

The Estate Planning Advisor

Life Insurance – Is it Really Tax Free?

By: Richard J. Shapiro, J.D.

Life insurance can be a critical part of an estate plan. It can provide vital income replacement upon the death of a main “breadwinner,” and life insurance can also cover the cost of estate taxes for larger estates.

Unfortunately, many people are unaware that under present law, life insurance that is not properly owned and administered may provide far less to the family than anticipated, with a significant portion of the death benefit potentially lost to estate taxes. 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 resident has a \$1 million term life insurance policy under which he is the owner and insured, and other assets of \$1 million. Because he is the owner of the policy, upon his death he will have a total taxable estate of \$2 million. With the current \$1.5 million federal estate tax exemption and \$1 million New York estate tax exemption, up to \$500,000 of the man’s estate may be subject to federal estate tax and \$1 million subject to New York estate taxes. Under current law, estate taxes could be as much as *\$225,000*.

Is this situation avoidable? You bet. 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 his taxable estate. The *entire* \$2 million would pass to his family free of federal or New York state estate taxes.

The ILIT would provide other benefits. The death benefit 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” which 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. With married couples, it is customary to use what is know as “second-to-die” policies, which pay out the benefits only upon the death of both the husband and wife. These policies are typically used to provide liquidity to cover any estate taxes the couple may incur upon the death of the second spouse. Because the insurance covers two lives, it is usually substantially cheaper than a single life policy.

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 which 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.

Richard J. Shapiro is a partner with the Middletown law firm of Blustein, Shapiro & Rich, LLP. Mr. Shapiro is a member of the National Network of Estate Planning Attorneys, the National Academy of Elder Law Attorneys, the New York State Bar Association (Trusts and Estates and Elder Law Sections), and the Hudson Valley Estate Planning Council. He can be reached at (845) 692-0011 or at rshapiro@mid-hudsonlaw.com. The information in this article is for general information purposes only and is not, nor is it intended to be, legal advice.