GUIDE TO SAVING ESTATE TAXES WITH LIFE INSURANCE AND TRUSTS

ZIMMER LAW FIRM
Estate Planning & Elder Law
DELIVERING PEACE OF MIND SINCE 1993

Guide to Saving Estate Taxes With Life Insurance and Trusts

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2015 Note to the reader: The estate tax figures referenced in the following materials are based upon the American Tax Relief Act of 2012. (ATRA). That law set the federal estate tax deduction "permanently" at $5.0 million per person, indexed for inflation. With inflation the exemption is $5.43 million per person for deaths occurring in 2015. This Act is the latest legislation affecting the federal estate tax law, beginning with the Economic Growth Tax Relief Reconciliation Act of 2011 (EGTRRA). EGTRAA established a schedule for increasing estate tax exemption amounts under the federal Estate Tax through 2009, a temporary repeal of the estate tax for deaths occurring in 2010, and then a sunset provision effective 1/1/2011, after which the estate tax law in effect as of June 7, 2001, would be applicable again. That meant that unless Congress enacted new legislation, after 2011 the federal estate tax exemption was to be $1.0 million per person with no indexing for inflation.

The next legislative action occurred when Congress enacted a bill very late in December of 2010 to extend the $5.0 million per person exemption from federal estate tax for deaths occurring in years 2011 and 2012. Effective January 1, 2013, unless Congress acted again, the federal estate tax law in effect in 2001 would apply for deaths occurring on and after January 1, 2013, thus making federal estate tax planning applicable to many more Americans because of the lower, $1.0 million per person exemption.

The estate tax became caught up in the budget and federal deficit debates of 2012, as well as the issues concerning the repeal of the Bush era tax cuts and mandatory federal spending reductions to take effect automatically on January 1, 2013, unless Congress acted. As of midnight on December 31, 2012, there was no legislation. On January 1, 2013, Congress enacted ATRA 2012. However, that law basically extended the Bush era tax cuts with some modifications and set the federal estate tax exemption amount (AEA) at $5.0 million, indexed for inflation. It also made "portability" permanent, which means that under certain conditions if the first spouse does not fully utilize his or her AEA, then the surviving spouse may apply the unused portion of the deceased spouse's AEA. There is not currently any legislation pending in Congress that would affect the AEA, but the Obama Administration's budget proposals in the so-called Green Book in 2015 called for a reduction in the AEA and other changes to the federal estate tax that would make more estates taxable if enacted.

Where this report mentions the federal estate tax exemption or AEA, the sum of $5.00 million indexed for inflation, which is $5.43 million in 2015, is meant to apply.

Life insurance is one of the last great tax savings opportunities available today – even after

EGTRRA 2001 and the changes it brought about for estate tax planning. It is also an often overlooked or misunderstood aspect of estate planning.

This *Guide* is intended to survey the reasons why life insurance can be an essential part of estate planning for married couples or individuals, to save estate taxes. This information is valuable not only for those who are presently affluent, whose need is clear. It's also meant for any person with life insurance at this time or who is planning to buy insurance in the future, and for anyone or who is likely to experience estate growth in the future that will take the estate to a taxable level.

TAX SURPRISE

More people than ever before must wrestle with the estate tax. That's in part thanks to inflation, the rapid growth of the stock market in the last few years, real estate appreciation, and the power of income tax deferred growth of IRA's and employer sponsored retirement plans. That's the good news.

The bad news is that the more widespread affluence of Americans means that more people than ever will be affected by the federal estate tax. That tax is the highest tax in the land. Think of it as an inheritance involuntarily left to Uncle Sam, instead of the loved ones you intend to inherit.

The federal estate tax is assessed at death, upon assets that you wish to gift to others. Congress has bestowed two primary ways to save on estate taxes, that anyone can use. First is the Unlimited Marital Deduction, which us to leave an unlimited sum to his or her spouse at death, estate-tax free. That's a great tool, but it has two significant shortcomings.

First, the Unlimited Marital Deduction does not *save* estate tax; it merely defers until the death of the last spouse, the time for the payment of the estate tax. So, it's not a tax saver because the tax still applies. The Marital Deduction may even yield a bigger estate tax than if the tax had been paid when the first spouse passes on. This is due to the fact that if the estate grows after the first spouse dies, then there's more to pass through the estate tax later, and the applicable tax rate will likely be higher. However, this risk is diminished under the portability rules extended and made "permanent" by ATRA 2012. Under portability, it is possible to double the AEA even if the first spouse's AEA is not fully applied, by allowing the estate of the second spouse to die to use the deceased spouses' unused exemption amount (the "DSUEA").

A second shortcoming of the Marital Deduction is that it's only available if the surviving spouse is a citizen of the United States.

When each spouse uses the Applicable Exemption Amount (AEA) *and* the Unlimited Marital Deduction, or when portability applies, then a married couple can protect $10.25 million in 2013 (and perhaps more) from the federal estate tax in the long run. But to fully apply the tax exemption open to each spouse -- and to assure the economic security of the surviving spouse by protecting the entire estate for his or her use -- requires the use of what's known as a "bypass trust."

The bypass trust can be used in a will or in a Living Trust. Americans increasingly favor the Living Trust over the will because it has probate avoiding features as well as estate tax saving benefits. (For more on the benefits of avoiding probate, contact THE ZIMMER LAW FIRM for the report, *"Where There's A Will, There's Probate."*)

However, as powerful as trusts can be for tax savings and other purposes, affluent Americans -- or those who build their estates through life insurance -- must face the fact that they have needs for tax planning that outpace what the AEA and the Marital Deduction can provide. That may come as a surprise to some, especially the unsuspecting family who may sacrifice part of an inheritance to pay the tax.

There's another tax surprise for the unsuspecting. The use of life insurance for building an estate and protecting the financial security of a stay-at-home spouse and dependent or college-age children is a well-established planning technique. But most people are shocked to learn that the death proceeds of their life insurance are subject to federal estate taxation. Rather they believe that life insurance escapes tax and passes to their loved ones intact.

This confusion probably began when people were told that life insurance is income tax-free. For married couples, the confusion is compounded by the belief that the Unlimited Marital Deduction somehow magically insulates one's life insurance proceeds upon death from ever being taxed, because the insurance pays to the surviving spouse. Regardless of the source of this confusion, a great many people will have far less life insurance proceeds than they expect because life insurance owned or controlled by the insured will be included in the taxable estate of the insured at death, or at the death of the surviving spouse. That means it will be subject to estate tax just like other assets, *even though it pays to someone else at the death of the insured, and even though it is not taxable income to the recipient*.

The failure to plan for the fact that life insurance is a taxable asset can lead to substantial estate tax liability. For individuals who have taxable estates (as of this writing, meaning at the time of death, over $5.25 million for single persons and $10.25 million for married persons who have implemented proper federal estate tax planning using a trust), federal estate taxes may consume 40% of the taxable estate, which also consumes life insurance proceeds. As a result, they are paying far more for their coverage than they should be paying, because their families will actually realize less than 100% of the insurance proceeds.

For those couples whose estates are not presently at these levels of value, life insurance may still cause an estate tax in the future. An estate that is not yet large enough to be taxable may grow over time and become large enough to incur a tax. If a growing estate includes personally owned life insurance, then the life insurance adds to the tax problem because it will be a taxable asset.

NEW LIFE COVERAGE CAN CAUSE TAX

Estate tax can become a significant planning issue when buying new or additional life insurance.

The conventional reasons for buying life insurance include providing security for dependents; planning for retirement; tax-deferred investment (because the growth of cash value in the policy is tax-deferred); or to build an estate for one's family, especially in the early years of a marriage when children are young and assets are not sizeable. However, the personal ownership of the life insurance will just add to the taxable assets upon the death of the owner or spouse. That could cause an estate to become taxable, and as described above the result is loss of the full value of the life insurance purchased.

For this reason and the other points discussed in this *Guide*, estate planning and life insurance are integrally related matters.

TAMING THE ESTATE TAX

One of the substantial benefits of a properly drafted Living Trust is the ability to shelter up to $10.25 million or more from federal estate tax. (Unmarried persons have a $5.25 million protection, but a trust is not needed to take advantage of the exemption.) But those who are affluent enough that their estate exceeds those sums at this time -- or will grow to exceed those sums, respectively, in the future -- need more estate planning than a Living Trust can provide on its own.

Life insurance offers a unique and cost effective means of advanced estate planning for those couples or individuals who have taxable estates, even though they've made a Living Trust. Life insurance can be purchased for the specific purpose of providing cash to pay the estate tax. That makes it relatively cost effective compared to the alternative of paying the estate tax dollar-for-dollar with your own money -- money that is earmarked for your family.

Life insurance is unique for estate planning use.

It's the only way to pay the tax at a discount. Since the cost of the life insurance is usually substantially less than the cost of the tax, you can save money for your family in the long run with life insurance and a Life Insurance Trust. For example, if an estate tax bill would eventually be $200,000, and you purchase $200,000 of life coverage to pay the tax, in proper circumstances the cost of the insurance will be much less than the tax. that's paying the tax with discounted dollars.

Using life insurance is also like "leveraging" your wealth. Many people are familiar with the concept of leveraging from the purchase of a home with a mortgage loan. When you make a mortgage loan, you leverage your money and earning ability by "buying" money from the bank. The "cost" of buying the bank's money is the interest charged for the loan. By making the loan, you can afford the home sooner than if you had to save the money yourself. Similarly, a business leverages its resources by borrowing money to buy equipment, which then produces income to repay the loan and grow the business.

The concept is basic, but the implementation takes careful planning. If you just purchase new life coverage, or rely on your existing coverage to pay the estate tax, then you'll still have the dilemma of estate tax on the life insurance proceeds. In essence, your family will lose some of the coverage you're paying for because the death benefits will be taxable in your estate at your death or the death of your spouse. The use of life insurance to pay the estate tax "leverages" your estate against the full brunt of the tax, and conserves more of your wealth to be passed on.

THE LIFE INSURANCE TRUST SOLUTION

Fortunately, there's an effective tool available to handle these hidden issues of estate planning. Through the use of a special trust known as a Life Insurance Trust, a skillful planner can eliminate the pitfalls of owning insurance personally. The Life Insurance Trust can prevent newly purchased or existing insurance from creating an estate tax liability, and can plan for the growth of an estate over time. It can save or eliminate tax, or provide the use of someone else's money to pay the tax. It has been tested extensively in court and is well established as an estate planning tool.

The Life Insurance Trust allows the taxpayer to control how the life insurance proceeds will be used to provide for his or her loved ones. The taxpayer can take full advantage of all of the available $14,000 annual gift tax exclusions to potential beneficiaries (2013 rate; indexed for inflation). The trust may allow death proceeds of the policy to pass to the taxpayer's loved ones free of estate taxes.

A Life Insurance Trust is controlled by trust law and by the Internal Revenue Code and various regulations, rulings and court cases. Because of its technical nature, the trust is often difficult to explain. These technical requirements are not always logical; and may even seem inconsistent. Nevertheless, if the requirements are followed, there can be sizeable estate tax savings with this planning tool.

"ESTATE TAX INSURANCE"

Despite the distinct advantages of life insurance to estate planning, many people still believe that life insurance is only needed for the traditional purposes outlined above. So they allow their policies to lapse as they age because the reasons for the coverage in the first place disappear. That thinking overlooks the important role that life insurance can play in providing cash to pay estate taxes, in a tax free manner, as will be explained shortly.

There's even a special type of life policy available for married couples, designed just for the purpose of paying estate taxes. It's called the **Joint Life** or **Survivor Policy.** It insures the lives of both spouses, but only pays at the death of the second spouse. That's ideal for estate planning because that's when the estate tax is assessed. The tax is payable within nine months. By insuring both lives and spreading the risk, the Survivor Policy may be more reasonable (less costly) to buy and easier to obtain than traditional type coverage, thereby making this life insurance even more sensible for estate planning.

THE ADVANTAGE UPON DEATH

The proper use of a Life Insurance Trust means that the proceeds of the life policy will not be taxed at the death of the policy owner (or the surviving spouse, if applicable). That's because ownership of the policy is in the Life Insurance Trust, and not in the taxable estate of the insured. The trustee receives the death benefit which the trustee can then use to provide cash to pay the death tax. The unused portion will pay to your loved ones. One hundred percent of the policy proceeds will be available to your family or to pay the death tax, and the tax will be lower or non-existent because the size of the estate is reduced by owning the life insurance through the trust rather than personally. It's a double benefit!

Some people try to accomplish results similar to the Life Insurance Trust by having their children own the policy. Many problems can arise under such an arrangement. A child can die; the policy can be attached and liquidated by a child's creditors; the policy could be considered as the child's property in the event of a divorce; or the child could cash in the policy or allow it to lapse. No provisions are made for youthful grandchildren or grandchildren that are legally enforceable or have tax planning also. (Would you want a child to receive a large inheritance at a young age, with no strings attached?) These and other issues can be avoided in a properly drafted Life Insurance Trust.

TO BUY OR NOT TO BUT NEW LIFE COVERAGE

For these reasons, when you buy new coverage or supplement your old policies, the policy application must be signed by the Trustee of the Life Insurance Trust, and not by the insured as the policy applicant/owner. That's essential to enjoy full benefit of the Life Insurance Trust. Although the legal reasons why are very technical, it can be summed up as follows: If you own a policy or have rights to control its benefit, then the death proceeds will be taxable in your estate. If the Trustee owns the policy, it's not taxed in your estate. Thus, for new policies it's best that the Trustee be the one to sign the application as the policy owner/applicant -- not you as the insured.

Using new coverage instead of existing coverage can have an advantage for tax planning, when compared to using old coverage in a Life Insurance Trust. New coverage acquired by the Trustee (instead of the insured) falls outside the three-year "look-back" rule. The three-year rule would cause existing coverage to be taxed at the death of an insured who owned or controlled a pre-existing policy transferred to a Life Insurance Trust, and then died within three years of the transfer. Even though existing policies can clearly be used with a Life Insurance Trust and create significant tax savings, the tax benefits are delayed for three years. That is, the insured who transfers the policy to the Life Insurance Trust must survive the transfer by that period for the tax benefits to apply.

Another reason to use new coverage instead of old relates to policy loans. The transfer of an existing policy can trigger a taxable event should policy loans exceed your cost basis in the policy. New policies don't have this aspect.

Don't be discouraged by the three-year rule if you already have coverage. This is still an effective strategy. Evaluation of your insurance by an insurance professional may uncover ways to tap your existing coverage and also avoid the three-year rule altogether.

ARE YOU INSURABLE?

If you're planning to use a Life Insurance Trust with new life insurance, you may wish to submit a trial application to an insurance company to ascertain that you are insurable at acceptable rates before paying good money to have a Life Insurance Trust drafted by an attorney. A qualified insurance professional will assist you in handling the insurance application correctly to avoid unneeded estate taxation. Of course, that step is not needed if you're using the life coverage you already own for the ILIT.

CONCLUSION

The combination of life insurance and trusts can be a powerful tool for saving estate tax. It involves a different way of thinking about life insurance -- and handling it -- than most people are aware. Overlooking this strategy can be costly. It's well worth the time to have a projection run to determine how big your estate may be in the future, so you can determine how much the estate tax may be. It may be the best thing you can do -- beyond the Living Trust.

This explanation is intended to provide the background and general information needed to understand the purpose and the functioning of the Life Insurance Trust. The foregoing discussion is a summary only, and is not intended to be a full recitation of pertinent legal principals and case law, the tax laws pertaining to life insurance trusts, or the process of setting up and funding a Life Insurance Trust. That is a job for your attorney and your insurance professional to handle. The Life Insurance Trust should be undertaken only with skilled and experienced legal counsel and an insurance professional to assist.

THE ZIMMER LAW FIRM provides complete Life Insurance Trust services. Expedited service is available. The firm will be pleased to work with your insurance professional in designing and implementing your life insurance trust. If you do not presently work with an insurance agent, we can introduce you to an experienced professional who can provide immediate assistance.

Attorney Barry Zimmer is a frequent speaker on living trusts and estate planning, and an authorized Continuing Legal Education instructor for financial professionals in Ohio, Kentucky and Indiana. He conducts seminars throughout southwestern Ohio on estate planning topics. He is a Fellow and a Charter Member of the American Academy of Estate Planning Attorneys, and has devoted his law practice exclusively to estate planning, trusts, estate administration and business planning since 1993. His firm has prepared more than 4000 trust-based estate plans since then and has assisted hundreds with estate administration. He graduated from the University of Cincinnati College of Law in 1979 and received his BA from U.C. in 1976, Phi Beta Kappa and Magna Cum Laude.

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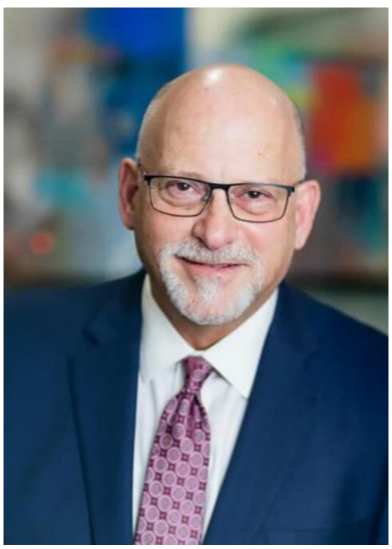
ABOUT THE ZIMMER LAW FIRM

Zimmer Law Firm, LLC is a charter member of the American Academy of Estate Planning Attorneys. It is the only member firm in Southwestern Ohio. The Firm has been providing quality estate planning services since it was founded in 1993. The fastest growing demand for its services has been asset protection from the cost of long term nursing care. Whether you need an Elder Law attorney, an attorney for general estate planning with trusts or wills, or an attorney to help settle an estate, our team of qualified staff are here to help you and your loved ones.

In these turbulent times, access to an experienced lawyer to protect your estate and accomplish your goals is more important than ever. If you or your family would like a complimentary consultation to discuss your estate plan or how to protect your estate from depletion to pay for long term nursing care, call us today at **513-721-1513** or visit our website at **www.zimmerlawfirm.com**. Check our website for upcoming seminars, or learn more about the firm at www.avvo.com where you will also find testimonials from our clients. See why *Cincinnati Magazine* recognizes us as a Five Star Wealth Manager. If you would like to receive email announcements for upcoming seminars, call to be added to our seminar mailing list.

A MESSAGE FROM THE FIRM FOUNDER



The goals of Zimmer Law Firm are to make asset protection and estate planning pleasant, easy, and understandable processes for clients. We believe that planning is much more than just creating legal documents. Rather it is about establishing relationships with clients and their family by providing a continuum of services through the passages of their lives. What we do makes an important difference and we take great professional pride and satisfaction in that.

If you or your loved ones would like a complimentary consultation to review your estate plan or to implement a plan, visit our website at www.zimmerlawfirm.com or call us today at 513-721-1513 (Toll-Free 1-866-799-4050) to schedule an appointment. See for yourself why *Cincinnati Magazine* has recognized the Firm as a Five Star Wealth Manager. For the latest news about estate planning or upcoming law firm events, subscribe to our blog and "like" us on Facebook. Check our website for upcoming educational events. We continue to expand our capabilities and services to meet the demands of a complex and changing estate planning world. Our experience has shown us what was a solution yesterday may no longer be adequate to fully protect our clients today.

This report reflects the opinion of the Zimmer Law Firm. It is based on our understanding of state and federal laws and is intended only as a simple overview of the planning issues. We recommend you do not base your own planning on the contents of this report alone. Review your estate planning goals with a qualified estate planning attorney.

ABOUT THE ACADEMY

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services. The Academy expects members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects.. The Academy has also been recognized as a consumer legal source by *Money Magazine and Consumer Reports Money Adviser,* and its Education Department has been quoted by other consumer press.

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