LIFE INSURANCE CONSIDERATIONS IN ESTATE PLANNING FOR FAMILIES AND BUSINESS OWNERS

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I. USING LIFE INSURANCE IN YOUR ESTATE AND BUSINESS PLANNING

Life insurance is often associated with protecting family members when an unexpected death could create a financial crisis for a surviving spouse or children who will struggle to pay off debts or maintain their standard of living after the loss of a loved one. However, life insurance is also a valuable tool that can be used in conjunction with estate planning and business succession plans.

Personal assets are often used to pay a significant portion of federal estate tax that is due on the gross estate of a deceased person within nine months after their death. Assets such as IRAs, real estate, and small business interests are not easily liquidated and doing so may incur penalties. On the other hand, death benefits from a life insurance policy are typically received income tax-free and are immediately available to be used for federal estate tax or to help ensure that a business survives.

II. HIGH NET-WORTH INDIVIDUALS

a. IRREVOCABLE LIFE INSURANCE TRUSTS

Irrevocable Life Insurance Trusts (ILITs) are a popular way to provide for children, grandchildren, or other heirs. ILITs are a savvy estate tax planning tool because money can be "gifted" by parents and grandparents into the trust, thereby moving money out of their taxable estates and reducing federal estate tax exposure. In addition, if properly drafted under applicable state law, ILITs can also provide significant asset protection for the trust beneficiaries.

If funded and administered properly, the death benefit from a life insurance policy owned by an ILIT will not be included in the grantor's taxable estate and therefore not subject to federal estate tax upon the grantor's death. If an existing life insurance policy is transferred to an ILIT, and the grantor dies within three (3) years from the date of the transfer, the death benefit will be included in the grantor's taxable estate. However, if the ILIT directly acquires a new life insurance policy on the life of the grantor, there is no three (3) year survival period. Care should be taken by advisors to ensure that new policies are established directly by the ILIT to avoid the three (3) year survival requirement.

ILITs are usually created for policies insuring a single grantor's life, however a special purpose ILIT can be created for second-to-die (or survivorship) policies. Second-to-die life insurance policies are a great strategy for married individuals with insurability concerns, as the non-insurable spouse may still be able to get a second-to-die policy if the other spouse is insurable. Second-to-die policies are also generally cheaper than a single policy on the life of the insurable spouse. Additionally, the surviving spouse can continue funding the ILIT by gifting premium amounts after the death of the first spouse, thereby removing assets from the surviving spouse's taxable estate. However, care must be taken to ensure the surviving spouse will have sufficient funds to do so. With either type of policy, ILITs can provide significant tax and gifting benefits for estate planning purposes, as well as provide liquidity in order to purchase assets from the grantor's estate or loan money for payment of estate and other taxes.

b. LEVERAGED GIFTING

For individuals who expect their estate to be above the federal estate tax exemption, one of the advantages of acquiring life insurance through an ILIT is the concept of "leveraged gifting." Generally, premiums on the life insurance policy owned by an ILIT are gifted by the grantor each year. If the ILIT is drafted and administered properly, these annual gifts can qualify for the federal gift tax annual exclusion (currently $17,000 per beneficiary in 2023). The annual exclusion is in addition to the lifetime exemption from gift tax and the estate tax exemption (both currently $12,920,000), so utilizing the annual exclusion can preserve the other exemptions for future gifts. If the ILIT has a large class of beneficiaries, such as all of the grantor's descendants (children, grandchildren, great-grandchildren…etc.), the grantor can gift a large amount to the ILIT each year via the annual exclusion, thereby allowing the ILIT to fund a life insurance policy with a significant death benefit. For example, if there are three children, each with two children of their own, the ILIT would have a total of nine beneficiaries to whom the annual exclusions can be applied. Under 2023 exclusion amounts, this would allow the grantor to gift a total of $153,000 each year to be used towards premiums. If the policy is a second-to-die policy, that number can be doubled so long as both of the insureds are still living.

For gifts to the ILIT to qualify for the annual exclusion, the transfer must qualify as a present interest. Generally, a future interest in the death benefit of a policy owned by an ILIT does not qualify as a "present interest." However, the ILIT can provide temporary withdrawal rights for each beneficiary, which would allow the gifts to the ILIT to qualify for the annual exclusion. To do so, the trustee will provide a beneficiary with notice that informs trust beneficiaries of their right to withdraw any amounts transferred to the ILIT within a reasonable period of time (usually 30 days). These notices are referred to as "Crummey Letters," and are important documentation for the trustee to maintain in the event of an audit by the IRS at a later date. Any amounts that the beneficiaries do not exercise their withdrawal right to within the stated time period become part of the assets of the ILIT which can then be used to pay premiums. As long as the present interest of the gift is less than the annual exclusion amount, there will be no tax implications for the donor of the gift.

Example: An ILIT owns a life insurance policy on the life of Jeff with a death benefit of $2,000,000. The annual premium payment for the policy is $68,000, and Jeff names four beneficiaries of the ILIT. Each year, Jeff gifts $68,000 to the ILIT, and the trustee issues a corresponding Crummey Letter notifying each of the beneficiaries of their withdrawal rights. Assuming no withdrawal rights are exercised, the gifts are then used by the trustee to pay annual premium payments. By utilizing this strategy, Jeff can make annual gifts free of gift tax (assuming the 2023 annual exclusion amount) while the policy appreciates in the ILIT. When Jeff passes away, the death benefit is distributed to the ILIT income and estate tax-free and is not included in the value of Jeff's gross estate. The ILIT can use the death benefit to purchase assets from Jeff's estate or loan money to Jeff's estate in order to pay estate tax that is due, if any, on Jeff's estate.

III. BUSINESS OWNERS AND THE NEED FOR LIQUIDITY

For many business owners, the bulk of their assets are held within the business itself. If this is the case, there may not be enough cash to pay estate taxes and other expenses in the event of death.

The untimely death a business owner, business partner, or a key employee can leave both the business and their families vulnerable. Life insurance can offer a layer of protection in these difficult situations with an immediate infusion of cash.

Strategies that can be utilized to provide business owners liquidity in these situations include ensuring that a business partner is able to buy out the other's share in the event that one passes away, equalizing the deceased's estate when some family members are more active in the business than others, planning for continuity and lost revenue replacement if a key employee dies, and providing collateral for a business loan so personal assets are not placed at risk.

a. PLANNING AROUND TECHNICAL DEFAULTS ON PERSONAL GUARANTEES

Taking on business debt secured with personal assets of the owner could put both the owner's family and business at risk in the event of an untimely death. Furthering this risk is the fact that in many personal guarantees, acceleration clauses allow the lender to accelerate the entire debt, forcing it to become due and payable upon the death of the guarantor. By purchasing a life insurance policy to be used as loan collateral, a business owner can guarantee debt repayment and avoid any risk to personal or business assets.

b. KEY MAN INSURANCE

Key man insurance is an insurance policy purchased by a company on the life of an owner, a top executive, or another individual considered critical to the business. The company is the beneficiary of the policy and pays the premiums. The money from the policy can be used in a number of ways – to hire and train a new employee to take over the key person's role, to help wind up the business following the key man's death, distribute money to investors, etc.

c. FUNDING BUY-SELL AGREEMENTS WITH LIFE INSURANCE

A buy-sell agreement is an agreement among closely held business owners (which may be part of a shareholders' or operating agreement) that restricts the owners' rights to transfer their interests in the business. Among other things, buy-sell agreements give the business and/or owners the right (and sometimes the obligation) to purchase the interests of an owner when the owner dies. In the case of death, this prevents the interest of a deceased owner from passing to others whom the remaining owners would not want to be in business with (e.g., a spouse), while simultaneously providing funds to the deceased owner's family from the sale of the deceased owner's interest.

Life insurance policies are often used to fund buy-sell agreements. Using life insurance ensures the transition will be smooth by providing cash from the death benefit to enable the surviving owner(s) to buy out the deceased partner's interest from his or her heirs. Life insurance policies on an owner can be paid for by the business or by each owner individually. Business succession plans funded with life insurance can help prevent difficult situations in which a partner finds themself in business with the surviving spouse or heir of a deceased partner who knows little about the business, or in a situation where the business or business interest must be liquidated or sold in order to settle the deceased partner's estate. Business owners seeking to arrange an insurance

backed buy-sell agreement should consult a qualified attorney to draft the agreement and a business valuation expert to assess the value of the business to find the proper insurance coverage needed. An insurance specialist should also be consulted to arrange funding of the agreement and periodically review the plan.

IV. BLENDED FAMILIES

Estate planning can be challenging for blended families when parents have children from previous relationships. For many families, a common distribution plan is to give all assets to the surviving spouse after the death of the first spouse, and then all assets to children after the death of the surviving spouse. In the case of a blended family, this can create problems if (i) the surviving spouse does not wish to provide for the other spouse's separate children, (ii) there is disharmony between the surviving spouse and the deceased spouse's children, or (iii) the surviving spouse substantially depletes assets prior to their death. Life insurance can be a helpful solution in this situation to ensure the deceased spouse's separate children "get something."

The use of life insurance in estate planning for blended families may be best illustrated by example: John is married to Kathy and has three children from a prior marriage. John's estate primarily consists of a business that he and Kathy run together. John's children do not have the best relationship with Kathy. Instead of leaving his entire estate to Kathy or splitting the business between Kathy and his children, John funds a life insurance policy that will provide a direct benefit to his children at his death, while the business is distributed to Kathy. If John utilizes an ILIT in this situation, additional gift and estate tax planning benefits are available.

V. EQUALIZING INHERITANCES

When an estate contains a large asset or several large assets that can't be evenly distributed - such as a family business or other private business interests - purchasing a life insurance policy and utilizing an ILIT can help equalize inheritances. If a family business interest represents a large portion of the estate, it can be challenging to ensure a fair inheritance to heirs who are not active in the business. This strategy can help avoid a forced liquidation of the business in order to fairly divide your assets. In this situation, there are many avenues to take. The policy could be owned by the business owner, heirs, or an ILIT depending on the objective of the business succession plan and wealth transfer needs.

Example: A business owner and father of two children creates and funds an ILIT for the purpose of equalizing inheritances after his passing. The father knows that his daughter has had an active role in the management of his business and will want to continue the business following his death. On the other hand, his son is not involved in the business and lives in another state. After the father's death, his daughter will receive the family business while his son receives the proceeds from the ILIT. Without the ILIT in place, his children may have been forced to sell all or part of the business to receive an equal share of his estate or possibly create a family conflict by being forced to own the business together.

VI. SPECIAL NEEDS

A special needs trust funded with life insurance can help maximize assets devoted to providing security to the special needs individual without impacting other financial planning needs, such as retirement or providing for other heirs. After the decedent's death, the death benefit proceeds will be used by the trustee to make distributions to support the individual and contribute to their medical and living expenses. Because the assets are not owned by the beneficiary of the trust, assuming the special needs trust is drafted properly, the insurance proceeds will not jeopardize benefits under income and asset-based government support programs.

VII. PHILANTHROPY

Charitable Remainder Trusts ("CRTs") are common vehicles for using illiquid assets to facilitate donations to charity. A CRT is established by the donation of assets to an irrevocable trust during one's lifetime. The donor receives an immediate income tax deduction and a stream of income payments tied to the value of the CRT during their lifetime. By using illiquid assets such as real estate, the donor can provide value to the CRT without having to gift cash or other liquid assets. A CRT is a tax-exempt entity, and therefore assets held in the trust are not subject to income tax. Instead, the taxpayer only pays tax on annual distributions from the CRT to the extent the distribution consists of taxable income. Therefore, the CRT can sell the illiquid asset, not recognize the gain inside of the CRT, and essentially provide a deferral and reduction of the income tax to the donor. When the donor passes away, the remaining assets in the CRT are distributed to the named charity and reduce the donor's federal estate tax exposure.

Life insurance can replace the "lost" gift to charity, essentially making the family "whole." If the donor uses the income payments from the CRT to fund a life insurance policy owned by an ILIT, the death benefits can be paid to the ILIT free of income and estate tax. As a result, upon the donor's death, the charity receives a large gift from the CRT, the donor's estate receives an estate tax deduction, and the donor's heirs receive income and estate tax free life insurance proceeds through the ILIT from a policy funded by CRT income; all in addition to the donor receiving an income tax charitable deduction upon establishing the CRT.