# A Modern Look at Life Insurance: Non-Estate Tax Uses

**Summary**

Life insurance is not a one trick pony. Sure, it provides cash to pay estate taxes. But there are many other uses of life insurance to consider, such as planning in second marriages, treating children equally, planning for retirement, or giving to charity.

**Related Information**

The Irrevocable Trust *in depth*; Estate Planning Basics *in depth*; Planning for Non-Citizens *in depth*; Qualified Plans and IRAs *in depth*; Lifetime Charitable Giving *in depth*

By now, we have all heard about how life insurance can be used to provide liquidity to pay estate taxes. In 2013, the federal estate tax exemption is $5.25 million ($10.5 million for a married couple).[1] Individuals with taxable estates above the exemption amount will be faced with paying federal estate tax at a 40% rate. Life insurance continues to be an important part of estate *tax* planning.

But is that all life insurance is good for? Absolutely not! Life insurance is uniquely suited to deal with many of the complexities of modern life.

For example, Jay, who is in his 60s, is married to Gloria, who is in her 40s. This is a second marriage for them. Both have children from their first marriages. Let's take a look at a few ways that life insurance solves their specific needs.

## 1. Planning for second marriages

Jay wants to take care of Gloria during her lifetime but also provide for his daughter, Claire, and his son, Cameron. Because Gloria is about the same age as his kids, Jay is concerned that they may never live to see an inheritance.

Can Jay provide funds to his children at his death but still leave Gloria enough to live on? Yes. Jay can own life insurance on his life and have it payable to his children outright, or to a trust for their benefit. Or the policy can be owned by and payable to an irrevocable life insurance trust (ILIT). On Jay's death, the proceeds can be distributed to the kids or held in

[1] Under the American Taxpayer Relief Act of 2012, the federal estate, gift, and GST exemptions are indexed for inflation each year (since 2011). State estate taxes must also be considered, as they often differ from federal law (e.g., the state exemption amounts are frequently lower than federal exemption amounts).

trust for their benefit. Either way, the children can be provided access to the proceeds beginning at Jay's death. Jay can leave his other assets to Gloria, either outright or in trust.[2]

## 2. Equalizing inheritances among children

Jay wants to treat his children equally. Jay's plan is to leave vacation property to Claire and a successful business to Cameron. After the specific bequests of these assets, Jay does not have enough assets to equalize their shares.

Life insurance again provides a solution. Life insurance proceeds provide the liquidity that Jay needs to make sure that each child receives equal value. And, if the policy is in an ILIT, the proceeds won't even be included in Jay's estate. The ILIT and Jay's other estate planning documents should be coordinated so that the total amount received by each child is equal.

## 3. Providing for grandchildren (and future generations) – dynasty trusts

Jay feels confident that he has adequately planned for his retirement. He also knows that he will leave enough for Gloria to live on and that Claire and Cameron are taken care of thanks to the insurance he has in place for them. He has some excess funds and would love to do something for his grandchildren. What is the best way to maximize his gifts?

He could simply make cash gifts to a custodial account for them. But he doesn't like the idea that they receive the assets at age 21, as the law in his state requires.[3] He prefers to build a legacy for his grandchildren and future generations.

To do this, Jay creates and makes gifts to an irrevocable trust for the benefit of his grandchildren and more remote descendants. A trust lasting for many generations is often called a "dynasty trust" and is designed to avoid inclusion of the assets in the beneficiaries' estates.[4] As such, any Crummey withdrawal right is typically limited to the greater of $5,000 or 5% of the value of the trust assets.[5] So, Jay will use some of his $5.25 million federal gift tax exemption for any portion of his gifts over the withdrawal rights. He will also allocate some of his $5.25 million generation-skipping transfer tax exemption (GST exemption) to these gifts.[6]

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[2] If Jay wants particular assets to remain in his blood line, he could instead transfer those assets to the children, and name Gloria as beneficiary of the life insurance policy.

[3] All states have a version of either the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). Under either UTMA or UGMA, the assets in the custodial account must be transferred to the minor upon reaching some age (typically between ages 18 and 21).

[4] Naturally, a dynasty trust is more feasible if it is governed by the laws of a state that no longer has a rule against perpetuities (or has a very long perpetuities period).

[5] § 2514(e). For a more detailed discussion of the issues associated with the lapsing of withdrawal rights, see The Irrevocable Trust *in depth* (March 2007), page 24.

[6] For a discussion of the generation-skipping transfer (GST) tax, The Irrevocable Trust *in depth* (March 2007), pages 53-58.

This trust can then buy a life insurance policy on Jay's life. On Jay's death, the income tax-free insurance proceeds are used for the benefit of his grandchildren, great-grandchildren and future generations.

What's more, some of the death proceeds can be used to pay premiums on life insurance policies that insure the later generations. Ultimately this can lead to a cascading of death benefit in a trust that provides funds for generation after generation, all the while avoiding any gift tax, any estate tax, any GST tax, and (to the extent life insurance is purchased) any income tax.

**4. Planning for a non-citizen spouse**

Gloria is a citizen of Colombia. Because she is not a U.S. citizen, any assets that Jay leaves her will not qualify for the estate tax marital deduction unless they are held in a Qualified Domestic Trust (QDOT). Jay wants to use a QDOT to defer estate taxes on his death. But a QDOT comes with restrictions, such as estate tax on most principal distributions.[7] In addition, Gloria cannot be the sole trustee of the QDOT; a U.S. citizen or corporation must serve as a QDOT trustee.[8] A QDOT just doesn't have all the flexibility that Jay and Gloria are looking for.

Instead, Jay sets up an ILIT to own a policy on his life. The ILIT does not need to contain the QDOT restrictions. Gloria can be both the trustee and beneficiary of the ILIT, without the ILIT assets being included in her estate on her death.[9] Unlike the QDOT, distributions of principal from the ILIT are not subject to estate tax. The ILIT is just more flexible.[10]

**5. Planning with qualified plan assets and IRAs**

Jay's daughter Claire is married to Phil. These two hold a significant portion of their assets in 401(k) accounts and IRAs, not all of which they will need for their retirement. They plan on withdrawing only the minimum required by law when they reach age 70½.

However, those retirement assets will be subject to estate tax upon the death of the surviving spouse, and the beneficiaries will also face required minimum distributions. It's not certain the Claire and Phil's wealth will be large enough to attract an estate tax, but because IRAs and qualified plans don't receive an at-death basis step-up, it is certain that any amount withdrawn will trigger an income tax.[11] Frequently, planning with retirement assets involves stretching the withdrawals over a long period of time. So, keeping those assets in the IRA as

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[7] § 2056A. There's an exception for hardship distributions of principal.

[8] § 2056A(a)(1)(A); Treas. Reg. § 20.2056A-2(c).

[9] While Gloria is acting as trustee, distributions should be limited to her health, education, maintenance, and support.

[10] See Getting More Money to a Non-Citizen Spouse, *Advanced Planning Bulletin*, August 2004.

[11] The beneficiary can take an income tax deduction for the federal estate tax attributable to the "income in respect of a decedent" (IRD) portion of the IRA or qualified plan (which would be all of it, if there had been no post-tax contributions). But the beneficiary can only use this deduction if he itemizes deductions on his individual income tax return. The deduction can reduce the burden of the double tax, but generally not dollar for dollar.

 

long as possible is good; withdrawing them to pay expenses (including but not limited to any estate tax) is bad.

One approach Phil and Claire can take is the creation of an ILIT to hold a second-to-die policy on their lives. Upon their death, the life insurance proceeds can help pay any estate taxes to preserve the opportunity to stretch distributions from the 401(k) and IRA accounts, or the proceeds can simply soften the sting of the income tax hit on the inevitable distributions from those accounts.[12]

### 6. Roth IRA conversions

Claire is considering converting her traditional IRA to a Roth IRA. She and Phil like the fact that Roth IRAs do not have required minimum distributions for the owner (although they do for the beneficiary). And they like more the fact that distributions from a Roth IRA are generally income tax-free (for the owner *and* the beneficiary).

Claire and Phil would like to arrange a plan where the survivor of them could enjoy a Roth IRA, but they particularly would also like *their child* to be able to take over the account as a Roth, so he too wouldn't have to pay income tax on any distributions.

There are two hurdles. First, converting to a Roth causes income tax, and neither Claire nor Phil are fond of paying taxes now from other assets. It seems that one way to deal with this would be to buy a second-to-die policy, so that their child could inherit the traditional IRA, convert it to a Roth, and use the life insurance proceeds to pay the income tax. Unfortunately, this brings up the second hurdle. *A non-spouse beneficiary of a traditional IRA is not allowed to convert to a Roth IRA.*[13] So, if Claire and Phil want their child to take their IRA as a Roth, one of them has to convert it while still alive.

To prepare for this, Claire and Phil buy two single life policies. If Claire dies first, Phil can roll over the IRA, convert it to a Roth, and use the policy's proceeds to pay the income tax. If Phil dies first, Claire can convert her IRA to a Roth, and again use the policy's proceeds to pay the income tax. Either way, by the time of the survivor's later death, a Roth IRA will be passing to their child, who can stretch the income tax-free distributions over his lifetime.

### 7. Planning for a special needs beneficiary

Claire and Phil are worried that their son with special needs will be disqualified from receiving government benefits if they leave assets to him at their death. So Claire and Phil set up a "special needs trust" for him. According to the laws of their state, this type of trust can be drafted to allow the trust assets to be used for their son's benefit without disqualifying him from receiving government benefits.[14]

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[12] For other alternatives, see Life Insurance and IRAs: The Dynamic Duo, *Advanced Planning Bulletin*, November 2004.

[13] Oddly enough, however, a non-spouse beneficiary of a *qualified plan* can convert to a Roth IRA. Notice 2008-30.

[14] See Planning for Beneficiaries with Special Needs *in brief* (November 2011).

 

Life insurance is a great way to ensure that there will be adequate assets available to take care of their son. Phil and Claire can own a life insurance policy and name the special needs trust as a beneficiary. Or, if estate taxes are a concern, the special needs trust can be an ILIT, which owns and is the beneficiary of a policy on the lives of Phil and Claire. Their son should not have a right of withdrawal in this trust because it could disqualify him for government benefits. Thus, Phil and Claire will use part of their gift tax exemption on gifts to the special needs trust.

## 8. Planning for unmarried couples

Cameron wants to leave assets to his long-time girlfriend, Susan, at his death. But assets he leaves to her do not qualify for the marital deduction for federal estate tax purposes.[15] Life insurance can provide liquidity to pay any estate taxes associated with the transfer of assets to her. And life insurance can generate funds that she can use to pay bills and replace lost income after Cameron's death.

If Cameron isn't worried about the proceeds being included in his taxable estate, Cameron can own the policy and name Susan as the beneficiary. As an alternative, Cameron can create an ILIT to own the policy. Cameron might wish to include a provision in the ILIT that excludes Susan as a beneficiary if they are not in a relationship at the time of Cameron's death.

## 9. Charitable planning

Jay and Gloria are looking for ways to use life insurance in their charitable planning. They know that they could name a charity as a beneficiary of a policy they own, but they would really like an immediate income tax deduction. Let's look at some of their alternatives.

If they have an existing policy, they can simply give it to a charity.[16] Or, they can transfer the cash to the charity to purchase a new policy. In either event, they get an income tax charitable deduction for the initial transfer and for any subsequent transfers of cash to pay the premiums, subject to certain adjusted gross income (AGI) limits.[17]

But there may be a way for Jay and Gloria to get the whole family involved in giving. Jay and Gloria can create a private foundation. Their contributions to the foundation qualify for the income tax charitable deduction, although the deduction is limited to either 30% or 20% of the donor's AGI, depending on the type of property contributed.[18]

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[15] The same issue – lack of a marital deduction – arises for same-sex couples, even if they are considered married under their state's law. Due to the Defense of Marriage Act (DOMA), federal tax law does not recognize marriage between same-sex couples. Correspondingly, the planning solutions are the same as those for any unmarried couple. The constitutionality of DOMA is currently being challenged.

[16] For gifts of an existing policy, the amount deductible is generally the lesser of the donor's basis in the policy and the policy value.

[17] For a more detailed discussion of the charitable deduction, see Lifetime Charitable Giving *in depth* (February 2008), pages 7-8.

[18] See Lifetime Charitable Giving *in depth*, page 4.

 

Assuming Jay and Gloria live in a state where a charity has an insurable interest in a donor, the private foundation can apply for a policy on either or both of their lives. The foundation could use a portion of its assets to pay premiums, or Jay and Gloria could make contributions each year to pay the premiums.[19] Upon their deaths, the proceeds increase the amount that the foundation can give to charitable organizations.

**10. Creditors – often good news, and can be even better news**

Jay is a successful businessman. Because of his many business dealings, he worries about potential creditors lurking in the background. He also worries about his family – some have been known to get themselves into trouble. What effect does all of this insurance planning have on his creditors and his family's creditors?

The "often good news" is that, although there is little to no *federal* creditor protection for life insurance, many *state* laws do provide some type of creditor protection. The level of protection varies widely across the country. Some states provide a nearly unlimited exemption from creditors, others do so only if the policy is owned by an individual and not a business, and still others offer very little protection. Jay will need to consult with an attorney in his state who is knowledgeable about asset protection to determine what protection, if any, his life insurance policies have.

The "even better news" is that life insurance owned by a properly drafted ILIT is generally entirely protected from both Jay's creditors and the beneficiaries' creditors. Absent a special circumstance such as a fraudulent conveyance, Jay's creditors cannot reach the ILIT's assets because he has no right to the interest or principal of the ILIT. If the trust agreement contains a spendthrift clause and gives the trustee discretion to distribute income and principal, the trust assets will generally be protected from the creditors of the trust beneficiaries too.[20]

**Conclusion:** We've always known that life insurance can be used to pay estate taxes. But when we scratch below the surface, we see that life insurance is uniquely situated to handle many of life's complexities.

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[19] A private foundation is subject to certain limitations on its investments. While life insurance is generally an acceptable asset to be owned by a private foundation, the private foundation managers should consider the type of policy purchased and the proportion of the life insurance to its other assets. For a more detailed discussion of private foundations, see Private Foundations *in brief* (October 2012).

[20] A spendthrift clause is a specific provision in the trust document that prevents a beneficiary's creditors from reaching the trust assets. Creditor protection is determined under state law. Therefore, the trust language should be drafted in accordance with the applicable state law.

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