

Special Needs Planning and Life Insurance

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Funding a special needs trust in an amount sufficient to purchase supplemental goods and services, advocacy, and other important benefits is a basic objective in special needs planning. Since most special needs trusts created by parents for their son or daughter are funded upon the death of one or both parents, it is an obvious and universally accepted fact that life insurance is a common way to fund, in part, special needs trusts. Parents must have basic understanding of life insurance in order to make informed decisions when purchasing these products. A naïve misunderstanding or lack of knowledge may result in unintended negative consequences such as unnecessary estate taxes, inadequate funding, higher than necessary premiums and loss of death benefits.

There are three basic types of life insurance policies – term insurance, whole life insurance, and flexible life insurance policies. There are many variations to these policies aimed to provide multiple options and additional protection. The purpose of this article is to provide a very basic outline of these policies and some common variations as they relate to special needs planning. Given the myriad amount of life insurance products and the large number of insurers in the market today, a complete description of all the variations is beyond the scope of this article.

Term Insurance: Just as its name implies, term insurance is designed to provide life insurance protection for a limited period of time. The death benefit of the policy is payable only if the insured dies during the term of the policy. If the insured lives beyond the term of the policy, no payment or refund is due. There is no cash value to basic term life insurance. The advantages of term insurance include relatively low cost so it's an attractive alternative to young families who want to fund a special needs trust but have limited financial resources. Also, term insurance is flexible and can be added on to a whole life policy as a means of providing additional protection. One of the disadvantages of term insurance in special needs planning is its very nature – it is temporary protection for a limited period of time. While many term life insurance policies may be either renewed as term insurance or converted to a whole life policy, there are upper-age limits in term policies at which point a term life insurance policy can no longer be renewed. Also, conversion of a term life insurance policy to a whole life policy can be quite expensive. Finally, since term life insurance is merely death protection, it offers no living benefits such as guaranteed cash values or long-term disability benefits. Still, given the choice of having some term life insurance protection versus not having any, term life insurance protection can be a valuable way of planning to fund a special needs trust so long as one is mindful of the drawbacks these types of policies present.

Whole Life Insurance: Whole life insurance, sometimes referred to as permanent insurance, is designed to provide protection for the whole life of the insured. Most whole life insurance policies provide for both level premiums and a level death benefit. Also, whole life insurance policies contain an increasing cash value as the owner of the policy continues to pay the premium each year. The principal advantage of whole life insurance is that it is permanent protection for funding a special needs trust. Because the premium typically remains the same, one knows the cost of this permanent insurance and the premium payment can become, in essence, a forced savings plan. The cash value in a whole life insurance policy is available to the policy owner for use in an emergency. The disadvantages of whole life insurance are that the premiums may become burdensome in the event of a job loss or at retirement. Also, whole life insurance provides a lower death benefit per premium dollar as term insurance. However, for families who can afford it, whole life insurance is a more secure method of funding a special needs trust than term life insurance since the policy will not end when the insured reaches a certain age.

Flexible Life Insurance: In contrast to ordinary whole life policies which provide certainty in the amount of premiums, cash value and death benefits, flexible policies offer the opportunity to change one or more of these components during the life of the insurance contract. Flexible life insurance policies go by various names depending on which element of the policy can be changed and how the policy is structured. Adjustable life insurance, universal life insurance, variable life insurance and variable universal life insurance are the common variations of flexible life insurance policies. The advantages of flexible policies provide for individualized customization of life insurance needs, possible investment in securities, and the ability to adjust premium payments based on current financial resources. However, as the stock market meltdown in 2008 demonstrated, a disadvantage of flexible policies that have a securities component is that the returns are not guaranteed. In fact, returns may not only be low but even be negative in policies that have a securities component. For families who need the certainty that the death benefit will be there to fund a special needs trust, a flexible life insurance product which relies predominately on securities to fund the death benefit is rarely, if ever, appropriate.

The use of a joint life policy, sometimes referred to as a second-to-die or survivor life insurance, is common and useful in special needs planning. This type of policy insures two lives and pays the death benefit upon the death of the second insured life. This type of policy has been frequently used in estate tax planning for many years as a way to pay estate taxes upon the death of the last

surviving spouse. In the context of special needs planning, it is very useful in ensuring that a special needs trust created by parents during their lifetime is funded upon the death of the survivor. By the way, the cost of a joint life policy is often less than if both parents took out separate individual life insurance policies.

An important consideration that must not be overlooked when using life insurance to fund a special needs trust is the impact life insurance proceeds will have on state and federal estate taxes. As of this writing, the federal estate tax repeal is effective during 2010 but then the act “sunsets” in 2011 and the estate tax reappears with an applicable exclusion amount of only \$1,000,000 unless Congress acts before then. The current Massachusetts estate tax exemption amount is \$1,000,000.

The death benefits payable to a special needs trust will be included the value of the estate of the insured if he or she had the power to, among other things, change beneficiaries of the insurance policy or to revoke the special needs trust. Since expenses of the estate, including estate taxes are paid prior to distributions to estate beneficiaries, the amount going to those beneficiaries, including the special needs trust, will be reduced by the payment of estate taxes.

One strategy to avoid the inclusion of life insurance proceeds in the estate of an insured is through the use of an irrevocable life insurance trust (“ILIT”). An ILIT is, by definition, irrevocable. It also requires an independent trustee who must administer the ILIT in very specific ways in order to avoid the insurance proceeds being included in the insured’s taxable estate. These ongoing administrative responsibilities usually involve an ongoing annual expense. Nonetheless, an ILIT’s potential for enormous estate tax savings, particularly for those with large life insurance policies and significant other assets, makes it a very important option worth considering. At a minimum, an analysis should be done on the impact the life insurance policy will have on the estate tax liability during the underwriting phase. This analysis should involve not only the financial advisor or insurance agent who is procuring the policy but also involve the parent’s special needs attorney. Given the relatively low estate tax exemption threshold in Massachusetts, it is very likely that the purchase of a life insurance policy may place parents who own

a home with other modest assets in the unexpected position of having taxable estates. Therefore, even if an ILIT is determined to be undesirable due to administrative cost, a special needs plan using marital deduction, credit shelter trusts together with an appropriate special needs trust should be considered in order to avoid or reduce estate taxes upon the death of the surviving spouse.

Finally, a key component of a special needs plan often involves identifying one or more family members who will play a key role in providing services and supports to a family member with a disability after the death of both parents. The expected responsibilities may involve significant time and energy. These responsibilities are frequently undertaken without the expectation of adequate monetary compensation to the family member care-provider. But what happens if the family member care-provider dies unexpectedly? There may not be other family members who have the time, expertise or willingness to assume this significant responsibility. As a consequence, parents may want to consider purchasing a life insurance policy on the life of the proposed family member care-provider to ensure resources will be available in the special needs trust to cover the additional costs of services, supports and advocacy occasioned by the death of the family member care provider.

Hopefully, this article sparks an appreciation of some of the significant issues presented by using life insurance to fund a special needs trust. A basic tenet of special needs planning is that parents, financial planners, insurance agents, and special needs attorneys need to work together in an integrated manner in order to maximize the funding of special needs trusts. This universally saluted tenet is most particularly relevant when life insurance policies are designed as an integral part of the special needs plan.

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