and flexibility. Inside build-up is tax deferred during life, initial distributions are tax-free and, if held until death, there's no tax on inside build-up. The death benefit is paid income tax-free. The combination of these income tax features and the policy owner's control over access to the policy distributions make it a favored asset. The tax-favored nature of life insurance, especially the many investment options found in a variable policy, are appealing. Rebalancing subaccounts tax-free to carry out revised portfolio objectives and risk tolerance is unique among personal investment assets. Existing cash value policies can be transformed from a death benefit orientation to a cash value accumulation focus by reducing the death benefit. Otherwise, replacement in a Section 1035 exchange may be appropriate.



SPOT LIGHT

Fanciful is a Strong Word...
"Fanciful Woman" (16 in. by 12 in.) by Milton Avery, sold for $50,000 at Christie's recent American Art Sale in New York on Feb. 26, 2014. Avery's work is clearly representational. It focuses on color relations and isn't concerned with creating the illusion of depth, unlike much conventional western art.

Effect of Estate Size

The higher exemption will permit affluent individuals with estates below the applicable exclusion amount to own their own policies. They can have ready access to cash value. There's no need to have an ILIT own the

policy to prevent estate tax.

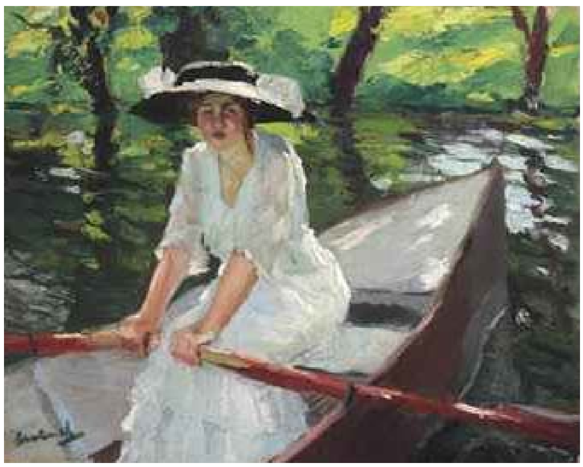
For an older, very wealthy individual, for whom federal estate taxes are a certainty, attaining maximum efficiency through funding during life the least amount of premiums to provide the largest death benefit over the longest duration drives planning. Back-loading premiums on a guaranteed no-lapse policy, assuring fixed (reduced) funding through life or life expectancy, is the goal. Cash value isn't relevant. Maximizing the IRR on premium outlay for death benefit is of primary importance. These clients are less willing to take investment risk and have given away assets to family and charity but still face a federal estate tax liability. ILIT ownership is vital, perhaps through a GST tax-exempt dynasty trust for grandchildren. Lapsing the policy isn't an option.

For younger individuals still in the wealth accumulation phase, life insurance funding must be flexible. These clients are reluctant to commit to funding for an unknown estate tax need. Single life products held inside a flexible trust will enable the death benefit to meet a variety of possible objectives: (1) payment of state estate tax (in a decoupled state), (2) possible federal estate tax liability, (3) support for a surviving spouse, (4) retirement safety net, (5) education funding, and (6) estate equalization.

It's very difficult to accurately predict future estate tax needs, future estate growth, year of death and whether estate freeze techniques will be successful. Rather than initially emphasize death benefit, a new alternative funding approach is to accelerate funding of a non-MEC policy to enable cash value to grow more quickly in early years and permit the death benefit to grow in later years. In early years, the policy will provide maximum cash value but minimal death benefit. Ultimately, if the insured lives beyond life expectancy and no meaningful distributions have been taken from the policy, a larger death benefit will be available at older ages when compared with guaranteed products. The higher cash value policy will also provide more flexibility in future years to alter the amount of coverage, swap for a new policy if the current policy underperforms or change investment options.

The alternative funding approach is compatible with clients' desires for tax-deferred vehicles, such as life insurance, that reduce exposure to high tax rates. Indexed UL and variable UL products are focused on equity market exposure (with variable transferring all investment risk to the policy owner). For those seeking efficient hedge fund or active portfolio trading, a private placement variable UL product holding these investments may produce the best after-tax returns.

SLATs work well for a younger, potentially very wealthy insured. SLATs exclude the death benefit from both the insured's and the insured spouse's estates. Due to the uncertainty of whether the insured and his spouse will have sufficient income during the insured's life, the SLAT permits the trustee to make trust distributions to the insured's spouse while the insured is alive, as well as after the insured dies. The trustee can access cash value without tax to make distributions to the spouse during the insured's life. Thereafter, the death benefit is received income tax-free, which can provide for spousal support and other needs. A SLAT that owns a single life policy on the insured spouse enables the non-insured spouse to serve as trustee, subject to an ascertainable standard, and to make other changes as the couples' circumstances evolve.



SPOT LIGHT

Row, Row, Row...
"Woman in Rowboat" (19 in. by 24 in.) by Edward Alfred Cucuel, sold for $40,000 at Christie's recent American Art Sale in New York on Feb. 26, 2014. Born in San Francisco, Cucuel was an Impressionist painter of genre and figures in landscapes, often using his family members as models rather than professionals.