“Top 10” Post ATRA Planning and Sales Opportunities

The 2012 American Taxpayer Relief Act, together with the Patient Protection and Affordable Care Act, changed the federal tax landscape significantly — prompting immediate need for strategic solutions, and emerging opportunities for effective income tax planning and wealth transfer tax planning. Post ATRA planning should also reinforce the importance of focusing on clients’ core underlying goals, objectives, priorities and concerns, including: providing for children’s and grandchildren’s education, setting aside a nest egg for retirement, supporting charitable endeavors, passing on a family business, transferring wealth to the next generation, incorporating appropriate planning to mitigate the erosion of wealth from income taxes or wealth transfer taxes, and ensuring adequate liquidity to support the plan.

1. Enhanced Appeal of Cash Value Life Insurance and Tax Deferred Annuities

ATRA imposes higher taxes on all aspects of individual income. Reinstatement of the FICA payroll tax, the personal exemption phase out, and itemized deduction limitations make effective tax rates even higher. In addition, increases in the highest federal income tax brackets, and the new Medicare surtax on net investment income impact higher income individuals (and trusts). The Joint Committee on Taxation estimates $620 billion in increased taxes over the next decade, creating an intensified focus on planning strategies to reduce/defer income tax.

This should increase interest in tax deferred investments — and enhance the appeal of cash value life insurance and tax deferred annuities. Life insurance offers the unique income tax benefits of tax deferred growth in policy cash value, income tax favored access to policy cash value (non MEC policy), and income tax free death proceeds. Tax deferred annuities permit control over the timing of income recognition. Investments in a life insurance or deferred annuity contract will grow free of exposure to the 3.8% Medicare surtax. By increasing exposure to life insurance products, individuals (and other entities) may be able to mitigate their income tax impact.

Life insurance plays an important role in a comprehensive financial plan — which should also incorporate tax reduction strategies to manage and stabilize current and future tax burden, and enhance overall efficiency.

2. Qualified Plans and Non-Qualified Deferred Compensation

ATRA increased the effective income tax rates for higher income earners through higher marginal income tax and capital gains tax rates, and new health care taxes on wages and net investment income.

This should increase interest in both qualified and non qualified deferred compensation arrangements, which permit deferral of income until retirement (when employees may be in lower tax brackets). Reducing Modified Adjusted Gross Income (MAGI) through income deferral will reduce an individual's exposure to the 3.8% net investment income surtax. Impacted individuals can mitigate or defer the effect of higher taxes by maximizing their participation in these arrangements.

3. Roth Conversions

Higher income taxes make Roth IRAs an attractive planning alternative (especially for higher income individuals). Roth's do not require mandatory distributions, and account distributions are not subject to income tax, or included in MAGI (for purposes of the Medicare surtax). ATRA also expanded the ability of individuals to convert pre tax balances in certain employer retirement plans into designated Roth accounts. Each individual's situation should be evaluated to determine whether Roth conversions make financial sense for the particular circumstances — taking into account current and future income tax implications, and in many instances, wealth transfer tax implications and planning objectives.

The elevated federal estate and GST tax exemptions provide opportunity for powerful wealth transfer tax planning, especially for families engaging in multigenerational planning — including strategies that benefit both the account owner, as well as the individuals who will inherit the account.

4. Distribution Planning for IRAs and Qualified Plans ("IRD" Assets)

An IRA or qualified plan interest is often the most significant asset comprising an estate — and growing as an increasing percentage of many estates. Consequently, an important aspect of estate planning for theses assets centers around strategies aimed at minimizing or deferring income tax (IRD) and enhancing the legacy for beneficiaries. This includes a focus on testamentary distribution strategies (e.g., stretch IRA, Roth conversion/stretch, charitable bequest, etc.), and the promotion of life insurance and annuities in roles that leverage these strategies.

The elevated estate and GST tax exemptions also offer opportunities for account owners to amplify these legacies through effective wealth transfer tax planning and beneficiary designations.

5. Income Tax Driven Charitable Planning

Increases in income taxes and capital gains taxes (for higher income individuals) may increase interest in tax driven charitable giving. A joint article published by the Urban Institute and Tax Policy Center suggests ATRA's impact will increase charitable giving by $3.3 billion.

Appreciated or low basis assets (e.g., underperforming or non income producing property) contributed to and sold by a charity (tax exempt entity) will not incur capital gains tax. Charitable gifts of assets with built in gains, or assets which produce ordinary income, shift net investment income to charities (which are exempt from the Medicare surtax). The unlimited charitable gift/estate tax deduction also reduces wealth transfer tax exposure (for higher net worth individuals), and "split interest" charitable giving arrangements (e.g., Charitable Remainder Trusts, Charitable Lead Trusts, Charitable Gift Annuities) provide benefits to both charitable and non charitable beneficiaries — including the donor, spouse, children, or others. Charitably inclined IRA owners (over age 70 ½) can also take advantage of the extended IRA charitable rollover opportunity for up to $100,000 per year (in 2013) for direct transfers to public charities.

A charitable contribution income tax deduction can help offset the cost of purchasing life insurance positioned for wealth replacement or other purposes. ATRA did not include caps on charitable deductions. "Pease" limits may reduce itemized deductions (including charitable deductions) for very high income individuals (by up to 80%). However, it is estimated that charitable gifts for 99% of donors will be fully deductible (up to AGI limits).

6. Opportunities Created by Low Interest Rate Environment

The prevailing environment of historically low interest rates combined with recovering markets (e.g., marketable investments, real estate, closely held business interests, or other undervalued assets with appreciation potential) represents an opportune time to implement certain interest rate sensitive planning strategies — including Grantor Retained Annuity Trusts, Charitable Lead Annuity Trusts, installment sales, private annuities, intra family loans, and split dollar arrangements.

In addition to being effective income tax and/or wealth transfer tax planning strategies, these popular planning tools and techniques (initiated in low interest rate environment) can also facilitate and enhance life insurance planning and premium funding. The appeal of life insurance funding should also be enhanced by the prevailing low interest rate environment coupled with relatively strong policy yields.

7. Valuation Discount Strategies

A closely held business interest can be one of the best assets to transfer to the next generation. The benefits include: the ability to keep the business in the family, motivating younger generation employees with ownership in the business, the ability to shift appreciation and income to younger family members, and the use of valuation discounts to minimize transfer tax and income tax exposure. Use of the elevated lifetime gift exclusion, coupled with strategies that employ valuation discounts for lack of marketability and lack of control (e.g., Family Limited Partnerships, Limited Liability Companies) can provide substantial planning benefits and tax savings. Individuals who have existing FLPs or LLCs should also consider fortifying these entities with transfers utilizing their elevated gift exclusion.

ATRA did not address several tax proposals relating to valuation discount strategies for business interests (family owned entities not used in the active conduct of a trade or business), or curtail the use of valuation discounts. The Administration's 2014 Budget proposes to limit the use of valuation discounts in connection with family owned entities (such as FLPs and LLCs). Now is the time to urge wealthy clients (especially closely held business owners) to take advantage of these techniques.

8. Effective Use of Gift, Estate, GST Tax Exclusions

ATRA provides generous transfer tax relief for lifetime gifts and testamentary bequests, offering unprecedented opportunities for using and leveraging the increased federal gift/estate and GST tax exclusions and inflation adjustments ($5,250,000 for 2013). Consideration should be given to making additional transfers to existing trusts that have cash needs, to cover insurance premiums, or acquire new life insurance coverage (to leverage trust assets). The increased exclusion enhances simplicity and facilitates premium funding for policies held in trust (ILITs), reducing the need for Crummey notices (required for annual exclusion gifts). Effective GST planning (long term intergenerational Dynasty trusts) can remove trust property from the wealth transfer tax system for many generations, and dramatically enhance the legacy passing to future generations. Life insurance can leverage the GST tax exemption to further amplify the legacy.

The increased exclusions not only create opportunities for implementing and funding new plans, but also for enhancing and fortifying existing plans. This can include facilitating an "exit strategy" for other estate planning or insurance arrangements — such as "underwater" split dollar plans, private premium financing transactions, installment sales, or loans. Transfers using the increased gift exclusion can create a means of allowing an earlier lifetime "rollout" of the transaction (using non policy values). Premium funding approaches including split dollar arrangements, installments sales, and intra family loans also remain useful to leverage and conserve remaining exclusions.

A recent LIMRA study indicates that more households have a need for life insurance post ATRA (2013), and the mean value of estates subject to the federal estate tax rose to $7.2 million (1% increase). Households with an estate tax liability (on average) have a need for $3.5 million of additional insurance, representing a 14% increase over 2012. The total life insurance need for households subject to federal estate tax is estimated to be over $40 trillion. In addition, these households, as well as households not subject to the federal estate tax, may need life insurance for other reasons which complement their estate plans — including income replacement, debt repayment, or equity of inheritance (which would increase the size of the overall life insurance sales opportunity).

9. Planning and Liquidity Funding for State Estate and Inheritance Taxes

Currently 22 states and D.C. have an independent estate tax ("decoupled" states). Most states have exemptions that are considerably lower than the current federal exemption. As fiscally challenged states look for ways to balance budgets, they may move to create, reinstate or increase existing estate and inheritance taxes. Lifetime gifts can help minimize the impact of both state and federal estate taxes (most states do not impose a gift tax), removing the value of the property and future appreciation from the taxable estate.

Life insurance (owned outside the taxable estate) remains an effective method of providing liquidity, without further inflating the value of the taxable estate for either federal or state tax purposes.

10. Maintaining Flexibility for Changing Tax Environment

Forgone revenue from ATRA is projected to be $3.36 trillion over 10 years and there is the prospect of comprehensive tax reform on the horizon. Income tax planning will become increasingly important for all taxpayers. Wealth transfer tax planning will remain important for higher net worth individuals. Optimal plans will be designed to incorporate flexibility for the changing tax environment. ILITs and other irrevocable trusts should incorporate provisions to enhance income, control and flexibility (e.g., spousal lifetime access provisions, use of powers of appointment, etc.).

ATRA did not address several tax proposals relating to: caps on employer and employee contributions to qualified retirement plans, estate taxation of grantor trusts (e.g., ILITs), 10 year minimum term GRATs, 90 year limit to GST allocation to Dynasty trusts, or valuation discount strategies for business interests (FLPs, LLCs). Future tax legislation may impact certain planning techniques not addressed by ATRA. This is an excellent time to get in touch with clients to discuss planning to minimize current and future taxes. By encouraging them to consider the right strategies now, you can bring significant value and enhance these relationships.

Tax law changes should encourage individuals to review and update their plans and assess their liquidity needs. Post ATRA planning should expand the roles and uses of life insurance for personal and business planning, including: post retirement resources, survivor income, business succession planning (buy-sell funding), estate equalization, charitable bequests, and liquidity for remaining debts, expenses, federal and state taxes.

Please feel free to contact one of our Advanced Sales members: John Ruggiero or Bill Cook at MAF Companies at (800) 979-9393.