



The Law Offices of Kidwell & Kent

john kidwell
Owner and Managing Partner
9695 C Main Street
703-764-0600
jkidwell@kidwellkent.com
www.kidwellkent.com



Life Insurance as a Wealth Replacement Tool





Life Insurance as a Wealth Replacement Tool

What is it?

People are often reluctant to make substantial gifts to charity because they fear they will be unable to leave sufficient assets to their heirs. By using life insurance as a wealth replacement tool, the amount given to charity can be replaced with an equal (or even greater) life insurance death benefit. Thus, your heirs may receive at least as much as they would have if you hadn't made a charitable gift, and you'll be able to give freely to your chosen charities, while gaining some tax benefits at the same time. This strategy is not right for everyone; consult legal and tax planning professionals for more information.

This discussion will focus on the most effective way of using life insurance as a wealth replacement tool. This method involves setting up both a charitable remainder trust (CRT) and a wealth replacement trust, which is an irrevocable life insurance trust (ILIT).

How to do it

Set up a charitable remainder trust (CRT)

First, enlist the help of an attorney to set up a CRT (usually a charitable remainder annuity trust or a charitable remainder unitrust). To make this strategy work, you will need to name yourself as the noncharitable beneficiary. You will also need to choose your charitable beneficiary (who will receive the trust assets at the end of the trust term) and set various other terms of the trust.

Transfer assets into the CRT

The next step is to decide what to contribute to the trust, which will then be donated to your designated charity. This can be anything from cash, to works of art, shares of stock, and even a house. The gift is limited only by the donor's imagination, provided the asset can be valued for tax purposes. Keep in mind, however, that the CRT is irrevocable, meaning that once ownership of an asset transfers to the trust, there is no going back. However, the donor will get a tax break as a reward for his or her generosity (subject to adjusted gross income limitations and other restrictions).

Set up a wealth replacement trust

A wealth replacement trust is the popular name given to an irrevocable life insurance trust (ILIT), established for the purpose of replacing assets given to charity that would otherwise have gone to the deceased's heirs. In other words, this irrevocable trust is set up to hold a life insurance policy. As with a CRT, the aid of an attorney is necessary to set up a wealth replacement trust. To create the ILIT, you will have to choose a trustee to manage the trust and name beneficiaries to receive the life insurance proceeds. To remove the proceeds of the life insurance policy from the insured's taxable estate, the insured must not possess any incidents of ownership in the policy. All ownership rights must be held by the trust and exercised by the trustee. In order to make this strategy work, name children or other heirs as beneficiaries of the trust.

Use CRT distributions and tax savings to fund wealth replacement trust

All CRTs make periodic payments to the noncharitable beneficiary, which is you. You can use these payments, along with the tax savings resulting from the charitable gift, to make cash gifts to the wealth replacement trust. The trustee of the trust will use these cash gifts to purchase life insurance coverage on your life, with the trust as beneficiary of the life insurance policy. Your heirs are the beneficiaries of the trust.

Caution: *It is also possible to transfer an existing life insurance policy into a wealth replacement trust. However, funding the trust in this manner creates additional complications because the insurance policy could still be considered part of the estate if you die within three years of this transfer.*

Life insurance proceeds will replace value of assets given to charity

The result of this strategy is that the proceeds from the insurance policy will pass to the named beneficiaries of the trust, your heirs, in place of the asset that was given to charity.



What are the advantages of this strategy?

Heirs do not suffer as a result of the charitable gift

Children and grandchildren may worry about their inheritance when they see family assets being given to charity. However, using an irrevocable life insurance trust as a wealth replacement tool ensures they will receive their inheritance intact. In fact, they may receive more than they otherwise would, because the proceeds from the life insurance policy will not be included in the donor's taxable estate.

Proceeds from insurance policy held by irrevocable trust not included in taxable estate of decedent

One of the main benefits to using a wealth replacement trust is that the proceeds from the life insurance policy will not be included in the taxable estate of the deceased. Thus, the life insurance policy will provide liquidity free of estate and income taxes to your heirs.

Cash gifts to trust, up to certain limits, to buy life insurance can be made without incurring gift tax

If the irrevocable life insurance trust is drafted properly, cash gifts made to the trust will qualify for the annual gift tax exclusion. Any individual can give \$14,000 annually to any other individual and not pay federal gift tax as long as the gift is one of a present interest (e.g., it can be used by the recipient immediately). A married person can make a gift of up to \$28,000 in the couple's name if they file a joint return. Gifts to an ILIT will be considered "gifts of present interest" if the beneficiaries are given the right to withdraw the money within a certain time period. If they do not withdraw the money, they forfeit the right to take the money and the trustee can use the gift to pay for the life insurance policy. An ILIT that offers the right of the beneficiaries to withdraw the money is said to have "Crummey Powers."

Trust protects a young or irresponsible heir

A similar result could be obtained if you simply gift an insurance policy or give cash to purchase a policy directly to your child. However, many people use a trust to hold the policy because their child is too young or too irresponsible to hold the policy in his or her own name. The trust allows you to select an independent trustee who understands your intentions, and who can make distributions from the trust by borrowing from the policy cash value (or other means) when it is in the best interest of the beneficiary. The trust may stay in effect after the grantor has died and the life insurance proceeds are received so that the trustee can manage the assets for the heir.

What are the disadvantages of this strategy?

Trusts must be irrevocable

As mentioned previously, both the CRT and the wealth replacement trust must be irrevocable. Once you have made your charitable gift, you can't change your mind and take it back. And once you set up and fund the wealth replacement trust, you cannot change its terms, although you may change the charitable beneficiary if the trust document so provides.

Strategy may be expensive to execute

Setting up the charitable remainder trust and the wealth replacement trust both require the help of a qualified attorney. This could become expensive. Depending on whom you name as trustee of the wealth replacement trust, you may have to pay for administrative costs and other expenses of managing the trust. Finally, the life insurance policy itself could be expensive, depending on your age and/or your health.

IMPORTANT DISCLOSURES This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



The Law Offices of Kidwell & Kent
john kidwell
Owner and Managing Partner
9695 C Main Street
703-764-0600
jkidwell@kidwellkent.com
www.kidwellkent.com

