

SPECIAL REPORT

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TOP 10 USES OF LIFE INSURANCE IN NON-TAXABLE ESTATES

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Using Life Insurance in Non-Taxable Estates

Estate planners commonly use life insurance as a method of creating liquidity to pay estate taxes. But with a \$5 million estate tax exemption (\$10 million for married couples), for most decedents, the federal estate tax has been repealed (at least for 2011 and 2012). Nevertheless, for the reasons described below, life insurance can still play a significant role in a non-taxable estate.

Replace Lost Income.

Life insurance has long been used to protect young families from the disastrous effects of a breadwinner's untimely death.

Wealth Replacement.

Charitable remainder trusts (CRTs) are often used by people who wish to sell highly-appreciated assets without generating any immediate capital gains tax liability. A CRT is also a great tool for obtaining a charitable income tax deduction (see page 14) These benefits are derived from the fact that upon the death of the donor and the donor's spouse, the assets remaining in the CRT must pass to charity. A life insurance policy can be purchased for the benefit of the donor's heirs to "replace" the wealth passing to charity.

Estate Equalization.

Most parents want to treat their children equally when dividing up their estate. But this may prove impossible with family businesses in which only the children active in the business are to receive the business. If the value of the business exceeds the active children's equal share of the estate, it is impossible to treat all the children equally. A simple solution is to use a life insurance policy as an estate equalizer. The non-active children (or a trust for their benefit) will be the beneficiaries of the policy.

Creditor Protection.

The cash surrender value of a life insurance policy and/or the death proceeds from a policy may be protected from creditors. The availability of protection and any dollar limits thereon varies from state to state, and may be dependent upon who the beneficiaries of the policy are. For example, some states only protect a policy's cash surrender value and death proceeds if the insured's spouse and/or children are the beneficiaries of the policy.

Second Marriages.

When children from a previous marriage are involved, estate planning becomes more complicated. Take the example of a second marriage in which the husband has children from a previous marriage. The husband establishes a living trust that, upon his death, provides his wife with income and principal as needed to maintain her accustomed standard of living, with the remainder passing to his children at his wife's subsequent death. This approach has two problems. First, the children have to wait until their stepmother's death to inherit their father's wealth. Second, as the remainder beneficiaries of the trust, the children have legal rights to challenge the distributions from the trust to their stepmother if those distributions exceed (in the children's opinion) the amount called for by the trust. A solution to these problems is life insurance on the husband's life. By naming his wife as the beneficiary of the life insurance, the husband can leave his estate to his children at his death (either outright or in trust).

Special Needs Children.

Upon reaching age 18, a developmentally disabled individual is usually eligible for Supplemental Security Income (SSI), a federally-funded program administered by the states. SSI eligibility generally is accompanied by eligibility for Medicaid, a state-administered federal program which primarily provides medical assistance. Many parents are skeptical about the future and/or level of the SSI and Medicaid programs. A solution to this potential problem is for the parents to purchase a second-to-die life insurance policy. The policy will be owned by the parents and will be payable to a "special needs trust" for the benefit of the disabled child at the surviving parent's death. A special needs trust is designed to "supplement" SSI and Medicaid without disqualifying the child from those programs' coverage. Upon the death of the disabled child before the complete distribution of the trust property, the assets remaining in the trust can pass to the other children.

Annuity Arbitrage.

Many people who are adverse to the stock market's daily fluctuations prefer to invest in municipal bonds or certificates of deposit (CDs). In exchange for this security, the yield on these investments is quite low. A better alternative to municipal bonds and CDs in many cases is a

single-premium immediate annuity contract. Not only is the annuity a safe investment (based on the strength of the carrier), it invariably will produce a significantly higher yield than muni-bonds or CDs. The problem with an annuity is that the payments cease when the annuitant dies. Accordingly, unlike the case with muni-bonds or CDs, the annuity owner's children will not inherit the annuity. The solution is to purchase a life insurance policy to "replace" the wealth lost when the annuitant dies. The cash to pay the premiums is generated from the increased cash flow from "converting" the muni-bonds and CDs into an immediate annuity.

Medicaid Planning.

For a person to become eligible for long-term care Medicaid benefits (i.e., nursing home care), income and assets must be below frightfully low levels. But, what about those persons with substantial assets who are not financially eligible for Medicaid? What options are available to them to protect their assets from the high cost of nursing home care? Long-term care (LTC) insurance can be purchased to pay for such care. However, LTC insurance premiums increase dramatically for persons over age 65. A better answer may be to purchase life insurance. If the insured needs long-term care and, therefore, must use private funds to pay for such care, the insurance proceeds will eventually "replace" the assets spent on long-term care. Life insurance assures that the insured's heirs are not "disinherited" by the high cost of long-term nursing home care. In the event that the insured never requires long-term care, then, upon the death of the insured, the heirs will receive a larger inheritance.

Charitable Planning.

Even without transfer taxes, many charitably-inclined persons will want to make lifetime gifts to their favorite charities. The advantages of naming a charity as the owner, beneficiary, and premium payer of a life insurance policy are numerous. First, the insurance proceeds eventually will provide the desired capital gift for a comparatively small outlay in the form of premium payments. Second, each year, if the donor-insured itemizes, he/she will be entitled to an income tax deduction equal to the premium payments gifted to the charity (subject to income limitations). Finally, because only the purchase of life insurance is involved, there are no complex details to be handled.

Avoiding Income Taxes on Traditional Retirement Plans.

Contributing to a traditional retirement plan or traditional IRA is perhaps the best way to accumulate wealth because of the combination of tax-deductible contributions and tax-deferred savings. Such plans, however, are the worst way to distribute wealth because of the double tax (estate and income taxes) imposed on the distributions. Even without an estate tax, upon the death of the surviving spouse, the children must begin taking distributions and incurring income taxes. A better strategy for a charitably-inclined traditional IRA owner might be to withdraw cash from the

IRA or pension plan, pay the income tax, and use the after-tax proceeds to purchase a life insurance policy for the benefit of the participant's heirs. The policy will have a face value equal to the IRA's projected value at the death of the participant. After the participant has died, the heirs will receive the insurance proceeds income tax free, and the balance in the retirement plan could pass to charity or to a private foundation — income tax free! For a married participant, a survivorship policy can be used. The only "loser" in this scenario is the IRS.

Conclusion.

While it is impossible to predict what lies in store for transfer taxes beyond 2012, for the many reasons described above, life insurance is uniquely suited to handle many non-estate tax issues commonly confronted in estate and financial planning. Moreover, life insurance is likely to remain tax-favored and a good hedge if the insured does not live until his/her life expectancy. As such, life insurance deserves a place in one's overall asset allocation.

Insurance Comparison Chart				
Insurance Type	Premium	Death Benefit	Access to Cash Value?	Market Participation?
Level Term Insurance	Relatively low; fixed	Fixed during the term, then zero	No	No
Renewable Term Insurance	Relatively low; increasing	Fixed	No	No
Decreasing Term Insurance	Relatively low; decreasing	Decreasing during the term, then zero	No	No
Whole Life Insurance	Relatively high; fixed	Fixed minimum amount, some upside	Yes	No
Universal Life Insurance	Relatively high; flexible	Variable	Yes	No
Variable Whole Life Insurance	Relatively high; fixed	Fluctuates with investment performance	Yes	Yes
Variable Universal Life Insurance	Relatively high; flexible	Fluctuates with investment performance	Yes	Yes

Please Note: This chart is intended to assist the reader in selecting life insurance coverage and is not a recommendation.