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## **Why and How to Use Life Insurance to Protect, Enhance and Transfer Your Estate**

by  
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Life insurance is regularly used in an estate planning setting to preserve the net worth that individuals have managed to accumulate during their lives. This outline is intended to highlight some of the main reasons for life insurance in this context and also to summarize the process of applying for and owning it.

### **Reasons for Estate Planning Life Insurance**

**(1) Preserve assets that would otherwise have to be sold to pay estate taxes:** Whether or not your holdings are illiquid, do you want half or any large percentage of them to have to be sold within nine months of your (or a surviving spouse's) death, perhaps at unfavorable prices? Life insurance protects your assets and grants flexibility in determining whether and when to sell them.

**(2) Prefund estate taxes with discounted dollars:** Beginning to pay the expected estate tax liability now in the form of annual insurance premiums enables you to fund it for a fraction of the cost that would be imposed at death. The eventual insurance benefit will be much greater than the premiums you pay and can be received free of both income and estate taxes. The tax-free nature of the proceeds enables insurance to compare favorably with similar investments of other types of gifts.

**(3) Assure the completion of a wealth transfer plan that takes the form of annual gifts:** Without insurance, a wealth transfer program occurring over many years will not be completed if you (or your surviving spouse) die too soon. Life insurance assures the success of the plan no matter when death occurs.

**(4) Equalize or balance the value of your children's' individual inheritances:** If only some of your children will inherit certain assets - for example, a family business, a home (including a second residence) - life insurance for the benefit of other family members helps to equalize the distribution of your estate.

**(5) Replace assets donated to charity:** Various tax-advantaged charitable giving techniques, especially charitable remainder trusts, enable donors to increase their current income from the donated assets that eventually go to charity. Using just some of the extra current income for insurance replaces, for the donors' heirs, the value of the charitable donation and makes it possible to help charity and family at the same time.

## **How to Apply, Own, and Pay for Estate Planning Life Insurance**

The following steps are either required or suggested in applying for, owning, and paying for estate planning life insurance.

**(1) Create a trust:** This legal document creates a separate entity that applies for and owns the policy. Your spouse, children, and grandchildren might be the beneficiaries (except that your spouse may not be a beneficiary if the insurance is a joint policy on you and your spouse). One or more family members, or a bank, or the two in combination, might serve as trustee or co-trustees.

Alternatively, adult children can own the policy directly if they are responsible, creditor protection for them is not a concern, and it is intended that they receive the full proceeds immediately when the insured dies rather than in future distributions from a trust.

**(2) Applying for the policy:** The trustee of the trust (or the children, or one of them, in the case of a children-owned policy) applies for the policy. A separate tax i.d. number is obtained for the trust from the IRS with a phone call. Both the applicant and insured sign the application, and the insured has a routine medical exam with the insurance company doctor at a convenient time at the insured's home or office.

Sometimes the application is made by the insured before the trust is created. Subsequently, when the trust is drafted, a substitute application can be submitted.

**(3) Paying for the policy:** The insured(s)/trust donor(s) makes a cash gift to the trust. The money is deposited in a non-interest bearing checking account and is then used by the trustee to pay the insurance premium. Premiums are generally paid each year for as long as the insured (or one of them in the case of a joint policy) is living, or at least until the policy can sustain itself without further payments.

**(4) Gift tax implications of premium payments:** The payment by the insured(s) to the trust of the premium amount is a gift to the trust's beneficiaries. Taxes are imposed on gifts at the same high rates as estate taxes, except that, if the trust is appropriately drafted, gifts may be eligible for the annual \$10,000 per recipient (trust beneficiary) gift tax exclusion (\$20,000 for joint gifts by both spouses even if one pays all the money). In addition, the insured(s) may use up the current \$1,000,000 per donor exemption from gift or estate taxes, which increases to \$1 million over the next several years. It is best to use this exemption as soon as possible to enhance its ultimate value to gift recipients. An insurance trust is also one of the best means of maximizing the use of the \$1 million per donor exemption from the generation-skipping tax to pass wealth, now and in the future, to grandchildren and beyond without current or future estate taxation.

**(5) Ways to generate extra cash flow to pay insurance premiums:** If the extra cash required to pay the premiums seems scarce, consider the following ways to increase it: (1) taking a larger annual distribution from a qualified plan or IRA than is minimally required; (2) converting conservative fixed-income investments (cd's or bonds) into an annuity to increase income for life in a way that at least offsets the premium cost (this approach also avoids estate taxes on the converted fixed-income investments); (3) gifting appreciated property to a charitable remainder trust, which property is then sold without immediate capital gains taxes, with the proceeds reinvested to produce a higher level of income that can last for the donor's life (the property passes to one or more charities when the donor dies, and insurance owned in a separate trust replaces, for family, the value of the property gifted to charity); (4) using the insured's business to pay most of the premium on a "split dollar" policy; (5) using income from assets that are already held in an irrevocable trust which can

also apply for and own the insurance policy.

## **Choice of Life Insurance Determines Results**

The success of these estate planning techniques that use life insurance 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, “What the Sophisticated Investor Should Know and Ask about Life Insurance”).

In any case, those who take the time to understand the basic factors that account for the relative performance of life insurance companies and products will recognize the attractive returns that can be realized from the best-performing, low-commission policies and will obtain the best returns from their use of life insurance as part of their estate planning.

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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.**