



Liquidity issues?

Consider buying a second-to-die life insurance policy to pay estate taxes

Even armed with a solid estate plan, if your and your spouse's estate is worth more than your combined lifetime exemptions, estate tax likely will be owed on the survivor's death. The problem will be exacerbated if your and your spouse's assets are mostly illiquid. Why? Because to pay the estate tax your executor may need to sell assets you intended to pass to heirs.

If you're in this situation and you're married, consider purchasing second-to-die life insurance.

Examining the policy

In essence, second-to-die life insurance is one policy that covers two lives. When you or your spouse dies, the policy continues to cover the surviving spouse, and no proceeds are paid until the surviving spouse dies. Because generally no estate tax is due when the first spouse dies (thanks to the unlimited marital deduction), a second-to-die policy can be a perfect instrument to pay estate taxes.

Second-to-die policies can be an attractive alternative to individual policies because the insurer spreads the risk over two lives instead of one; thus, the premiums typically are significantly lower. Or, if one spouse is in poor health, a second-to-die policy may be the only way he or she can get coverage. In this case, the premiums will probably not be much different than they'd be for a policy on the healthier spouse's life.

Paying the premiums

Before buying a second-to-die policy, consider the premium payments. For instance, are payments fixed or interest sensitive? If investment performance will cause premiums to fluctuate, worst-case scenario projections can help gauge your ability to afford the policy.

Also, are the premiums projected for only a limited period of time? In this case, the insurance company assumes that eventually annual dividends, cash value or interest will replace your premium payments. In other words, you won't need to pay your premiums with out-of-pocket cash. Make sure that assumptions aren't too aggressive or you could end up paying premiums out-of-pocket longer than expected.

It's also important to plan before buying the policy for how premiums will be paid after the first spouse dies. If the deceased spouse earned the income needed to pay premiums, the surviving spouse must be able to continue paying them. One solution is to add a rider to the policy providing money to pay the surviving spouse's premiums. Or if you buy a policy that builds cash value, that may be sufficient, depending on when the premiums will no longer need to be paid.

Avoiding estate tax liability with an ILIT

When you or your spouse owns (or you jointly own) a second-to-die policy, the policy's proceeds will be included in the surviving spouse's taxable estate, which could create greater estate tax liability. To avoid this outcome, you may opt to keep the policy outside of the estate by holding it in an irrevocable life insurance trust (ILIT).

If you transfer an existing second-to-die policy to an ILIT, be aware that you must make the transfer at least three years before the surviving spouse's death to realize the estate tax savings.

You can fund the premiums by making annual exclusion gifts to the ILIT. With proper planning, you and your spouse can jointly give up to \$24,000 (your combined annual exclusion amount) times the number of trust beneficiaries annually — plus, if necessary, tap your \$1 million lifetime gift tax exemptions — and not incur any gift tax liability. Remember that, after your or your spouse's death, the annual exclusion is limited to the survivor's individual annual exclusion amount, currently \$12,000, times the number of beneficiaries.

Is a second-to-die policy right for you?

If you and your spouse have a substantial estate but illiquid assets, your executor may need additional funds to pay the estate tax due on the surviving spouse's death. Using a second-to-die life insurance policy to cover the estate tax can be a powerful estate tax strategy.

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