MCLE Estate Planning Basics

Estate Planning With Life Insurance

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I. Why use Life Insurance? While an attorney need not be an insurance expert, you should be prepared to speak with your client about their reasons for using life insurance and be able to at least point out concerns that the client should address with a trusted insurance professional.

A. Replace Income and Provide Security – People often wish to pay off a mortgage, pay for higher education, and/or have the opportunity to stay at home for a few years after the death of a spouse.

B. Provide Liquidity – When a family's assets are tied up in illiquid assets – a closely held business, a large piece of real estate, etc. – life insurance provides cash within the short time frame available for paying estate taxes (generally nine months) as well as for paying the immediate expenses related to a death. This means that there is no need to sell an asset quickly and perhaps have to accept a lower price – or to sell it at all

if the family would prefer to maintain it. This purpose is a common reason for purchasing a "survivor" or "second-to-die" policy, which is less expensive than two individual policies because it only pays out upon the second death – which is when estate taxes may be due if basic marital deduction planning has been completed.

C. Business Purposes – Life insurance can be very important in planning for the continued prosperity of a closely held business in the years following the death of a key person within the company. The founder may wish to treat his or her children equitably but may want to leave the business only to the involved child or children to avoid tension between the involved and uninvolved children. The proceeds from a life insurance policy can provide a cash fund from which to distribute the legacy of the uninvolved children.

Life insurance may also fund a buyout agreement among partners or shareholders, provide funds to give a company a cushion in the aftermath of the death of a key person, or to enhance the benefits available to executives in the employ of the company.

D. Investment – As the life insurance industry develops new products with more attractive features, including a better return on investment, clients will be increasingly interested in exploring life insurance as an investment. It is important to understand the specific provisions – and the Internal Revenue Code treatment of those provisions – while planning for your client.

E. Wealth Replacement – Tax planning involving a charitable remainder unitrust ("CRUT") may utilize a life insurance policy to replace funds given to charity.

F. Long-Term Care Protection –An increasing number of life insurance contracts have added a long-term care "rider" to the base contract or a chronic illness provision. Both enable the owner to accelerate (i.e., take during life) the death benefit of the insurance contract should the insured become unable to perform 2 out of 6 Activities of Daily Living (ADLs) such as eating, bathing, transferring, dressing, continence or severe cognitive impairment.

G. Roth Conversions – Following the passage of the SECURE Act (Setting Every Community Up for Retirement Enhancement Act) on January 1, 2020 a strategy some advisors are employing when a client is terminally ill (hospice scenario), has life insurance in place and also a large qualified retirement account that will be passing to a non-spouse beneficiary is to convert all or part of the retirement plan to a Roth IRA with the expectation that the life insurance death benefit proceeds will soon be available to fund the Roth conversion. This strategy in the right situation will provide the client's beneficiaries (generally children) with significant income tax savings at it will effectively allow the qualified plan beneficiaries to avoid imposition of the SECURE Act's 10 year rule whereby the entire qualified plan must be distributed within a ten year period to the designated beneficiaries resulting in the plan withdrawals being reported on the plan beneficiaries personal income tax return (IRS Form 1040) as ordinary income.

II. How is it Taxed? Despite what clients believe, life insurance is not always "tax free," so you will need to educate them.

A. Income Tax – Generally, the death benefit of a life insurance policy is not subject to income taxation.

B. Gift Tax – Massachusetts does not have a gift tax. There is a federal gift tax, with an exemption amount of $11.7 million and a tax rate of 40%.

The transfer of a policy on one's life to another person, or to a trust for the benefit of another person, is a gift to that person. Similarly, the payment of premiums on a policy owned by another person or entity will be considered a gift. Gifts of life insurance are all valued according to the cost to replace the policy, but the replacement cost for each type of policy is determined in a different manner. While not the only types of policies gifted, the most common types of policies that you will need to value are term insurance policies and those with cash value.

1. **Term Insurance** – A term life insurance policy will be valued at the amount of premium that has been paid but not yet earned for the current term.

2. **Cash Value Policies** – A life insurance policy that has built up some cash value will be valued for gift tax purposes by first calculating, as above, the amount of premium that has been paid but not yet earned for the current term. That amount is added to the "interpolated terminal reserve" (an amount calculated by the insurance company to be the replacement cost of the policy) and any dividend accumulations, minus any outstanding policy loans.

C. Estate Tax – The proceeds of life insurance will be includible in one's estate if they are receivable by that person's executor, or if they are receivable by anyone else, yet at the time of the insured's death, he or she retained any of the "incidents of ownership" in the policy. The phrase "incidents of ownership" is interpreted in a broad manner, and includes economic interests in or benefits from the policy – or the power to control any such interests or benefits. Thus, the power to change the beneficiary or the manner in which the beneficiary receives the proceeds, the right to receive any proceeds, even if the chances of doing so are quite remote, are all considered incidents of ownership and would cause inclusion in the insured's estate. These incidents of ownership will cause inclusion even if they are exercised only in conjunction with another person or if the powers were held but released within three years prior to death.

III. Utilizing Irrevocable Life Insurance Trusts

A. Why Create an ILIT? – An Irrevocable Life Insurance Trust ("ILIT") is created to be the owner and beneficiary of a life insurance policy. If created, funded and maintained correctly, an insurance policy owned by an ILIT will not be includible in the insured's estate, as it will neither be receivable by the executor of the insured's estate nor will the insured retain any "incidents of ownership" in the policy nor in the trust as discussed above. ILITs have long been a popular estate planning tool for removing life insurance proceeds from estates. However, in light of the permanent nature of any irrevocable trust and the fluctuating state and federal estate tax exemption, they have been employed with some caution and much disclosure to clients in recent years.

B. Funding a new ILIT – There are two ways to initially fund an ILIT. The first and easiest way is to create a new ILIT, gift cash into the ILIT and have the ILIT purchase a new policy on the insured, naming itself as the beneficiary as well as the owner. In this case, the insured could die immediately after the ILIT obtained the life insurance policy with no negative implications for the insured's estate.

An alternate method of funding an ILIT, and one that may be necessary if the insured is no longer insurable or the rates for his or her insurance have risen dramatically, is to create the new ILIT and transfer an existing life insurance policy into the ILIT. This transfer will be considered a gift and the transferred policy will be valued for gift tax purposes as discussed above. If the insured survives for three years from the date of the transfer, the life insurance proceeds payable upon his or her death will not be includible in his or her estate. If, however he or she dies before that time, the proceeds will be includible in his or her estate.

Another option is to seed cash to the ILIT and have the ILIT purchase the existing life insurance policy for fair market value. Be sure to have the life insurance company prepare a policy valuation.

C. Providing for Annual Premium Payments – In order to maintain the insurance policy now held by the ILIT, annual premium payments must be made. However, the only asset of the ILIT at this point is the insurance policy. Generally, the insured will make gifts to the trust sufficient to pay these premiums. Without special planning, a gift to a trust is not a present interest gift and therefore is not qualified for the

annual exclusion (currently $15,000). However, by including and utilizing "Crummey" withdrawal rights in the trust, such gifts can qualify for the exclusion.

A Crummey provision (so named for the case that confirmed the effectiveness of this technique) provides that each of a certain class of beneficiaries may withdraw their pro rata share of any gift, generally up to the amount of the annual exclusion. The beneficiary, or the beneficiary's guardian, if the beneficiary is a minor, must be aware of this right and the fact that a gift has been made. In order to prove that beneficiaries did have such knowledge, the Trustee will generally send "Crummey notices" to the beneficiaries. Even though it is the knowledge about the gift and the right, rather than the existence of the notices, that is important, you should advise your client to maintain Crummey notices in case of an IRS audit. It is important to advise your client that this must be a real right on the part of the beneficiary, although a wise beneficiary understands that if they exercise it, the ILIT may no longer be funded, and other aspects of a person's estate plan may be altered.

The Crummey notice should be drafted to acknowledge receiving notice of the gift, and not to release any right that the beneficiary may have, as the gift tax consequences of the two.

D. Ongoing Administration

An effective ILIT does require ongoing administration. Crummey notices, as discussed above, should be provided each year in which gifts are made to the ILIT, and records of such notices should be maintained. The Trustee must make sure premium payments are made. After the death of the Grantor, annual tax returns will be required.

E. Other Suggestions for Drafting an Effective ILIT

1. It is vital that the ILIT not be required to pay any expenses on behalf of the estate. However, you may give the ILIT the option to pay such expenses.

2. It is wise to include "saving" language in case the insured does not survive the 3-year inclusion period – such language directs the proceeds of the life insurance to the marital trust, if any, or to otherwise qualify for the marital deduction in order to defer estate taxation as long as possible.

3. You should obtain **in writing** who is responsible for making sure the policy is owned correctly and lists the correct beneficiary. If your client is handling this, ask that they send you written confirmation from the insurance company of both items.

4. You should determine **in writing** who is responsible for sending and maintaining Crummey notices and, where necessary, filing gift tax returns.

5. Although you will have thoroughly discussed it with your clients, you should confirm **in writing** that the trust is irrevocable.

IV. Dealing With Life Insurance – A good insurance professional can help to teach you about the practical implications of obtaining and maintaining life insurance – and can be a great source of referrals. It is worth seeking out another well-respected professional in this area.