The Wealth Counselor

A monthly newsletter for wealth planning professionals

From Michael Wittick

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My practice is people oriented and exclusively devoted to estate planning, estate and trust administration, estate and trust litigation, asset protection and business planning. My newsletter highlights wealth planning issues designed as helpful insights to your practice

The Continuing Need for Life Insurance

Last month's issue of The Wealth Counselor examined the various educational savings vehicles available to clients, including 529 plans, UGMA/UTMAs, Coverdell Education IRAs and life insurance. Using life insurance as an education savings vehicle prompted several questions about other uses for life insurance. Therefore, this issue of the Wealth Counselor examines some of these other common uses for **life insurance, the only asset class that can ensure the completion of proper funding for a myriad of unique planning needs** regardless of the state of the federal estate tax!

Income Replacement ("How will my family eat if I die?")
Even if the client is not subject to estate tax, life insurance can replace lost income if the client dies unexpectedly (more policies pay out for income replacement than for liquidity to pay estate tax). For example, clients with young children should consider using life insurance to ensure that there are sufficient funds available to pay for child-rearing or college and post-graduate expenses in the event of a parent's premature death. For these income replacement policies, the estate tax, including the possibility of estate tax repeal, has no significance.

> **Planning Tip:** Clients should consider life insurance to replace income from the premature death of a breadwinner spouse or parent.

Wealth Creation ("What if I die before I build an estate for my family?")
Another need for life insurance unaffected by the estate tax is the use of life insurance to create wealth. Examples of this need are families who wish to add to their wealth for future generations or to fund their philanthropic objectives.

> **Planning Tip:** Consider life insurance to create wealth or additional wealth for the client's family and future generations.

Wealth Replacement ("How can my family receive the full value of my assets?")
Traditionally, life insurance has been used to replace wealth lost to the federal estate tax. However, with an increasing federal estate tax exemption (currently $2 million per individual, $4 million per married couple), fewer clients are subject to federal estate tax. Thus, fewer clients need traditional wealth replacement policies. However, many clients have significant other wealth replacement needs.

For example, many clients' most significant assets are tax-qualified plans (such as IRAs, 401(k)s and pension plans). Because these assets are Income in Respect of a Decedent (IRD), they will be subject to ordinary income tax when distributed to beneficiaries. While we often discuss with clients maximum income tax deferral ("stretch out"), many beneficiaries will deplete these assets quickly, incurring **significant income tax.** Recognizing this, many clients would benefit from life insurance designed to replace this lost wealth.

In addition to traditional wealth replacement needs, wealthier clients would benefit from wealth replacement for assets transferred to a charitable remainder trust (CRT) or to a charitable lead trust (CLT), which is often used to eliminate estate tax.

> **Planning Tip:** Consider life insurance for non-traditional wealth replacement purposes, such as to replace income tax paid for significant IRAs and other tax-qualified plans, or where the client has used a charitable lead trust to avoid estate tax.

Planning Unrelated to the Federal Estate Tax ("I didn't know there were so many other situations where only life insurance will assure me my goals will be reached even if I die!")
Clients often use life insurance in planning that is wholly unrelated to the estate tax. There is a continuing need for life insurance as a funding vehicle in numerous situations, including:

- buy-sell planning;
- key employee coverage;
- nonqualified deferred compensation;
- death-benefit-only plans;
- liquidity to pay debts;
- liquidity for state death taxes; and
- inheritance equalization.

Income-Tax-Free Status of Death Benefits ("What a difference not paying taxes can make on the amount to which my premiums can grow.")
With increasing federal estate tax exemption amounts, there is now an increased emphasis on income tax planning, with a

particular emphasis on assets that combine basis step-up with tax-free or tax-deferred growth. Life insurance proceeds paid upon the death of the insured, as well as proceeds attributable to investment appreciation on the cash value portion of the policy, are excluded from gross income. As a result, not only is the death benefit of a life insurance policy tremendous compared to the premiums paid if the insured dies prematurely, in a properly designed policy the death benefit remains quite handsome even if the insured lives past life expectancy.

> **Planning Tip:** The unique character of life insurance allows a capable and competent life insurance agent to design a product providing excellent results over a long time frame.

Irrevocable Life Insurance Trusts ("A little planning can provide enormous tax savings.")
Even though the insurance death benefit is not subject to income tax, the life insurance proceeds will likely be included in the client's gross estate and, therefore, be subject to federal and/or state estate tax absent a properly drafted and maintained Irrevocable Life Insurance Trust (ILIT). As a result, many clients create ILITs for the purpose of owning life insurance to avoid federal and state estate tax on the death proceeds.

> **Planning Tip:** Use an Irrevocable Life Insurance Trust to purchase, own and be the beneficiary of life insurance to avoid having the death proceeds subject to estate tax. A good lawyer with prompt turnaround of a trust document is a critical component of the planning team.

Planning Flexibility ("How can I deal with the uncertainty of estate taxes?" "Will I need the extra cash at my death, or not?")
The uncertainty surrounding the federal estate tax and the exemption equivalent amount may suggest the use of the most flexible types of cash value policies, such as universal life policies. These policies permit the policy owner to vary the amount of premium payment, the level of death benefit, and the amount of cash value (in exchange for this flexibility, the client may give up the guarantees that the premium will provide a guaranteed death benefit for the life of the policy). No other single asset provides the same degree of planning flexibility. However, it is incumbent on the planning professional to ensure that the product selected fits the needs of the particular client.

> **Planning Tip:** Permanent life insurance is a unique asset that provides the highest degree of flexibility for changes in the law or changes in the client's circumstances. The quality of the life insurance agent and the life insurance company he or she selects are among the most important

choices a client can make.

Conclusion

Life insurance is the only asset class (other than cash) that a client can remove from his or her gross estate, yet it still provides liquidity (e.g., for federal or state death tax or capital gain tax) or wealth replacement (e.g., to make beneficiaries "whole" for large IRD items like IRAs, 401(k)s, and pension plans) without itself incurring income tax. All other assets removed from the client's gross estate for estate tax purposes must be sold and the gain realized to net the required amount.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

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