Unwelcome maturity

Did you know that some whole life insurance policies mature when the insured reaches age 100? What happens then? What should be done? Those are questions we lead off with in this issue of Trusted Insights.

The candidate for governor who advocated eliminating the Connecticut estate tax lost the election. Therefore, we can expect that tax to remain a concern for Connecticut estate planners for the foreseeable future. But that leaves Connecticut among the minority of states that continue to levy a death tax, as we note in our secondary article.

We look forward to engaging with you throughout 2019 on key developments that affect our mutual clients. When your clients are in need of fiduciary services, we hope you will keep Webster Private Bank in mind.

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Director of Fiduciary Services

Eileen Cahill, SVP
Director of Financial Planning

Owning life insurance at age 100

In the 20th century, when life insurance companies calculated premiums needed to fund a whole life policy, they expected that no one would live beyond age 100. Accordingly, most whole life insurance issued then includes a termination date. When the insured reaches age 100, the policy has matured.

As life expectancy grew, the insurance industry updated their actuarial tables to provide coverage to age 121. However, this change took place in 2001. Policies issued before 2001 may still include termination provisions at age 100.

This phenomenon was explored and explained by financial planner Barry Flagg in his recent article, "What Happens to My Life Insurance at Age 100, and What Can I Do About it?" (Leimberg Information Services, November 6, 2018).

Effect of policy termination

Termination of a life insurance policy is not likely to be welcomed by the insured. At that moment the insurance company pays out the accumulated cash value of the policy, and the insurance ends before the death of the insured.

If the coverage were designed as an “endowment” policy, the cash value would be equal to the face value of the insurance. If the insured amount were $500,000, for example, the entire $500,000 would be paid to the policy owner upon reaching age 100. However, unlike insurance death benefits, which are free from income tax, this payment would be subject to state and local income taxes in the year of receipt.

Endowed policies are the exception, not the rule, according to Mr. Flagg. Given the increases in the cost of insurance in recent years, coupled with declines in policy earnings, the cash value in most policies will be less than the face value of the insurance, and could be as low as $1.00. The insured then loses the death benefit after receiving the cash value.

Still worse are those policies that allowed for borrowing from cash
Life insurance . . . continued

values to pay additional premiums. When the policy terminates, the loan is forgiven—but a loan forgiveness is taxable income! The phantom income could be taxed at a moment when the insured has no money to pay the tax.

Possible remedies to consider

There may be a way out for some policyholders who bought whole life insurance before 2001 and who might live to 100. Some insurance companies offer a Maturity Extension Rider to continue the policy. The terms of such extensions need to be thoroughly understood, however. In some cases the value of the extension is defined as the cash value of the policy at age 100—if the cash value is low, so is the value of the continued insurance. Still, at least an income tax has been avoided.

The next best option to consider, according to Mr. Flagg, is to exchange the limited policy for a new one that defines maturity beyond age 100. This approach works best with younger insureds (in their 70s) who are still insurable. As one approaches age 90, the chance of obtaining a new life insurance contract diminishes rapidly.

As a last resort, Mr. Flagg suggests that the policy may be exchanged tax free for a deferred annuity. Income taxes are not avoided, but at least they may be deferred until death. The gain from the policy would then be taxed as income in respect of a decedent.

If you or your client are the owner of a whole life insurance policy issued before 2001, you’ll want to read the fine print on the policy and explore your alternatives.

TAX COURT FIXES THE DISCOUNT FOR A LIMITED PARTNERSHIP AT 18%

In 2008 Streightoff and his wife created a family limited partnership for their investment portfolio. The portfolio was 61.6% in stocks, 23.6% in municipal bonds, 13.5% in mutual funds, and the balance in cash. The initial value of the transfer is not given in the decision. Streightoff Management, LLC (managed by Mrs. Streightoff) was the general partner. Upon creation there were nine limited partners, with Streightoff retaining an 88.99% limited partnership interest. Limited interests of 0.77% and 1.54% for the younger generation family members were reported as taxable gifts.

On the same day as the family limited partnership was created, Streightoff created a revocable living trust. He transferred his limited partnership interest to the trust, and he also executed an assignment of that interest to the trust. Under local law, an assignment of a partnership interest grants rights to partnership distributions but not responsibilities in managing the partnership.

Streightoff died in 2011. On the alternate valuation date of November 11, 2011, the net asset value of the partnership was $8.2 million. The estate claimed substantial discounts to Streightoff’s interest, which the IRS objected to, issuing an estate tax deficiency of $491,750.

The Tax Court held that whether the trust held the partnership interest directly or by assignment made little economic difference for federal tax purposes. The estate’s 13% discount for lack of control was not allowed, as the Court found that Streightoff maintained control of the trust to the end of his life. A discount for lack of marketability was permitted. However, the Court accepted the IRS expert’s analysis of an 18% discount rather than the estate expert’s more generous 27.5% discount [Streightoff, Estate of Frank D. et al. v. Commissioner, T.C. Memo. 2018-178].

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Are state death taxes going out of style?

The phrase “state death taxes” has been in the tax code for many decades—it was not invented by Republicans, as some have argued, though Republicans certainly did popularize its use. The phrase encompasses the two distinct kinds of taxes imposed at death by the various states:

- Inheritance taxes are imposed upon the right to receive property. The amount of any exemption as well as the rate of taxation typically depends upon the relationship of the recipient to the decedent.

- Estate taxes are imposed upon the right to give property away at death. An exemption applies to the estate as a whole, as does the tax rate. Typically amounts passing to charity and surviving spouses are exempt.

The federal government imposes only an estate tax, with an exemption this year of $11.4 million and a tax rate of 40%.

The major turning point

During the last century, all states imposed one or the other kind of death tax, and a few states levied both. The IRS allowed a credit against the federal estate tax for any state death taxes paid, dollar for dollar, up to stated limits. Many states keyed their estate taxes to the maximum allowable credit, no more and no less. Repealing such a state death tax would not help taxpayers, because it would not have changed the total tax liability of an estate. Eliminating the state level tax would only have meant more money for the IRS.

However, the format changed in 2001, when the credit was converted to a deduction for state death taxes. The change was accompanied by an increase in the amount exempt from federal estate tax, so on net this was still a better deal for taxpayers. Making state death taxes deductible, rather than creditable against federal taxes, meant that if any state repealed its death taxes the benefit would accrue to the estates, not to the IRS.

States rapidly began to repeal their estate and inheritance taxes, as well as increase amounts exempt from tax. Today only 12 states and the District of Columbia continue to have an estate tax; five have an inheritance tax, and one—Maryland—has both. (See table at right.) Connecticut and most of the New England states still have an estate tax, with a relatively low exemption, but the Connecticut exemption will increase from $2.6 Million to $3.6 million this year. Connecticut also has the distinction of being the last state to levy a gift tax.

The future

The doubling of the amount exempt from federal estate tax last year is temporary, and the smaller exemption is scheduled to return in 2026. Nevertheless, the increase in the federally exempt amount increases the pressure on the remaining states with death taxes to increase their exemptions or drop these taxes altogether.

The state of state death taxes

<table>
<thead>
<tr>
<th>State</th>
<th>Estate tax</th>
<th>Inheritance tax</th>
<th>2018 Estate tax exemption (millions)</th>
<th>2018 Top tax rate</th>
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</thead>
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<tr>
<td>Washington</td>
<td>X</td>
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</tr>
<tr>
<td>Oregon</td>
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<tr>
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<tr>
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<td></td>
<td>$5.2</td>
<td>16%</td>
</tr>
<tr>
<td>Connecticut</td>
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<td></td>
<td>$2.6</td>
<td>12%</td>
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<td>Vermont</td>
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<td>District of Columbia</td>
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</tr>
<tr>
<td>Maryland</td>
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<tr>
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<tr>
<td>Pennsylvania</td>
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<td>15%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>X</td>
<td></td>
<td></td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Tax Foundation, April 5, 2018
Briefly noted

Revenue and the Tax Cuts and Jobs Act

The official revenue scoring of the Tax Cuts and Jobs Act last year by the Joint Committee on Taxation may be found at JCX 67-17. The individual tax cuts were projected to lose $75.3 billion in 2018 alone, the business tax reforms $129 billion, but the international taxation reforms were expected to gain $68.9 billion. The net one-year decline in revenue was forecast to be $135.7 billion.

The final tally for the 2018 fiscal year is in, and it turns out that federal tax revenue did not fall; it rose compared to 2017, reaching $3.329 trillion, some $14 billion ahead of 2017’s $3,315 trillion [Mnuchin And Mulvaney Release Joint Statement On Budget Results For Fiscal Year 2018, https://home.treasury.gov/news/press-releases/sm522].

These numbers are not directly comparable, because JCT’s projections were not against the 2017 actual experience but from the higher baseline of expected revenue from continued slow economic growth.

The deficit grew in fiscal 2018 because spending increases vastly outpaced the $14 billion revenue increase. As a percentage of GDP, federal revenue fell from 17.2% to 16.5% (0.7% decline), while spending fell from 20.7% to 20.3% (0.4% decline).