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Life Insurance and Estate Planning for Retirement Plans

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What is using life insurance and estate planning for retirement plans?

The assets in your qualified and nonqualified retirement plans will be included in your gross estate when you die. For those who have accumulated substantial assets in their retirement plans, the inclusion of these assets in their estates may cause a tax problem. So, you may have to pay a tax for which you had not planned.

Many estate planners recommend that people use life insurance as a means to provide liquidity to their heirs for the payment of any future federal gift and estate tax resulting from the inclusion of retirement plan assets in your estate. In most cases, estate planners recommend that you set up an irrevocable life insurance trust and name your heirs as the beneficiaries of the trust. You can then either transfer an existing life insurance policy into the trust or make gifts of cash into the trust so that the trustee can buy a new life insurance policy on your life. If you do not retain any incidents of ownership in the policy within three years of your death, the insurance proceeds should not be included in your gross estate. Another possible option if your spouse is still alive is to purchase a second-to-die life insurance policy. Then, when the surviving spouse dies, your heirs can use the insurance proceeds to help pay the applicable tax due at that time. Your heirs will then have the necessary cash to pay for any increase in your tax because of the inclusion of the retirement assets. (One exception to this rule is if you transfer an existing insurance policy to another individual or into a trust, and then you die within three years of the transfer. The insurance proceeds will then be included in your gross estate, but the proceeds will still be available to pay any associated taxes.)

When should you use life insurance as an estate planning tool for your retirement plans?

Inclusion of retirement plan assets may increase federal gift and estate tax

You can use life insurance as an estate planning tool for your retirement plan when the inclusion of the retirement plan assets in your gross estate will increase your tax liability. It is important to note that the assets in both qualified and nonqualified retirement plans will, in almost all cases, be included in your gross estate when you die. If you have substantial assets in your retirement plan, then the inclusion of the assets may dramatically increase the tax liability for your heirs. One way to offset the tax liability is to provide additional liquidity to your heirs to pay the tax through the use of life insurance.

Use life insurance even if all assets left to spouse

You may want to consider using life insurance to provide liquidity to your heirs (to pay the federal gift and estate tax on your retirement plan assets) even if you plan to leave all your assets to your spouse. Although transfers to a spouse qualify for the unlimited marital deduction (meaning an unlimited amount of assets can be left to your spouse without paying any tax), when your spouse dies, then the assets will be subject to tax. Your heirs (usually your children) will then be responsible for paying the applicable tax. To provide liquidity to their heirs at this point, many people will purchase a second-to-die life insurance policy (so that when the surviving spouse dies, the insurance policy will pay off at that point). It is important that the ownership of this policy be set up properly, so that the insurance proceeds are not included in the surviving spouse's estate. Another benefit to using a second-to-die life insurance policy is that the premiums on these policies are usually less than the premiums for an insurance policy on a single life.

Example(s): *You are concerned about the federal gift and estate tax consequences of inclusion of your retirement plan assets in your estate if you should die in the near future. In your estate plan, you leave all of your assets to your surviving spouse. Because of the unlimited marital deduction, there is no federal tax due at your death. Your spouse then executes a will, leaving all of his or her assets to your three children. At your spouse's death, your children will then be responsible for paying any applicable tax. With a second-to-die insurance policy, with the proper ownership, your children will have the liquid assets to pay the tax attributable to the inclusion of the retirement assets in your spouse's estate.*

What are the strengths of using life insurance as an estate planning tool for your retirement plans?

Provides liquidity to heirs for payment of federal gift and estate tax

The main benefit to using life insurance as an estate planning tool for your retirement plans is that it will provide liquidity to your heirs to help pay the taxes(federal and perhaps state) on your estate. As noted above, the assets in your qualified and nonqualified retirement plans when you die will be included in your gross estate. This inclusion may substantially increase your tax liability. A life insurance policy can be an excellent source of liquidity for your heirs to pay the additional tax.

Transfers into irrevocable life insurance trust may qualify for annual gift tax exclusion

If you set up an irrevocable life insurance trust to hold the life insurance policy, then transfers of cash into the trust (to buy the insurance policy or to pay premiums) may qualify for the annual gift tax exclusion from federal gift and estate tax. As long as the beneficiaries of the irrevocable life insurance trust are given Crummey powers, then gifts into the trust will qualify for the annual exclusion from the tax.

Example(s): *You are concerned about the tax consequences of inclusion of your retirement plan assets in your estate if you should die in the near future. You would like to find a way to provide some liquidity to your heirs. One solution is to set up an irrevocable life insurance trust, name your children as the beneficiaries, and then begin making transfers of cash into the trust so the trustee can purchase a life insurance policy on your life and pay premiums on that policy. As long as the beneficiaries are given Crummey withdrawal rights, transfers into the trust will qualify for the annual gift tax exclusion. (The annual exclusion applies against all gifts to a donee by one donor during the year.)*

Assets in irrevocable trust not included in your gross estate

Another benefit of using life insurance as an estate planning tool is that, if set up properly, the insurance proceeds are not included in your gross estate for federal gift and estate tax purposes. If the insurance policy on your life is held in an irrevocable trust or if your heirs are the owners of the policy, then the policy proceeds will not be included in your estate. Your heirs will then be able to use the full proceeds to pay any applicable tax.

Life insurance proceeds not subject to income taxes

Another benefit to using life insurance as an estate planning tool is that life insurance proceeds are not subject to income tax. Your heirs will be able to use the full proceeds to help pay for any additional taxes due because of the inclusion of your retirement assets.

What are the tradeoffs to using life insurance as an estate planning tool for your retirement plans?

Insurance policy may be costly

Depending on your age and health, purchasing a large insurance policy on your life may be very expensive. Furthermore, when buying a policy to provide liquidity to your heirs, you usually want to purchase a cash value life insurance policy. These policies are much more expensive than a term policy.

Irrevocable life insurance trust may be expensive to set up

Another tradeoff to using life insurance as an estate planning tool is the cost of setting up an irrevocable life insurance trust (assuming you want to provide liquidity for your heirs through a trust). A life insurance trust can be quite expensive to set up and to maintain. You will need to hire an experienced, competent estate planning attorney to draft the trust documents. If you hire a professional trustee (a bank trust department, for example), you may have to pay an annual trustee's fee. You may also have to hire an accountant to file trust tax returns.

Trust should be irrevocable

To avoid having the life insurance proceeds included in your taxable estate, the life insurance trust should be an irrevocable trust. Once the trust is established, you lose the ability to amend or revoke the trust. You generally cannot change the beneficiaries, you cannot change the trustee, and you cannot change the terms of the trust.

What are the tax implications?

Proceeds from life insurance policy may be included in your gross estate

If you maintain any incidents of ownership of the insurance policy at your death, the proceeds from the policy will be included in your gross estate for federal gift and estate tax purposes. If you do not retain any incidents of ownership in the insurance policy, then the proceeds from that policy will not be included in your estate at your death (unless the policy was transferred within three years of your death). This is true whether your heirs are the direct owners of the policy or whether they are the beneficiaries of an irrevocable life insurance trust that is the owner of the policy. Your heirs will then have the full amount of the life insurance policy to provide them with liquidity to pay any increased tax resulting from the inclusion of your retirement plan assets in your estate.

Life insurance proceeds not subject to income tax

Life insurance proceeds are usually not subject to income taxes. Your heirs will then not have to pay any income taxes on the life insurance proceeds.

Gifts to buy life insurance may qualify for annual gift tax exclusion

If you make direct gifts of cash to your heirs to purchase a life insurance policy or if you make transfers into an irrevocable life insurance trust for the same purpose, then these transfers may qualify for the federal annual gift tax exclusion from the federal gift and estate tax. You can make annual gifts up to $14,000 per donee to an unlimited number of individuals without paying any federal tax on those transfers. If your spouse elects to split the gift with you, this amount is increased to $28,000 per donee. Your heirs or your trustee can then use these gifts to purchase a life insurance policy on your life and to pay premiums on the policy.

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