

# *The Estate Planning Advisor*

## **Integrating Life Insurance With Your Estate Plan**

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Life insurance is typically purchased for two primary purposes: providing vital income replacement upon the death of a main “breadwinner, and covering some or all of the cost of estate taxes for larger estates.

Unfortunately, many people are not aware that if life insurance is not properly owned, the insurance may provide far less of a benefit to the family than anticipated, as estate taxes may consume a significant portion of the death benefit. Why is this so? Most people purchase life insurance in the following manner: the insured is also the owner of the policy, with the spouse as the primary beneficiary and the children as contingent beneficiaries. Under this arrangement, upon the insured’s death, the *entire amount of the death proceeds* are included as part of the insured’s taxable estate.

Consider the following example: a forty year old New York resident has a \$1.5 million term life insurance policy of which he is the owner and insured, and other assets totaling \$1 million. Because he is the owner of the policy, upon his death he will have a total taxable estate of \$2.5 million. With the current \$2 million federal estate tax exemption and \$1 million New York estate tax exemption, up to \$500,000 of the man’s estate is subject to federal estate tax, and \$1.5 million is subject to New York estate taxes. Under current law, combined federal and New York estate taxes could be as much as **\$301,340**.

Is this situation avoidable? Absolutely! If in our example the life insurance had been owned in a properly structured and administered **Irrevocable Life Insurance Trust** (commonly referred to as an “ILIT”), *none* of the death benefit would have been included as part of the man’s taxable estate. The *entire* \$2.5 million would pass to his family free of federal or New York state estate taxes.

The ILIT would provide other benefits. The insurance proceeds can be held in one or more creditor-protected trusts for the benefit of a spouse, children and other generations. ILIT’s can also be used effectively to create “Dynasty Trusts” that can hold assets in trust for multiple generations free of both estate and generation-skipping taxes.

ILIT’s can be set up for individuals or couples. For married couples with large estates, it is common to purchase a “second-to-die” life insurance policy that pays out the insurance benefits only upon the death of both the husband and wife. These policies are typically used to provide liquidity to cover estate taxes that may be incurred upon the death of the second spouse. Because the insurance covers two lives, it is usually substantially cheaper than a single life policy, and may often be acquired even if one of the spouses has health issues.

One caveat: if existing policies are transferred to an ILIT, the insured must live at least three years from the date of transfer to have the death proceeds excluded from his or her taxable estate. If possible, it is best to replace existing policies with new policies that are owned from the outset by the ILIT trustee; under this arrangement, the death proceeds will be fully excludable from the insured's estate from day one.

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