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TRUSTS AND ESTATES

Dispelling Two Popular Myths About Estate Planning With Life Insurance

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All too often, clients do not understand how their life insurance policies fit within their overall estate plan. The misunderstanding generally involves two key myths, both of which are false: (1) the idea that a will overrides a life insurance policy beneficiary designation and (2) the mistaken belief that life insurance proceeds are not includible in the insured's taxable estate for federal estate tax purposes.

Myth 1: The idea that a will signed after a life insurance policy is acquired will override the life insurance beneficiary designation.

In our experience, people usually obtain life insurance policies before deciding to have a will drawn up. In many cases, people first obtain life insurance through work, or, young couples who have just started families seek it out to make sure that their minor children would be adequately provided for in the event of a premature death. The estate planner tends to be the last stop. By the time wills are signed, the life insurance beneficiary designations are already in place and forgotten about, or it is assumed that the newly signed wills supersede those prior designations. However, that is not the case.

It is crucial that any time an estate plan is updated, the life insurance beneficiary designations are reviewed and possibly updated. Otherwise, there can be an unintended result at death. For example, the life insurance beneficiary designation could have named someone who the insured later intended to disinherit by will. More often, the case is that the life insurance names the spouse and/or children as outright beneficiaries, but the wills (or revocable trusts) provide that the estate assets are to be held in trusts for them. In order to fund such trusts with life insurance proceeds, it is necessary for the trusts to be specifically named as the beneficiaries in an updated beneficiary designation form. This will provide consistency in the estate plan. The beauty in naming the trusts under the insured's last will or revocable

trust (as the case may be), is that, if done properly, subsequent changes to the provisions of those trusts will apply to the insurance proceeds without the burden of needing to make additional changes to the beneficiary designations.

Myth 2: The presumption that because life insurance proceeds are (1) exempt from income tax, (2) may be easily excluded from a decedent's probate estate, and (3) may be exempt from creditors' claims, such proceeds are likewise exempt from the federal estate tax.

In addition to considering beneficiary designations, it is important to understand the estate tax impact of owning life insurance. Although life insurance is not includible in one's taxable estate for Pennsylvania inheritance tax purposes, life insurance proceeds are includible in one's taxable estate for federal estate tax purposes. Thus, for those who believe that their net worth at death, when combined with the life insurance proceeds, will exceed the federal estate tax exemption amount (i.e., the amount that can pass free of federal estate tax — currently $5.25 million or double that amount for married couples), it is advisable to structure the ownership of life insurance policies carefully in order to avoid having the proceeds be includible in the insured's taxable estate. If properly structured, the ownership of life insurance by an irrevocable life insurance trust (often referred to, in the estate planning world, as an ILIT), rather than by the insured, will prevent the proceeds payable at death from being included in the insured's taxable estate, thereby eliminating a potentially substantial (and unnecessary) amount of tax.

Here is how an ILIT works. The trust must be drafted in such a way so that the insured has no "incidents of ownership" (as defined in Treasury Reg.§ 20.2042-1(c)) in the policies held in trust. In general, this means that the insured cannot serve as a trustee of the trust or otherwise have control over the policies owned by the trust, and the insured cannot be a named beneficiary of the trust. Once the trust is created, for any existing life insurance policies, the insured would complete an assignment of ownership form to assign the policies to the trust, and the trustees would then complete change of beneficiary designation forms to name the trust as the beneficiary of the policies. In the case of any newly acquired policies, it is important that the trust be named as the applicant on the insurance application and as the initial owner. This will avoid the three-year rule, which provides that the insured must live for three years after any gift of an insurance policy in order to avoid having the policy be included in the insured's taxable estate. A potential way around the three-year rule is to sell the insurance policy to the trust (rather than assign it by gift).

Once the policies are owned by the trust, the premiums should be paid by the trustee of the trust. The premiums can be funded in several ways by the insured, such as: (1) making annual gifts to the trust each time premiums are due and, if the trust is properly drafted and administered, these contributions will qualify for the annual gift tax exclusion by the use of a so-called "Crummey" withdrawal power; (2) initially funding the trust with an amount that will be sufficient to allow the trustee to make the ongoing premium payments each year (this gift will use some of the insured's unified credit amount, which will reduce the $5.25 million federal estate tax exemption amount available at death); or (3) providing one or more loans to the trust.

The terms of the ILIT applicable at the insured's death would generally provide for the same trust structure for the spouse and children as the trusts under the will provide (or the wills may even be drafted to pour the estate assets into the insurance trust at death). In that way, the estate plan is consistent, ensuring that all of the assets in the estate (including life insurance) end up in the right hands. •

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