John Hancock

LIFE INSURANCE

BECAUSE YOU ASKED

ADVANCED MARKETS

Top 10 Estate Planning Mistakes

The John Hancock Advanced Markets group strives to help producers assist their clients in creating an estate plan that will help support and benefit the family in a manner that is both efficient and minimizes potential taxes.

Many times, however, we are asked to assist with estate planning issues that arise after the fact — after decisions have already been made, trusts have been executed, insurance has been issued or individuals have died. Based on our collective experiences over the years, the attorneys of the Advanced Markets group collaborated to devise a list of the top 10 planning mistakes that we commonly see, particularly as they pertain to life insurance.

This article will discuss the top 10 planning mistakes.

NUMBER 10:

Ineffective Beneficiary Designations

This problem typically arises simply because clients fail to review beneficiary designations after the initial designation. Because of death, divorce, or changes in circumstance, it is important that clients review these designations to ensure that the proper persons — e.g., not the ex-spouse — will receive the benefits of a life insurance policy (or annuity, IRA, etc.) at the insured's death.

If a minor is an intended beneficiary, the client should consider naming a trust or custodian as beneficiary under the Uniform Transfers to Minors Act (depending on state law) to avoid potential court interference. Care should also be taken when naming a trust or estate as the beneficiary of an IRA, 401(k) or other qualified plan so as not to jeopardize the option to stretch out payments over the beneficiary's life expectancy.

NUMBER 9:

Improper Individual Ownership of Life Insurance Policies

To avoid inclusion of death benefit in the insured's estate and the cost of executing a trust, many clients decide to have a spouse, child or other family member own a life insurance policy on his/her life. Although this may not always be problematic, the client should be aware of some potential pitfalls to this arrangement.

For example:

(a) Out-of-order Deaths: If the spouse of the insured is owner of a policy and the spouse predeceases the insured, 9 times out of 10 the insured becomes the new policy owner per the spouse's will or intestacy laws.

(b) Creditors: Individual ownership of a policy may allow creditors to access the policy. Trusts typically provide much more substantial creditor protection.

(c) Unintended Gifting: We usually see this problem when there are three different parties involved: the insured, the owner and the beneficiary. For example, son owns policy on his mom's life for the benefit of son and his two siblings. Seems harmless enough, but what mom and son may not know is that at mom's death, the son may be deemed to have made a gift of all amounts going to his two siblings from the death benefit.

NUMBER 8:

Ignoring the Formalities of a Trust

As is common with most irrevocable life insurance trusts (ILITs), the grantor annually contributes some or all of the money needed to pay the premium on a life insurance policy owned by the trust and wishes to have that contribution qualify as an annual exclusion gift (subject to annual gifting limitations — for 2013, the limit is $14,000). However, if beneficiaries are not properly alerted to their right to withdraw amounts contributed (known as a Crummey power) or the grantor pays the premium directly to the insurance company, such amounts may not qualify for the annual gift exclusion and a gift tax return will need to be filed.

NUMBER 7:

Failure to Do Business Succession Planning

Proper business succession planning isn't just about creating a business succession plan, but it is also about ensuring the plan is updated periodically, complements and integrates with the larger estate plan, and considers proper ownership of life insurance when used to fund the buy-sell obligation.

NUMBER 6:

Planning Only to Address Gift/Estate Tax Laws

Tax uncertainty is nothing new and should not keep clients from reviewing, updating and engaging in estate planning. There are many reasons to create an estate plan that have nothing to do with taxes; creditor protection, blended families, special needs family members, or divorce, for example. Bottom line — estate planning is important regardless of taxes!

NUMBER 5:

Under Appreciating Charitable Planning Complexities

Special considerations must be made when using life insurance with charitable planning, particularly if the client seeks an income tax deduction. For example, the income tax deduction associated with a gift of an existing life insurance policy to a qualified charity is limited to the lesser of the contract's cost basis and the contract's fair market value. This limitation often means a much smaller deduction than originally anticipated when looking at the contract's cash value. A gift of an existing policy with a cost basis (or fair market value if less than basis) of over $5,000 also requires a "qualified appraisal" in order to receive an income tax deduction, which may be an unwelcomed cost to the client. Even if just a cash gift is being made to a charity, it is important to know and understand the requirements to obtain a deduction — a recent court case upheld the IRS' denial of an income tax deduction to the taxpayer simply because a proper receipt was not provided within the time allotted.

NUMBER 4:

Unexpected Gain Recognition with 1035 Exchanges

Although a taxpayer can generally avoid gain recognition when exchanging one life insurance policy for another life policy, a withdrawal taken in conjunction with, or within close proximity to, a 1035 exchange may be taxable as "boot." "Boot" is property or money received in the exchange in addition to the like-kind property (e.g., the life policy). Boot is only taxable to the extent there is gain in the policy.

For example, Mike owns a contract with $1,000 gross cash value, no loan, and a basis of $500. Mike withdraws $400 before exchanging his policy for another life policy. After the exchange, Mike owns a new policy and has $400 in his pocket, which is considered boot. Because there was $500 of gain in the policy, the full amount of boot received is taxable to Mike.

Similar rules apply to policy loans paid off using cash value as part of, or in close proximity to, a 1035 exchange.

NUMBER 3:

Noncompliance with 101(j)

Section 101(j) applies to all life insurance policies owned by an employer or "related party" on the life of any employee issued after August 17, 2006, or materially modified after this date. While the requirements and considerations to avoid taxation of death benefit for employer-owned contracts are beyond the scope of this article, one of the most pervasive issues the Advanced Markets group sees regarding 101(j) is the lack of compliance with these requirements—particularly with Notice and Consent.

When an employer or "related party" (e.g., subsidiary) is applying for life insurance on the life of an employee, 101(j) rules should be consulted to determine its applicability. Don't assume that attorneys, CPAs or other advisors are familiar with these rules. For helpful guidance on the rules, requirements and issues associated with 101(j), please access our Because You Asked: Understanding Employer-Owned Life Insurance (EOLI) and 101(j) piece on this topic located in the Advanced Markets Library of www.jhsalesnet.com.

NUMBER 2:

Triggering Transfer for Value

A life insurance policy "Transferred for Value" (TFV) may cause the death benefit to become income taxable when received by the beneficiary. A TFV requires consideration to be received by the transferor, so gifts of policies (without loans) do not fall under this rule. Even when consideration is received, certain transfers qualify for an exception to the TFV rule. These exceptions include transfers to: (1) the insured, (2) to a partner of the insured, (3) to a partnership in which the insured is a member, and (4) to a corporation in which the insured is a shareholder. Another exception to TFV exists when the transferee takes the basis of the transferor (e.g., corporate reorganization, transfers related to divorces).

It is important to remember that a transfer for value can be triggered even when only a part of a life insurance policy is transferred for consideration. For example, A and B are shareholders in a corporation and each own a life insurance policy on their own lives. For buy-sell planning purposes, A agrees to name B as the beneficiary of A's policy and B agrees to do the same in favor of A. By naming each other as beneficiary, A and B have effectively transferred death benefit to the other for consideration and have created a transfer for value for which an exception does not exist.

NUMBER 1:

Improper Valuation of Life Insurance Policies

One of the most difficult questions to answer is the question on policy valuation. The general rule for valuing property for tax purposes is the use the property's "Fair Market Value" (FMV), which is defined generally as the price at which the property would change hands between a willing buyer and willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts. In certain instances the IRS has issued rules regarding policy valuation. For example, in gifting situations, the value of a policy that has been in force for some time and on which further premiums are due is said to be its "Interpolated Terminal Reserve" (ITR) plus unearned premium. In most other situations, however, there are no clear rules or regulations as to how one determines FMV.

As a general rule, one should not assume Cash Value (or the lack thereof, as with term policies) constitutes a policy's FMV. Other values may need to be obtained (e.g., ITR, PERC, Life Settlement Market Values, etc.) and the client should consult with his/her tax counsel to determine the most appropriate value based on the type of transfer.

For more information on the top 10 estate planning mistakes, contact the Advanced Markets Group at 888-266-7498, option 3.

IM7047 MLINY02271318312 02/13