

The importance of life insurance in estate planning

As part of the estate planning process, you may talk to any number of advisors—from lawyers, accountants and trust officers, to financial and retirement planners. These advisors often provide not only valuable services, but also may be in the business of selling investments, annuities and insurance. You will need to evaluate carefully as you do your planning whether the products offered to you are useful to you.

Take life insurance, for instance. At first glance, it may not seem to have a great bearing on how you will dispose of your assets. Yet, life insurance is very often an integral part of a well-thought-out estate plan.

Why life insurance

The proceeds of a life insurance policy can do much more than provide a large sum to your beneficiaries. Here is just a partial list of the benefits provided by making life insurance a part of your estate planning strategy

- It provides immediate cash at death to pay funeral expenses, debts and final income taxes of the insured.
- The cash provided by the proceeds can be made available to pay estate taxes and, thus, avoid the forced sale of an asset.
- Generally, life insurance proceeds payable to a named beneficiary pass to that beneficiary free of income tax.
- Proceeds from the policy provide a relatively low-cost source of funds that can be transferred to a trust created in the insured's will for the benefit of, for example, minor children or elderly or handicapped relatives.
- Life insurance proceeds payable to someone other than the insured's estate can avoid passing through probate when the policy is owned by an irrevocable insurance trust. For example, the funds may be used to satisfy marital settlement obligations for child or spousal support.
- When the insured owns a closely held business, life insurance proceeds may fund a buy-out of his or her interest.

Irrevocable life insurance trusts

One estate planning strategy involving insurance is to establish an *irrevocable life insurance trust* as a way to avoid federal estate tax on the proceeds paid at the insured's death. Because the tax benefits are significant, it is important that professionals be involved in the creation of the trust in order to ensure that all the proper steps are taken.

Here's how an irrevocable life insurance trust works: The owner of the policy transfers it to the trust, or the trustee of the trust purchases the policy. Funds are provided for the trust to pay the premiums due on the policy (unless the policy has been paid up). In order for the proceeds that are paid to the trust to avoid inclusion in the insured's estate and, thus, be subject to tax, he or she must survive for three years after the transfer,.

Another important step in establishing an irrevocable life insurance trust is to be certain that the insured has no "incidents of ownership" in the policy that connect him or her to the life insurance held by the trust. For instance, the right to change a beneficiary or modify the terms of the trust are incidents of ownership that would result in the inclusion of the proceeds in the insured's estate for estate tax purposes. Further, the trust should have sufficient assets to pay for the premiums, though the insured may make gifts to the trusts in order to pay the premiums. Special technical rules must be observed to ensure that these are gifts of "present interests" in order to minimize the gift tax consequences.

The form of life insurance chosen (whole life, term, etc.) to be transferred to an irrevocable life insurance trust will depend on the age and situation of the insured. If existing policies are transferred, the insurance company must be notified of the ownership change. (Because a large gift may be involved, a gift tax return will have to be filed.) If new policies are purchased, all of the documentation should reflect that the trust is the owner of the policy and that the insured has no interest in it.

Final note

Because a trust can be funded at death by life insurance proceeds, life insurance is often a viable and affordable way to provide for vulnerable loved ones. If the insured is not comfortable with the stringent requirements of an irrevocable trust, a *revocable trust* may be a good alternative. Although the estate tax savings may be lost, all of the many other benefits of a life insurance strategy may remain in place. For example, trusts are often established to

care for minor children, disabled or elderly relatives, or others who rely on the insured for support.

In sum, life insurance can be a valuable tool that, when used properly, can provide financial security for your loved ones, after you no longer can do so.

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Any developments occurring after January 1, 2009, are not reflected in this article.