Using Life Insurance To Cushion Blow Of Estate Taxes

JULY 19, 2021 • JEFF STIMPSON

Life insurance can come with many tax benefits, such as tax-free payouts to the beneficiary. Now it may offer another benefit for for estate planning.

President Joe Biden has asked for higher taxes on inheritances to help pay for the American Families Plan, and life insurance can be a way for heirs to ease the impact. Biden is calling for capital gains taxes on inherited property at death (with a $1 million exclusion of gains for individuals), as well as a hike on the capital gains rate itself.

Life insurance used to be more widely used to help defray inheritance costs. In 2017, tax reform raised the estate tax exemption and fewer clients needed to use the tool. That could be changing as more realize that such insurance can help minimize estate tax and provide liquidity for heirs.

An irrevocable life insurance trust (ILIT), for instance, can in effect use the policy to pay taxes at death. For estate tax concerns, use of an ILIT or having the beneficiaries themselves be the owner of the life insurance policy will prevent estate tax on the life insurance proceeds.

“An ILIT will be used so the trust can control the payout to the beneficiaries beyond the account owner’s lifetime,” said Robert Polans, a CPA at Drucker & Scaccetti in Philadelphia.

Private placement life insurance (PPLI) is often structured to include only the “minimal amount of mortality risk needed to achieve optimal income tax treatment,” said Brent Lipschultz, partner in EisnerAmper LLP’s personal wealth advisor practice. Lower mortality cost helps reduce drag on the return of the investment and can increase the total premium deposited that will be allocated through the investment account.

“The benefit of PPLI is that there’s no income tax paid on the investments held by the PPLI nor is there any reporting, including international reporting for those that invest in hedge funds or private equity that invest overseas,” Lipschultz said. “PPLI offers the best of both worlds, used to maximize a portfolio without income tax consequences, and can be an efficient tool used in wealth transfer planning.”

Purchasing life insurance can also be done with tax efficiency. One distribution-based option gaining popularity after the Setting Every Community Up for Retirement Enhancement (SECURE) Act is using RMDs or pre-RMD distributions to fund permanent life insurance on the account owner or on the lives of the account owner and their spouse (aka “second-to-die” insurance).

“By drawing down taxable retirement plan balances during the account owner’s lifetime to pay life insurance premiums, an account owner may take advantage of lower tax brackets today and restore a greater amount of inheritance to beneficiaries,” Polans said. “It’s helpful if premiums can be limited to being paid for only a fixed period, as this increases the likelihood the insurance will remain fully funded and last until needed.

“This strategy can provide completely tax-free life insurance benefits to beneficiaries, can be used to offset tax, and provide control over distributions,” he said. “Another added benefit is there are no lifetime RMDs required on life insurance proceeds.”

“Take distributions after age 59½, [which are] penalty free, pay the income tax and buy a life insurance policy with the remaining cash inside an irrevocable life insurance trust (ILIT),” said Robert Karon, CPA and J.D., Minneapolis-based managing director at CBIZ MHM. “The death proceeds are income tax-free. Inside the ILIT, the death benefit is estate tax free.

Some tax and financial planners have said clients are relieved that their life insurance heirs will be able to use tax-free money to cover end-of-life expenses and other debts. Others have started trying to calculate their eventual capital gains if Biden's proposals go through.

As always, advisors warn against leaping at one planning tool.

"Do the math, run the numbers," Karon said. "The potential insured must be insurable. That is why the sooner you look at this option, the better off you are—before health problems develop."
