LIFE INSURANCE AND ESTATE PLANNING

By Neil R. Lubarsky

Life insurance is usually the best method of funding estate taxes and should be purchased by anyone with a potential estate tax liability who does not wish his or her estate to be diminished by the confiscatorily high estate taxes which most moderately sized and large estates are now subject.

One of the first steps in the estate planning process is figuring out whether you will have any potential estate tax liability, and if so, figuring out how to minimize such liability. Legal techniques for reducing potential estate taxes include, among others, establishing credit shelter trusts, setting up family limited partnerships, and creating qualified personal residence trusts. Once these measures, if appropriate for a particular family's situation, have been taken, and if it still appears that estate taxes will have to ultimately be paid, finding a method of funding such estate taxes becomes crucial. Estate taxes can often extract upwards of 50% of the value of an estate, leaving heirs with only a fraction of what they otherwise would have received had estate taxes not been imposed. This factor alone often provides sufficient cause for purchasing life insurance.

Life insurance can be purchased in an amount sufficient to pay the estate taxes likely to be due, thereby keeping the original assets of the estate available to pass on to heirs instead of having them pass to Uncle Sam. The use of life insurance to pay estate taxes is most imperative when a large portion of an estate's assets are illiquid. Should a large portion of the estate's assets consist of family business interests or real estate, and should the estate be subject to federal estate taxes, such assets might have to be sold off, thereby being lost to the family unit, in order to raise funds to pay estate taxes. If such assets needed to be sold in the time period necessary in order for estate taxes to be paid when due, such assets might have to be sold at lower prices than if they had been held until market conditions were optimal, thereby further reducing what the estate beneficiaries would ultimately receive.

Situations where estates have been shrunk by taxes to as little as 35% of their original value due to the failure to fund estate taxes with life insurance have occurred where the majority of the estate's assets consisted of pension, profit-sharing, 401(k) and IRA balances. In situations where monies contained in pension plans, profit sharing plans, 401(k)'s and IRA's have to be drawn down in order to pay estate taxes, substantial income taxes are also incurred, thereby further shrinking the estate to the detriment of the estate's beneficiaries.

An alternative manner of funding estate taxes, without having to immediately sell off assets or buy life insurance, involves the borrowing of monies by the estate. Such borrowed funds, however, are often extremely difficult or impossible for an estate to secure, and in any case would have to ultimately be paid back in full with interest. On the other hand, the type of insurance available for the payment of estate taxes can often be purchased, depending on the ages of the insured(s) and the type of insurance contract involved, for a total of $.10 to $.50 on the dollar.

Although life insurance proceeds are usually paid free of any income taxes, life insurance proceeds may themselves be subject to estate taxes. In order for life insurance proceeds not to be subject to estate taxes, it is essential that a person or entity other than the insured own the insurance policy. A properly drafted irrevocable life insurance trust, which provides a structure under which insurance proceeds can be used and/or distributed, shields the life insurance proceeds from being included in the estate of the deceased. Such a trust is generally the best entity for holding insurance policies intended to be used to fund potential estate taxes.

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