PACIFIC LIFE

SO NOW WHAT?

ISSUES AND OPPORTUNITIES PROVIDED BY THE FISCAL CLIFF LEGISLATION INVOLVING LIFE INSURANCE

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American Taxpayers Relief Act (ATRA) of 2012

- Most comprehensive piece of tax legislation since 1986
- Passed at the very beginning of 2013 to avoid the "fiscal cliff"
- Has a significant effect on:
  - Income taxes
  - Transfer taxes
  - Capital gains taxes
- Permanent legislation – no sunset provision

Some of the Changes

	2012	2013
Top Income Tax Rate ($400k for single filers, $450k for joint filers)	35%	39.6%
Top Capital Gains Rate (including taxation on some dividends)	15%	23.8% (20% + 3.8% Medicare surtax*)
Estate, Gift and Generation Skipping Transfer (GST) Tax Exemption**	$5,120,000	$5,250,000
Top Estate, Gift and GST Tax Rate	35%	40%

* Implemented as part of the Patient Protection and Affordable Care Act of 2010. The 3.8% Medicare surtax will be applied to certain net investment income for individual taxpayers with a Modified Adjusted Gross Income, net investment income or a combination of both of more than $200,000. The threshold for the surtax increases to $250,000 for joint income tax filers.

** According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

In Addition

- Indexed for inflation
  - Estate, gift and GST exemption
    - Portability of estate tax exemption still in place
  - Income threshold for 39.6% income tax and 20% capital gains rates
    - Currently $400k for single filers, $450k for joint filers
- Phase out for personal exemption and itemized deductions
  - Individuals - $250,000
  - Joint filers - $300,000
  - The limitation on the phase out of itemized deductions is the lesser of
    - (i) 3% of excess AGI over the specified threshold or
    - (ii) 80% of "unprotected" itemized deductions (e.g., mortgage interest, charitable contributions, state and local taxes, etc.)

Don’t Forget – Medicare Surtaxes'

- Implemented via the Patient Protection and Affordable Care Act
- 3.8% Medicare surtax on net investment income
  - Includes some investments, rents and dividends, etc.
  - Individual filer threshold - $200,000
    - Modified adjusted gross income
    - Investment Income
    - A combination of both
  - Joint filers - $250,000
- .9% additional Medicare tax on income
  - On income above $200,000 for individuals and $250,000 for joint filers
- The thresholds for these taxes are not indexed for inflation

Items Not Affected by ATRA

- Taxation of life insurance
  - Inside build-up
  - Death benefit*
  - Distributions**
- Intentionally defective grantor trusts (IDIT)
- Minimum duration for grantor retained annuity trusts
- Discounting for transfers of some property
- Dynasty trust duration
- All or some of these items could be affected by future tax legislation

* For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

** T ax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

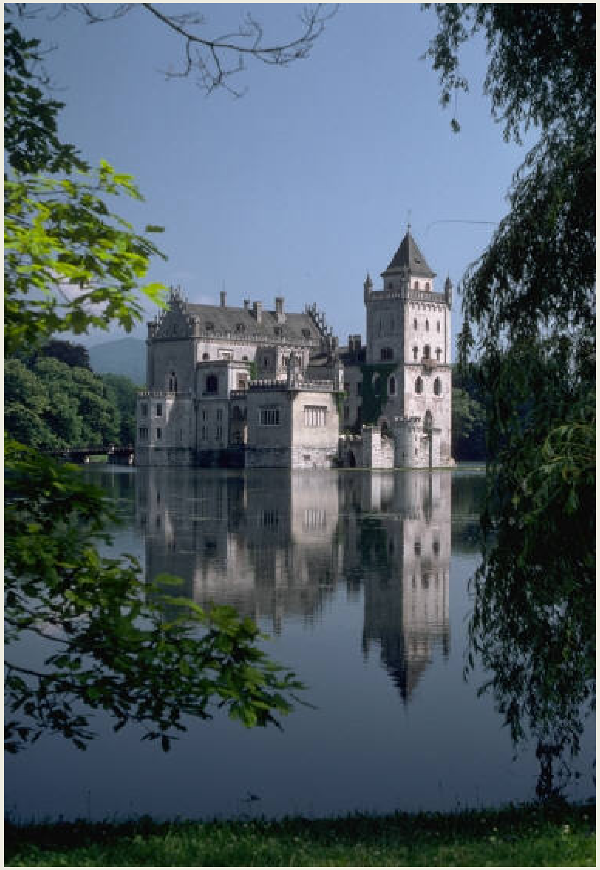
Where Are The Opportunities?

ESTATE PLANNING

What Size is the Estate?

- Larger Estates
  - Estates worth more than $10 million ($5 million for an individual)
    - Estates with assets with the potential for explosive growth
  - Large estates with limited liquidity
- Smaller Estates
  - Estates worth less than $10 million ($5 million for an individual)
  - Portability makes it very unlikely that estate taxes will ever be an issue (assuming no further change in estate taxes)
  - Families with closely held businesses or farms

Larger Estates



- Nothing has really changed*
- Still a federal estate tax liquidity need for many of these estates
- Estate tax rate has increased from 35% to 40%
- Gift tax and GST exemption are $5 million+
  - Still allows for larges gifts to trusts
  - Clients may remove appreciation from their estate

* Nothing has really changed *except* for potentially owning a smaller estate tax from pre-EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) law.

Dynasty Trusts

- Trusts that can last for multiple generations
  - Subject to state laws regarding permissible trust duration
- Allocate GST exemption along with large gifts to the trust
- Can preserve family legacy for many years
- Life insurance in a dynasty trust may provide estate tax liquidity if structured properly

Sale of Property to an IDIT

- May allow for the maximum use of gift tax and GST exemptions
- Higher gift tax exemption for seed gift is imperative
- Why an IDIT sale?
  - Low interest rate environment
  - Potential for conservative discounting
  - Depressed asset values in some cases
- IDIT may be structured as a Dynasty Trust
- Life insurance may be included in the IDIT
  - To help repay the note if seller dies prematurely, or
  - To provide estate tax liquidity

Smaller Estates

- Focus is no longer on federal estate taxes
  - Higher estate tax exemption
  - Exemption is indexed for inflation
- Focus on family protection and business succession planning

Planning Opportunities

Emphasis on other wealth transfer needs:

- State death taxes
- Business succession planning
- Debt repayment at death
- Providing for surviving spouse and/or children
- Planning for blended families

Simplified Planning

- Estate inclusion of death benefit may not be problematic in many cases
- May include opportunities for:
  - Personally owned life insurance
    - Family protection
    - Life Insurance Retirement Plan (LIRP)
  - Qualified plans with life insurance
  - Permanent benefit section 79 plans

Where Are The Opportunities?

INCOME TAX PLANNING

Impact of Higher Taxes on High Income Earners

- 5 Possible tax increases on high income earners
  - Top income tax rate – 39.6%
  - Top capital gains rate – 20%
  - Phase out of personal exemption and itemized deductions
  - 3.8% Medicare surtax on net investment income
  - .9% Medicare tax

Impact of Higher Taxes on High Income Earners (cont.)

- All of these potential tax increases start for taxpayers above certain income thresholds
- Strategies that may reduce or defer taxable income may reduce the impact of these increases

Potential Strategies

Qualified Plans

Permanent Benefit Section 79 Plans

Captive Insurance Companies

Nonqualified Deferred Compensation

Qualified Plans – Two Basic Types

- Defined contribution (DC) plans
  - Contribution levels capped
  - Most plans limited to maximum contribution of $51,000 in 2013
    - Elective deferrals for 401(k) plans is $17,500 in 2013 ($23,000 for participants age 50 or over)
- Defined benefit (DB) plans
  - Contribution levels based on defined benefit amount
    - Maximum defined benefit in 2013 is $205,000
  - Contribution levels in many cases are significantly higher than DC plans
- Regardless of plan type, must provide benefits for rank and file employees in addition to business owner
  - Cross-testing of DC and DB plans may reduce costs for business owners if applicable

Why Qualified Plans?

- Significant and potentially predictable stream of retirement income
- May reduce current taxable income for high income business owners
  - Contributions for qualified plans are pre-tax for the participant and generally income tax-deductible for the sponsoring business
  - May push participant's income under thresholds for higher income and capital gains taxes
- Assets inside of qualified plans may be creditor protected

Why Life Insurance in a Qualified Plan?

- Provides financial protection for the participant's family
  - Participant must annually pay tax on cost of current life insurance protection
    - Currently based on Table 2001
    - Net amount of risk may be income tax-free*
- May increase the annual deductible contribution for a DB plan**
- Does not reduce the retirement income benefit
- Estate taxes may no longer be an issue
  - Higher exemption levels make estate inclusion of death benefit a non-issue for most

* For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j). Per Treas. Reg. Sec. 1.72-16(c)(2)(iv), if the participant included the cost of life insurance protection as taxable income, a portion of the death benefit proceeds (that amount above the cash value) is treated as excludable benefits under IRC Sec. 101(a)(1).
** The amount of life insurance that may be purchased inside a plan is limited to an incidental benefit limit and should be discussed with legal and tax counsel prior to its purchase.

Permanent Benefit Section 79 Plans

Internal Revenue Code Section 79:

- Tax rules regarding group term life insurance
- Provides requirements for either a master policy or individual policies to qualify as "group term life insurance"
- Allows a business to establish a group term plan that provides permanent benefits as well as group term benefits*

*Please consult with your employee benefits legal counsel as to whether this is an employee benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA) and if so, whether any additional requirements are necessary to comply with ERISA.

Benefit Options

- Participants may choose:
  1. $50,000 of free group term
  2. Supplemental term insurance
     - Participant is annually taxed on the cost of the death benefit in excess of $50,000
  3. Permanent benefits (individually owned cash value policy)
     - Participant is annually taxed on cost of death benefit in excess of $50,000 plus cost of permanent benefits (determined by the deemed death benefit formula)
     - Formula "may" result in participants being taxed on less than 100% of the policy premium

* *See Treas. Reg. Section 1.79-1(d)(2). Revenue Procedure 2005-25 provides a safe harbor fair market valuation for use in determining permanent costs.* Taxable income to participants in a Section 79 Permanent Benefit plan is comprised of two parts: (1) the life insurance benefit; and (2) the permanent benefit. Calculation of taxable income is not performed by Pacific Life, and is not a part of any sales material or illustration prepared by Pacific Life. Taxable income calculations are typically performed by independent third party administrators based on their understanding of the Section 79 regulations. Pacific Life makes no representation as to the appropriateness of these taxable income calculations. Your client should obtain whatever advice you deem necessary and appropriate from your independent tax and legal counsel as to the reasonableness of those calculations performed by such third parties.

Why Permanent Benefit Section 79 Plans?

- Life insurance policy death benefit may provide protection for insured’s family
- Life insurance policy’s cash value may be a source of supplemental retirement income
- Potentially reduced income may reduce current income tax liability

What Is a Captive?

- "C"-Corporation created for the purpose of providing property and casualty (P&C) insurance to a small group of businesses
  - Intended to supplement (not replace) existing commercial P&C coverage
  - If parent company is self-insuring risk:
    - Captive provides an upfront deduction for these risks;
    - Captive provides a dedicated source of funds to cover such risks
- Small market for captive insurance companies
  - Must have significant property and casualty liability exposure
  - Must have substantial cash flow to form and capitalize the captive

Why Captives?

- Potentially favorable tax treatment
  - Premium payments made by the parent company are deductible
  - Per IRC section 831(b), premiums received of up to $1.2 million are tax-free
    - However, investment income is taxable
  - Upon liquidation captive assets are taxed as capital gains
- Potential cost savings
  - Any profit arising from favorable claims experience benefits the owners of the captive
    - Distributions may be taxed as dividends

NOTE: Captives are complex and should be discussed with legal counsel prior to implementation.

Potential Use of Life Insurance

- Life insurance for estate tax liquidity
  - Split-dollar arrangements
    - Life insurance policy will be owned by an irrevocable trust
    - Economic benefit or loan regime arrangement
  - Using dividends from the captive
    - Pay premiums directly
    - Pay interest or economic benefit costs for private split-dollar or premium financing arrangement

Nonqualified Deferred Compensation

- A promise by a business to pay a benefit to a key-executive at a specified permissible time or occurrence
- May allow for elective salary deferrals in excess of the qualified plan limits
  - No current income tax deduction for the sponsoring employer
- Funds are controlled by the business until paid to the executive
  - Plan may be informally funded with cash value life insurance*
    - Business is the owner and beneficiary of a key-person life insurance policy
  - All assets used to informally fund a nonqualified plan are subject to the claims of the business' creditors

* Note that the policy is not the plan and the promised benefit to the executive may be more or less than the policy's available cash value.

Why Nonqualified Deferred Compensation

- May provide retirement income in excess of the business' qualified plan options
  - Distributions must comply with IRC Section 409A requirements*
- May reduce the participant's current income
  - If the plan allows for elective deferrals
  - Election to defer generally must occur in year prior to the deferral – two exceptions
    - New plans
    - Performance based compensation
- Life insurance policy's death benefit provides key-person coverage for the business

* Employers who establish nonqualified deferred compensation plans that contain amounts earned or vested after December 31, 2004 must comply with IRC Sec. 409A. If a non-qualified deferred compensation plan fails to meet IRC Sec. 409A's requirements, then all compensation deferred under the plan that is subject to IRC Sec. 409A for the current tax year and all preceding tax years is includible in the participants' income in the current tax year (with a 20 percent tax penalty and potential interest) to the extent that the amounts are not subject to a substantial risk of forfeiture and not previously included in the participants' gross income.

The Next Steps

- Estate planning
  - Shift focus – no longer planning for estate taxes for vast majority of households
  - Focus on family protection, business succession, etc. and the use of life insurance to provide financial protection
- Income tax planning
  - Identify high income earners
    - Business owners
    - Key-executives
  - Discuss strategies that may reduce income
  - Explain how life insurance may be an important part of these strategies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Questions?
Call Ken