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EstatePLANNING

# Are life insurance trusts still a viable planning technique?

**Back in "the old days" i.e. 1997**

The federal estate tax exemption was $600,000 per person and the highest estate tax rate was 55 percent of the taxable estate. Back then, the federal estate tax applied to, perhaps, 4 percent to 5 percent of the U.S. population. Life insurance trusts were a valuable part of the arsenal estate planners used to increase the inheritances of their clients' families and to provide liquidity for the payment of their clients' estate taxes.

Ownership of life insurance by a trust enabled some middle class families to ensure that their children would receive an inheritance as a way to pass on the rewards of financial success.

**Nowadays — January 2012**

The federal estate tax exemption is $5 million per person/ $10 million for a married couple. The estate tax rate is 35 percent of the taxable estate. I have heard estimates that the current federal estate tax applies to roughly 0.5 percent or less of the U.S. population.

As a result, the demand for life insurance to pay the estate tax has fallen off dramatically. New York is one of the 18 states that assesses an estate tax. The top marginal tax rate is 16 percent of taxable assets in excess of $10.4 million. The New York estate tax is deductible for federal estate tax purposes.

The effective combine estate tax rate is not 51 percent (35 percent federal plus 16 percent state). Rather, it is 45.4 percent (35 percent minus 5.6 percent federal plus 16 percent state).

**Estate Taxation of Life Insurance policy proceeds**

The basic premise: "if you own it, we can tax it".

The corollary: "if you don't own it, we can't tax it".

Section 2042 of the Internal Revenue Code states that the estate tax applies to the proceeds of any life insurance policy owned by a decedent or any policy owned by someone else but over which the decedent, at death, had "incidents of ownership".

The power to borrow from the policy or to select or change the beneficiaries are "incidents of ownership" that result in the assessment of the estate tax to the policy proceeds. Section 2035 of the code states that, if the taxpayer gave away all incidents of ownership more than 3 years prior to death, the proceeds of the life insurance policy will not be taxed in the decedent's estate. The corollary: if all incidents of ownership are not given away at least 3 years prior to death the insurance policy proceeds will be taxable in the insured's estate.

By DAVID C. PETTIG

Daily Record Columnist

**How do insurance trusts work?**

The over-simplified version follows:

- A life insurance trust is usually created by the client (C) as the grantor. The trustee can be anyone other than (C, or C's spouse if they are purchasing a joint life policy).
- The trust is irrevocable and non-modifiable by the grantor.
- To avoid the 3-year gift rule (see above), cash is usually transferred to the trust to purchase the life insurance.
- Following creation of the trust, the trustee signs the application for new life insurance.
- The insurance company issues the policy in exchange for the premium payment.
- If there are not sufficient funds to purchase a new policy or if (C) is uninsurable, then (C) funds the trust by assigning ownership of an existing policy or policies.
- In the years subsequent to the funding of the trust (C) makes additional contributions to the trust for the payment of premiums.
- If (C)'s resources start to diminish, the children can contribute money to the trust to pay the premiums or they can pay the premiums directly.
- Upon (C)'s death, the insurance proceeds are collected by the trustee who then carries out (C)'s dispositive plan.

Note: There are other tax planning techniques dealing with the interplay of the payment of the premiums and gift/estate tax laws. There are also other methods for dealing with the funding the premium payments. All are beyond the scope of this article.

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*Continued ...*

Note: In all events, a qualified life insurance professional should be consulted as to the type of insurance to be owned by the trust and the best methods for the payment of the premiums.

### Are insurance trusts still viable?

Yes. Let me count (some of) the ways:

1. For those individuals whose estates will be subject to federal estate taxes (and, to a lesser extent to New York estate taxes), the creation and funding of a life insurance trust the old planning techniques and benefits still apply.

2. For those individuals who have illiquid estates, a life insurance trust can provide liquidity to the estate by purchasing the illiquid assets from the estate.

3. For balancing/equalizing the inheritance of family members. For example, (C) owns a closely held business and has 2 children, one is in the business, the other is not. Life insurance can be paid to the child who is not in the business to achieve (relative) equality. If the life insurance policy is owned by a trust, the proceeds will not be estate taxable.

4. For special needs beneficiaries. (C) has a descendant for whom a trust will be created that will qualify as a special needs trust (SNT). (C) is concerned that the child's pro-rata share of the estate will not be sufficient for the descendant's needs. The life insurance trust can fulfill 2 objectives: to ensure funding of the SNT and to allow the freedom to pass all of (C's) assets to the other children.

5. For Medicaid planning. The current 5-year Medicaid eligibility "look back period" has made it very difficult for people to give away their assets. Already existing life insurance policies could be transferred to the children or, preferably, to a trust that incorporates the client's dispositive plans.

It is my understanding that the value of the insurance policy at the date of transfer is controlling for Medicaid transfer purposes, rather than the death benefit. (C) can continue paying the premiums. Assuming ownership of the policy has been transferred outside the look-back period, then only the premium payments made by (C) during that period would be counted.

The children might be able to return to (C) the amount required for Medicaid qualification and then continue to make the premium payments. Another option would be for the policy owner (the children or the Trustee) to take a policy loan to ensure Medicaid qualification.

### Other Considerations

One issue not addressed in this article is what to do with an existing insurance trust, the dispositive provisions of which are not in accord with the grantor's current wishes. The short answer "decant." To learn more about New York's new law on "decanting" I recommend that you attend the MCBA Trusts & Estates Section program next Tuesday, Jan. 17.

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