



# Articles

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## **Living with the Cost of Dying**

*by Peter Katt, CFP, LIC*

The political forces that prompted Congress to temporarily reduce the costs of dying seem to be reversing. Consensus may be building on increasing the estate- and gift-tax exemption protecting asset values in the neighborhood of \$3.5 million per spouse with an estate rate around 50 percent. Regardless of what final action is taken, there now seems to be little hope that the transfer tax will be eliminated. It is a good time for a brief primer on life insurance and estate planning.

While many seem to connect the amount of life insurance with the estate value to provide liquidity, it really is a more subtle process. I believe there are three major reasons to consider life insurance associated with estate planning.

### **Life Insurance and Estate Planning**

**Liquidity.** Estates with difficult-to-market assets valued at greater than the exemption equivalents should consider life insurance for liquidity so assets won't have to be sold during a short period of time. Usually level death-benefit life insurance is used, with additional policies purchased if the estate value grows. For couples, survivorship life insurance is probably ideal. Of course, the life insurance should be owned by and payable to an entity outside the estate.

**Wealth transfer.** Clients whose assets are primarily marketable securities don't have a liquidity problem. They should consider modifying the future increase in estate value by making systematic gifts using annual exclusions and credits, if necessary. These cash gifts need to be invested, and life insurance is a uniquely qualified asset because the proceeds are income-tax-free. An ideal wealth-transfer life insurance program is participating whole life with dividends buying paid-up additions. The yields will tend to mimic fixed-income yields, but as noted, free of income taxes. Couples should use survivorship policies, and the policies should be owned by and payable to an entity outside the estate.

**Inheritance equalization.** Some clients' primary estate planning issue is equalizing inheritances between heirs. There are two major causes of this. One is when there are older children from a first marriage, and a considerably younger second wife with young children. It might be wise to use life insurance on the

husband's life to provide an immediate inheritance for the older children upon his death, with full and equal distribution of the estate when the second wife dies.

The other primary reason to use inheritance equalization is a family business with some children not participating in it. It is generally a good idea to leave the business to children involved with it and other assets to non-involved children. In this regard, a worthy plan is to insure the first-generation business owner, with the proceeds payable to the children not in the business to equalize their inheritance without encumbering the business. This type of planning requires some creative policy ownership and beneficiary techniques. Inheritance-equalization life insurance should be coordinated with estate liquidity needs that are sure to be present due to the desire to retain the family business.

### Gifts

Life insurance premiums for estate planning purposes are primarily transferred to irrevocable life insurance trusts via gifts. Gifting can be placed into three categories.

**Annual exclusion gifts.** Gifts of \$12,000 per spouse can be made annually to children (or anyone else for that matter) without any gift taxes or reductions in the estate and gift tax credits. Therefore, a couple with two children can gift \$48,000 annually, and as grandchildren come along the couple can increase the annual exclusion gifts by \$24,000 a year per grandchild. Annual exclusion gifts are a primary source of life insurance premiums.

**Estate and gift tax credits.** Couples have estate- and gift-tax credits that are the equivalent of \$4 million (\$2 million individually) in 2008, and higher and then lower in subsequent years under the current law that is sure to change. Cumulative gifts can be made without any gift taxes being due until they exceed the exemption equivalent amount. Large estates should be using their credits as soon as possible because unlike annual exclusion gifts that remove the actual amount of the gift and any future growth, gifts using the credits are brought back into the estate upon the second death, at the gifted value. It is the future growth of such gifts that is removed from the estate. For example, if a couple gifts \$4 million, and the value is \$10.6 million at the second death, they have effectively removed \$6.6 million of future value from their estate, reducing estate taxes by about \$3.3 million. Credits should also be used to fund estate planning life insurance.

**Making gifts and paying gift taxes.** Gifts that exceed the annual exclusion amount on an annual basis, and exceed the estate and gift tax credits on a cumulative basis, are subject to current gift taxes. Making gifts and paying current gift taxes, compared with retaining the same amount within the estate and paying an estate tax at death, is very advantageous—yet it seems to be avoided by most tax professionals because they either don't understand it, or don't care to take the time to explain it. The reason paying current gift taxes works is because the amount of the gift tax isn't included in the value of the gift, whereas the amount of subsequent estate tax is.

An example will explain. A \$1 million taxable gift will incur taxes of \$435,000 (2011) for a total cost of \$1,435,000. Let's say this gifted cash earns the same outside the estate as inside (6 percent). The net \$1 million gift has an after-transfer-tax value in ten years of \$1,790,848. If no gift has been made, the estate retains \$1,435,000 and has an estate value in ten years of \$2,569,866. This is subject to estate taxes of \$1,258,426, leaving heirs with a net of \$1,311,440. The gifted \$1,790,848 is 37 percent more than if the gift had not been made. Except for a disconnection between a unified estate and gift taxing system, gifts provide excellent estate planning.

A failure to appreciate the benefits of gifting for large life insurance premiums causes some life insurance sellers to recommend ill-conceived split-dollar and

premium financing schemes that are always difficult to manage years later.

### **Conclusion**

Adding up estate assets and recommending life insurance in half this amount doesn't get the job done. Estate planning life insurance should make the not-so-subtle distinctions of what types of assets are involved and what people planning issues can be handled. A good test of whether life insurance is a good fit is if the available cash flow can easily handle the premium payments with a well thought out gifting program.

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