The Role of Life Insurance in an Estate Plan

Life insurance can play an important role in your estate plan. It is often necessary to support your family after your death or to provide liquidity. Not only do you need to determine the type and amount of coverage you need, but also who should own insurance on your life to best meet your estate planning goals.

Avoid Liquidity Problems

Estates are often cash poor, and your estate may be composed primarily of illiquid assets such as closely held business interests, real estate or collectibles. If your heirs need cash to pay estate taxes or to support themselves, these assets can be hard to sell. For that matter, you may not want these assets sold. Insurance can be the best solution for liquidity problems.

Even if your estate is of substantial value, you may want to purchase insurance simply to avoid the unnecessary sale of assets to pay expenses or taxes. Sometimes second-to-die insurance makes the most sense. Of course, your situation is unique, so please get professional advice before purchasing life insurance.

Choose the Best Owner

If you own life insurance policies at your death and you die while the estate tax is in effect, the proceeds will be included in your taxable estate. Ownership is usually determined by several factors, including who has the right to name the beneficiaries of the proceeds. The way around this problem? Don't own the policies when you die. But don't automatically rule out your ownership either.

Determining who should own insurance on your life is a complex task because there are many possible owners: you or your spouse, your children, your business, an irrevocable life insurance trust (ILIT), a family limited partnership (FLP) or limited liability company (LLC). Generally, to reap maximum tax benefits, you must sacrifice some control and flexibility as well as some ease and cost of administration.

To choose the best owner, you must consider why you want the insurance: to replace income, to provide liquidity, or to transfer wealth to your heirs. You must also determine the importance to you of tax implications, control, flexibility, and ease and cost of administration. Let's take a closer look at each type of owner:

You or your spouse. Ownership by you or your spouse generally works best when your combined assets, including insurance, do not place either of your estates into a taxable situation. There are several non-tax benefits to your ownership, primarily relating to flexibility and control. The biggest drawback to ownership by you or your spouse is that on the death of the surviving spouse (assuming the proceeds were initially paid to the spouse), the insurance proceeds could be subject to federal estate taxes, depending on when the surviving spouse dies.

Your children. Ownership by your children works best when your primary goal is to pass wealth to them. On the plus side, proceeds are not subject to estate tax on your or your spouse's death, and your children receive all of the proceeds tax free. There also are disadvantages. The policy proceeds are paid to your children outright. This may not be in accordance with your general estate plan objectives and may be especially problematic if a child is not financially responsible or has creditor problems.

Your business. Company ownership or sponsorship of insurance on your life can work well when you have cash flow concerns related to paying premiums. Company sponsorship can allow premiums to be paid in part or in whole by the company under a split-dollar arrangement. But if you are the controlling shareholder of the company and the proceeds are payable to a beneficiary other than the company, the proceeds could be included in your estate for estate tax purposes.

An ILIT. A properly structured ILIT could save you estate taxes on any insurance proceeds. Thus, a $2 million life insurance policy owned by an ILIT could reduce your estate taxes by hundreds of thousands of dollars in 2006. How does this work? The trust owns the policies and pays the premiums. When you die, the proceeds pass into the trust and are not included in your estate. The trust can be structured to provide benefits to your surviving spouse and/or other beneficiaries. ILITs have some inherent disadvantages as well, foremost among them that you lose control over the insurance policy after the ILIT has been set up.

Planning Tip

CONSIDER SECOND-TO-DIE LIFE INSURANCE

Second-to-die life insurance can be a useful tool for providing liquidity to pay estate taxes. This type of policy pays off when the surviving spouse dies. Because a properly structured estate plan can defer all estate taxes on the first spouse's death, some families find they don't need any life insurance then. But significant estate taxes may be due on the second spouse's death, and a second-to-die policy can be the perfect vehicle for offsetting the taxes. It also has other advantages over insurance on a single life. First, premiums and estate administrative costs are lower. Second, uninsurable parties can be covered. But a second-to-die policy might not fit in your current irrevocable life insurance trust (ILIT), which is probably designed for a single life policy. Make sure the proceeds are not taxed in either your estate or your spouse's by setting up a new ILIT as policy owner and beneficiary.