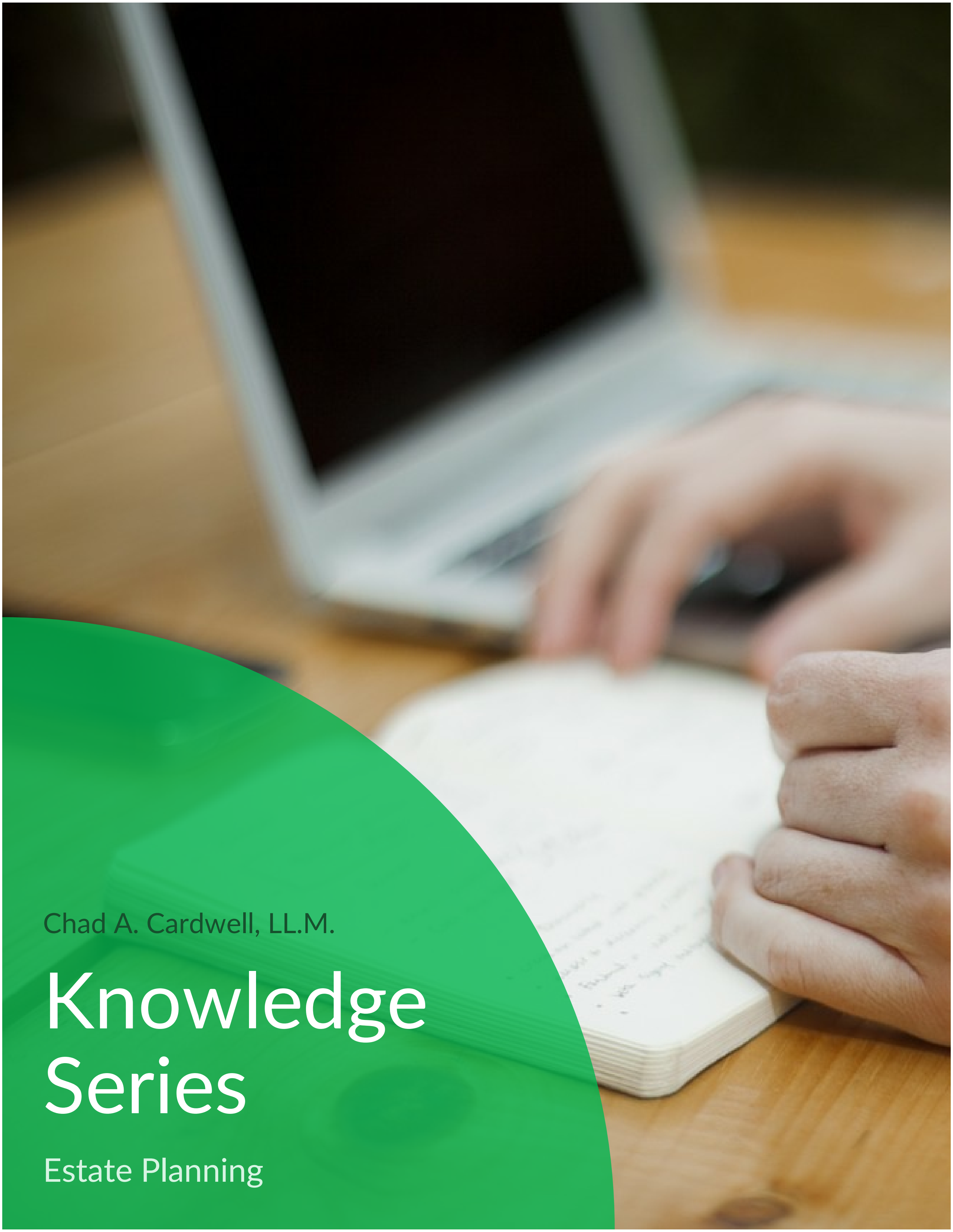
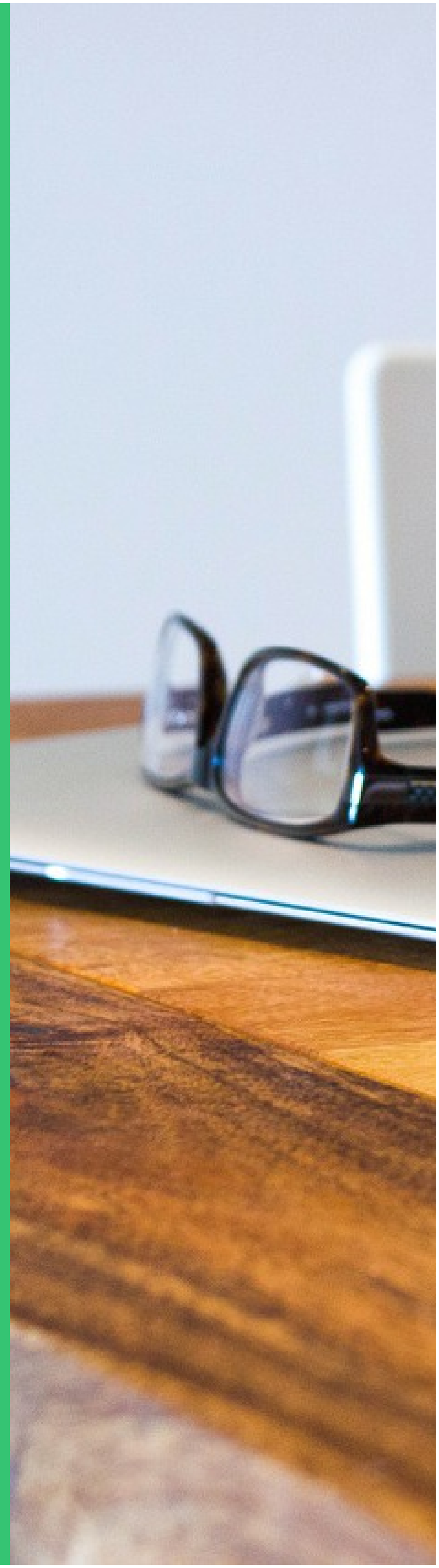


Chad A. Cardwell, LL.M.

Knowledge Series

Estate Planning

Table of Contents



Introduction to Knowledge Series

This series of four succinct topics focuses on the importance of life insurance to the estate plan of your clients. Because this series is presented to a wide range of professionals, we will start with the basics of estate planning and work towards a more involved overview of life insurance planning using trusts. Much of this information may be a refresher for you, but we hope you find the information useful to your practice and helpful in explaining these techniques to your clients. All materials compiled from and used by permission from Broadridge Advisor Solution

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Introduction to Estate Planning

What is estate planning? Simply stated, estate planning is a method for determining how to distribute property during life and at death. It is the process of developing and implementing a master plan that facilitates the distribution of property after death and according to established goals and objectives.

If your clients care about (1) how and to whom their property is distributed, and (2) ensuring that their property is preserved for their loved ones, they need to know more about estate planning.

May be especially needed under certain circumstances. While all clients have at least some need for estate planning, generally, there are certain life circumstances that increase the need for formal estate planning. Examples of those circumstances are:

- Your client has children who are minors or who have special needs
- Your client is business owner
- Your client has property in more than one state
- Your client intends to contribute to charity
- Your client has strong feelings about health-care decisions Your client has privacy concerns or want to avoid probate

How to do it? Designing a plan is a process that is unique to each estate owner. Don't be intimidated or overwhelmed at the prospect. Even the most complex plan can be achieved if your client proceeds step by step. Remember, the peace of mind that comes with developing a successful estate plan is worth the time, trouble, and expense.

Understand the factors that will affect your client's estate. Your client will also need to have some understanding of the factors that may affect the distribution of your client's estate, such as taxes, probate, liquidity, and incapacity.

What are your client's goals and objectives? Your client's goals and objectives are personal, but your client can not formulate a successful plan without a clear and precise understanding of what they are. They can be based on your client's particular circumstances and the factors that may affect your client's estate, as discussed earlier, but your client's feelings and desires are just as important. The following are some goals and objectives your client might consider:

- Provide financial security for your client's family
- Ensure that your client's property is preserved and passed on to your client's beneficiaries
- Avoid disputes among family members, business owners, or with third parties (such as the IRS)
- Provide for your client's children's or grandchildren's education
- Provide for your client's favorite charity
- Maintain control over or ensure the competent management of your client's property in case of incapacity
- Minimize estate taxes and other costs
- Avoid probate
- Provide adequate liquidity for the settlement of your client's estate
- Transfer ownership of your client's business to your client's beneficiaries

Seek professional help. Seeking professional help (an attorney or financial advisor) will help your client understand the strategies that are available and formulate and implement your client's master plan.

Planning Tools

Last will and testament A will is a legal document that lets your client state how your client want your client's property distributed after your client dies, who shall administer your client's estate, and who will care for your client's minor children. This is probably the most important tool available to your client. Anyone with property or minor children should have a will.

Will substitutes. A will substitute, for example, Totten Trust and payable on death bank accounts, allows your client to designate a beneficiary of certain property that will automatically pass to that beneficiary after your client dies and avoids passing through probate.

Trusts. A trust is a separate legal entity that holds your client's assets that are then used for the benefit of one or more people (e.g., your client, your client's spouse, or your client's children). There are different types of trusts, each serving a different purpose, and include marital trusts and charitable trusts. Your client will need an attorney to create a trust.

Joint ownership. Joint ownership is holding property in concert with one or more persons or entities. There are different types of joint ownership, such as tenancy in common and community property, each with different legal definitions, requirements, and consequences.

Gifts. A gift is a transfer of property, not a bona fide sale, that your client make during your client's life to family, friends, or charity. Making gifts can be personally gratifying as well as an effective estate planning tool.

Life insurance. Life insurance is a contract under which proceeds are paid to a designated beneficiary at your client's death. Life insurance plays a part in most estate plans

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Life Insurance: Estate Planning

Why buy life insurance? Life insurance is one of the biggest players in the estate planning game. For some, it is the only way to ensure that family members will be able to support themselves after the death of the primary wage earner. For those with larger estates, life insurance can provide the funds needed to pay estate taxes (and other costs) without liquidating estate assets. For those with a business interest, life insurance can be used as a vehicle for business succession. Finally, for those with a generous spirit, life insurance can permit your client to make charitable gifts.

Provides an income for your client's family. Life insurance can provide your client's family with immediate cash to cover their day-to-day living expenses after your client's death. This may be desirable if your client's estate is small so there would be little left for your client's family to fall back on after payment of debts and expenses. This may also be desirable if: (1) your client's property has a high value but is not income-producing, (2) Your client has heavily invested in speculative securities, (3) Your client has parents, young or disabled children, or other family members who are dependent on your client, or (4) your client's property is weighted heavily on the variable side.

Provides for the special needs of your client's family. Life insurance can provide funds for your client's children's (or grandchildren's) education, or it can be used to satisfy the special needs of individual family members (e.g., financial demands of a physically or mentally handicapped or learning disabled child, aging parents, or other dependents with physical or mental limitations).

Provides for children of a previous marriage In today's world, a family is often a mixture of "yours, mine, and ours." If this is the case for your client, your client may need to plan ahead to ensure that your client's assets are sufficient to provide for your client's new family as well as your client's children from a previous marriage. Life insurance may be one option that is right for your client.

Provides cash for payment of estate expenses and debts. Life insurance can provide funds for payment of federal and state death taxes and other estate settlement costs.

Can be used to fill business needs. If your client is a business owner, life insurance proceeds can be used to:

- Fund a buy-sell agreement
- Finance nonqualified deferred compensation arrangements
- Finance death benefit only (DBO) plans

Can be used to fund a charitable gift. Life insurance proceeds can be used to fund or supplement charitable donations. This can be accomplished in two ways: by having the proceeds paid directly to the charity or by using the proceeds to replace other assets given to charity.

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Maximizing the Estate Planning Value of Life Insurance

What is maximizing the estate planning value of life insurance?Simply put, maximizing the estate planning value of life insurance means getting the most bang for your buck. That is, it involves keeping as much of the proceeds as possible away from the IRS and in the hands of your client's beneficiaries. When your client dies, all his or her worldly goods (e.g., money, house, car, stocks, bonds, as well as life insurance proceeds) become a pie. The pie is then cut into slices and served. One slice goes to your client's heirs and beneficiaries, one slice to the federal government, one slice to your client's creditors, and so on. The size of the slice that goes to the federal government can be as big as 40 percent (the rate for the estates of persons who die in 2013 and later years), and what goes to the federal government does not go to your client's heirs and beneficiaries. Your client needs to plan now to make sure that the slice that goes to the federal government is as small as possible, leaving a bigger slice for your client's loved ones.

Arrange proper ownership of the policy. Who owns the policy and for how long can affect how life insurance is taxed for estate tax purposes. If your client owns a life insurance policy, the proceeds of the policy are includable in your client's gross estate for estate tax purposes, regardless of who your client's designated beneficiaries are. If your client owns a policy and transfer it to another owner within three years of your client's death, the transfer is not recognized for estate tax purposes and the proceeds are therefore includable in your client's gross estate. However, if your client transfers ownership of the policy to someone else more than three years before your client's death, the transfer is recognized for estate tax purposes and the proceeds will therefore not be included in your client's estate. Since insurance that your client owns at death (or within three years of death) is included in your client's estate and therefore may be subject to estate tax, someone other than your client should own the policy if your client wishes to avoid subjecting the proceeds to estate tax. The owner of the policy can be another individual or a trust such as an irrevocable life insurance trust (ILIT).

Designate the right beneficiary. Who your client's beneficiaries are can also affect how life insurance is taxed for estate tax purposes. For example, if the designated beneficiary of a policy on your client's life is your client's estate, the proceeds are generally includable in your client's gross estate for estate tax purposes even if your client did not own the policy at death (or did not own it within three years of death). If the designated beneficiary is your client's executor or your client's estate, the proceeds may be includable in your client's gross estate.

The primary reason for not naming the estate or executors as beneficiaries of policies on life insurance is that doing so subjects the proceeds to the expense of probate and claims of creditors. If your client owns the policy and name a third party as a beneficiary, the proceeds will be included in your client's estate for estate tax purposes but they will pass by operation of law outside of the probate process and will not be subject to the claims of creditors of your client's estate. Proceeds payable to your client's children are not subject to estate tax unless your client owns the policy at death or within three years of death. If your client owns the policy, the proceeds are includable in your client's estate (and therefore subject to the estate tax) regardless of who your client's beneficiaries are.

However, as noted above, if your client names his or her children as beneficiaries, they will receive a greater benefit from the policy than if your client named his or her estate as the beneficiary and then directed that the proceeds be distributed from the estate to your client's children, because proceeds paid to your client's estate will be reduced by probate expenses and claims of creditors while proceeds paid directly to your client's children will not.

The Irrevocable Life Insurance Trust

What is it? An irrevocable life insurance trust (ILIT) is a trust that is funded, at least in part, by life insurance policies or proceeds. If properly implemented, an ILIT can help minimize estate taxes and provide a source of liquid funds to your client's estate for the payment of taxes, debts, and expenses.

Generally, assets your client owns at death are subject to federal estate tax. This includes life insurance policies and proceeds. Estates in excess of the exemption equivalent amount (in 2017, $5,490,000 plus any deceased spousal unused exclusion amount) may have to pay estate tax at rates as high as 40 percent. If your client is an insured individual whose estate will have to pay estate tax, your client's family may receive less money from your life insurance than your client originally planned for.

An ILIT can solve this problem, and may be especially appropriate if your estate would not have to pay estate taxes were it not for the inclusion of the policy proceeds.

How does it work? Because an ILIT is an irrevocable trust, policies and proceeds (and any other assets) held by the trust are considered owned by the trust entity and not owned by your client. Since your client will not own the policy at your death, the proceeds will not be included in your estate. They will be received by the ILIT and ultimately pass to your client's family members undiminished by estate taxes. Your family members can use the proceeds to pay estate expenses. This may save your client's family members from having to sell assets at fire sale prices, and allow them to keep assets that may generate needed income or are valued family keepsakes. One key to this strategy is that your client must relinquish all power over and benefits from the property in the trust.

In a typical scenario, an insurable person (the grantor) first creates an ILIT, names an independent trustee (e.g., a bank trust department), and names the beneficiaries of the trust (usually his or her spouse and/or children). The trustee then applies for life insurance on the grantor's life and designates the ILIT as the sole beneficiary. The trustee also opens a checking account for the ILIT. The grantor gives the trustee funds for the initial premium, which the trustee deposits into the ILIT checking account. The trustee writes a check from the ILIT checking account, pays the premium to the insurance company, and coverage becomes effective. As premiums come due, the grantor and trustee repeat the same procedure. Whenever the ILIT receives funds from the grantor, the trustee provides a special notice (a Crummey notice) to each of the beneficiaries. This Crummey notice lets the beneficiaries know that they have a right to withdraw the recently deposited funds, but only within a certain limited time frame (e.g., 30 to 60 days). The trustee waits until this time frame passes before remitting the funds to the insurance company. This notice procedure serves to qualify the gift for the annual gift tax exclusion (see the section on Crummey withdrawal rights). At the grantor's death, the ILIT trustee collects the total proceeds and distributes them to the beneficiaries according to the terms of the trust.

Why use an ILIT? There are many reasons to use a trust rather than have an individual own your life insurance policy. An ILIT can accomplish some or all of the following:

- Avoid inclusion of the proceeds in your (and your spouse's) estate
- Make the cash liquidity provided by the total proceeds available to the estate of the insured
- Insulate the proceeds from estate taxes over multiple generations
- Provide professional management of the proceeds
- Protect the policy and proceeds from future creditors and potential ex-spouses
- Provide incentives to beneficiaries

Funding the ILIT. Your client can create an ILIT and leave it unfunded during your lifetime. An unfunded ILIT is one that holds a life insurance policy only, and does not hold any other assets. With an unfunded ILIT, your client will need to gift money to the trust so the trustee can pay policy premiums. If the trust holds a permanent life insurance policy and the policy allows it, premiums can be paid with accumulated cash values or dividends, and your client may not need to gift additional funds.

Alternatively, your client can fund an ILIT during your lifetime with assets in addition to your life insurance policy. Funding an ILIT with income-producing assets can provide the trustee with the money needed to pay the policy premiums. An additional benefit of funding your ILIT is that any future appreciation in the assets will be sheltered from estate taxes, again because the trust is irrevocable.

Funding your ILIT also allows your client to coordinate the asset's final disposition with the insurance proceeds.

After your client dies, the ILIT (unfunded or funded) will receive the policy proceeds and the trustee will administer them according to the terms of the trust. The trust can receive other assets at your client's death along with the insurance proceeds, such as assets poured over from your client's will, or death benefits paid by your client's employer or employer benefit plan. The trust terms can direct that the proceeds be distributed to the beneficiaries immediately, or the trust terms can direct that the proceeds remain in the trust and under the trustee's management for a period of time before being distributed. The latter option may be desirable if your client anticipates that his or her heirs might mismanage the funds or if his or her heirs are minor children.

The ownership problem. To keep the proceeds out of your client's estate and your client's spouse's estate, your client and your client's spouse must not retain any incidents of ownership in the policies held by the trust. Though the IRS doesn't specifically define incidents of ownership, the phrase generally refers to any rights your client retains that might benefit your client economically. Those rights include:

- The right to transfer, or to revoke the transfer, of ownership rights
- The right to change certain policy provisions
- The right to surrender or cancel the policy
- The right to pledge the policy for a loan or to borrow against its cash value
- The right to name and to change a beneficiary
- The right to determine how beneficiaries will receive the death proceeds

Your client must not retain any of these rights. Further, the trust document should expressly state that the trust is irrevocable and that the insured is retaining no rights to the policies held by the trust.

Crummey withdrawal rights. Transfers of cash (or any other property, including cash values accumulated in existing policies) to your client's ILIT may be subject to gift tax. However, your client can minimize or eliminate your client's actual gift tax liability by structuring the transfer so that it qualifies for the annual gift tax exclusion (currently $14,000 per beneficiary).

Generally, a gift must be a present interest gift to qualify for the exclusion, which allows your client to gift $14,000 (in 2017) per beneficiary gift-tax free. A present interest gift means that the recipient is able to immediately use, possess, or enjoy the gift. Gifts made to a trust are usually considered gifts of future interests and do not qualify for the exclusion unless they fall within an exception. One such exception is when the beneficiaries are given the right to demand, for a limited period of time, any amounts transferred to the trust. This is referred to as Crummey withdrawal rights or powers.

The beneficiaries (or their parents/guardians) must also be given notice of their rights to withdraw whenever your client transfers funds to the ILIT, and they must be given reasonable time to exercise their rights. The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice at least 30 to 60 days before the expiration of the withdrawal period. It is the duty of the trustee to provide notice to each beneficiary.

Trust's income generally attributed to the grantor. If your client funds his or her ILIT with income-producing assets and the trust is a grantor trust, income from the trust will be taxed to your client, and your client can use any gains, losses, deductions, and credits realized by the trust (most ILITs are grantor trusts). If the trust is not a grantor trust, the trustee must obtain a taxpayer identification number (TIN), which can be obtained online, over the phone, or by mail. If the trust is a grantor trust, a TIN is not required while your client is alive, but the trust will need one upon your client’s death. That being the case, it may make sense to obtain a TIN at the outset.

Transfers to an ILIT are taxable gifts. Transfers to an ILIT are taxable gifts. Crummey rights of withdrawal held by the beneficiaries, however, allow the transfers to qualify for the annual gift tax exclusion. Transfers that do not qualify for the annual gift tax exclusion are exempt from gift tax to the extent of your client’s lifetime gift and estate tax exemption ($5,490,000 in 2017) which is automatically applied.

Proceeds from life insurance policy not included in grantor's estate. If the ILIT is drafted, funded, and administered properly, the proceeds from insurance policies held by the trust will not be included in your client’s estate. This is one of the main benefits of setting up this type of trust.

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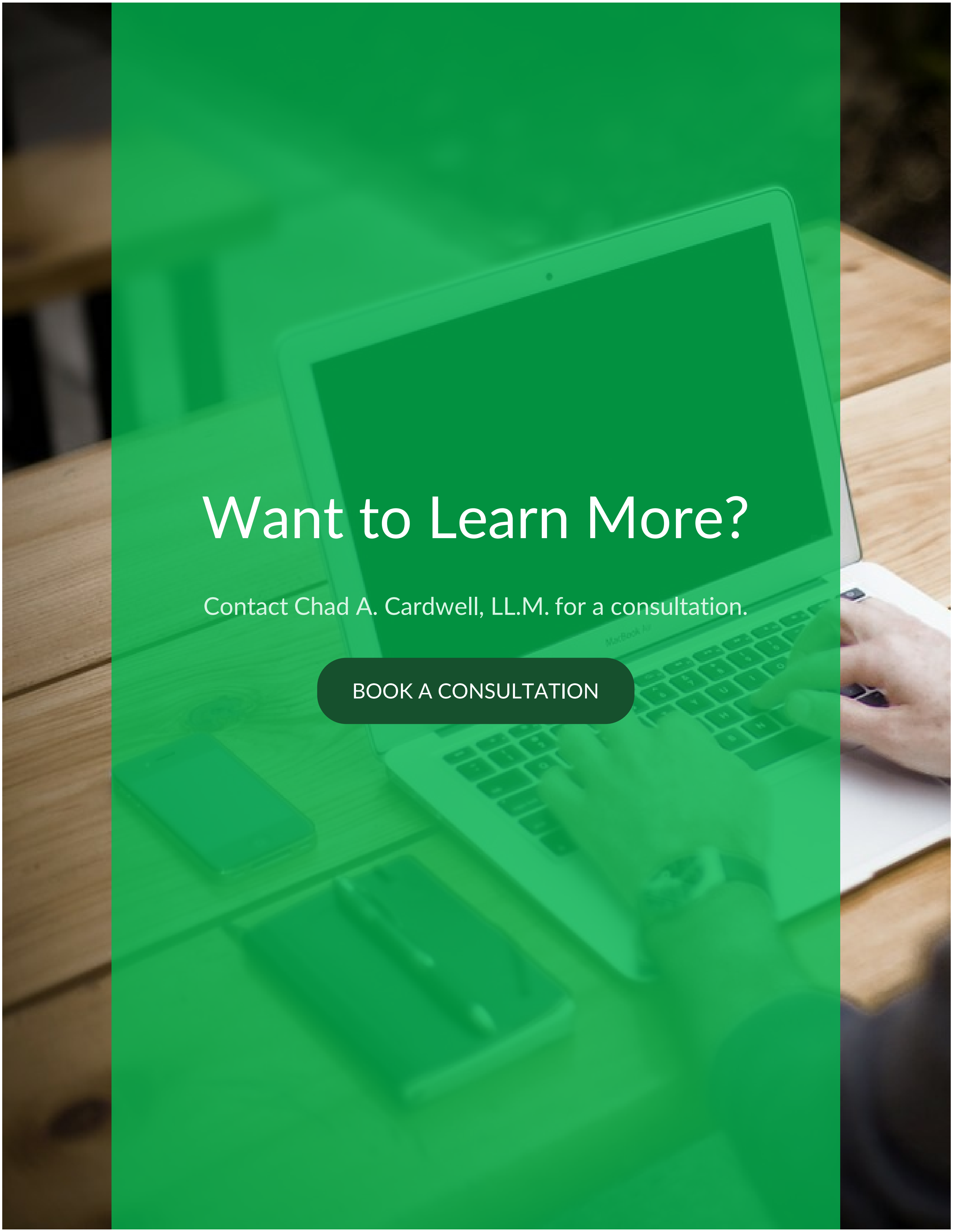
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Information

Chad Cardwell, LL.M. believes in helping clients through processes that can be challenging by giving each matter personal attention, providing sound legal information and having open communication with every client. Attorney Cardwell has dedicated his career to practicing exclusively in the area of estate planning since 2008. Attorney Cardwell was admitted to practice before the Supreme Court of Tennessee in 2007 and the United States Tax Court in 2008, and holds the distinction of being an Accredited Estate Planner® designee by the National Association of Estate Planners and Councils.