Helping Wealthy Families Transfer Assets to Future Generations

A Family Steward’s Approach to Estate Taxes

By David J. Gordon, CFP®, CIMA®, CFMC

Individuals with taxable estates in excess of $5.12 million and married couples with taxable estates of more than $10.24 million should take a long, hard look at implementing advanced wealth-transfer strategies in 2012. Taxable estates in excess of these amounts face a marginal tax rate on the excess of 35 percent in 2012. This means that, for an individual, the 2012 tax on a $10-million estate could be more than $1.5 million—not counting any state death taxes that may be due. Given that some of those dollars may have been earned in past years when personal income tax rates were 50 percent, 60 percent, or even 70 percent, some heirs could receive less than 20 cents on the earned dollar. Adding an element of uncertainty, current estate tax rules are due to expire at the end of 2012.

For taxpayers facing significant death-tax payments or estate liquidity needs, or for those seeking to equally divide an illiquid estate among heirs, a specialized financial product known as survivorship life insurance may offer a cost-effective opportunity to essentially “prepay” those taxes with discounted dollars. Conceptually, it is almost as if the Internal Revenue Service (IRS) offers a family discount to those paying estate taxes during their lifetimes. For many people, “How much tax and how much discount?” would be first thoughts. Next, assuming the withholding to prepay, a family steward might calculate the expected after-tax rate of return and compare it against competing uses, such as other potential investment opportunities.

This article examines the uses of survivorship life insurance in estate-tax planning. Heavily marketed to the leaders of Fortune 500 companies and ultra-high-net-worth families, survivorship programs also are referred to as “second-to-die” or “joint-life” contracts. With unique tax benefits and attractive internal rates of return, this type of insurance can be one of the best financial protections against the impacts of estate taxation.

Not Just for the Ultra-Wealthy
Survivorship insurance long has been an important estate-planning tool. It can offer competitive rates of return, strategic flexibility, and unique estate-planning applications. It is easy to understand, compare, and implement. For many wealthy families, the cost-benefit analysis confirms compelling returns and tax-saving opportunities that can exceed other planning and investment alternatives.

In typical cases, insurers offer guaranteed (subject to the claims-paying ability of the insurer) after-tax returns comparable to those of other financial instruments used to generate income, including municipal bonds. In addition to estate-tax mitigation, these cost-effective products can provide strategies to address tax depletion, forced sales, or simply equalizing an inheritance among multiple heirs. Often, survivorship insurance is just one of many components in a well-balanced family estate plan.

How Survivorship Insurance Works
With survivorship insurance, two lives—usually (but not necessarily) husband and wife—are covered by a life insurance policy that pays its proceeds after the death of both insureds. The provision for payment upon the second death results in a premium cost that can be significantly lower than that needed to insure either person separately. In fact, persons who are otherwise uninsurable because of age or poor health (or insurable only at great expense) may find a solution in survivorship programs, usually at a potentially lower cost than traditional coverage.

The assumption behind the lower cost of insurance is found in the concept of “premature death.” In fixing a premium payment, insurance companies factor life expectancy along with the probability of premature death. Because the likelihood of two premature deaths is lower than the likelihood of one premature death, the projected risk to the insurance company (a double premature death) is vastly reduced. Less risk to the insurance company can translate to lower premium costs for the clients and generally is reflected in survivorship policy rates.

Because life insurance proceeds generally are free from both state and federal income taxation, survivorship insurance can provide tax-free cash at the time when the estate tax is imposed. Properly structured, the benefit also can be estate-tax free. Although, these contracts usually are designed to maximize the death benefit, plans can be structured to provide access to accumulated cash value during the lives of both spouses and/or after the death of the first spouse. These cash values usually can be accessed free of income taxation.
and can provide added flexibility to meet unexpected family needs.

At the death of the surviving spouse, the policy makes its major payment. This can be used to provide needed funds for preserving the estate and passing assets to heirs. Well-prepared survivorship programs help avoid the often damaging consequences of estate-tax liabilities, forced liquidations, unequal divisions, or required borrowings. Where properly structured, the proceeds also can avoid probate and can provide a source of easily accessible and readily available funds.

Give Away Your Taxes, Not Your Estate

One common method of estate-tax reduction is to simply gift assets to children or other future legatees. This offers the attractive benefits of reducing the overall taxable estate, while also keeping future appreciation on the gifted assets outside of the grantor’s taxable estate.

Although the rules for 2013 and beyond may yet change, many believe that the $5.12 million estate and gift tax exemption amount will be reduced and marginal tax rates (currently 35 percent) will be higher—both of which were true under prior legislation. In fact, if Congress does not act, the rules are due to revert to the earlier levels ($1-million estate exemption amount, graduated tax rate from 41 percent to 55 percent, and 55 percent generation-skipping tax rate). As a result, wealthy taxpayers may wish to consult their advisors and consider taking advantage of gifting opportunities that may expire at the end of 2012.

Current provisions allow annual gifts up to specified amounts ($13,000 in 2012) to be transferred without taxation as “annual exclusion gifts.” Together, a husband and wife may gift up to $26,000 to any number of persons each year. This means that a couple with three children could transfer a total of $78,000 free of tax in 2012. By adding additional beneficiaries, such as grandchildren or other relatives, taxpayers have an opportunity for significant tax savings by simply reducing the taxable estate over time. These annual exclusion gifts are independent of and in addition to the $5.12 million lifetime gifting allowance. The annual exclusion gift is a “use it or lose it” opportunity that “resets” each year. In other words, these gifts cannot be carried over into future years.

An enhanced planning strategy combines the annual gift exclusion with a survivorship policy. Rather than simply giving away assets, funds are transferred instead to an irrevocable life insurance trust (ILIT) that can use the money to fund a survivorship life policy. (To keep the insurance proceeds from becoming part of the taxable estate, it often is recommended that an ILIT own the policy.) A limited right of withdrawal (Crummey power) by the beneficiaries will allow the gifts to qualify for the annual exclusion.

In many cases, premium payments will represent only about 2 percent to 5 percent of the total estate tax. Table 1 provides an example of how this works.

New Developments

Although survivorship policies have been around for decades, recent regulatory changes have allowed insurers to offer a particularly cost-effective program with exceptionally strong guarantees. The major change has been the addition of a guaranteed death benefit to the old-style universal policies. Of course, the guarantee is based on the insurance company’s claims-paying ability.

In older universal-life contracts, when policy earnings did not meet expectations, clients had the opportunity to choose between reduced death benefits and lower policy costs or making higher premium payments to support the initial death benefit. While this feature often was considered an attractive flexibility by some policy holders, others balked at the uncertainty and instead chose costlier whole-life programs that featured level payments and fixed benefits.

Universal policies now are available with guarantees that fix both the death benefit and the premium payments. If the policy’s experience is poorer than expected, the policy holder need not be concerned. On the other hand, if the policy’s earnings are higher than projected, the policy holder can benefit with larger death benefits, lower premiums, and/or increased cash values. While primarily designed for wealth transfer, these types of policies also may provide some flexibility in payment and benefit options.

Newer policies also take advantage of more-optimistic (longer) mortality projections. As a result of the increase in life expectancy, older policies issued under the 1997 mortality tables generally were more expensive than today’s programs. Taken together, these advances suggest that current policies may merit review and, for most cases, internal rates of return are higher than in the past. If you have an older policy with built-up cash value, it should be reviewed and possibly replaced by a

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**TABLE 1: ESTATE TAX PAYMENT VS. INSURANCE PURCHASE**

<table>
<thead>
<tr>
<th>Surviving Spouse’s Taxable Estate</th>
<th>Pay this Estate Tax&lt;sup&gt;a&lt;/sup&gt;</th>
<th>or offset it with this Annual Gift&lt;sup&gt;b&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6 million</td>
<td>$350,000</td>
<td>$4,837.47</td>
</tr>
<tr>
<td>$8 million</td>
<td>$1.05 million</td>
<td>$13,619.61</td>
</tr>
<tr>
<td>$10 million</td>
<td>$1.75 million</td>
<td>$22,601.00</td>
</tr>
</tbody>
</table>

<sup>a</sup> Federal estate tax at death of surviving spouse based on 2012 rates.

<sup>b</sup> Annual premiums for survivorship insurance coverage on a husband and wife, both age 65, in an amount equal to the estate tax, based on current standard rates from ING Survivorship Universal Life with Guaranteed Death Benefit. Actual premiums and policy issuance are subject to underwriting. Using the annual gifting allowance, individuals may gift up to $13,000/year without gift tax consequences. Gifts in excess of available annual exclusions may use the lifetime gift exclusion and/or be subject to gift taxes.

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Continued on page 40

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new policy with lower costs or higher death benefits.

While survivorship insurance will not fit every situation, its status as a unique financial tool merits investigation for wealthy families and businesses seeking to mitigate estate-transfer issues. Factors to consider include those found in traditional investments such as the financial strength of the insurer, policy earnings assumptions, internal rates of return, and a sharp comparison of alternatives. After all is said and done, many decisions are based upon a combination of economic and emotional factors—all the more reason to conduct a careful evaluation.

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