

**“You are  
worth more  
dead than  
alive”**

## ESTATE PLANNING AND LIFE INSURANCE

In *It's a Wonderful Life*, the cruel and miserly Mr. Potter points out to George Bailey that George is “worth more dead than alive.” While the movie went on to show that this was not true, given the lives George touched in a positive way, Potter was technically correct when looking strictly at finances; and, the same holds true for many people, like George Bailey, who own life insurance. For many people, the largest asset at their deaths is the death benefit from a life insurance policy. Despite this fact, however, there is much misinformation among policy holders, life insurance professionals and even attorneys about how life insurance fits into estate planning. In this article, we attempt to clear up some of these misconceptions.

First, life insurance is not governed by an insured's will or trust, unless the insured has named her estate or trust as the beneficiary. Life insurance is a contract between an individual (the insured) and the life insurance company. In the event of the death of the insured, the company will pay the death benefit to whomever the insured has designated as the beneficiary. Therefore, if an insured has named his wife as the beneficiary of his estate at death, but he continues to name his mother as the beneficiary under a life insurance policy (including one he

might have purchased prior to getting married), at his death his wife will be surprised to find out that the life insurance proceeds will pass to her mother-in-law, not to her. Whether or not this was the intention of the insured after writing the will is irrelevant – the company's contractual obligation is to pay out the policy to whomever is listed as the beneficiary at the time of death. Thus, when an estate plan is being prepared, it is vital that the person disclose to the attorney all life insurance policies and who is the beneficiary under those policies. If the insured wants the death benefit to be distributed to beneficiaries as outlined in a will or trust, then the estate (in the case of a will) or a trust needs to be named as the beneficiary at death.

Second, the death benefit of life insurance is not subject to income tax in most cases, but life insurance held by an individual is added to that person's estate for estate tax purposes. This fact alone puts many people in an estate tax situation, even if these folks do not see themselves as millionaires. For example, a man could have \$1.5 million of life insurance on his life (to replace any income that might be lost to his family if he should die) and have \$1 million of other assets (such as a retirement account, equity in a home, other investment accounts or business



# SUPREME COURT DECIDES TAX CASE

interest). If this individual dies, he has an estate of \$2.5 million for estate tax purposes. If he does not engage in proper planning, the potential estate tax could be as high as \$250,000.

For this reason, many estate planning attorneys advocate putting life insurance in a certain type of trust called an irrevocable life insurance trust (ILIT). An ILIT is a trust that, if drafted and administered properly, is not considered part of a deceased person's estate for estate tax purposes. The rules regarding ILITs are very complicated (too complicated for this article), but one thing is clear - an ILIT is not a revocable living trust. Naming your trust as a beneficiary of life insurance is not the same as creating an ILIT to hold life insurance on your life. Furthermore, if you create an ILIT, it is better, provided the person is insurable, for the trust itself to purchase a policy on the person's life. Existing policies that are transferred into ILITs are subject to a three-year rule, in which the insured must survive for at least three years following the transfer into the ILIT for the death benefit of that transferred life insurance to be excluded from the estate for estate tax purposes.

The most important thing to remember is that when you engage in estate planning, you must disclose the existence of all life insurance, including insurance under an employer's benefit plan, and know who the beneficiaries are. If the beneficiaries of the life insurance are not the same beneficiaries as under a person's estate plan, there may be a problem. When properly handled, life insurance can protect a deceased person's loved ones from financial ruin on the account of that person's death. Improperly handled, life insurance can become its own problem.

The U.S. Supreme Court is charged with overseeing decisions made by all federal courts and has final authority on all decisions in those courts. Whether or not to hear an appeal from the lower federal court is the Supreme Court's decision alone. There are numerous reasons why the Supreme Court would hear an appeal. One reason is the lower Appellate Circuits have come out with legal decisions that directly contradict one another. Such was the case with respect to the deductibility of investment advisory expenses on a trust income tax return.

In *Knight v. Commissioner* (of the IRS) (also known as *Rudkin*), the Supreme Court was faced with a question of whether investment advisory fees charged to a trust were subject to the general 2% floor for miscellaneous deductions. In general, individuals can take certain deductions for miscellaneous expenses, including investment advisory fees. Those expenses are deductible to the extent they exceed 2% of the individual's adjusted gross income for the year. Also in general, trusts are subject to the same rules about deductions as individuals; however, there is an exception for those expenses that a trust incurs that are considered necessary and unique to a

trust. If this is the case, these expenses are fully deductible and not subject to the 2% floor limitation.

The Court, in a unanimous decision, found that investment advisory fees were subject to the 2% floor. The Court keyed on the idea that, while

it is true that a trustee may feel compelled to hire an investment manager to insure that the trust assets are being properly invested, taking such prudent action is not unique to trusts, as many individuals do the same with their own investments. A trustee who fails to properly manage

trust assets could be liable to the beneficiaries, but the Court focused on the fact that investment advisory fees are charged to individuals and trusts alike, whereas trustee fees, for example, are unique to trusts alone. As you can imagine, there is much dissent from the financial industry on this decision, but, unless Congress rewrites the law, the decision is the final word on this matter.

If you do incur investment advisory fees in a trust, make sure that your tax advisor is properly reporting these on the trust income tax return for this year and all years going forward.



# IN TERROREM CLAUSES – DO THEY WORK?



We live in a litigious society. Everyday the news is filled with reports about lawsuits - individuals suing the state, the state suing the individuals, and worse yet, family members suing each other. Individuals, and their attorneys, have looked for ways to reduce the threat of litigation. Possible solutions have been attorney's fees clauses (so called "loser pays" rules), mandatory arbitration clauses and, in the case of estate plans, *in terrorem* clauses. An *in terrorem* clause is a provision placed in a will or trust that states that if an heir contests a will or trust after the person creating the document has died, that heir has forfeited the inheritance granted under the document. It is used often in the context of children who have been otherwise disinherited. A person can leave a specific amount to a child on the condition that the child will not contest the will or trust. The theory is that the child will not risk losing the stated amount and will quietly take the gift and go away. But do these clauses really work?

A study of the case law in Illinois and other states shows that often courts will ignore *in terrorem* clauses, particularly if the court believes that there is in fact a valid claim on the part of an heir

that there might have been grounds for the will or trust to be overturned. Another problem is such heirs receiving bequests subject to an *in terrorem* clause can be nuisances even if they do not litigate. For example, all beneficiaries to a trust (which is otherwise a private document) have a right to see the trust. Therefore, by giving a person a small gift subject to *in terrorem* clause, that person would still have the right to see the trust document (and know who will get the lion's share). It is not clear whether that person would have a right to see the entire document, but courts will generally allow people to see trusts in their entirety if the person is a beneficiary. Furthermore, it is often the case that when people make these gifts, they never leave enough money. Would a child disinherited from a \$1 million estate be dissuaded from taking his chances in court over the possible loss of a \$1,000 gift? How much must a person leave to such an heir to buy that person's cooperation during estate administration?

In the end, *in terrorem* clauses may not achieve what they set out to do, keep family harmony and avoid litigation. Instead, they might have the opposite effect.

## ARTICLE IDEAS

The Caring Hand is only as good as the relevant information it provides to members of the congregation. Therefore, we welcome your suggestions for future article topics. Feel free to contact a member of the Planned Giving Committee if you have an article suggestion or a question. We would love to hear from you.



# the Caring hand

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Readers should seek professional as-  
sistance in structuring and implementing  
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substantial or structured charitable gifts.*

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