

USING LIFE INSURANCE IN ESTATE PLANNING

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Life insurance has become a frequently used tool in estate planning. Most individuals are familiar with it and utilize it due to its common nature. But the effects of using life insurance as an estate planning tool really aren't that simplistic. Gone are the days when the insured being the owner was the norm---there are now dozens of advantages and disadvantages to using life insurance, depending on who (or what) owns the policy.

THE INSURED AS POLICY OWNER

Advantages

Naming the insured as the policy owner has very basic and obvious advantages. For starters, making the insured the policy owner is a simple, flexible arrangement. It gives control over the proceeds, the cash surrender value and other benefits directly to the insured during his or her life.

Another plus is that the ability to pay premiums is related to the obligation to do so. And, of course, there obviously is no gift for gift tax purposes.

Disadvantages

There also are disadvantages to naming the insured as the policy owner. Under IRC Section 2042 (2), the full proceeds will be included in the insured's gross estate for estate tax purposes.

There aren't any cash values since there is little economic reason to retain ownership of such for:

- term policies,
- minimum payment universal life policies, and
- most types of traditions financed whole life insurance policies.

Another disadvantage occurs in the event of the insured's incompetency. This would create problems relating to his or her ability to borrow against the policy, change the beneficiary, etc. A probate court guardianship or an attorney-in-fact acting under a Durable Power of Attorney could solve this dilemma.

INSURED'S SPOUSE AS POLICY OWNER

Advantages

Naming the insured's spouse as the policy owner has some similar advantages to naming the insured as owner. First, it is a relatively simple arrangement. Secondly, the policy's proceeds and cash surrender value are kept in the insured's *potential* control---provided that marital harmony exists.

The proceeds are removed from the insured's estate for estate tax purposes with no gift tax cost, assuming:

- the insured outlives the transfer by three years;
- or the spouse was the initial policy owner and paid all premiums with funds that didn't directly or indirectly originate with the insured.

Finally, there are non-tax advantages to this ownership, such as creditor protection from the insured's point of view.

Disadvantages

An obvious disadvantage of spousal ownership of a policy arises in the event the spouse dies before the insured. One must determine who then becomes the successor owner and who pays the subsequent premiums. If the insured becomes the owner and dies owning the policy, the proceeds will be included in his or her estate for estate tax purposes. If the insured becomes the owner, giving the policy away again begins a new three-year period under IRC Section 2035. If the children become the owners, they may not be legally competent to own the policy, in which case joint ownership may not make sense.

If the policy passes through the spouse's probate estate, there are a number of issues to consider, including:

- Who will pay the premiums due during administration and will those payments qualify for the gift tax annual exclusion?
- Can the insured safely be the executor without risking inclusion of the proceeds in his or her gross estate?
- Will the policy require a probate estate to be opened where none would be required otherwise?
- Similarly, if a testamentary trust created by the spouse becomes the owner directly by a successor-owner designation, who will pay the premiums?
- Will those payments qualify for the gift tax annual exclusion? Can the insured safely be a trustee without risking inclusion of the proceeds in his or her gross estate?

- Will contributions to the trust qualify for the present interest exclusion?
- Is the policy large enough to justify maintaining the trust?

In the event the spouse is declared incompetent before the insured's death, can the insured safely act as guardian or attorney-in-fact under a Power of Attorney without risking inclusion of the policy in his or her estate for estate tax purposes? After the insured's death, how will the proceeds be managed for the spouse's benefit?

The insured loses *direct* control of the proceeds, the cash surrender value and other life-time benefits. The insured's control depends on influencing the spouse to act (or not act)---be certain the insured can do so and be willing to rely on his or her ability in a given case.

The remaining proceeds will be a part of the surviving spouse's probate estate and, as such, will be subject to claims of his or her creditors and any new spouse's rights. The insured's plan can be defeated during the insured's lifetime if the spouse surrenders or gives away the policy, changes the beneficiary, etc.

As discussed, the estate tax on the policy proceeds at the insured's death is only *postponed*, not saved, since the proceeds will be cash in the spouse's hands, taxable in full at his or her death—to the extent the proceeds are not spent, given away or left to a surviving spouse (or a marital trust).

OTHER FAMILY MEMBER(S) AS POLICY OWNER(S)

Advantages

Like naming a spouse as the owner, it is a relatively simple arrangement to name another family member as the policy owner.

Proceeds are removed from both the insured's and the spouse's gross estates for estate tax purposes, subject to the IRC Section 2035(d) three-year rule for policy transfers by the insured. This is estate tax avoidance, not merely deferral; however, it is only tax avoidance at the insured's generation level. Since the child(ren) will be the policy owner(s) as well as the beneficiary(ies), the proceeds will be includible in their estates for estate tax purposes if they survive the insured. Additionally, moving the policy proceeds down only one generation may not be enough for wealthy families.

The annual exclusion and gift-splitting by the insured's spouse are available for the gift of the policy and for subsequent premium payments by the insured.

Disadvantages

An obvious disadvantage of this ownership is the possibility the owner may be a minor. A Uniform Transfers to Minor Law custodianship is a possible solution; however, the insured can't safely be the custodian.

Another disadvantage is that the policy and its lifetime benefits are beyond the insured's control. They are subject to claims of the owner's creditors and, depending on state law, claims of his or her spouse during the insured's life---a major concern for many insureds.

The proceeds are payable directly to the owner at the insured's death. The possible minority of the owner is an added problem relating to the collection and investment of the proceeds. The Uniform Transfers to Minors Law is a possible solution.

Another problem is that the owner may die before the insured. There is the additional potential problem of a policy transfer to the owner's spouse at that point unless the insured or the insured's spouse is the policy's contingent owner---both may pose other problems. The remaining proceeds will be taxed in the owner's gross estate at his or her death and they, too, will be subject to the claims of both his or her creditors and spouse at death.

The insured's plan can be defeated by the owner surrendering or giving away the policy. This is even more of a risk than with the spouse of the insured as the owner.

In most cases, there is the added problem of multiple owners (for example, the insured's children as a group)—some of whom may be minors---which raises issues about their capacity to deal with the policy or its proceeds. This creates administrative and practical problems, such as: Who pays the policy premiums? What if one owner doesn't? What if one owner dies, becomes disabled, gets divorced or goes bankrupt? Who, then, has an interest in or owns his or her share of the policy---an executor, a surviving spouse, a former spouse, a guardian or a bankruptcy trustee? What if one owner wants to borrow against, withdraw from or surrender the policy? What if one owner falls out of favor with the insured or the other owners? What if the owners can't always agree on everything with regard to the policy---is there a mechanism to deal with lack of unanimity?

IRREVOCABLE TRUST AS POLICY OWNER

Advantages

The policy proceeds are removed from the gross estates of both the insured and his or her spouse for estate tax purposes, assuming there is no direct policy transfer by the insured or the insured outlives any such transfer by three years. This is real avoidance of the tax, not mere deferral.

The insured's spouse can and normally does have an interest in the trust after the insured's death, as long as the policy is not a survivorship policy and he or she is not given an estate tax sensitive power or interest in the trust. For decedents dying after 1981, this is the only way to do more than defer the tax *and* give the spouse any benefit from the proceeds.

The general advantages of naming a trust as the beneficiary are:

- flexibility;
- protection of the beneficiaries against creditors' and spouses' claims (and potentially against their own indiscretions);
- investment management of the proceeds;
- providing the surviving spouse with an interest in the trust and, therefore, the policy proceeds without transfer tax consequences to the spouse and subsequent beneficiaries.

The proceeds can be made available to the executor to pay costs and taxes of the insured's estate by a loan, purchase of assets or direct payment. Each of these techniques has its possible disadvantages; perhaps, the purchase of assets concept makes the most sense---assuming a stepped-up basis for the assets at death.

Another advantage is that it solves the problem of the primary beneficiary's death before the insured's. It also avoids:

- the problem of the possible incompetency of the policy owner;
- the potential frustration of the insured's plan by the owner during the insured's life; and
- the problems of multiple and/or potentially legally incompetent owners.

Depending on state law, naming a trust as the policy owner may provide creditor protection for the policy during the insured's life. It also can provide creditor and spousal protection for the beneficiaries.

The policy although beyond the insured's *direct* control, is in the hands of a trustee chosen by the insured to carry out the terms of a trust created by the insured. Therefore, this is a *fairly*---but by no means totally---comfortable arrangement for most insureds once the decision has been made to give up policy ownership.

Disadvantages

On the other hand, naming the trust as the policy owner is an irrevocable arrangement. The word means what it says, despite any drafting techniques designed to increase flexibility.

If the insured is likely to have any regrets about losing his or her ability to directly make decisions about the future of the policy, that insured is not a candidate for this technique. Although, at least in the early years, the insured's ability to "pull the plug" on the arrangement, by stopping the payment of premiums (except on employer provided coverage) is the ultimate flexibility the insured retains.

An unstable family situation, the likelihood of economic changes, etc. may indicate a particular insured is not someone who should consider this technique.

Naming the trust as the policy owner also is a complex arrangement. It is a strategy for only the most sophisticated clients who are willing to undertake, pay for and live with the most complex of plans, and to have his or her beneficiaries live with such a plan for what may be an extended term. It should require the client's "knowledgeable enthusiasm" for the concept.