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WHITE PAPER

Estate Planning

TOPIC: LIFE INSURANCE TRUSTS

If you have utilized a basic estate plan and available gifting strategies in order to reduce your taxable assets, and you still have substantial assets above your needs that will be subject to estate taxes, then you might consider establishing a life insurance trust. This is a trust that purchases an insurance policy on your life (you are called the "insured"), which pays a death benefit upon your death. If the life insurance trust is properly structured, then the life insurance benefit can be received by your heirs free of both federal income and estate taxes. It is this tax-free character of the life insurance proceeds which makes a life insurance trust attractive.

First, the death benefit is received tax-free by your heirs because life insurance proceeds are free from federal income taxes. The more difficult problem is to make sure the life insurance proceeds also are not subject to estate taxes. This is done by making sure the life insurance proceeds are not included in your estate.

This is accomplished by establishing an insurance trust, with an independent trustee, that will purchase and own the insurance policy. You must have no control over the trust, and the trust must hold all incidents of ownership in the policy. Your heirs are the beneficiaries of the trust.

However, in order for the trust to purchase the insurance policy, it must have sufficient assets to pay the policy's annual premium. This means you must annually gift to the insurance trust an amount sufficient to cover the cost of the annual premium.

This raises an additional problem. If you gift to the trust an annual amount to be used to pay the annual insurance premium the gift will be considered a gift of a future interest rather than a present interest. This means the gift cannot qualify for the annual gift tax exclusion ($14,000 in 2015) and will either reduce your estate tax exemption or be subject to gift tax. This can be avoided if the annual gift to the insurance trust is subject to what is called a "crummy power." This simply means that each time you gift the annual premium to the insurance trust, the beneficiaries of the trust (your heirs) must be notified and be given the power to receive the annual gift directly rather than having it used to pay the insurance premium. If the notice and crummy power are properly structured, then the annual gift will be considered a gift of a present interest which qualifies for the annual gift tax exclusion.

Of course, if the beneficiaries demand to receive the annual premium gift in cash, rather than having it used to pay the insurance premium, then the goal of the insurance trust will be thwarted. The structure depends upon all parties sharing the goals and purposes of the trust.

If all parties cooperate, then upon your death your heirs will receive the death benefit from the policy free from both income and estate taxes. This death benefit can replace much if not all of the value of the estate that may have been lost to estate taxes.

The life insurance trust is not a perfect solution for reducing the effect of estate taxes. First, it involves administrative complexity and cost. The trust must be carefully structured to meet all requirements, and this will often require the services of an attorney. The crummy powers notice and withdrawal requirements must be strictly complied with or any annual gift of the insurance premium will not qualify for the annual gift tax exclusion.

More important, however, is that insurance costs money. Instead of paying the annual cost of an insurance policy, you might simply gift an equal amount to your heirs each year. Your heirs could then invest the money. Although earnings and gains on such investments would be taxable to your heirs, over the years these investments could grow to an amount as great or greater than the death benefit from the insurance policy.

This means that before establishing an insurance trust, you should carefully analyze alternative strategies. You should have a clear understanding of the investment and life expectancy assumptions under which the life insurance trust is more favorable as compared with annual gifting to heirs. Only then can you make an informed decision as to which alternative works best to fulfill your goals.

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