LIFE INSURANCE ISSUES AND THE PROPOSED TAX LAW CHANGES

By Peter Katt

The usefulness of some life insurance products may be affected by tax law changes that may or may not be passed. What to do in the face of uncertainty.

The Clinton administration has proposed that certain tax laws affecting life insurance, annuities, and estate planning be changed. This column alerts readers to four of the proposed changes, and it discusses how you may want to handle insurance, annuity, and estate planning issues while faced with the uncertainty of whether or not these changes will be enacted.

ELIMINATION OF CRUMMEY RULE

One change that would affect some life insurance purchases is the proposed elimination of the so-called Crummey rule.

The Crummey rule is an estate-planning device. Gifts must be immediately available to the persons receiving them in order to qualify for the annual gift tax exclusion of $10,000 per donor per donee per year. When life insurance is purchased by an irrevocable trust, the cash gifts to the trust to pay life insurance premiums do not qualify for what is known as gifts of a *present interest*. Therefore, they do not qualify for the annual gift tax exclusion *unless* the trust notifies the trust beneficiaries that they have the right to demand that these cash gifts be immediately given to them. By having the right to take the cash gifts, a present interest is created and they qualify for the annual gift tax exclusion, even though the beneficiaries do not actually take the cash gifts, which are used by the trust to pay the life insurance premium. This is referred to as the Crummey rule, because of the 1968 tax court case, Crummey v. Commissioner, that established it. There are thousands of irrevocable life insurance trusts that use the Crummey rule to reduce or eliminate gift taxes on gifts that are used to pay premiums. As I understand it, the elimination of this rule would be retroactive and would apply to any gifts to irrevocable trusts after the law's effective date.

Regarding this proposed law change, for existing irrevocable trusts there are two major alternatives. One is to continue making gifts to the irrevocable trust without being covered by the annual gift tax exclusion. Such non-annual exclusion gifts would reduce a taxpayer's remaining estate and gift tax credits, which have a current equivalent value of $600,000, scheduled to increase to $1 million by 2006. Taxpayers who have considerable wealth and would benefit from increasing their gifts anyway could make gifts directly to their children (and grandchildren if appropriate) that would qualify for the annual gift tax exclusion as well as make gifts to an irrevocable trust that would not qualify for the annual exclusion.

Another alternative, if allowed by the irrevocable life insurance trust, is to gift the life insurance premium amount directly to adult beneficiaries, who would then contribute the cash gifts to the trust, which would in turn pay the premiums. This arrangement would qualify for the annual gift tax exclusion because the adult beneficiaries receiving such gifts would be under no obligation to contribute them to the irrevocable trust and therefore a present interest would be created.

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For those currently contemplating the purchase of life insurance associated with estate planning, the irrevocable life insurance trust could still be used, funded as noted in the previous paragraph. Alternatively, instead of using an irrevocable trust created by the family matriarch and patriarch, their beneficiaries could execute a revocable trust to own the life insurance policy(ies). The gifts for the premiums would be made directly to adult children and grandchildren, which would qualify for the annual gift tax exclusion; the children or grandchildren would then contribute these gifts to the revocable trust for the payment of the premiums. This latter technique, whereby the children own the life insurance via a revocable trust, removes some of the privacy of such planning for their parents. Parents who wish greater privacy may opt to continue to use the irrevocable trust even if the gifts to pay the premiums reduce their estate and gift tax credits.

CORPORATE-OWNED LIFE

Many corporations, especially banks, have purchased individual cash value life insurance policies on the lives of many employees in order to fund certain employee benefits. The cash value build-up is tax-deferred, and the death benefits are tax-free. Operating or capital funds that are needed by the business and that would otherwise come from the life insurance premium budget can be borrowed, with the interest payments of this debt a tax-deductible expense to the business. Because the Clinton administration believes this is unfair tax arbitrage, it has proposed legislation that will effectively limit its use by denying deductions for debt service when the business also has purchased life insurance on non-owner employees.

Employers considering such a plan should wait to see if this change is enacted because it will impose a large tax penalty on such business.

EXCHANGING CONTRACTS

Under current law, (IRC Sec. 1035) life insurance and annuity policyowners who exchange their contracts for certain other insurance policies can do so without incurring any taxable gain. Current law does not distinguish between types of life insurance (whole, universal or variable life) or types of annuities (fixed or variable). However, the Clinton administration has proposed to tax any gains on exchanges between whole or universal life and variable life or variable annuities, and to tax any gains on exchanges between variable life and whole or universal life. As written, the proposed change in current law would allow for one last tax-free exchange for policies already in existence before the proposed new law would apply.

The term *exchange* is a euphemism for the term *policy replacement*, which occurs all too often and is frequently adverse to a policyowners' best interests. A new law taxing certain policy replacements might actually benefit unwary consumers if it reduces inappropriate policy replacements.

REDUCED COST BASIS

Under current law, a policyowner calculates taxable gain on the surrender of a life insurance or annuity policy as the amount received in excess of his cost basis, usually defined as the cumulative premiums paid. The proposed tax law change would reduce the cost basis for life insurance by the cost of insurance and other policy expenses and for annuities by a fixed 1.25% of the surrender value. Under the current law, a life insurance policy with a 10th year surrender value of $195,000 and a cost basis of $200,000 would not report any taxable gain if surrendered because the surrender value is less than the cost basis. However, under the proposed new law, if the cost of insurance and other policy expenses were, say, $70,000, this would reduce the policyowner's basis by $70,000 to $130,000, creating a taxable gain of $65,000. This tax would similarly impact cash value withdrawals from life insurance.

The proposed change would also impact the surrender of annuity policies as well as the partial withdrawal of cash values. However, it would not change the current taxation of annuities that pay monthly benefits for the rest of the annuitant's life, which will continue to use the full investment in the annuity as its cost basis.

Regardless of whether this new law is enacted, life insurance and annuities will continue to provide favorable tax treatment for consumers. Life insurance death benefits are still income tax-free, and annuities that pay monthly benefits for the life of the annuitant still allow for the full prorated recovery of the investment in the annuity. Life insurance purchased for the dual purposes of protection and investment will still have tax-deferred accumulation of the cash values and recovery of basis before taxation, even if the cost basis is reduced. And deferred annuities will continue to accumulate tax-deferred. It is my opinion that this proposed change is more of a nuisance than a catastrophe.

CONCLUSION

Proposed changes of obscure and complicated tax laws can produce significant additional revenues for Washington, D.C., without the general public even knowing it is happening. This allows elected officials to increase their control over the wealth of a nation without having to pay the political price of proposing major tax increases.

But for individuals, the bottom line is what you get to keep after taxes, and it is important for those who may be affected to take the proposed changes into consideration when making long-term decisions. ◆