CONSIDER THE IMPORTANCE

The Legacy of Life Insurance

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Legacy planning should be a thoughtful and strategic process that is crucial for individuals aiming to secure their financial footprint for future generations. With a plethora of assets available for deployment in legacy planning, care should be given to the analysis of which assets best meet the client's overall goals and achieve wealth preservation and tax mitigation. Often this analysis will factor in cost basis and its interplay in sophisticated planning measures such as irrevocable trusts, and when it comes to pure legacy planning endeavors, life insurance is a tool that can give clients an edge in the cost basis game when compared against other asset classes, especially in light of commentary from the IRS. Let's take a look!

THE BASICS

Inherent in life insurance is the possibility of passing along wealth in a tax-free or tax-advantaged manner. When structured appropriately, life insurance death benefits are received free of federal income taxation by the beneficiaries (and, in some states, potentially free of state-level taxes as well[*]). With permanent insurance, the cash value of in-force policies grows tax-deferred, much like a qualified asset, and loans or withdrawals can potentially be made in a tax-advantaged way.

None of these features should be surprising to any advisor who understands the power of life insurance and conveys that to their clients, but when it comes to estate and, moreover, *legacy* planning, the true power of life insurance can sometimes be left on the table when passed over for other assets or planning regimes. One area that stands out as a prime example is the classic game of cost basis, which recently had some insightful updates from the IRS.

THE IRS

In 2023, the IRS issued Revenue Ruling 2023-2. In it, the IRS clarified a key question in estate planning, namely whether the assets in an Irrevocable Grantor Trust[†] receive a step-up in cost basis upon the death of the grantor. A subset of planners/attorneys argued for the step-up, but ultimately the IRS decided in favor of the prevailing view that for an asset to receive a step-up in basis it must be held in the taxable estate at the time of death. As this Revenue Ruling confirmed that common understanding, it indirectly gave renewed focus to the efficacy of trust-owned life insurance from an estate and legacy planning perspective.

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[*] *e.g.* state estate/inheritance taxes, depending on circumstances and/or policy structure

[†] Simply put, a trust wherein the assets are treated as owned by the grantor for income tax purposes, but outside of the estate (and therefore uncounted) for federal estate tax calculations.

THE COST BASIS

Though the Revenue Ruling essentially closed off the argument for creative cost-basis treatment, the planning arrangements available with grantor trusts remained‡. In particular, grantors can still retain a “swap power” to exchange assets of like value up to death, allowing the swapping of different assets to ensure the inclusion of certain low-basis assets in the taxable estate (and thereby ensuring a step-up in basis) or moving of legacy assets out of the taxable estate (at the “price” of the lost step-up).

The swap power certainly makes for creative planning mechanisms, but like all strategies it is not without risk. Untimely death or administrative hiccups prior to death can deny the opportunity to execute a swap. In the case of certain assets, such as commercial real estate, the cost basis can be so low that the risk of failing to execute a swap can be impactful. To hedge against these risks, life insurance can and should be considered in any robust legacy plan.

BACK TO BASICS

When viewed through the lens of cost basis, life insurance is an asset that effectively receives a step-up at payout, by way of the income-tax free death benefit. This holds true regardless of whether the life insurance is personally-owned or trust-owned (though the latter preserves the holy grail of tax mitigation: estate tax avoidance).

Given that trust-owned life insurance can be funded inside a trust in a variety of ways that have minimal gift tax implications – annual gift/Crummey regimes, split-dollar funding, premium financing, etc. – it only makes sense to explore life insurance in any serious legacy planning initiative.

In sum, when considering assets to analyze or earmark for legacy planning, few – if any – assets can compete with life insurance. For clients looking to preserve wealth for future generations, look no further than incorporating an insurance discussion into your next client meeting.

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‡ Though the essence of grantor trusts has recently been targeted for legislative intervention, *e.g.* in provisions of the Build Back Better Act of 2022, which were ultimately abandoned when it transformed into the Inflation Reduction Act.