Using Life Insurance in your Estate Planning

By Mark Albertson

Senior Counsel

Albertson Law Group, P.S.

mark@albertsonlaw.com

Introduction

Life insurance is an important and integral part of estate planning. Although the life insurance industry has changed significantly in the last 20 years in the products it offers and the purposes for which life insurance can be used, life insurance, in its purest form is specifically intended for estate planning. Consequently, everyone, no matter their age or net worth, should consider using life insurance as one tool in their estate planning portfolio.

From my perspective, life insurance is most useful in the following cases:

- First, people without an estate who would like to create one to take care of heirs when they die.
- Married couples with over $2 million in net assets or who have a high probability their estate will exceed $2 million.
- For single persons, over $1,000,000, or who have a high probability his or her estate will exceed $1,000,000.
- People with an insurance policy in their estate who would like to remove it for tax purposes.
- Anyone with high interest in giving to charity while not reducing inheritance to heirs.
- People with taxable, yet illiquid estates.

- People who have businesses in which they have partners or co-shareholders, and desire to have cash to buy-out the heirs should the partner die unexpectedly.

My intention in this article is to focus on the situations I deal with the most; primarily, in cases where there are estate taxes that will be due on death.

The Two Tax Systems in America

Anyone who has been actively investing for any period of time understands that we have two tax systems in the U.S.: One for the *uninformed*, and one for the *informed*. Congress relies upon Americans falling into the former category. Each year many millions of people pay more taxes than they should. Nowhere is this more true than in the case of estate taxes.

When World War I came along, the Revenue Act of 1916 was born. Unlike previous estate taxes this tax did not go away. Interestingly, this tax was not intended to raise extremely large amounts of revenue; its original purpose was to prevent the very wealthy from keeping large concentrations of wealth in the family for many generations. President Franklin Roosevelt, speaking of the estate tax very bluntly, stated that it was based upon, “the very sound policy of encouraging a wider distribution of wealth.” The federal estate tax was thus created to penalize successful people in the United States.

Although the country was built upon basic capitalist concepts such as free trade and the unhindered ability of anyone in American to become successful and wealthy based upon their own personal abilities. In short, the government, through the estate tax, will force the fruits of their labor to be redistributed upon their death. Need for capital to feed the federal government overcame the social policy against controlling its citizens. Our government fell into the same routine as governments throughout history, by restricting ownership rights of property based upon social policy rather than revenue policy.

Opponents of the tax challenged it in the U.S. Supreme Court, but the Court held the federal estate tax to be constitutional under Article 1, Section 8, Clause 1 of the United States Constitution, which says:

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay Debts and provide for the common Defense and general Welfare of

the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

Because the federal estate tax is not technically a tax on property, the Courts could *squeeze* its constitutionality into other areas of the Constitution. Essentially, the Supreme Court was holding that the estate tax is a tax on the *privilege* U.S. citizens have to give their property to another. Because it is not a tax on the property itself, there was no requirement for Congress to attempt to change the Constitution to fit within its strict wording.

In 1935, the redistribution of wealth concept garnered even more support in Congress with a significant rise in the estate tax rates. The nature and character of the estate tax has gone through many changes over the years, with the details changing significantly down to today. Fortunately, major changes to our tax system in 1986 and in 2001 allow citizens faced with estate taxes to take action to reduce them dramatically. The burden of taking that action, however, rests with the citizen, and without proper education and planning, doing nothing, or doing the wrong thing, can have significant negative effects for heirs.

Estate and Gift Taxation

Currently, the estate taxation system in the United States is what is known as a “unified” system. This term came about as a result of Congress integrating gift taxes, estate taxes, generation-skipping taxes and excess retirement accumulations taxes. The implication for this is that Congress taxes both gifts during life and transfers to beneficiaries after death under the same system. With the most recent 2001 tax changes the “unified” system will be phased out beginning in 2009.

The Gift Tax

The gift tax is levied on gifts made during lifetime. Each time a person makes a gift, the gift tax applies. There are exceptions to this rule which will be explained below. Federal tax regulations define a gift as a transfer made, during lifetime for

less than fair market value. In order for persons to make a gifts, they must relinquish complete control over the gifted asset.

The Estate Tax

The estate tax is a transfer tax levied after death. Congress requires that an estate tax return be filed, and any taxes due and owing be paid within nine months of the date of death. We will discuss this issue in depth below.

Under current rules, if the gross estate exceeds $1,000,000, estate taxes will be due and owing. If there were taxable gifts made after 1976, that $1,000,000 threshold is reduced by the amount of those taxable gifts made.

The personal representative, or in the case of a revocable living trust, the Trustee, has responsibility for filing the estate tax return, form 706, and paying the taxes, in cash, within nine months of the date of death.

The Estate Tax Rates

The federal estate tax rates are extremely high, and the brackets are fairly small between rate increases. For paying estates, every dollar over $1,000,000 is taxed at 41% or higher, up to a rate of 55%. In addition, there are penalties for giving too much to generations that are more than one generation below yours, and for IRA accounts that are too large.

Key Question: If your estate will owe taxes, how will they be paid?

When it comes time for your estate to have to pay taxes, the key questions to be answered is how will they be paid? The four ways estate taxes may be paid are:

1. Cash

If your estate has enough liquid assets, your estate will pay cash, within 9 months to the IRS.

2. Forced Sale

If your estate does not have enough cash, the system will require that your best assets (the most marketable) be sold to raise the money for taxes, once again, within 9 months. The primary problem with this method is that if the asset does not have a published market value, buyers who are aware the property, business, etc. is being sold to pay taxes will probably seize the opportunity to pay less than what would otherwise be fair market value.

3. Borrow

Your personal representative may have to mortgage property in order to keep the property and still have enough money to pay taxes. The cost of borrowing will reduce the amount ultimately destined for the heirs. If you own a family farm and it consists of more than 25% of your estate, or if you own a closely held business and it consists of more than 35% of your estate, the government may be willing to loan the estate the money to pay off your estate tax bill.

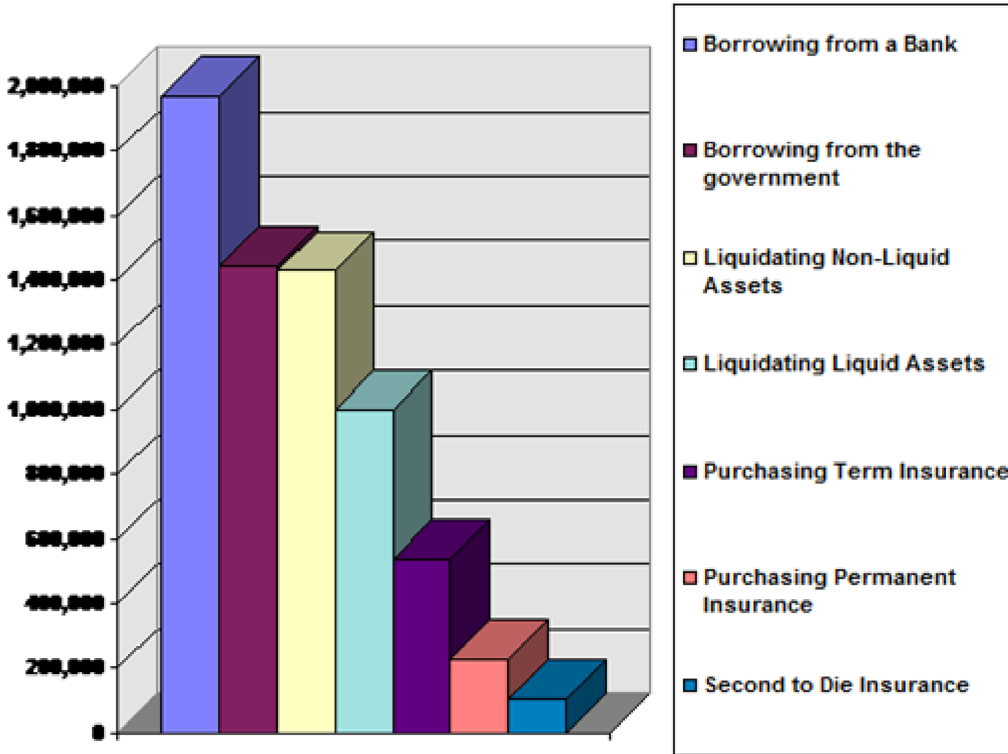
4. "Tax" Insurance

A life insurance policy that is either owned by your children or an irrevocable life insurance trust, will provide estate tax free liquidity, and will actually reduce your estate's share of the cost for estate taxes.

In the situation where you are insurable, very often a life insurance policy becomes an opportunity to deeply discount your estate taxes. In fact, the *entire cost* of estate taxes can be traded for the cost of premiums on a life insurance policy. If you do not own the policy, the proceeds are not includable in your taxable estate and are therefore not taxed. Additionally, the proceeds from a life insurance policy are not income taxable to the recipients. The result is that the actual cost of paying off the IRS is usually *dramatically* reduced. On the next page is a chart illustrating just how dramatically the cost of taxes is decreased using life insurance.

There is another benefit to using life insurance. If your estate is not very liquid; for instance, if much of your estate is a business or hard to sell property, the proceeds of the life insurance policy are immediately available to pay the taxes. This eliminates the requirement to sell the assets quickly, which increases your estate's chances of selling the property at a much higher value.

Financing Your Estate Tax Liability Assuming $1,000,000 Estate Tax Assessment



Borrowing: From a Bank (10% interest for 15 years):: $1,972,107

From the Government (IRC Section 6166): $1,443,459

Liquidating Assets: Non-liquid $1,428,571

Liquid assets: $1,000,000

Buying Life Insurance: Term*: $538,240

Permanent: $229,247

Second to Die: $106,195

*These are for illustration purposes only: Have your Life insurance professional quote you premium costs (Assumptions: Preferred policy for 55 year old couple, assuming an 8% net rate of return)

Second to Die Policies

For married couples, there can be an even more cost-effective way to use life insurance as “tax” insurance. Many life insurance companies now offer a life insurance policy which is based on both lives, and only pays-off at the second death. Because the entire purpose of “tax” insurance policies is to provide the cash for taxes at the second death, this is a perfect product for estate planning. The benefit to you is the fact that the premiums are generally lower than other policies, and even if one spouse is not insurable, very often the underwriters will still issue a policy.

Irrevocable Life Insurance Trust

In order for life insurance death benefits to avoid inclusion inside your estate for estate tax purposes, the insured cannot be the owner of the policy. If the insured is the owner, then the entire death benefit of the policy will be included in the net value of the estate. Consequently, if the owner of the policy is someone other than the insured, it will not be included in the estate.

It is possible for the owners of the policy to be the children of the insured. This strategy has some potential problems associated with it. First, if the child goes through a divorce, the cash value of the policy may be subject to the divorce proceedings, and could be awarded to the in-law spouse. Second, if the child is sued or goes through bankruptcy, a creditor could potentially get the cash value. Third, if the child is the owner of the policy, the insured will be gifting the premium dollars to the child to pay for the policy. Very often when faced with the choice of paying for life insurance premiums or orthodontist bills, mortgage payments or toys, the policy premium lapse. This is one policy that the insured wants to be very careful not to allow to lapse.

If any of these situations concern the client, an irrevocable life insurance trust may be one solution. The irrevocable life insurance trust (known to estate planners as the "ILIT", pronounced eye-lit) is an irrevocable trust specifically set up to hold the insurance policy. A Life Insurance Trust, frequently called a Special Family Trust, plays a unique role. It not only enables the proceeds from life insurance policies to be available for taxes and other expenses at the time of the insured's death, but keeps the proceeds from ever being taxable upon either the insured's death or the surviving spouse's death. A Life Insurance Trust is one of the most popular estate planning tools for individuals facing estate taxes.

How an ILIT is Set Up

A Trustor cannot be a Trustee of the Life Insurance Trust. Usually a trusted friend, an accountant, or the eventual beneficiaries (e.g. your children) will be the Trustee of the Trust. Trustors will make contributions to the Life Insurance Trust and the Trustee has the authority to purchase policies and to pay the premiums on these policies. By making the Trustee of the Life Insurance Trust the owner of the life insurance policies, it prevents the policies from being taxed in the estate of the insured.

If however, if you die within three years of transferring an existing policy to the Trust, the proceeds will be includable in your taxable estate. When purchasing a new policy for the Trust you should wait until the Trust is signed and then the Trustee can purchase the policy with money you contribute to the Trust. The Trustee will be listed on the application as owner of the policy, as Trustee for the Trust.

What Happens When the Insured Dies

The beneficiary of the life insurance proceeds is the Trustee of the Life Insurance Trust so that the Trustee then has the cash which is usually needed to pay taxes. However, the Life Insurance Trust cannot directly pay estate taxes. The Trustee has the authority to lend money to the Trustee of your Living Trust or to buy assets from your Living Trust. The end result is that the liquid cash needed to

pay taxes is available to the Trustee of your Living Trust without having to sell significant portions of hard assets to raise the necessary cash. The assets in the Life Insurance Trust are then distributed as you have directed, usually the same as in your Living Trust.

Types of Insurance Policies

One of the most popular types of policies for a Life Insurance Trust is a "second-to-die" policy that just pays out when the second spouse dies; these are less expensive than policies on one life. If a policy on one life is used and the insured predeceases the other spouse then the Trustee of the Life Insurance Trust has the discretion to make distributions to the surviving spouse.

Withdrawal Rights

Your Trust may also contain the option of giving withdrawal rights (sometimes referred to as "Crummey" powers, named after the Crummey family involved in the case) to the beneficiaries so that contributions made by Trustors to the Trustee to pay premiums do not use up any of Trustors' estate tax lifetime exemption. Crummey power holders are notified by the Trustee *each year* regarding what contributions Trustors have made to the Trust that year, then the power holders have the option of making a pro-rata withdrawal of the Trustors' contribution. The power holders nearly always choose not to make such a withdrawal so that the Trustee can make the premium payment.

As you can see, the goal is to have the cash available to pay taxes while circumventing the IRS's desire to take a portion of those funds for taxes. Life Insurance Trusts have been in effect for many years and can be a very effective tool in achieving your goals.

The Bottom Line: What Do You Want?

Proper estate planning is much more than mass producing wills and probating estates.

Proper estate planning is a process in which professionals, including an attorney who concentrates his or her practice on estate planning, spends significant time with you, asking the right questions, in order to understand your needs, your concerns and the objectives for your estate.

When you and your attorney reach a mutual understanding of those needs, the attorney will prepare the highest quality legal documents that will assure your control of your property while you are alive, that you and your loved ones are taken care of if you become disabled, and enable you to give what you have to whom you want, the way you want, and when you want, at the same time saving every last tax dollar, professional fee, and court cost possible.

Whether you want to plan using life insurance or not should be your decision, based upon your particular circumstances and personality. There is no one right answer for anyone. Having an estate planning attorney help you through the process, however, will be an important investment of your time.

In an age of increasing complexity and specialization, it is good advice to seek a competent estate planning attorney rather than someone who does estate planning part-time. Many practitioners will offer free initial consultations and will quote flat fees for their services. If you do not know an estate planning attorney, you can find them by asking friends and relatives, your local estate planning council, your financial planner, stockbroker or calling your local bar association.