WEALTH ADVISORS

FOR PRIVATE CLIENT SERVICES

ESTATE TAX UNCERTAINTY AND YOUR LIFE INSURANCE

BY DAVID WEINSTOCK

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Will life insurance play a role in large estates if estate taxes are repealed?

Jeff Pennell, professor of Law at Emory University got me thinking when he opined at Heckerling this year that in a world without a step-up (§1014 basis adjustment), life insurance would be a “most favored” asset due to the tax free death proceeds and buildup of cash value. That aside, life insurance may continue to add value in many circumstances and for various reasons:

- Repeal may be followed by resurrection of the estate tax prior to a client’s death.
- Estates with large businesses may use insurance to facilitate equitable distribution among children involved in the business and those who aren’t.
- Repeal may be accompanied by a loss of step-up or capital gains tax at death – for some (negative capital real estate) this tax burden could be worse than estate tax.
- State estate tax may continue, leaving a lesser, albeit potential, need for liquidity.

Life insurance as an asset for heirs (not an expense)

When a potential benefit of life insurance is concluded and premiums are deemed inconsequential to the client’s financial security, an analysis of the economics often alters the perception of the client.

- The internal rate of return (IRR) often ranges from 4% to 7% beyond normal life expectancy – higher when adjusted to consider that proceeds are tax free - it should be considered an investment for heirs uncorrelated with others and part of an overall allocation of estate assets. The IRR is the rate required to match the result if premiums are instead left invested elsewhere.
- Life insurance is typically not subject to market or interest rate risk – analogous to an option on cash at death and brings a relatively high degree of certainty, unlike other assets.
- It serves as a hedge against the uncertain outcome of planning techniques that bear few early benefits, but potential significant benefits over time – It is a windfall return in the early years and a reasonable return over time.

Don’t rush to terminate

Consider all of the above, and as a last resort don’t forget the possibility of selling an unwanted policy for more than the surrender value (life settlement).

I hope this input helps prevent rash and potentially regrettable decisions.

FOR MORE INFORMATION CONTACT:

DAVID WEINSTOCK, CFP, AEP, CPA
PRINCIPAL
MAZARS USA WEALTH ADVISORS
+1 516.620.8560
david.weinstock@mazarsusa.com

VISIT US AT www.mazarsusa.com