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The Importance of Cash Value Life Insurance in Financial, Retirement and Estate Planning

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Executive Summary

Being able to gain control of one's individual personal finances is an almost impossible task. Assuming that individuals have funds to invest, the myriad of available investment opportunities is, for many, beyond comprehension. Even assuming that it is possible to find a suitable investment, it may not be suitable in a few short years.

Even though returns may seem satisfactory, investors often neglect to factor in the terrible consequences and erosion of wealth caused by our tax system. Planning with the use of cash value life insurance is one of the few planning strategies an individual has available to counteract the tax system.

Cash value life insurance allows each individual to gain control of his or her financial planning to achieve two important objectives of financial planning—wealth preservation and wealth accumulation.

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The Goals of Financial Planning

Financial planning is based solely on the ability of the individual to:

- (1) keep what he or she has earned or created for many generations to come,
- (2) free of erosion, diminution or confiscation by an unrelenting tax system that knows no bounds, and
- (3) notwithstanding the constant bombardment and challenges of the system to create additional wealth.

Financial and Estate Planning

The goals described are essentially a form of planning that may be referred to as "financial and estate planning." The reason the two types of planning are combined is that they cannot be treated in a vacuum. They are linked since one affects the other.

Financial planning is essentially asset invest-

Leveraging with Cash Value Life Insurance

Cash value life insurance is the substitute for the lost opportunity. Cash value life insurance permits the investor to leverage tax dollars to build up cash values which may be withdrawn and used without paying any income taxes.

Cash value life insurance has the following tax benefits:

- The increase in cash values (earnings under the contract) grow on a tax free basis.
- Dividends paid by the insurance company are received tax free, whether they are (1) paid in cash, (2) used to purchase (a) paid-up life insurance additions (which also generate more cash value) or (b) term insurance, or (3) left with the insurance company at interest.
- Cash withdrawals are received income tax free to the extent of the premiums paid into the policy, less dividends. Once the owner recovers his or her investment (premiums less dividends and nontaxable distributions), withdrawals are thereafter subject to income tax.

The great benefit of cash value life insurance is that investing in such insurance maximizes returns since there are no lost opportunities due to the payment of income taxes.

Cash value life insurance is also an effective and cost efficient wealth builder. An entrepreneur who has devoted a lifetime to building a business faces a loss of that business on death due to the progressive estate tax which starts at 37 percent for taxable estates in excess of \$650,000 (for 1999 and increasing in increments to \$1 million from 1999 to 2006) and reaches 55 percent when the taxable estate exceeds \$3,000,000. Life insurance provides the wealth replacement and liquidity to pay that tax and preserve the business for future generations.

The cash value in the life insurance policy will also serve to supplement the entrepreneur's retirement years in a lifestyle to which he or she has grown accustomed. Since, as noted above, withdrawals of cash value are not subject to income tax until after the owner recovers his or her investment in the contract, the retiree need not be concerned about using such withdrawals to pay income taxes.

Life insurance may also be structured so that the death benefits are not subject to estate and gift taxes and to provide leverage to avoid the devastating consequences of the generation-skipping transfer tax. If life insurance is owned by a third party, such as an irrevocable life insurance trust, then none of the death benefit will be included in the insured's estate. If the insured transfers a policy to a third person and dies during the three year period following the transfer, the death proceeds will be subject to estate tax. If the insured survives for three years after the transfer, then the death proceeds are not included in his or her estate.

Cash value life insurance is the one investment that provides more financial planning benefits and income, gift and estate tax benefits than any other investment.

Impediments to Wealth Creation

The most effective impediment to wealth creation is the federal tax system. This is aggravated by the many states that copy the federal system with their own tax system. The following summarizes the most important tax impediments to wealth creation affecting individuals.

The Income Tax

The highest federal income tax rate is 39.6 percent. This is not, however, the highest marginal rate. If taxable income is high enough, then the amount of deductions an individual is entitled to take on his or her income tax return is limited. Further, personal exemptions are phased out as taxable income increases. These two items raise the marginal rate by almost 4.4 percent (reduction of itemized expenses—almost 1.2%; phaseout of exemptions—3.2% for a family of four at 0.8% per exemption) to almost 44 percent.

Social Security Taxes

The Social Security and Medicare tax is 15.30 percent of the first \$72,600 of earnings in 1999. The earnings amount increases each year for inflation. The tax is paid one-half by the employer and one-half by the employee. The total tax for 1999 is \$11,107.80. In addition, every employee and employer pays a Medicare tax of 1.45 percent each on all compensation in excess of the Social Security limit. The total Social Security and Medicare taxes for an individual earning \$200,000

first death. At the second death, the tax comes due and must be paid. (If a spouse is not a US citizen, different rules and more restrictive rules apply.)

The Impact of the Generation-Skipping Transfer Tax

The generation-skipping transfer tax (GSTT) is a transfer tax in addition to the regular gift and estate tax. The result is a confiscatory tax that destroys wealth. The tax is at the highest estate tax rate—currently 55 percent. The tax is imposed whenever a transfer (either in trust or outright) skips a generation (from grandparent to grandchild while the parent-child is living).

The GSTT also applies when there is a taxable termination of a trust to a skip person or a taxable distribution from a trust to a skip person.

Taxation of Qualified Retirement Income (IRAs and other Qualified Plans)

The taxation of income from individual retirement accounts and qualified retirement plans is not well understood by the average retiree. The area represents a tax trap for the uninitiated and requires careful planning to avoid the costs associated with these plans.

Qualified retirement plans have a great appeal since the plan participant believes that he or she is getting something for nothing. The something for nothing is that funds paid into retirement plans are tax deductible to the employer and are not taxable income to the participant employee. Further, all earnings in the plan accumulate on a tax deferred basis.

The usual format is that business owners and self-employed individuals will create qualified plans that are designed to provide for the maximum contributions over the longest period of time. At or near retirement, the amount credited to the participant is then usually rolled over into an individual retirement account (IRA). The account continues to build up on a tax deferred basis. At age 70 ½ the account owner is required to start receiving minimum distributions from the IRA, usually based on his or her life expectancy or the joint life expectancy of the owner and usually his or her spouse.

Tax Consequences of IRA Assets

IRA distributions are subject to income tax. IRA assets are subject to estate tax. IRA owners are required to distribute minimum amounts from

their plans. These distributions are generally based on life expectancy. If the owner does not distribute the minimum, a 50 percent penalty tax is imposed on the amount of the shortfall.

It is estimated that the combination of the income tax and the estate tax may represent a loss of about 70-85 percent of the retirement assets. The loss is worse if the transfer is subject to the GSTT.

The Political Impact

The decision whether to tax and how much is a political decision. Whether taxes go up or down depends on who may be in control of the government at the time. Future tax planning is not predictable. Investors must be weary of promises.

Conclusion

The tax system is complex and plagued with costly traps. The lost opportunity factor arising from the tax system makes alternative planning a necessity. Cash value life insurance is an efficient and safe alternative.

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