Estate planning isn't going to disappear

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As Long As There Are Families...

The uncertainty surrounding potential reform of the estate tax law is likely to continue through 2001 and heighten the level of angst among financial services professionals, but to paraphrase a song of yesteryear, "Our business is here to stay."

Families will continue to have estate planning needs: the orderly transfer of property from one generation to the next is critical for the continuation of family wealth.

Professionals working in the estate planning area may simply need to adjust their focus. The greatest challenge will be to see that clients do not let the possibility of repeal blindside them into not protecting themselves.

It is unlikely that we will see the repeal of estate taxes this year. If anything, we may see some reform to provide relief to family businesses. It is also possible that there may be an increase in the applicable exclusion amounts (formerly referred to as unified credit exemption equivalent). For 2001, the applicable exclusion amount is $675,000, with increases scheduled over the next few years until the maximum exclusion amount of $1 million is reached for deaths occurring in 2006 and later.

Several compelling reasons exist for clients to take action now. The most significant is the immediate need for protection until the tax issue is decided. Since most of the proposed legislation phases in estate tax elimination over a 10-year period, some clients may procrastinate and shortchange their immediate need for protection and guaranteed insurability. This need can be satisfied, even for those in questionable health with the purchase of term insurance.

A few companies permit the exchange of two convertible term insurance policies for a survivorship policy without the need to provide insurability a second time. This is an important benefit for those looking for permanent coverage but who are reluctant to commit in the near future.

It's important to emphasize to clients that certain permanent needs should be addressed today, regardless of the estate tax outcome in Washington. Clients should examine permanent coverage for survivor income, education, business continuation, state death taxes and final expenses. Other key permanent needs should be examined in planning for the distribution of qualified plan assets, especially in light of "Income in Respect of a Decedent" taxes, or IRD, and charitable giving.

Business continuation planning and planning for the distribution of qualified plan assets are two permanent needs that can be addressed without reference to estate taxes.

Most pitfalls in passing on a family business can be prevented through the use of a buy-sell agreement and keyperson insurance. These structures, particularly when used in tandem, help assure that the business will have the needed cash for the short-term losses incurred as a result of the death of a founder or other key employee- owner.

The buy-sell agreement should address the terms of the purchase, identify how, when and by whom the purchase will occur, and how payment will be made for the business interest. Options include cash payments from savings, borrowing, installment sale or life insurance.

Life insurance may be one of the most cost-effective methods. Additionally, if the business has purchased cash value life insurance, the policy may serve a double duty, providing a death benefit as well as a cash accumulation fund that grows on a tax- deferred basis.

Cash value in the policy, if any, may be available to provide some of the funds necessary to purchase the interest of an owner or key employee at retirement or withdrawal from a business. Access to cash value through withdrawals and loans will reduce policy values and death benefits, and may have tax consequences.

Life insurance also can produce an immediate death benefit that generally is received income-tax-free. In these ways, the use of life insurance for business continuation assures creditors and new management about the future of the business.

Many people conserve their IRAs and other qualified plan assets with the intention of passing those dollars on to their heirs, but this type of inheritance may still be subject to income taxes to the heirs as IRD. Life insurance, however, is one of the most cost-efficient ways to protect heirs against the loss of their inheritance to taxation.

Under present law, the federal income tax on IRD must be paid whether there are federal estate taxes owed or not. Most heirs will be in a minimum 28% tax bracket in the year the money is received just because of receiving the money.

As an example, consider a widow with a $2.5 million estate, $1 million of which is in an IRA. If the widow's heir takes the IRA distribution as a lump sum, the heir will be bumped up to the 39.6% tax bracket and will pay $396,000 in federal income taxes alone. This does not consider the deduction for estate taxes paid on IRD.

Therefore, although qualified plans are generally the best way to accumulate dollars for retirement, they are not good vehicles for passing money to future generations.

Clients in the process of establishing an Irrevocable Life Insurance Trust should provide for the contingency of estate taxes being eliminated if the need for insurance in the trust is to help pay estate taxes. Many advisors find an "escape clause" an appropriate solution. This clause allows the trustee the discretion to collapse the trust if estate taxes are eliminated.

A better solution may be to structure the trust as a "Dynasty Trust," thus allowing the life insurance proceeds to create additional wealth for future generations.

One of the strongest arguments against estate tax repeal has been the potential loss of charitable gifts made by clients for the purpose of reducing or eliminating estate taxes. On the other hand, families will have more dollars to contribute to charities if estate taxes are reduced or eliminated. The structures they use for giving may be less complicated, such as naming a charity as a full or partial beneficiary of a life insurance contract. And many may be more apt to use foundations to continue their gifts over longer periods of time. In turn, charities may be more willing to team with planning advisors to solicit long-term giving solutions.

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Your clients should come in from the estate tax cold when...

* Aunt Bertie just died and left them a bundle.

* They bought a Humvee and are worried about their education kitty.

* The "ex" ran away to Tibet to attain a "higher being" and left the kids.

* They remarried for the fifth time and only have two years to live.

* Their children keep carping about who gets to run the family business.

* They want to leave all qualified plan assets to the local pet cemetery.

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