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TWENTY REASONS FOR LIFE INSURANCE FOR THE LARGE AND LIQUID ESTATE

by
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The estate planning function of life insurance is generally viewed too narrowly.

Recognized for its role both in creating an estate to generate cash and continuing income for dependents and also in avoiding a forced sale of illiquid assets to pay estate taxes, it offers still other possibilities for those who are both wealthy and liquid.

The purpose here is to go beyond a discussion of these usual life insurance applications to identify reasons why life insurance has an important place in the estate plans of those who would not be perceived, and who most likely do not perceive themselves, as having a traditional life insurance need.

Overcoming Objections: People who assume they will have plenty of liquid assets with which to pay estate taxes do not naturally consider the advantages of life insurance. Neither do many of their professional advisors. In some cases -- perhaps at the direction of their clients, perhaps because of some bias of their own -- lawyers and accountants even go to great lengths to figure out how the purchase of life insurance can be avoided. The initial objections or questions may be based on the following:

·**"My Children Will Get Their Fair Share; Why Should I Care?":** Even those whose estates will shrink by 50 percent at death may not be easily motivated to do anything about it. Those who see the government as a more worthy recipient of their estate than family, or who believe family have already received enough and Uncle Sam or perhaps charity should get the remainder, may not want to read on.

More often, there is a reluctance to make children rich(er) or better off than they would be if existing gifting practices, if any, go unchanged. This sentiment is based on attitudes ranging from "I made it on my own, why shouldn't they?" to "I don't want to spoil my children (grandchildren)." As understandable as those feelings are, the fundamental question is whether children are so undeserving or family relations are so strained that the government is the preferred heir.

Those who have money have usually worked hard, sometimes against great odds, and have paid substantial income taxes along the way. There is every reason for them to seek to minimize the much larger tax bite at death that, in the absence of thoughtful planning, will consume most of what they have worked a lifetime to create.

·**"It Is Not As If I Want The Government To Take Most Of My Money When I Die, But Estate Planning Is Boring Or I Am Too Busy":** To minimize death taxes and increase the share of net worth that family rather than the government eventually receives, without reducing lifetime income, is not that difficult, but it does require at least some interest, time and attention. It calls for a strategy for investment, tax, and asset disposition planning that lasts beyond life.

Those who have been most successful in business or have invested most wisely must extend their time horizons just a bit so as to examine investment rates of return after death taxes and expenses have taken their toll? If a permanent loss of 50 percent of net worth is unthinkable during life, why tolerate it at death? If the managers of a business were to contemplate a similar loss in its value and recognized it as avoidable, would they stand by and allow it to happen? Would the directors and shareholders let them? The answers should be obvious and compelling. There are, after all, some fairly simple alternatives.

For those who are, indeed, interested in minimizing death taxes but who resist making maximum cash gifts to family, wealth transfers in the form of life insurance premiums, a gift which is only realized at death (and perhaps not even then for proceeds paid into and controlled by the terms of a trust) make perfect sense. This strategy avoids either spoiling children or unnecessarily enriching the government.

·**"I Have Plenty of Liquid Assets; Why Would I Want Life Insurance?":** Just because assets are liquid does not warrant giving 50 percent of them away to the government. Life insurance is, of course, not the only means of transferring these assets to family instead, but it can, at least, work well along with other techniques. This is as true for those with liquid estates as it is for those who, in the absence of life insurance to provide estate tax liquidity, would be forced to sell closely-held businesses, real estate, or other assets intended for the next generation. Here are twenty reasons why this is so.

The 20 Reasons For Life Insurance For The Large And Liquid Estate

(1) Providing a Gift of a Guaranteed Minimum Value: Life insurance is the only means of guaranteeing that a gift or series of gifts will have a certain minimum value at death so long as the gifts in the form of premium dollars are made. Many other gifts could turn worthless, lose substantial value, or amount to far less if death comes sooner rather than later. If one has a death-time gift of a certain value in mind, life insurance is the best means of assuring that it will be made in at least that amount.

(2) Life Insurance Assures the Completion of a Wealth Transfer Plan: One of the reasons that gifts of insurance premiums to an irrevocable trust or to adult children may make more sense than gifts of cash or other assets is because there is no assurance that the donors will survive to complete the transfer, outside of their estates, of the gifts that they intend to make over the remainder of their lives. For example, if husband and wife plan to give their children $1 million by gifting $50,000 each year for the next twenty years, life insurance can accomplish this goal if the couple does not live that long. In this case, insurance is performing its traditional function of guaranteeing a certain death benefit no matter when death occurs, with the benefit equaling the amount the donors would want to transfer by future gifts over an extended period of years if they live long enough.

(3) The Income Tax-Free Death Benefit from Life Insurance Can Outperform the After-Tax Return of Similar Investments: This is clearly the most overlooked advantage of life insurance gifts for the wealthy and liquid.

The big advantage of the life insurance option is the current and probable continued favorable income tax treatment -- (1) investments inside an existing policy appreciate without taxation and (2) the death benefit is also income tax-free.

The advantage of the life insurance investment alternative, however, depends on, or is at least considerably enhanced by, the right kind of life insurance policy. Rates of return on life insurance policies vary considerably - by 2 percent (200 basis points) or more - even when the underlying investments of the policy are identical. That is because differences in the pure insurance costs of an insurance policy (the "mortality and expense" charges) can account for variations of at least 100 basis points. In addition, the savings from a policy with a low commission versus a standard commission premium structure can reduce commissions by 80 percent or more and can also enhance the investment return by 100 basis points.

To put these differences in perspective, imagine an investment in insurance premiums of $25,000 annually for 30 years with one such investment producing an internal rate of return at the insured's death of 6% and the other 8%. These returns are, of course, after-tax rates, since life insurance death benefits are (in almost all cases) not subject to income taxation. The first such investment produces $1,976,454, and the second yields $2,832,080 – a difference of $855,626 or 43%.

Other articles from Life Insurance Advisors, Inc. provide further insight into the ways to assure the best results and the advice required to obtain them. (See, among others, "How to Make Permanent Life Insurance a Good Investment").

(4) Death Taxes Are Usually Underestimated: When calculating life insurance needs to pay death taxes, the typical analysis is limited to the biggest tax, the estate tax. That is horrifying enough to contemplate by itself, but consider also the following:

(a) The Appreciation of Property in Your Estate: The future value of your taxable estate is a moving target. Examine the total value of your estate today and then its probable values at various points in the future out beyond normal life expectancy. Consider the likely rates of appreciation of the different existing assets in your estate, your future rates of additional savings (if any), probable inheritances, and the rates at which your estate will be depleted, if at all, by spending and gifts in excess of future income.

(b) State Inheritance and Estate Taxes: Some states impose death taxes on the estate or its beneficiaries over and above the Federal estate tax. The number of such states is likely to increase because the 2001 estate tax law revisions replaced the credit allowed against Federal estate taxes for state taxes paid with a deduction instead. The effect, in most states, will be an increase in state death taxes of the amount of the state taxes less the state taxes multiplied by the Federal estate tax rate.

(c) Income in Respect of a Decedent: This refers to accrued income of the deceased on which income taxes have not been paid. The biggest and unhappiest surprise for many is the fact that undistributed balances in retirement plans, made up of contributions on which income taxes have never been paid, are subject not only to estate taxes but also to income taxes on the amount which remains after a deduction for estate taxes. Consequently, substantial balances in retirement plans are often eroded by combined taxes of 70% or more.

(5) How Truly Liquid Is Your Estate and Does It Need It To Be?: It is a good bet that if you consider your estate to be liquid, it consists mostly of personal residence real estate (perhaps two homes) and publicly traded stocks and bonds. However, if you do not have actual cash in hand when you die with which to pay estate taxes, recognize that as much as 50 percent of all your property will have to be converted to cash to pay estate taxes within nine months of your (or your spouse's) death.

In the first place, much of what appears to be a liquid estate may not be intended for sale. It may be preferred or expected that real estate passed down through the family (the family homestead or vacation home) or publicly traded stock in a company in which one or more family members have played key roles will not be sold. The liquid estate is now illiquid, and the need for alternative sources of cash is urgent.

Even when it is assumed that estate assets will be sold as needed, the necessity to produce quickly large amounts of cash to pay taxes will put your heirs and executor in a very difficult position. Some of the assets (perhaps the real estate, closely-held securities, and personal effects) may be difficult to sell under any circumstances. Even in the case of the more marketable securities and real estate, should your heirs be forced to accept the market values, no matter how depressed they might be, that happen to prevail in this very limited nine-month time frame?

Your estate will be valued as of the date of death or, at the option of your executor, six months later. Imagine that sometime between the estate valuation date and the sale of securities to generate the cash for the tax payment, there is a stock market crash similar to the downturn of October, 1987. Your executor may have no alternative, without another source of cash, but to sell your assets at firesale prices, thus depriving your heirs of the greater value they could have realized if they had been given the flexibility, in the form of liquidity provided by life insurance proceeds, to wait for a market correction. Worse still, because of the difference in the timing of the estate valuation and tax due dates, your estate could be forced to pay taxes on values that are greater than those actually received.

The logical solution is enough life insurance held outside of the estate with which to purchase estate assets or to loan money to the estate that can then be used to pay taxes. The amount of insurance need not equal the full tax liability but should amount to a high enough percentage of it to give your heirs and executor significant discretion and flexibility in deciding what estate assets to sell and when. Only in this way can the seemingly liquid estate be made truly liquid.

(6) Creating an Automatic Gifting Program: For those who have not yet made gifts to their children, or perhaps only limited ones, gifts of premiums to an irrevocable life insurance trust are a good place to start. For those who have made gifts to children but not to grandchildren, a "generation-skipping" life insurance trust designed to take advantage of the $1 million plus per donor exemption from the punitive generation-skipping tax is also a logical alternative. Those who have made only sporadic gifts but who now see the good reasons to set up a regular gifting program should like the fact that the need to pay annual premiums is an effective way to make gifts for children and/or grandchildren a regular annual event. It is really the simplest and most automatic gifting program available.

(7) Diversifying an Existing Gifting Program and the Investments of Existing Gifted Assets: The rate-of-return argument for life insurance gifts was made in section (3) above. By using a highly competitive, low-commission life insurance policy to create a high-performing tax-free foundation of gifted investments, and by relying on life insurance to complete the gifting program if death comes sooner rather than later (see (2) above), flexibility is provided to undertake more aggressive investments with other gifted assets or with investments retained in the estate. Given the potential investment advantages of life insurance described above and the additional flexibility and liquidity it provides, there is generally no reason it should not be a significant piece of what might otherwise be a diverse gifting program.

(8) Assuring A Probate-Free Specific Cash Bequest: A life insurance policy is unquestionably the easiest means of making a specific bequest free from both estate taxes and probate. As long as the premiums are paid, there is no question that the bequest will be satisfied within short order after the claim is filed. This is an especially effective way to make special arrangements for individual beneficiaries.

The assurance of privacy may be an additional selling point for a bequest funded by life insurance. Because it is made automatically and without approval of a probate court, which must supervise the distribution of any assets in the estate, there is no official court record of this bequest. Nobody but the beneficiary of the insurance proceeds, which might be the trustee of a trust set up for one or more beneficiaries, needs to know about it.

One of the most frequent and logical applications for a special bequest with life insurance is the second marriage, where life insurance is used either to assure an inheritance for children from an earlier marriage when the estate would otherwise pass to the surviving spouse (and perhaps also to children from the subsequent marriage). Another approach is a provision in a pre-nuptial agreement providing a life insurance benefit to the new spouse with the estate otherwise passing to the children from a prior marriage. Because of the unlimited marital deduction from estate taxes for transfers to surviving spouses, gifts of life insurance premiums into a trust for the children of the previous marriage, with the estate otherwise going to the second spouse using the marital deduction, are probably more common than having the estate pass to the children of the first marriage, after estate taxes are paid, with the life insurance benefit going to the spouse. Also in the family law context, life insurance is routinely used as a way to fulfill child support and alimony obligations.

(9) Making Unequal Bequests Among Children Without Guilt: It may make complete sense in any number of situations for bequests not to be equal among children, and yet the natural tendency is to feel guilty about such a decision.

Where such a plan may be most logical is when one or more family members have been instrumental in helping to carry on a business, while others have been uninvolved. Those who will run the business inherit or are given the business interests, and the others often receive their shares in life insurance proceeds, although not necessarily in an amount equal to the value of the business.

In other situations, simply deciding upon a fixed sum funded by a life insurance policy, perhaps owned by and paying into a trust, may be the easiest way to provide for the interests of one or more children, without worrying about whether all the shares are equal.

(10) Funding the Special Needs of a Child: In addition to the marital applications mentioned above, special bequests made with life insurance are used most effectively and compellingly to benefit disabled family members. Life insurance trusts for this purpose are most common today in those states that have, by statute or common law, allowed for "supplemental" or "special needs" trusts. The policies are owned by or pay into such a trust and are then used to supplement levels of care that are provided with public funds. There is no requirement that the monies be used to pay for support that is provided by the government or to make any reimbursement for these services. Instead, they can be applied towards supplemental items, over and above those the government will pay for or provide. Even where the parents are wealthy enough that no dependence on government support is envisioned, a life insurance-funded trust can still be the best way to provide for a handicapped child, with other family members (or perhaps the facility providing the care) designated as secondary beneficiaries.

(11) A Gifting Program for Grandchildren: Gifts to grandchildren in the form of premiums for policies on the lives of donors can make even more sense than these same gifts for children, because grandchildren are less likely than children to have immediate need or use for cash gifts. The ownership of such insurance policies can be structured so as to take advantage of the annual exclusion from both the gift tax and the even more onerous generation-skipping tax (GST).

No discussion of estate planning is complete without at least some mention of the potential impact of the GST and the need to plan around it. The GST is designed to limit the ability to pass significant wealth more than one generation down the line without most of it being subjected to estate taxes in the process. It is imposed in addition to the estate tax at a flat rate equivalent to the top estate tax rate.

There is, however, an exemption of over $1 million that each donor has for transfers that skip a generation. In addition, outright gifts that qualify for the annual gift tax exclusion ($11,000 per donor ($22,000 for husband and wife) for each recipient) are also exempt from the GST and can thus stretch the $1 million plus GST exemption further.

For the most part, gifts into a trust, even though they may be exempt from gift taxes within the annually excludable amounts, are not exempt from the GST and will use up a portion of the $1 million plus exemption. However, GST-exempt contributions in trust are possible, including contributions in the form of life insurance premiums for policies owned by trusts, where separate trusts are established for each grandchild. For this to work, the individual gifts (premiums) must be kept below the amounts of the annual gift tax exclusion, no trust income or principal can be distributable to anyone else during the life of the beneficiary, and the trust property must be includable in the beneficiary's estate (it may not skip another generation).

Where there is enough money that gifts to grandchildren as well as children are considered affordable, such gifts are an effective means of reducing the size of the taxable estate, and their long-term impact will be greater still if they do not use up the GST exemptions. Making these gifts in the form of life insurance premiums represents sound planning for all the other reasons given here.

(12) Providing for a Trust Beneficiary's Dependents Who Are Not Also Beneficiaries of that Trust: Those who depend heavily on a well-funded trust from a previous generation should examine whether, if they die, all of their dependents could also rely on that trust as a source of support. For surviving spouses, the answer is usually no, unless a "limited power of appointment" has been given to the beneficiaries to allow them to designate their spouses as successor beneficiaries. It is highly unlikely that step-children who might be dependents could be beneficiaries. In the case of adopted children, some state laws presume an intent to include them as beneficiaries. However, the trust document may expressly provide otherwise. In any case, it is usually spouses and step-children whose lifestyles will suffer in the absence of life insurance, especially in situations where the trust beneficiaries have not had a chance to accumulate estates of their own. Where there are not other sources of significant income, trustees should be encouraged to distribute extra income to beneficiaries who are in this position so that they may buy life insurance to provide for non-beneficiary dependents.

(13) Deferring the Receipt of Large Gifts to Avoid Spoiling Children: At the outset, it was recognized that one of the potential objections to making gifts is the fear of spoiling children and removing their incentive to lead productive lives. Because life insurance gifts are only received at death (and not even then if the proceeds are paid into a trust with the trustee given the discretion to make or not make distributions of income and principal), gifts in the form of life insurance premiums are an effective way of both minimizing the impact of estate taxes and withholding the value of an inheritance. Other gifts may, of course, also be made into trust with similar provisions restricting future distributions.

(14) Asset Protection: The Cash Value in Life Insurance (and Annuities) Cannot Be Reached by Creditors: Professionals and investors concerned about the possibility that a liability judgment could exceed any casualty insurance policy limits should understand that under the laws of many states, the cash value in life insurance and annuity policies for which dependents are beneficiaries is exempt from creditors (other than the IRS). For those who are especially exposed to the risks of liability lawsuits, this may be an important additional consideration that tips the scales in favor of permanent insurance. Other investment dollars could be seized by creditors, while the cash value in life insurance and annuity policies could not. By shifting existing savings assets and future savings vehicles, asset protection is assured with no cost to investment rate of return.

Concern for asset protection may apply both to retained assets and to property gifted to a child or another donee who faces liability exposure. Either circumstance may present another strong reason for the use of life insurance.

(15) Avoiding Gifts of Appreciated Assets to Take Advantage of Stepped-Up Basis at Death: A gift of life insurance premiums to family members or to an irrevocable trust for their benefit, instead of highly appreciated assets with large built-up capital gains, can reduce potential capital gains taxes. The recipient of a gift assumes the donor's cost basis and will also pay capital gains tax on the post-gift appreciation when the gifted assets are sold. Retaining those assets in the donor's estate until death will, under current law, give them a stepped-up cost basis at death and will limit the capital gain upon sale to the amount of appreciation after the transfer by inheritance.

On the other hand, to the extent there is not an immediate need for or interest in cash gifts, making them in the form of insurance premiums is, as has been noted, most advantageous from a tax and investment rate-of-return standpoint. The investments inside the insurance policy appreciate on a tax-free basis, and the proceeds at death are not subject to income taxation either. This ability to transfer significant wealth by paying for and properly structuring the ownership of life insurance provides a significant advantage over the alternative of gifting appreciated assets on which the recipients will pay capital gains taxes.

(16) Maximizing Gifts, Even It Means Paying Gift Taxes, because Gift Taxes Cost One-Third Less than Estate Taxes: Some wealthy people, who might otherwise entertain the idea of making life insurance gifts, may refrain from doing so because they are already making other gifts which are using up their annual gift tax exclusions and the total combined exemptions from gift or estate taxes. Those who have more than enough assets for their lifetime needs, however, should, for tax reasons at least, consider additional gifts, even though they are taxable, because gift taxes are ultimately less costly than estate taxes.

While gift and estate taxes are similar in many respects, it is important to note that the estate tax is paid on the entire estate, including on those dollars used to pay estate taxes, while the gift tax is imposed only on the value of the gift, not on an amount that also includes the gift tax. The estate tax is therefore tax-inclusive and is partially a tax on a tax. The gift tax, on the other hand, is tax-exclusive, except that gift taxes paid on gifts within three years of death are included in the estate tax base.

Assuming a gift/estate marginal tax rate of 50 percent and identical percentage changes in the value of assets in future years whether or not gifts are made, making gifts and paying gift taxes instead of leaving those assets in the estate and incurring estate taxes will always increase the value of the transferred assets by one-third. This is true no matter when estate taxes are incurred in relation to when the gift was or might have been made.

This argument is a harder sell in the wake of the 2001 tax law offering the possibility (which most experts consider very remote) of the future repeal of estate taxes. For those who correctly conclude that estate taxes are here to stay, paying gift taxes today and avoiding a heavier estate tax in the future can be advantageous.

(17) Retaining Lifetime Benefits, If Necessary, While Also Providing Estate Tax-Free Death Proceeds: Even those who might objectively be considered quite wealthy, who love their children, and who have no desire to pay more pay taxes than necessary may not feel secure enough about the future to relinquish a substantial portion of their estates. Part of the reluctance to make gifts, or additional gifts -- to part with one's property in the form of life insurance premiums or otherwise -- is based on uncertainty about the economic future (fear of another Great Depression) or concern for large unanticipated expenses, especially for health care. After all, few people are so concerned about the impact of estate taxes that they will take a perceived risk of a meaningful reduction in lifestyle.

In general, gift reluctance among the wealthy carries a steep price in the form of punitive death taxes. In addition to taxing assets owned outright at death, the estate tax also hits property that provides a retained income interest and property over which the deceased is able to exert control.

Even so, there are a few ways to maintain control over property or to recover that which has already been transferred as a gift. Several of these techniques involve life insurance.

(a) The Wait-and-See Gifted Policy: Irrevocable insurance trusts are often set up with existing policies gifted into a new trust, as opposed to creating a trust and subsequently taking out a policy. The danger is that the death proceeds will be included in the insured's estate if death occurs within three years of the transfer into a trust, and there is no such risk if an irrevocable trust acquires the policy in the first place.

When an existing policy is gifted, the value of the gift is equal to the cash value in the policy plus the unused premium for that year. Because cash value grows slowly at first, a new policy might first be left in the estate while the insured waits to make sure that the cash value will not be needed as a source of retirement income. If the transfer to the irrevocable trust occurs within the first ten years of the policy, the value of the gift may be less than the premiums previously paid. If it occurs within the first few years, it will normally be a lot less subject to certain special rules. In this way, a policy can be taken out, held for a time while the insured waits to be sure that the gift is affordable, and then gifted to an irrevocable trust or directly to adult children at a relatively low value if done in the early years of a policy.

(b) Family Limited Partnerships -- Retaining Control Over Property Gifted Away: A widespread estate planning technique as a means of transferring and yet continuing to manage and control life insurance policies and other family assets is a gift to a family limited partnership. The general partner who controls the property in such a partnership is typically the donor of the assets or a corporation in which the donor is the majority shareholder.

The advantage of this family limited partnership is that donors can hold only a token interest, perhaps as little as one percent, in the partnership, but, by remaining the general partner, can continue to exert control over the partnership property without having these assets, other than the small percentage actually owned, included in their estates. This is a significant exception to the general rule that one cannot maintain control over transferred assets while having them escape estate taxation.

In the case of life insurance owned by a family limited partnership, the insured might own only a very small portion of the partnership and yet, as the general partner, be authorized to surrender the policy or otherwise withdraw cash value if necessary. Although the IRS may at some point attempt to take a contrary view, it is generally thought that only the percentage of the insurance proceeds equal to the share of the insured's interest in the partnership is included in the estate.

(c) The Special Power of Appointment -- Giving Power to Another to Return Property Gifted Away: The "special" or "limited" power of appointment allows a donor to give another person the authority to designate someone else, including the donor, as the recipient of all or a portion of the property that has previously been gifted away. It is a way to make an irrevocable gift revocable through a power given to another trusted person, e.g. a child, to transfer the property back to the donor. If this power of appointment is limited (in contrast to "general" powers which allow the holders of the powers to transfer the property to themselves or their creditors), the property is not included in the estate of the power holder.

Where life insurance is concerned, this limited power of appointment is a way for donors to purchase insurance policies with irrevocable gifts of premium dollars while preserving the flexibility to recover the policy's cash value through the exercise, by some trusted person, of a limited power of appointment in favor of the donor/insured. The limited power of appointment thus hedges against the possibility that the donor may need the gifted asset in the future.

Understanding that estate planning life insurance can be purchased without initially making an irrevocable gift, and that, in any case, there are ways for irrevocably gifted premium dollars to be either controlled or recovered by the donor, will help to overcome gift reluctance. It will encourage those who harbor lingering concerns about an uncertain future to share their wealth with their families and to preserve it by minimizing estate taxes in the process.

(18) Life Insurance In Connection With Charitable Gifts: Life insurance is frequently used as a means of making charitable gifts or to replace some or all of the property which has been gifted to charity and will therefore not pass to the next generation.

(a) Life Insurance for Capital Gifts: A pledge to a capital campaign to be satisfied at death rather than during life is best met with a life insurance policy for the same reasons stated in (8) above relating to the simplicity and certainty of carrying out probate-free specific bequests with life insurance. In addition, many policies are or can be structured in such a way that a portion of an annual gift goes directly to the charity rather than entirely to the life insurer as a premium. In this way, the charity receives some of the contributions annually and a larger sum at the death of the donor in the form of life insurance proceeds.

(b) Life Insurance to Replace the Value of a Charitable Gift -- The "Wealth Replacement Trust": Life insurance is commonly used to replace the value of a charitable gift made through a charitable remainder trust (CRT). This charitable giving technique involves a donation to charity, often of assets with built-up capital gains, coupled with a stream of income for life or a period of years paid by the charity back to the donor. The difference between the value of the income stream and the value of the donated property is the charitable contribution. Many of those who make donations in this manner want to replace some or all of the value of the property that they are giving to charity rather than to the next generation. This is done by using some of the extra lifetime income paid from the CRT to buy life insurance in a policy held in trust outside the estate of the donor. Thus, life insurance funds the replacement of the property eventually passing to charity rather than family. This technique has come to be called a "wealth replacement trust."

Charitable remainder, coupled with wealth replacement, trusts have five combined tax advantages, which some would argue pay for the cost of such charitable contributions or which at least make them very inexpensive. First, the donation of appreciated assets to charity avoids capital gain taxes on appreciated assets that would otherwise have to be sold to generate additional cash. Secondly, an immediate income tax deduction is given for the current full value of the remainder interest eventually passing to charity, even though the charity does not receive its interest until the end of the term of the donor's income interest. Third, the transfer of the remainder interest going to charity escapes either gift or estate taxes because of its charitable nature. Fourth, the life insurance proceeds paying into an irrevocable trust and replacing some or all of the value of the charitable donation remainder interest avoid estate taxes, whereas the original property before it was gifted to the charity would have been subject to them. Finally, the proceeds also avoid income taxes because of the income tax-free treatment of life insurance benefits.

This is not to suggest that this plan should be undertaken for tax reasons alone. However, for those who do have independent charitable motives, this technique is a remarkably effective way to make substantial charitable gifts at relatively little cost.

(19) Life Insurance Purchased By Pre-Existing Trusts Exempt From Estate and Generation-Skipping Taxes: Even the oldest of monied families, whose wealth may largely be already ensconced in pre-September, l985 generation-skipping trusts that are exempt from generation-skipping taxes, can profit from having some of these assets invested in life insurance. This is not done to remove this property from anyone's estate, for that was already accomplished when the trust was created. Rather, the life insurance investment is a means of enhancing the trust's rate of return and diversifying the investment of its assets for the same tax advantage and investment diversification reasons mentioned in paragraphs (3) and (7) above.

The fact that trustees must now be guided in their investment decisions by the recent legislative adoption in Illinois and many other states of the Prudent Investor Rule rather than the older and more conservative Prudent Person Rule gives trust beneficiaries a greater ability to seek a creative trust investment of this kind.

These old trusts may also be a valuable source of premium dollars for life insurance on the life of a beneficiary who may otherwise have an illiquid estate or who, as mentioned in paragraph (12), may want to provide for dependents who are not beneficiaries of the trust.

Where trust income is used to purchase life insurance on the life of the grantor (the person setting up the trust) or the grantor's spouse, the income is taxable to the grantor rather than to the trust or the beneficiary. This may not be a desirable result. On the other hand, where the grantor wants to maximize additional gifts without paying gift taxes and has plenty of money to pay income taxes that would otherwise have to be paid from the trust, having the grantor pay the income taxes makes possible an additional gift tax-free gift to the beneficiaries. In this way, life insurance purchased with trust income increases the amount of gifts that can be made without incurring gift taxes.

(20) Using Annuities With Life Insurance To Obtain Increased Lifetime Income While Also Providing A Larger Net Estate: The combination of increased lifetime income and a larger net estate can be obtained simultaneously by annuitizing a portion of assets in the existing estate and by then using only a portion of the extra income to purchase and hold insurance outside of the estate.

The annuity guarantees that the income will last a lifetime (a joint annuity will pay as long as at least one spouse is living), no matter how long that might be, while the life insurance assures the desired property transfer outside of the estate to children, no matter how soon death might occur.

Similar ways to increase life-long after-tax income, even after a portion of it is used to buy insurance, include two strategies previously mentioned -- the charitable remainder trust combined with a life insurance-funded wealth replacement trust and increased retirement plan distributions. Accelerating these distributions also avoids the possibilities of income taxation imposed at death on undistributed retirement plan assets.

Turning existing assets into lifetime income and then using life insurance to transfer an inheritance of equal value to those assets outside of your taxable estate accomplishes three desirable objectives: increasing net income (even after insurance premiums are paid), assuring that this income will last as long as you do, and then doubling (assuming a 50 percent rate for death taxes) the value of your assets that will pass to your family rather than the government. This is not a gimmick. It is simply sound planning made possible by two life insurance products -- annuities and life insurance.

Applying For Life Insurance: With an understanding of the many reasons for life insurance for the wealthy and liquid, it is important also to know something about the application process and what to look for in a life insurance company.

. The Application Process: Buying life insurance is not like purchasing stocks and bonds. Unfortunately for the applicant (and the agent), life insurance is not automatically procured once the prospect accepts the cost of the premium but is further conditioned upon taking a routine medical exam and answering a series of questions on the application about health and finances. People with money generally place the highest value on privacy and are sometimes put out by this uncomplicated but somewhat probing process. The agent can only ask the applicant for patience and an understanding that the insurer's promise to pay a large sum of money in exchange for what might be a payment of only a small fraction of that amount cannot be made without a careful review by the insurer.

. Am I Too Old For Insurance?: Given the trend towards longer and healthier lives, it is common for people in their seventies and sometimes even their eighties to buy life insurance for estate planning purposes. The common use of second-to-die policies, paying a death benefit only upon the death of the surviving spouse, makes companies more willing to insure applicants of advanced ages, but older single people may obtain insurance as well.

. Am I Too Unhealthy For Insurance?: Occasionally, the answer is yes. More often, the insurance will simply be more expensive because the insurer's medical underwriters anticipate a life expectancy less than that for the healthiest applicant. If this judgment is correct, the rate of return per premium dollar will be just as good as for the somewhat less expensive policy sold to the healthier policyholder of the same age.

With second-to-die insurance, one spouse can be in relatively poor health and the policy can still be approved if the other spouse is sufficiently healthy. Under this circumstance, however, it may be less expensive to insure the healthier spouse alone, especially if the healthier of the two is younger and female.

Quality of the Company and Structure of the Product and Premim: All life insurance companies are not alike. Both in their financial solvency and in the rate of return per premium dollar that their policies offer, they are very different. These company differences, coupled with the advantages of purchasing insurance at the lowest possible commission cost (as explained in paragraph (3) above) can amount to millions of dollars and can turn a mediocre investment into a highly attractive one. Even sophisticated insurance buyers need objective advice in order to obtain the best results.

Do Not Procrastinate: Estate planning, especially for busy people, always seems like something that can be done tomorrow, at year end, or only every few years. However, there are two good reasons not to delay.

The most obvious is that tomorrow may not come; there may not be time to complete the plan that should have been made yesterday. Secondly, where insurance is or should be part of a plan, an illness or condition may develop which makes it unobtainable or a lot more expensive. Life insurance is almost always easier to obtain, and on a more favorable basis, the earlier an application is made.

Plan With The End In Mind: Effective estate planning, like the fulfillment of our fondest hopes and dreams, requires a long-term perspective that lasts beyond our own lifetimes. On the other hand, business and investment planning which uses a rate-of-return analysis that ignores the impact of death taxes does less than half the job. Similarly, planning which overlooks the need for cash almost immediately after death, or which assumes that it can be painlessly generated from the sale of real estate, stocks, and bonds may be equally shortsighted.

For those who have somewhat illiquid estates subject to estate taxes, life insurance can be indispensable. Those who think they have liquid estates should reassess their plans and recognize that, even in their situations, the tax-free proceeds from life insurance may be very much appreciated when it comes time to pay estate taxes. Life insurance buys cash, time, and flexibility just when they will all be needed the most. When that time comes, those may be extremely valuable commodities, may substantially increase the value of the legacy you leave, and could clearly seem well worth the premiums you had the foresight to pay today.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois..