Life Insurance Elevates the Plan

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There is no doubt that the ultimate fate of the federal estate tax remains unclear at this time as Democrats roll out their intentions to repeal the “step-up” in basis rule. As the debate unfolds into 2016 it will likely amount to a proposed trade of the estate tax for either a carry-over basis regime or a capital gains at death tax.

In this state of uncertainty, attention must be directed to techniques that ensure successful estate planning whether the estate tax is ultimately repealed or not.

Insurance Funded Irrevocable Trusts: A Win-Win Strategy

How can planners develop an estate plan when there is no rational basis for predicting whether the law will be changed, and if so what the new law will be? A logical way to proceed is to adopt strategies to hedge against these uncertainties. And the unique characteristics of life insurance make an irrevocable life insurance trust a unique hedge against both the uncertainty of the law and the contingency of mortality, ensuring predictable results whether the estate tax is repealed or not, whether transferred assets are treated as having a stepped-up or carryover basis, and whether the transferor lives for one year or twenty.

The insurance-funded irrevocable trust is a uniquely flexible hedge against the planning uncertainties that prevail today because it can:

- serve as a vehicle for the passage of wealth, free of the burden of a possible future carryover basis regime or a capital gains at death tax;
- serve as a funding vehicle for an irrevocable trust in the event the estate tax and GST tax are ultimately retained (or reappear after a period of repeal) sheltering those funds from wealth transfer taxation; and
- serve as a device for elevating the plan above the political vagaries of an ever shifting set of tax rules.

POINT 1: Life Insurance Effectively Transmits Wealth Irrespective of Basis Regime

The most likely estate tax repeal model affects the basis of assets transferred at death. Instead of stepping the basis up to fair market value at the date of death, it carries over the acquirer's basis. (A similar carryover basis provision was enacted as part of the Tax Reform Act of 1976. Due to its inordinate complexity and administrative difficulty (arguments that would not likely succeed today due to advancements in technology), it was repealed four years later, before ever taking effect.) The capital gains consequences could be great, eroding wealth even in the absence of estate tax.

Life insurance avoids this problem altogether: since death benefits are exempt from income tax, there is no question of the recipient's basis, whether we have an estate tax/stepped-up basis regime or a no estate tax/carryover basis regime or a no estate tax/capital gains due at death regime.

POINT 2: Irrevocable Life Insurance Trusts Retain Their Planning Advantages under an Estate Tax Regime

If the estate tax and the GST tax are ultimately not repealed, ILITs will remain attractive vehicles for wealth transfer they have always been. The life insurance proceeds that fund the trust will still be exempt from estate tax, and the trust can be structured so as to exempt them from the GST tax as well.

POINT 3: Insulation against Political Winds

The third major benefit of life insurance as a planning tool is that it elevates the plan above the political vagaries of an ever-shifting set of tax rules.

The recent history of estate tax legislation demonstrates that the issue has become captive to political interests. There is no reason to expect an end to this situation.

The insurance-funded irrevocable trust has always offered protection against these contingencies. If the estate tax is not repealed, it retains the traditional benefits of life insurance in estate planning. If the tax is repealed, it affords unique protection against the carryover basis regime (or the capital gains at death tax regime) that will likely then be in effect. The client wins either way.