Nassau Lawyer

The Journal of the Nassau County Bar Association

March 2020 www.nassaubar.org Vol. 69, No. 7

Elder Law/Trust & Estates

Utilizing Life Insurance to Improve Your Client's Estate Plan

Life insurance is a valuable asset, as it provides an insured's family with resources to cope with the adverse financial consequences of the death of a loved one. Beyond that, it can be an important tool when implementing one's estate plan. For the year 2019, approximately 57% of American adults owned life insurance, according to the 2019 Insurance Barometer Report;[1] of those consumers who inquired into purchasing life insurance, only 15% determined that they could not afford the cost of coverage.[2]

In fact, there is a general lack of knowledge regarding the cost of life insurance among many individuals, with a recent study showing that over half of respondents believed term life insurance premiums to be over three times more expensive than they actually are.[3] In the event coverage is affordable, practitioners should be coordinating with clients' insurance representatives to determine how life insurance can integrate with their estate plans.

Benefits of Life Insurance in Estate Planning

There are a number of estate planning benefits to owning a life insurance policy, some of which may vary depending on an individual's financial and personal situation. A significant benefit of life insurance for all individuals, regardless of asset level, is the ability for others to pay expenses after death. If an insured names a beneficiary on his or her policy, the beneficiary can put in a claim for the proceeds immediately upon the insured's passing, and receive the proceeds within weeks. This allows the beneficiary to be reimbursed for burial costs quickly, as well as pay for the cost of administering the estate.

Individuals without significant assets may seek to purchase life insurance in order to replace income for their heirs. This may be the case for parents seeking to replace wealth for young children, or a predeceased spouse seeking to replace wealth for a non-working surviving partner. Naming dependents as the beneficiaries of a life insurance policy provides the beneficiaries with income and wealth if the insured's passing would leave them financially stricken. Furthermore, wealthy individuals may seek to purchase life insurance in order for their heirs to conveniently pay federal and/or state estate taxes.

Without the benefit of life insurance proceeds, heirs may be forced to liquidate assets or otherwise reduce their inheritance. For the year 2020, at the federal level, estate tax is imposed on assets in excess of $11,580,000, at a maximum rate of 40%. In New York, an additional state estate tax is imposed on assets in excess of $5,850,000, at a maximum rate of 16%. In both situations, practitioners must understand the importance of recommending life insurance, either as income or wealth replacement for the insured's beneficiaries, or as liquidity for paying estate taxes.

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The use of life insurance is also becoming more prominent for those clients owning closely held businesses. From 2017 to 2019, there was an 18% increase in those individuals purchasing life insurance for business purposes.[4] When structuring a client's estate plan, practitioners must get a full picture of the assets, including any business interests. When there are multiple owners in a business, the owners should consider the acquisition of life insurance to fund any potential buy-out or provide working capital. If one of the owners were to pass away, the remaining owner(s) would need to have enough liquid funds to compensate the deceased owner's family or estate. Additionally, the company would be faced with the burden of replacing the deceased owner, in the event there is an operating business.

If, however, there was available life insurance, those funds could be utilized to pay the deceased owner's estate with no negative monetary impact on the company. Either the owners or the company could be the owner(s) of the policy, and the coverage amount could be the basis for the valuation of the deceased owner's interest. Insurance is a valuable tool when planning the succession of one's business because it alleviates a financial burden upon an owner's passing. It also dictates who will succeed to the insured's ownership interest, based on the ownership structure of the life insurance. The interplay of utilizing life insurance for a client's business succession must be taken into consideration when building an estate plan.

Estate Planning Considerations for Life Insurance

When considering insurance as part of an estate or business succession plan, it is important to review the ownership of the policy. The value of an insurance policy owned by an individual will be included when calculating his or her asset value, and therefore may increase the client's taxable estate. Ownership of a life insurance policy by an Irrevocable Life Insurance Trust (an "ILIT"), can provide tax and other advantages when compared to the policy being owned individually.

An ILIT is a lifetime, irrevocable trust set up by the insured individual, that either purchases an insurance policy, or is the recipient of an insurance policy as a gift from the insured. If the ILIT purchases the insurance policy directly, the value of the death benefit is not includable in the insured's estate assets and therefore will not be used when calculating whether estate taxes are due. If, however, the insured makes a gift of the insurance policy to the ILIT, three years must elapse before the value of the policy is removed from the insured's taxable estate.

By utilizing an ILIT, upon the insured's passing, the terms of the trust determine how the proceeds are to be distributed, which is a valuable estate planning tool in a variety of situations. For example, proceeds can be held in trust for young beneficiaries, or for beneficiaries who otherwise need financial protection as a result of creditor issues or marital problems. In the case of a blended family, using an ILIT allows an insured's spouse to be named the beneficiary for his or her lifetime, but ultimately distribute the balance of the death benefit to the insured's descendants.

There are certain procedures that must be followed in order to ensure that the value of any policy transferred to an ILIT is removed from the insured's taxable estate. First, the trust must be irrevocable, and the insured cannot act as a trustee. Instead, an independent third party must act as trustee and administer the trust in the beneficiaries' best interests. Additionally, the trustee must make the premium payments on behalf of the insured from a trust bank account. Before each premium payment is made, the insured must transfer the premium amount to the trust bank account, and should simultaneously advise the beneficiaries of their right to withdraw a portion of the contributions from the trust within a certain time frame. This right of withdrawal ensures that the transfer to the trust is treated as a present interest gift, eligible for the annual gift tax exclusion ($15,000 per donee during 2020), enhancing the transfer tax benefits of the use of an ILIT.

Insurance policies are also flexible in the sense that the death benefit can be changed and the premiums adjusted, to adapt to a change in lifestyle. Additionally, there are different types of life insurance products, providing an insured with options. For example, an insured can choose between term insurance, which pays a death benefit only if the death occurs during the policy term, or whole life insurance, which pays a death benefit regardless of when the death occurs. Beyond that, some whole life insurance options also provide the insured with an investment vehicle to increase the ultimate death benefit. By supplementing the death benefit with an investment account, the insured may also borrow funds from the policy in times of need.

Aside from traditional life insurance, the market for combination products which contain long-term care coverage is growing as well. These policies include benefits for both long-term care needs during an insured's life, as well as a death benefit upon his or her passing. These policies are gaining popularity as the aging population is seeking to lower the possibility that their savings will be depleted as a result of needing long-term care. In the estate planning context, the emergence of these policies is extremely beneficial, as they are being used in conjunction with other asset protection methods, such as trusts, to ensure a client's wealth is preserved.

Don't Wait

Overall, insurance is a valuable asset for a number of reasons, especially when looking to develop one's estate plan. With recent changes in the world of estate planning, both clients and advisors should be emphasizing a renewed importance and focus on the ownership of life insurance. Attorneys cannot simply gather a client's asset information without considering the potential need for life insurance. Advisors must be more proactive in communicating to their clients the numerous benefits of purchasing life insurance, as well as in considering the ownership options and how it will coincide with a client's overall estate plan.

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1. James Scanlon, *2019 Insurance Barometer Report, Life Happens, 2019* at 23, available at www.shorturl.at/pxAD9.
2. *Id.* at 39.
3. *Id.* at 28.
4. *Id.* at 38.