Many successful individuals are shocked to learn that the federal estate tax may consume as much as 45% of their accumulated wealth. They spend a lifetime working and investing, yet they never get around to the planning it takes to preserve their wealth for loved ones. As a result, when they die, the government takes approximately half of their wealth in estate taxes.

While there are many effective planning strategies to reduce estate taxes, many people end up paying substantial estate tax when they die due to the failure to plan or poor planning. Some die unexpectedly before they ever get serious about estate planning. Others intend to trim their estates through family gifting but never get started (or don’t live long enough to seriously reduce estate taxes). Many don’t realize how valuable their assets have become, and the enormity of the tax bite. Finally, recent legislation promising to reduce the estate tax over the next decade (and possibly repeal it after 2010) causes others to hold off on serious estate planning in the hope that they will live long enough and that Congress someday will eliminate the estate tax.

For those who hope to leave wealth to loved ones, careful planning is necessary or advisable. The first phase of estate planning consists of the design and implementation of a well-drafted, tax-wise Will or Living Trust (and coordinated beneficiary designations) to control the distribution of their property and capture the basic tax exemptions. The second phase of estate planning aims to reduce the impact of estate taxes further, either by (1) strategies to reduce estate taxes by gifting to reduce the estate, or (2) strategies to neutralize estate taxes using life insurance to facilitate payment. Many individuals use both of these strategies, gifting as much as they can while hedging against the possibility of an early death with life insurance.

Strategies to reduce estate taxes through gifting (often while retaining some degree of control over and income and financial security from the transferred assets) are described in other S&Z Monographs.¹ Over the years, however, we have found that many individuals are reluctant to gift on the scale necessary to avoid estate taxes either because they don’t want to shift control.

¹ See various separate S&Z Monographs on gifting strategies including “GIFTING & LEVERAGED GIFTING: For Estate Tax Savings”, “FAMILY PARTNERSHIPS: Everything you Need to Know”, “HOUSE TRUSTS: An Incredible Technique”. The potential use of life insurance to leverage and hedge the effectiveness of a family gifting program is discussed in “USE OF LIFE INSURANCE IN ESTATE PLANNING: Part of a “Diversified Estate Plan”.

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to their children, or because they worry that they may someday need the income and financial security such assets provide. Other individuals feel overwhelmed and confused by the gifting strategies we propose, and find it easiest to do nothing at all.

This Monograph is for individuals or couples who are reluctant to make substantial gifts to children and others to reduce estate taxes for whatever reason, and focuses on the alternative strategy of using life insurance to neutralize the impact of estate taxes. Gifting a lot, early and often, is a fine theoretical solution to estate taxes; in practice, however, many successful individuals give too little and too late, and a gifting strategy falls short when the donor dies younger than expected. Similarly, gifting has limited appeal to young people with substantial wealth who don’t want to devote time and energy to the design of irrevocable structures at this stage in life, or make substantial transfers to children who are as yet quite young (or not even born). For such individuals, the purchase of life insurance in an irrevocable trust may be the simplest strategy to put estate tax worries to rest.

**Life Insurance as the Simplest Solution for Estate Taxes**

When a life insurance strategy is employed, an individual or married couple spends a small amount of cash for life insurance that pays a relatively large death benefit when the insured(s) die(s). Usually, the policy proceeds are used to pay the estate tax, enabling the insured(s) to pass their own assets intact to loved ones. When properly executed, this strategy provides liquidity to neutralize the estate tax burden, avoiding a forced sale of assets whenever death occurs.

Both traditional “single life” policies and “2nd to Die” or “Survivorship” policies can be used for this purpose. Most people are familiar with traditional single life insurance policies that pay a death benefit on the death of one insured individual, and such policies can be used to fund estate taxes or other liquidity needs on the death of an individual. When planning to use life insurance to pay estate taxes, however, married couples often use a different type of life insurance policy called “survivorship life insurance” or “2nd to Die life insurance” that insures two lives and pays a death benefit only after they both die. Since one of the insured individuals nearly always survives the other for some time, such a policy usually is cheaper than single life insurance on either individual. And since most married couples use the unlimited marital deduction to defer all or most estate tax liability until the death of the surviving spouse, 2nd to Die Life Insurance fills the need for liquidity to pay estate taxes perfectly.

There are many types of life insurance policies available in the market place today that go beyond the old choice between “whole life insurance” and “term insurance” to include a
variety of new policies including “universal life insurance” and “variable life insurance”. Modern life insurance policies provide more flexibility in funding, and allow the insured some ability to regulate the cost and investment performance of the policy. More than ever before, it is critical to receive professional assistance in the design and purchase of life insurance from a conscientious life insurance professional who is familiar with diverse insurance options, your personal financial situation, and your personal investment and estate planning objectives.

Many people who are engaged in estate planning assume that life insurance will not be available to them at a reasonable price because of their age or health history. Certainly, life insurance is more costly as we get older but it is nearly always available at some price. Usually, it makes sense to investigate the availability and cost of life insurance in the client’s particular circumstances before making a decision one way or the other.

**AN IRREVOCABLE TRUST TO OWN THE LIFE INSURANCE**

Anyone who has (or hopes to have) a taxable estate larger than $3.5 million when he or she dies should purchase their life insurance “outside” the insured’s taxable estate to avoid estate tax on the insurance proceeds when the insured (or his or her spouse) dies. An irrevocable trust (often referred to as an “Irrevocable Life Insurance Trust” or “ILIT”) is nearly always used for this purpose.

Typically, a life insurance trust is established by the insured for the benefit of his or her estate beneficiaries, which may include any surviving spouse, children or other descendants, and/or other loved ones. If the contemplated life insurance is a 2nd to Die or survivorship policy, typically both spouses will establish the trust together for the benefit of their descendants. However, married individuals often create a life insurance trust unilaterally if

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2 Every individual has an exemption from estate tax of $3.5 Million in 2009.
3 Many people know that life insurance proceeds are income tax free, and assume that insurance proceeds are exempt from estate tax as well. In fact, life insurance proceeds are subject to estate tax if (1) the death benefit is paid to the insured’s estate, or (2) the insured holds any “incidents of ownership” (i.e. ownership rights) in the policy at the time of death.
4 The benefits and mechanics of this popular strategy are described in detail in the separate S&Z Monograph entitled “LIFE INSURANCE TRUSTS: Getting the Most from your Life Insurance”.
5 Some practitioners advocate gifts directly to adult children to enable them to purchase and own life insurance on the parents as a simpler, more economical alternative to an irrevocable trust. In theory, this approach works fine but it has two disadvantages: (1) an insurance policy on the parents’ lives owned by the children is subject to their control and could be allowed to lapse, surrendered, or encumbered before it serves its purpose, (2) such a policy is subject to various risks arising in the children’s own lives including but not limited to potential creditors’ claims and divorce claims, and (3) there is no assurance that the children will maintain and apply the life insurance proceeds for the intended purpose after the parent(s) die(s). A trust avoids each of these risks and also enables the parents to give responsible, adult children their ultimate inheritance in a “better way” in the form of a generation-skipping trust that gives lifelong protection against these risks, and also avoids estate taxes when the children themselves die. See the separate S&Z Monograph entitled “GENERATION-SKIPPING TRUSTS: A Better Way to Leave Assets to Responsible Adult Children”.
insurance on one spouse will be placed in the trust, and it is desired to make the spouse a beneficiary ahead of the children and/or other beneficiaries.

A life insurance trust must be irrevocable, and must have an independent trustee for the policy proceeds to be “outside” the estate of the insured. Ideally, the trust should be established before the insurance is purchased, and the Trustee (rather than the insured) should apply for and purchase the policy. The Trustee of the insurance trust should be named as both the owner and designated beneficiary of the policy, and the Trustee should make all premium payments out of a separate account opened in the name of the trust.

To pay the required policy premiums, the Trustee deposits in the trust account. Such transfers are treated as gifts to the beneficiaries. If the trust “Crummey withdrawal right” is made and the appropriate procedure is followed scrupulously, such transfers may qualify as $13,000 annual exclusion gifts. Otherwise, such transfers will utilize part of the transferor’s $1 million lifetime gift exemption.

When the insured dies, the life insurance policy proceeds are paid to the Trustee and are received subject to all of the provisions of the trust agreement and applicable state law. If insurance proceeds may be needed to pay estate taxes, it is advisable for the Trustee to be the same individual who acts as Personal Representative of the insured’s estate, and the trust provisions should parallel those of the decedent’s Last Will & Testament to the degree possible to ensure smooth coordinated administration. Since estate taxes are owed by the decedent’s estate rather than by the insurance trust, proceeds needed to pay estate taxes are either (1) loaned to the decedent’s estate, or (2) used to purchase assets from the estate. In either event, the insurance trust does not merely pay out the funds and go out of existence. Since it will end up holding either (1) the insurance proceeds, (2) a promissory note from the estate, or (3) other assets purchased from the estate, and it may hold other assets as well, the trust agreement may provide for either immediate termination and distribution of the trust assets to the specified beneficiaries or for continued trust administration of such assets for some time.

Typically, the trust is designed to parallel the plan of distribution and any trusts established under the Last Will & Testament or Living Trust of the insured, so that the trust may be merged with or consolidated with such trusts to minimize the administrative burden going forward.
The net benefit of an irrevocable life insurance trust is twofold: (1) it facilitates the purchase and secure ownership of life insurance outside the taxable estate of the insured, and (2) it provides a vehicle to which the insured can make other gifts during the lifetime of the insured. Since gifting early and often is the key to passing wealth to loved ones with minimum estate tax erosion, the potential for additional gifts to an irrevocable trust originally established merely to own life insurance often turns out to be as beneficial as purchase of the underlying life insurance itself. 

**Overcoming the Aversion to Life Insurance**

Many successful individuals resist the suggestion of life insurance as an estate planning tool. They feel they don’t need life insurance, or that it is a poor investment. Their prejudice against life insurance as an investment makes them unreceptive to its use as a tool. Such prejudice prevents them from considering the tax and intangible benefits of life insurance with an open mind, and making an objective decision concerning the usefulness of life insurance as a tool in their estate planning.

Comparing an investment in life insurance to an investment in the stock market or a bond fund is like comparing apples to oranges since it is hard to give appropriate weight to the tax and intangible benefits of life insurance in estate planning. Life insurance provides liquidity at precisely the moment it is needed to avoid a forced sale to pay estate taxes. Life insurance performs a hedging function without counterpart in other investments. Further, the purchase of life insurance through an irrevocable life insurance trust leverages estate and gift tax exemptions to a degree not otherwise possible. Finally, for those not interested in gifting strategies and/or potential use of family partnerships, qualified personal residence trusts, and their ilk, life insurance offers an alternative simple solution to an estate tax problem. These intangible benefits make life insurance part of any diversified strategy for dealing with estate taxes, and for some people, the only strategy.

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6 See the separate S&Z Monograph entitled “GIFTING & LEVERAGED GIFTING: For Estate Tax Savings”.
7 The use of life insurance as a tool in estate planning is discussed in the separate S&Z Monograph entitled “USING LIFE INSURANCE: Part of a “Diversified Estate Plan”.
8 Sometimes individuals are reluctant to spend part of their liquid resources to buy insurance that they feel benefits only their children. While that attitude is certainly understandable, the beneficiary is ultimately the government since their only choice is whether to leave their assets to the government in taxes or to family members. Life insurance is the tool that makes it possible to deflect part of the government’s share to family members. However, sometimes when individuals don’t feel life insurance is affordable or desirable, their children pay for it themselves. While this may facilitate insurance coverage, it isn’t the optimal approach since the taxable estate of the insured isn’t reduced by gifting.
If policy premiums are paid with annual exclusion gifts to an irrevocable trust that otherwise wouldn’t be made, the tax-savings cover 45% of every premium dollar. As every taxable dollar is used to purchase a nontaxable life insurance death benefit, the government “subsidizes” the purchase of a nontaxable pool of funds for the insured’s beneficiaries.

**An Example of the Benefits of the Life Insurance Strategy**

The benefits of life insurance can be illustrated by an example. Assume a married couple age 65 with assets worth $5 million consisting of savings, a house, and investment real estate, all appreciating at 5% percent annually. Assume the husband dies in 2003 with a Will that includes appropriate Credit and Marital Trusts for his surviving spouse, and his wife dies three years later in 2006. Their taxable estate will be approximately $4,600,000 and, after payment of estate taxes of $1,196,000 at her death, their descendants will receive $4,561,625.

Assume the same facts but that the same couple establishes an irrevocable trust to purchase a second-to-die life insurance policy with a death benefit of $1,000,000 in 2003 and made three transfers of $17,500 each to the trust to pay three premiums. By the date of the wife’s death in the year 2006, their taxable estate will be reduced slightly to $4,547,500 (due to the gifts to pay premiums) and, after payment of estate taxes of $1,171,850, their descendants will receive $5,533,275 after taxes due to the extra insurance. The children will receive an extra $971,650 after taxes, and the risk of a costly forced sale is avoided altogether.

If the surviving spouse lives until 2026 in the foregoing illustration, substantially more money will have been paid in premiums. However, at 5%, their taxable estate still will have grown to approximately $11,487,217. After payment of estate taxes of $5,687,330 due at that time, their descendants will receive $9,871,411 after taxes (assuming that Congress does not change the current law). Under this scenario, the purchase of life insurance results in the children receiving an extra $4,338,136 after taxes. And again, the risk of a costly forced sale is avoided.

Without life insurance, the couple’s taxable estate would be larger since no premiums would have been paid ($12,205,161), but their descendants would receive less. After payment of estate taxes of $6,118,097 in year 2026, their descendants would receive $9,158,587 after taxes- $712,824 less than they would have received with insurance.

While life insurance has more obvious intuitive appeal when an individual or couple owns illiquid assets such as real estate or a closely-held business interest, the benefits are just as compelling when the estate consists of cash and marketable securities. Further, the benefits are
even more attractive when much of the estate is in qualified retirement accounts or IRAs since life insurance avoids the possibility that the children will have to accelerate plan withdrawals to pay estate taxes.\(^9\)

**Conclusion**

Ultimately, no one wants to buy life insurance but then no one wants to die either. In the end, however, we all die, and for many of us, the government takes a 46% “bite” out of our assets. Theoretically, the best strategy to reduce estate taxes is a family gifting program that facilitates the largest lifetime gifts an individual or married couple can afford, early and often, using the donor’s $13,000 annual exclusions and $1 million lifetime gift exemption(s), and using life insurance to leverage and hedge such gifts. However, such a plan requires a little effort and complexity, and some individuals are reluctant to make significant lifetime gifts to adult children under any circumstances.

For individuals who are reluctant to make lifetime gifts now, the purchase of life insurance can be an effective alternative strategy to neutralize estate taxes. This approach has particular appeal for young people with substantial wealth who don’t want to devote time and energy to the design of irrevocable structures at this stage in life, or make substantial transfers to children who are as yet quite young (or not even born). It also makes sense for young and middle-aged individuals who hope that programmed increases in estate tax exemption and/or possible elimination of the estate tax in the future will make lifetime gifts unnecessary. Whatever the future holds, life insurance solves the problem for now.

We recognize that life insurance doesn’t make sense for everybody. However, we do believe that life insurance has tax and intangible qualities that make it an invaluable estate planning tool for many individuals, and some will choose life insurance as their only strategy. Since we at Smith & Zuccarini, P.S., are attorneys who do not sell life insurance, we are well-positioned to help clients understand and assess the potential usefulness of life insurance as an estate planning tool. We are committed to helping people determine the best planning strategies, including potential benefits of life insurance, when appropriate. We pride ourselves in our independence and objectivity, and in our ability to develop creative, customized strategies to accomplish each individual client’s unique planning objectives.

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\(^9\) Retirement plan dollars are particularly expensive dollars with which to pay estate tax since income tax must be paid on plan withdrawals at rates ranging up to 35%, leaving only the after-tax amount to pay estate tax.
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