

Estate Planning & Elder Law

The Role of Life Insurance in Your Estate Plan

The benefits are only realized with proper planning

By Rita M. Danylchuk and
Cathleen T. Butler

Life insurance can play an important role in the estate plan of every individual, no matter the size of an individual's estate. Life insurance offers many financial benefits as well as* an emotional benefit that can give an insured peace of mind in knowing that his or her family will be financially taken care of after death. While the federal estate tax is currently repealed as of January 1, it is likely this repeal will be temporary, so that the role life insurance plays in an individual's estate plan will continue to exist. Accordingly, this article explores the role of life insurance in estate planning and estate tax savings under the assumption that the federal estate tax will be resurrected.

Danylchuk is of counsel and is a member of the corporate department and chair of the trusts and estates group at Gibbons in Newark. Butler is an associate in the trusts and estates group.

With proper planning, life insurance can escape federal estate taxation to provide liquidity to an estate to pay estate taxes, medical bills, funeral expenses or other debts of a decedent. Life insurance can also replace illiquid estate assets and the loss of income generated by the decedent and provide financial security to a decedent's loved ones. For a business owner, life insurance can provide for the smooth transition of a closely-held business interest at death without disrupting the operations of the company or forcing the estate to sell the business interest to pay estate taxes. The benefits of life insurance are only realized, however, with proper planning.

The Irrevocable Life Insurance Trust

The proceeds of life insurance are subject to federal and potentially state estate tax, unless an individual gives up all control and ownership rights (including incidents of ownership) over the life insurance policy. Incidents of ownership include the power (individually or as trustee) to change the beneficiary, to surrender or cancel the policy, to assign the policy or to revoke an assignment, to pledge the policy for a loan, or to borrow against the cash surrender value of the policy. The

best way for life insurance to be excluded from a decedent's federal taxable estate is for the individual to transfer the life insurance to an irrevocable trust and survive three years from the date of transfer. To avoid the three-year survivorship rule, an individual can create an irrevocable life insurance trust and have the trust directly purchase a new life insurance policy. As another alternative for an existing policy, an individual can create an irrevocable trust, fund the trust with cash and then have the irrevocable trust purchase the life insurance policy for an amount equal to the policy's fair market value (which for certain policies may be referred to as the policy's interpolated terminal reserve).

Funding and Creation of the Life Insurance Trust

Although the establishment and funding of a life insurance trust seems relatively simple, there are certain procedures an insured must follow to ensure that the life insurance is not included in the insured's taxable estate. First, the life insurance trust must be named as the irrevocable owner and beneficiary of the life insurance policy.

Second, to avoid the inclusion of the policy proceeds in an individual's taxable

estate, the trust must be drafted as an irrevocable trust and the grantor of the trust must not retain any beneficial interest in the trust or any incidents of ownership over the life insurance policy. In this regard, the grantor must not serve as the trustee of the trust. The grantor also must not have the power to remove and replace a trustee with someone who is related or subordinate to the grantor as defined under Section 672(c) of the Internal Revenue Code of 1986, as amended. A related or subordinate party generally includes spouse and lineal descendants. The beneficiaries of the life insurance trust can be the grantor's spouse, children and future descendants or any other individuals, other than the grantor, that the grantor intends to benefit.

Third, the life insurance trust must not contain any provisions directing that the life insurance proceeds be used to pay the grantor's estate taxes or estate administrative expenses. If the trustee is legally obligated to use the life insurance proceeds to pay the debts or taxes of the grantor's estate, then the proceeds will be included in the grantor's taxable estate. To provide liquidity to a grantor's estate to pay estate taxes or debts, the trust terms can allow the trustee the discretion to use the policy proceeds to purchase estate assets. If this discretion is exercised, the estate will have cash from the life insurance proceeds to pay estate expenses.

Administration of the Life Insurance Trust

Procedurally, the trustee of the life insurance trust will open a bank account in the name of the trust and pay the life insurance premiums from the trust bank account. The grantor will make annual gifts to the life insurance trust (deposited in the trust's bank account) in an amount sufficient to pay the policy premiums and administrative expenses.

The payment of premiums by the

grantor as well as the initial transfer of the life insurance policy to the trust are considered gifts by the grantor. To avoid or reduce the gift tax consequences associated with the payment of premiums and transfer of the life insurance policy to the trust, the trust must be drafted to give the beneficiaries a withdrawal right over the trust assets. The withdrawal right, known as a "Crummey Power," provides the trust beneficiaries with a limited right to withdraw assets from the trust each time a transfer is made to the trust. Typically, the withdrawal right is limited to the annual gift exclusion amount (currently \$13,000 for an individual and \$26,000 for gifts split between spouses), which is the amount each individual can gift annually per donee without incurring a gift tax. Therefore, if there are four beneficiaries under the trust and the annual insurance premiums are \$50,000, no gift tax will be incurred because the premiums would be covered by the annual exclusion amount ($4 \times \$13,000 = \$52,000$). To qualify as annual exclusion gifts, the trustee must send written notices to the beneficiaries notifying them of their withdrawal rights.

The Buy-Out Insurance Trust

An individual who owns an interest in a closely-held business may consider creating a buy-out insurance trust. The buy-out trust can be created as a vehicle to own an insurance policy on the life of an individual who also owns an interest in a closely-held business. The objective is to have the buy-out trust fund the buy-out of the business owner's interest in the business at death while excluding the policy proceeds from the owner's estate for estate tax purposes. If the buy-out trust is structured properly, the death benefits from the life insurance policy will not be included in the business owner's estate for federal estate tax purposes, subject to the three-year survivor-

ship rule discussed above.

The buy-out trust is created and administered in the same manner as an ordinary life insurance trust. On the business owner's death, the trustee will collect the death benefits. All or a portion of the death benefits would be used to purchase the decedent's ownership interest in the company from the decedent's estate. If the company interest passes to the decedent's estate, then the trust would purchase the interest from the estate, giving the estate necessary cash to pay any estate taxes or any other debts of the decedent. The business interest purchased by the trust could be held for the benefit of the spouse or descendants of the surviving owners. The ownership of the business interest by the trust is effective to provide for the centralized management of the business interest, rather than having the deceased owner's business interest potentially divided among various family members and risking the sale of the business to an outsider. Further, the business interest owned by the trust can be held outside of the estates of any surviving owners of the business to avoid further estate inclusion in the surviving owners' estates. Any excess insurance proceeds not used to purchase the business interest can be held in trust for the benefit of the decedent's family members or other beneficiaries of the trust. With any buy-out trust, the company's governing documents should be reviewed to confirm that a trust is legally authorized to own an interest in a company and, oftentimes, a buy-sell agreement is drafted to include these terms.

Life insurance, if properly owned as part of an individual's estate plan, can provide financial security without also increasing an individual's estate tax exposure. To achieve these results, an insured must ascertain that the ownership and beneficiary designations are consistent with the overall estate plan and any life insurance trust complies with proper administration requirements. ■