“First to Die” Estate Planning

Paying your Taxes & Providing for your Spouse

In 2001, Congress changed the law on estate taxes, creating federal estate tax exemptions that changed over the years. For instance, in 2009, the exemption from federal estate tax was set at $3.5 million ($7 million for married couples). If your estate exceeds that number, your excess will be taxed at a minimum of 45 percent; estate taxes are due 9 months after death.

The concept of purchasing life insurance in an Irrevocable Life Insurance Trust (ILIT) has become an effective technique to offset the burden of estate taxes. The ILIT is both the owner and the beneficiary of the life insurance policy. The face amount of the policy is typically equal or greater than the projected amount of estate tax that will be due. Because the ILIT is a separate entity, the proceeds of the life insurance are not included in the Grantor’s estate and thus, not subject to estate tax. The beneficiaries of the ILIT can use the proceeds of the policy to pay any estate taxes due; they won't be forced to sell real estate quickly (in a bad housing market) or liquidate assets (such as a family business) to pay the federal estate tax bill. Furthermore, the premiums paid are less than the estate taxes will cost.

A popular planning method has been to purchase second-to-die life insurance to pay estate taxes and other estate settlement costs owed after <u>both</u> spouses pass away. A second-to-die life insurance policy, or survivorship life as it's sometimes called, insures two lives (usually a husband and wife). Unlike traditional life insurance, the death benefit isn't paid out until the second insured person dies. This product was developed in the early 1980s in response to a law that enables married couples to postpone federal estate taxes until both spouses pass away.

While life insurance may be the most common technique to combat estate taxes, second-to-die life insurance is not necessarily the best type of insurance for your planning. Life insurance proceeds allow one’s beneficiaries the convenience of liquid assets quickly and income-tax free. However, as mentioned earlier, the proceeds of a second-to-die policy are not distributed until both spouses have passed away. What about the financial concerns of the surviving spouse?

It is not uncommon for a couple’s wealth to be comprised of “non-liquid” assets; those that are not easily converted into cash (business interests, real estate, etc.). In such cases, upon the first spouse’s death, the surviving spouse (who is not the primary earner) becomes financially uncomfortable. The same situation arises that was mentioned earlier: the surviving beneficiary is forced to sell assets at inopportune times in order to become financially secure. The concern is not paying estate taxes, but continuing to live in an accustomed manner.

For married couples, one of the primary beneficiaries of their estate plan is almost always the surviving spouse. If the purpose for buying life insurance is to alleviate the undue financial stress of your beneficiaries, wouldn’t the same hold true for your spouse as well? Instead of purchasing a second-to-die life insurance policy, it may be more appropriate to purchase life insurance on one life: the primary earning spouse.

Consider the following example in 2009:

Husband & Wife estate: $10 million
Estate tax: approximately $1.5 million
Irrevocable Life Insurance Trust: $2 million
Husband's assets: $6 million
$5 million → business holdings/real estate
$1 million → IRA
Wife's assets: $4 million
$3.5 million → real estate
$500,000 → Cash/securities

If you assume that the husband dies first, the surviving wife will have a financial dilemma: not enough cash flow. If the Irrevocable Life Insurance Trust is funded with a second-to-die policy, she cannot reap the benefit of the life insurance proceeds. Assuming she is the primary beneficiary of her husband's IRA, she will have access to that asset, but there are income tax consequences (reducing the <u>net</u> amount of the asset) and the possibility of out-living the asset based on her life expectancy. The estate tax will be paid (after her death) out of the share of the secondary beneficiaries of their estate plan, but the wife will have to sell assets to support herself during her lifetime. Ultimately, she may have to sell real estate or business assets at a discount.

In this scenario, the husband is the spouse that supports the family financially. Therefore, the ILIT should be funded with life insurance on <u>his</u> life to supplement the lost income. The primary beneficiary of the ILIT should be the spouse and the secondary beneficiaries can vary based on the couple's situation. Assuming the same facts as before, with the only difference being the type of insurance used to fund the ILIT, the situation changes for the better. In this situation, if the wife needs to supplement her income, she will have funds available from the ILIT. Not only will she have the luxury of waiting for the market to improve before selling non-liquid assets, but she will also be able to get a return on the proceeds held inside the ILIT. For example, if she survives her husband by five years and the ILIT returns only 2% annually, she will still have earned more than an additional $200,000.

One hurdle with this type of planning is that the client may be apprehensive to pay higher premiums on the single life policy as compared to the second-to-die policy. However, the question must be raised to the non-earning spouse: is the lower premium today worth the risk of outliving your income tomorrow?

Marc D. Melamed is an attorney at Strobl & Sharp, P.C. in Bloomfield Hills, Michigan. Marc concentrates his practice in the areas of estate planning, business planning, estate administration, and charitable giving. He received his B.A. from the University of Michigan and his J.D. from the University of Detroit Mercy School of Law.

Prior to practicing law, Marc was a Financial Advisor and a Director of Development for two universities. He is a member of the State Bar of Michigan Standing Committee on Publications and Website Advisory, the Program Committee of the Planned Giving Roundtable of Southeast Michigan, and the University of Detroit Mercy School of Law Alumni Board of Directors. He is also a frequent speaker on estate planning and charitable giving.