

# **TEN WAYS TO USE LIFE INSURANCE (AN ESTATE PLANNING PERSPECTIVE)**

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**Kathy Belcher**

McGinty & Belcher Attys PC

694 High St NE

PO Box 12806

Salem OR 97309

[www.mcginty-belcher.com](http://www.mcginty-belcher.com)

## Ten Ways to Use Life Insurance (An Estate Planning Perspective)

Presented by Kathy Belcher  
McGinty & Belcher, Attorneys

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## LIFE INSURANCE

There are worse things in life than death. Have you ever  
spent an evening with an insurance salesman?

*Woody Allen*

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## Life Insurance as Part of Estate Plan

- Life insurance is present in almost every estate plan and serves as a source of support, education-expense coverage and liquidity to pay death taxes, pay expenses, fund business buy-sell agreements and sometimes to fund retirement plans.

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## Types of Insurance

- A Risk Shifting Vehicle
- Term
- Traditional Permanent (Whole Life)
- Flexible Permanent (Universal Life)
- Second-To Die

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## Traditional Whole Life

- Guaranteed Cash Value
  - Reserve for payment of death benefit
  - Guaranteed cash value = death benefit age 100
  - Loans against policy

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## Flexible (Universal Life)

- Introduced in 1970's
- Flexible premium (lower than Whole life)
- Some opportunity for growth
- Minimal guarantees
- Policy owner assumes the risk

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## Second-To-Die

- Same Generic Product Forms
  - Insures two lives
  - Benefits paid at second death
  - Unlimited marital deduction

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## Planning Considerations

Not always more cost effective

Consider age differential and time value of money  
Male 75 - Female 60

- 10 Million 2<sup>nd</sup> to Die
- 10 Million Single Life
- M Dies age 90
- M Dies age 90
- F dies age 90 (15yrs later)
- 10 Million benefit received
- 10 Million to beneficiary
- 15 years growth @4%
- 18 Million to beneficiary

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## Which Product is Best????

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## Benefits of Life Insurance

- Death benefit generally received by beneficiary income tax-free under IRC §101(a)
- Life insurance proceeds included in estate of deceased and part of the taxable estate
- Death benefit can be structured to be estate tax-free
- Estate inclusion can be avoided if the owner of the life insurance policy is someone other than the deceased, however; this assignment must have occurred more than three years prior to the date of death

Although the primary reason to purchase life insurance is for the death benefit, many policies provide the potential for cash accumulation

- Tax-deferred cash value build-up
- Generally can borrow cash value without tax

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## Benefits of Life Insurance

- Notwithstanding the time value of money, periodic small gift transfers for premium can provide large death benefits
- Form of property people generally don't mind giving away during lifetime
- Unique in its ability to provide instant substance (death benefits) where insured is prevented from doing so because of death (life insurance is self-completing)

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## #1 Income Replacement

- Life insurance death benefits can create a fund that survivors (beneficiaries) can access to help replace income lost at the death of a wage earner.
  - Family with few assets dependent on the income of an insured
  - Survivors (beneficiaries) who may be asset rich but income poor
    - Inherited assets are low/non-income producing (i.e., land, minority interest in a closely held business)
    - Trust beneficiary with minimal income distributions (i.e., income-only trust beneficiaries)

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## #2 Source of Cash

- Life insurance death benefits can instantaneously create a pool of cash at an insured's death to help survivors:
  - Pay down or pay off mortgages or other debts
  - Fund services provided by the deceased (house cleaning, child care, cooking, etc.)
  - Fund for education
  - Fund for the care of individuals who are physically or mentally not able to provide for themselves (i.e., children with special needs)
  - Pay estate taxes, final expenses, costs of administration

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## #3 Noncitizen Spouse Marital Deduction

- Life insurance proceeds can help address the marital deduction limitations of a surviving noncitizen spouse.
  - To qualify for the unlimited estate tax marital deduction, property passing to a surviving noncitizen spouse must pass into a qualified domestic trust (QDOT).
    - Distributions of principal from a QDOT during the life of the noncitizen spouse, except for hardship, are subject to estate tax.
    - Assets remaining in QDOT at the death of noncitizen spouse do not qualify for that spouse's estate tax exemption, rather they are subject to estate tax as if they were included in the estate of the prior deceased spouse.

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## #4 Enhance an Estate

- Life insurance death benefits can help reduce estate planning problems.
- Commitments for substantial transfers in the future can be made with more modest current transfers for life insurance premiums.
  - Provide wealth for children of prior marriage
  - Divorce and child support commitments
  - Help pay for the purchase of a business interest
  - Help "equalize" estates of heirs who do not work in the family business

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## #5 Stabilize a Business Interest

- Life insurance death proceeds can help provide additional cash to help reassure creditors, vendors, distributors and employees that the business is financially sound.
  - Help satisfy business debt
  - Provide cash flow during the inevitable crisis that follows the death of a key person
  - Create a “stay bonus” fund to retain key employees during a transition period of a business
  - Security for line of credit

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## #6 Charitable Wealth Replacement

- Life insurance can help to fulfill a desire to make a substantial gift to charity.
  - Many people don't make gifts/bequests to charity because they fear their family will be deprived of an adequate estate or family members will be unhappy about being deprived of the assets left to charity. Life insurance can help alleviate these concerns
    - Charitable Remainder Trust: Insurance purchased to replace some or all the asset passing to charity
    - Testamentary Charitable Lead Trust: Insurance provides source of income to family while trust income diverted to charity

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## #7 Support Stretch of IRAs & Qualified Plan Distributions

- Life insurance can help qualified plan participants and IRA owners maximize their ability to stretch distribution of qualified retirement funds over multiple generations.
- Basic “Stretch” concept:
  - Delays distributions for as long as permitted
  - Names a young beneficiary to minimize distributions
  - Distributes only the minimum amount required
  - Result: Compounded tax-deferred earnings potentially creates substantial wealth for future generations

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## #7 Support Stretch of IRAs & Qualified Plan Distributions

- Example: Jack and Jill
  - During Jack's Life:
    - Jack, IRA participant and his wife, Jill, is named as beneficiary of his IRA.
    - Jack first distribution is due by 12/31 of the year he reaches age 70½.
    - Jack can choose to defer his first distribution to April 1 of the year following the year he turned age 70 1/2, but he would still be required to take another distribution by 12/31 of the same year.
  - After Jack's Death During Jill's Life:
    - Jill elects to treat the IRA as her own, does not begin distributions until the year she reaches age 70½.
    - Jill is now the owner of the IRA, names grandson John, as beneficiary.
    - Jill receives distributions until death (including the year of death).

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## #7 Support Stretch of IRAs & Qualified Plan Distributions

- After Jill's Death:
  - John, elects to take distributions over his lifetime extending income tax deferral over his life expectancy of many years. Estate taxes are paid from other funds.
- A survivorship life insurance policy insuring Jack and Jill can help provide John the liquidity needed to pay estate taxes.

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## #8 Replace Assets Lost to Tax on IRD Assets

- The death proceeds on an individual life insurance policy can be a source of cash to help replace assets lost to income tax on "income in respect of decedent" (IRD) assets.
- IRD assets are subject to income tax even if the estate is not subject to estate tax.
- Example of IRD assets: annuities, traditional IRAs, qualified retirement plans (i.e., 401(k), SEPs, 412(i) etc.).

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## #9 Roth Conversion Opportunity

- IRA owner names spouse as beneficiary. At IRA owner's death, spouse converts IRA to Roth IRA in spouse's own name. Spouse names children or grandchildren as beneficiaries.
- No minimum distributions are required during lifetime of surviving spouse allowing for tax-free compounding of Roth assets.
- Entire IRA amount can be passed on to younger beneficiaries income tax-free if all requirements are met
- Requires cash (preferably from sources outside of the traditional IRA) to pay taxes due at time of conversion.
- To help pay the tax due at conversion, purchase life insurance on the life of the traditional IRA owner with spouse as the beneficiary.

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## Summary: Use of Life Insurance in Estates with Qualified Assets

- The key to maximizing the sum left to the beneficiary of an estate with qualified retirement assets is to make sure the beneficiary does not lose benefits to taxes.
- For all estates with qualified retirement assets, it means having funds to offset the loss caused by income tax on IRD.
- For an estate subject to estate tax, it means there must also be adequate funds to provide estate tax liquidity without using qualified retirement assets to pay estate taxes.

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## #10 Education v. 529 college savings plan

- Life insurance proceeds can fund education.
- Flexibility - 529 plans can only be used for "qualified education expenses". Life insurance no restriction on use
- Financial Aid – 529 plan countable resource for financial aid.
  - Life insurance – loan vs. income
  - Not counted for financial aid purposes

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## Preserving Estate Exemption - ILIT (Irrevocable Life Insurance Trust)

- Federal Exemption \$5.2M – Oregon Exemption \$1M
- Small policy \$500 can use half of Oregon exemption
- ILIT – holds and owns life insurance policy – removes from taxable estate if:
  - Trust is irrevocable
  - Grantor is not the trustee
  - Grantor has no incidents of ownership over insurance policy
  - More than 3 years have passed since established.
- ILIT – designated beneficiary of life insurance proceeds
- Funded vs. Unfunded
  - Annual Gifts to pay for premiums
  - Crummy powers

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