

# Wealth Planning **Insights**

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At some point in your life, the following issues may percolate and become items you and your family will need to address:

- Taxes
- Estate planning
- Asset allocation
- Insurance
- Education funding
- Liability management
- Financial and retirement planning
- Philanthropy

UBS can help you with each of these issues as they arise. Throughout the year, *Wealth Planning Insights* will touch on all of these topics. This month, we are focusing on life insurance and irrevocable life insurance trusts (ILITs).

## Create a Safety Net for Your Family With Life Insurance

Life insurance, for those who qualify, is a powerful tool that is regularly employed to help meet a wide range of personal and financial objectives. Most people are familiar with life insurance as a way of providing funds to replace lost income in the event the family “bread winner” passes away. It can also be used to pay off existing liabilities such as mortgages, and can provide funds for future expenses such as college costs for children or grandchildren. Life insurance can even be used as a method of supporting your favorite charitable organizations.

Life insurance can also play a role in business planning. Banks and other lending institutions may require life insurance on a borrower’s life as collateral for loans. Business owners may also use it to fund buy-sell agreements or to equalize asset transfers to children who do not participate in a family business or farm.

The focus of this article is on the applicability and family need for life insurance and how life insurance may mitigate certain family risks.

Income replacement is especially pertinent for younger families where the family relies heavily on the income of one individual to meet day to day expenses, such as utilities, mortgage payments, property taxes, medical bills, groceries, etc.

Four broad categories come to mind:

1. Income Replacement: Life insurance proceeds at the death of the income earner are used to replace his or her lost earnings.
2. Investment: Certain life insurance policies may be an attractive and appropriate investment choice given a client's investment and risk profile.
3. Estate Liquidity: Life insurance proceeds are used to provide an estate with the liquidity needed to pay state and/or federal estate taxes, if applicable.
4. Wealth Replacement: Life insurance proceeds are used to replace the assets used for other purposes, such as philanthropy, so family members are not unduly disadvantaged by the diversion of assets.

Based on current Federal tax law, the last two categories tend to be applicable for larger estates (\$5,000,000 or larger for a single person and \$10,000,000 for a married couple). However, please note that state estate taxes may be applicable at lower levels of wealth as state exemption amounts are often lower than the Federal exemption amount, so estate liquidity issues may apply to less wealthy clients as well.

Nonetheless, we will focus on the first category as it is applicable to a wider range of individuals and families.

### **Income Replacement**

Income replacement is especially pertinent for younger families where the family relies heavily on the income of one individual to meet day to day expenses, such as utilities, mortgage payments, property taxes, medical bills, groceries, etc. These families are typically younger families with parents in their early 30's to late 40's where, if the income earner passes away and that income disappeared, it would be very difficult for the remaining family members to continue the lifestyle to which they have grown accustomed. That could mean that children may not be able to attend their desired college, or more fundamentally, it could mean that the family may not be able to meet its basic needs.

A common strategy used to address income replacement needs is through the use of a term life insurance policy. A term policy is generally designed to provide coverage for a specified period of years assuming premiums are paid on a regular basis. Most term policies for income replacement needs are structured as level pay annual premiums with a term of 10, 15 or 20 years. Some companies will offer a 30-year term policy, but that is not the norm. When deciding

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the length of the term, factors to consider include length of time replacement income is needed, health, age, age of children, risk of becoming uninsurable in the future, and affordability. At the end of the term period, the policy may terminate according to its terms, or the premiums may become prohibitively expensive so the insured terminates it voluntarily. If individuals wish to obtain a new policy at that time, they would need to reapply for new insurance subject to new underwriting requirements. One factor to consider is the risk that health issues may arise over the period a term policy is in force. This may present a complication when applying for additional insurance or new insurance after a term policy terminates. Fortunately, most term policies have a feature that allows the owner/insured to convert the policy prior to termination into permanent coverage based on age with no additional underwriting. The initial premium for permanent life insurance is generally higher than term. However, permanent policies are designed to stay in force throughout the life of the insured and may offer a better long-term value.

The need for income replacement may seem straightforward, but when considering the broader family impact of one spouse's death, complexities may arise. For example, even in families with only one primary income earner, he or she may not be the only individual the family should insure. Obtaining insurance on the non-income earner--the parent who stays at home to care for young children--is often overlooked.

Families should discuss amongst themselves and with a financial advisor the impact of the non-income earner passing away. Questions that immediately come to mind are the following:

1. Are there young children in the family? How will their needs be met if the stay-at-home parent has passed away?
2. Will the income earner need to hire a caregiver for the children? How much will this cost?
3. Will the income earner need to spend more time at home with the children if the other spouse has passed away? (Many income earners take extended time off or quit their job to focus on the family during the initial transition period.)
4. Will there be a psychological impact on the children if the income-earner continues in a job that requires a large amount of time away from home? How will this be addressed?

There are other issues to be considered, such as who owns the policy and whether proceeds are preserved for the intended beneficiaries.

These are just a few questions that should be addressed and reviewed before deciding how much and what type of insurance to purchase. Answers to these questions may significantly impact the final decision.

### Preserving the Proceeds

There are other issues to be considered, such as who owns the policy and whether proceeds are preserved for the intended beneficiaries. When young couples are involved and one spouse passes away, there is a reasonable likelihood that the surviving spouse may remarry, and the new spouse may have children as well. Individuals other than those for whose support the insurance was originally acquired may then have access to the insurance proceeds, and to make matters worse, in a subsequent divorce, a portion of those proceeds could end up being diverted away from the original family entirely. Families may therefore want to consider holding life insurance policies in trust structures designed not only to preserve assets for the intended beneficiaries but also to protect assets from creditors and "predators."

If a life insurance trust is under consideration, attorney fees would need to be factored into the decision because an attorney would need to draft trust documents. While it is more common for permanent policies to be held in a trust, term policies can often benefit from a trust structure as well.

One last issue to bear in mind: when considering the purchase of life insurance, individuals are often forced to confront difficult personal issues and decisions for the first time, which may lead to procrastination. A sudden illness during this time may prove to be very costly and in some cases may preclude obtaining any type of coverage at all. A financial advisor can act as a valued resource to help you work through such issues and reach appropriate decisions in a timely manner.

--Richard Scarpelli  
Head of Private Planning

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Director – Wealth Planning Sales

## The Power of an Irrevocable Life Insurance Trust

Life insurance can play an important role establishing effective estate plans. Simply put, your estate plan is a way to help you care for the right people, at the right time, and for the right purposes. Moreover,

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a common estate planning objective is to minimize the impact of federal and state estate taxes. Life insurance can play a key role in helping to meet unique estate planning goals and, in particular, may be an effective way to provide funds to pay estate taxes.

### **Life Insurance in Your Estate Plan**

When determining whether life insurance might fit with your estate plan, it's best to begin with an understanding of everything on your balance sheet – this includes retirement accounts and all personally-owned life insurance policies. Often, people don't realize that owning life insurance in their own name causes the life insurance death benefit to be in their taxable estate. This is true even though the proceeds of a life insurance policy may go to a spouse, children, or a business partner. Determining who will own the life insurance, and considering the use of an Irrevocable Life Insurance Trust (ILIT) is an important part of estate planning discussions.

In addition to determining how life insurance will be owned, it's also important to understand who will pay the premiums. When life insurance has a different owner than the insured person, premium payments may be considered taxable gifts. Use of an ILIT may be a key strategy to address not only the ownership issues but also the premium payment issues in order to minimize adverse gift and estate tax consequences.

### **Planning with Irrevocable Life Insurance Trusts**

In general, an ILIT (pronounced "eye-lit") is an irrevocable trust that owns one or more life insurance policies. An ILIT may own other assets as well, such as cash, stocks, bonds, real estate and other types of property. In many instances, however, the only assets in the trust are life insurance policies.

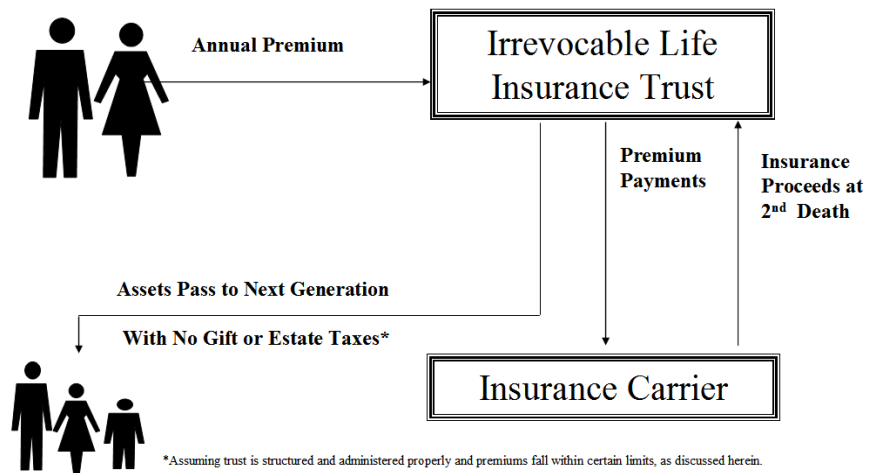
There are several parties involved in any type of trust planning. The person(s) creating the trust is/are usually referred to as the "grantor(s)" or "settlor(s)". The trustee, who may be an individual or a bank/trust company, is the fiduciary who manages the property placed in trust according to the terms and provisions of the trust agreement. This is done for the benefit of one or more beneficiaries – the children, grandchildren, or other individuals or entities that you wish to benefit.

There are many non-tax considerations involved in estate planning and, as a result, a family's unique needs, goals and values will become the basis of their estate plan. But in the case of life insurance, tax considerations tend to dominate the planning -- and using an ILIT is often at the center of these discussions.

Properly executed, an ILIT will distribute life insurance proceeds to beneficiaries estate and income tax free.

The primary function of having an ILIT own one or more life insurance policies is to minimize the risk that, at death, the life insurance policy proceeds are included in the taxable estate of the insured. Additionally, because the ILIT is the beneficiary of the life insurance proceeds, the trust is designed to keep the life insurance proceeds out of insured's spouse's taxable estate as well. Properly executed, an ILIT will distribute life insurance proceeds to beneficiaries estate and income tax free.

The diagram below shows the flows between the grantors, the ILIT, the insurance policy, and the beneficiaries:



### The Details Matter

In order for an ILIT to effectively keep life insurance out of the estate of the insured, the ILIT must be drafted so that the insured has no "incidents of ownership" over any policies owned by the ILIT. "Incidents of ownership" means the right to exercise any privileges of policy ownership.

The ILIT, therefore, should be drafted to limit the insured's rights to do such things as change the beneficiaries; surrender or cancel the policy; assign the policy; or obtain a policy loan. Even the right to change a contingent beneficiary is an incident of ownership. Since the details do matter, it's important to work with an attorney specializing in estate planning to make sure these pitfalls are avoided.

Once the ILIT is established, the trustee – not the insured – applies for life insurance on the life of the insured. The trustee also makes certain that the ILIT is owner and beneficiary of the policy. Following these formalities helps ensure the life insurance proceeds are not subject to

The trustee, as owner and beneficiary, applies for a life insurance policy on the insured.

estate tax. (Existing life insurance policies can be transferred to an ILIT, but the grantor must survive 3 years after the date of transfer or the value of the insurance will be brought back into the insured's estate.)

### Paying the Premiums

It's important when setting up the ILIT to consider how life insurance premiums will be paid. Because the ILIT is a separate entity from the insured, premium payments made to the ILIT are considered gifts to the trust. For example, a newly created ILIT is established and not yet funded with assets. The trustee, as owner and beneficiary, applies for a life insurance policy on the insured. The insurance company, after considering the insurability of the individual(s), extends an offer and the policy is issued. At this point, the insured will typically make a gift to the trust to pay the premium. Then, the trustee sends some or all of the cash it receives from the insured to the insurance company to pay the premium, and continues to do so as the premiums come due.

Complicating the issue of gifting to the ILIT is the desirability of having each gift made by the insured treated as a "gift of a present interest". A present interest gift is one in which the donee (the person receiving the gift) has immediate rights to use, possess and enjoy the gift. In the case of an ILIT, the donee is a beneficiary of the trust, such as a child or grandchild.

This is an important consideration because only present interest gifts qualify for the annual gift tax exclusion (\$13,000 per donee in 2011).

Gifts of future interests do not qualify for the annual gift tax exclusion and would, instead, use the donor's lifetime exemption (currently \$5 million). If the donor's lifetime exemption is fully used, future interest gifts to the ILIT would trigger not only the filing of a gift tax return but also the payment of gift taxes against the value of the taxable gift being made. While future interest gifts can be a very powerful wealth transfer strategy, this article focuses on employing present interest gifts.

To make certain the insured's gift to the ILIT is treated as a present interest gift, the trustee must notify the donees of the gift and their right to withdraw the gifted funds from the ILIT. This notice is commonly called a "Crummey" letter and is based on the court decision *Crummey v. Commissioner*. If the donee elects not to make a withdrawal from the ILIT, the trustee is free to invest the gift within the rules of the trust, including the payment of insurance premiums. The trustee should keep evidence of the Crummey letters for Internal Revenue Service recordkeeping requirements.

## When Insurance Death Benefits are Paid

Upon the death of the insured, life insurance policies owned by the ILIT pay death benefits to the trust. These death benefits can provide cash which, through the terms of the trust, can be made available to the insured's estate to help pay estate taxes. For example, the ILIT may loan money to the insured's estate or purchase illiquid assets from the estate, thereby generating liquidity to pay any estate tax that comes due.

The ILIT can meet personal estate planning goals as well. For example, the trust can stay in place and, by its terms, help protect family members from being overwhelmed by the transfer of wealth. For example, the terms of the trust could provide that the trustee must distribute the income to the surviving spouse for his or her lifetime and then distribute the balance of the trust children or grandchildren upon the death of the surviving spouse if they have reached a certain age. This type of planning can help benefit the family over generations and can provide protection against divorce and creditors.

## Case Study

- Jim & Mary Parker, both age 60, own the following assets:
  - 3 commercial office buildings with aggregate FMV \$18 million; and
  - Liquid assets of \$2 million

Assuming Jim and Mary both die before the end of 2012, current tax law allows them an estate tax exemption of \$5 million each, so together they can transfer a total of \$10 million estate tax free to their two children. With a total estate of \$20 million, this would still leave \$10 million exposed to federal estate tax, at current rates of 35% on amounts over the exemption, in the Parkers' estate would owe \$3.5 million in federal estate taxes, due 9 months from the date of death.

Where is the liquidity to pay this tax going to come from? Their \$2 million liquid assets would pay a portion of the tax due, leaving the Parker children with only illiquid real estate holdings. While the estate could try to sell some of the real estate holdings to pay the balance, the short time frame may force a sale at a value lower than fair market value.



Without the insurance inside the irrevocable trust, the family might be forced to borrow in order to pay estate settlement costs.

In our example, the Parkers are found to be insurable by an insurance company. They create a trust, with the trust agreement naming a trust company as trustee and their two children as beneficiaries. The trustees apply for the policy to be issued with the trust being the owner and beneficiary of the policy. The Parkers plan to use their annual gift tax exclusion amounts of \$13,000 each per donee, thereby making total gifts of \$52,000 each year for the rest of their lives.

These gifts will not impair the Parkers' standard of living, so they are comfortable with giving this amount away each year. Based on their ages, their insurability, and the type of policy, the amount of life insurance the trust could obtain is \$4.8 million. The Parkers feel this amount would be sufficient to cover any estate taxes today but also allow for some increase in estate value in the future. (They decided that if the estate tax exemption is decreased in 2013, they will consider acquiring additional insurance then.) The type of policy selected insures both of their lives, but only pays the death benefit at the second death (known as a second-to-die policy), which is typically when the federal estate tax is due.

Without the insurance inside the irrevocable trust, the family might be forced to borrow in order to pay estate settlement costs. Repaying a 6 percent loan of \$4.8 million in 10 equal annual installments requires total payments of \$6.5 million. (If the family were able to obtain a 40-year loan under the same terms, its total payments would be \$12.7 million!) Most families find it more palatable to pay insurance premiums during life than to impose borrowing costs on their loved ones after they themselves are gone. (Of course, there are other potential options as well. For example, over a long enough period of time, it might be economically better to use the money otherwise contributed to the trust for premium payments and have the trust invest it in other assets, as doing so might yield more than \$4.8 million by the time both spouses are gone. But the essence of life insurance is addressing the risk of dying too soon; there are other strategies—outside the scope of this article—to address the risk of living too long.)

Properly structured, the combination of an ILIT using this type of life insurance policy will generate the dollars that will be received into the trust, free from federal estate tax, in a sufficient amount and at the exact time it is needed.

### **Conclusion**

With thoughtful planning, life insurance can be a powerful financial vehicle to help families protect what they have worked hard to build.

Since the details matter, it's prudent to work with your UBS Financial Advisor in concert with your tax and legal professionals when designing an estate and life insurance plan.

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Speak with your Financial Advisor for additional information about the wealth planning ideas discussed in this publication. Throughout your lifetime, you plan for many personal and professional milestones. Helping you meet these challenges and educating you on making appropriate choices are what our wealth planning professionals do best. To deepen our understanding of your financial needs and apply the technical skills to address the complexities of wealth management, your Financial Advisor may also introduce you to a UBS Wealth Management Consultant, a specialist in wealth planning. Working with a Wealth Management Consultant and utilizing our sophisticated financial planning tools, your Financial Advisor can help develop strategies to keep your wealth planning goals on track. We look forward to talking with you.

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