



Informational ideas important to large and complex cases

# Advanced Sales DIGEST

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## PURCHASING LIFE INSURANCE IN CREDIT SHELTER TRUSTS

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### Current Federal Estate Taxation.

Under current federal estate tax law a decedent whose net taxable estate exceeds \$1.5 million may be subject to federal estate tax. The highest marginal federal estate tax rate on estates is currently 47 percent.

### Rules Affecting Married Couples.

Current law provides married persons the ability to make gifts and bequests to U.S. citizen spouses in unlimited amounts without the decedent spouse being subject to either federal gift or estate tax. In other words, if both married persons' wills or trust agreements specify that the surviving spouse receive all of the decedent spouse's property at death, there will be no federal estate tax upon the death of the first spouse. An advantage to this estate plan is that the surviving spouse receives all of the couple's assets at the death of the first spouse and there will be no estate tax due at the first spouse's death by virtue of the "unlimited marital deduction." A disadvantage is the possibility of federal estate tax liability upon the death of the second spouse depending upon the size of that spouse's estate at death.

### Simple Estate Planning Strategies.

Many couples' estate plans simply provide that upon the

death of one spouse, all remaining property (including jointly owned property and separate property of the deceased spouse) is bequeathed to the surviving spouse. By employing this technique, the deceased spouse fails to utilize his/her individual federal estate exemption amount of \$1.5 million. This is a non-event, at least tax-wise, if the couple's combined total net taxable estate is less than \$1.5 million; but if the couple's taxable estate exceeds that amount, federal estate tax may be payable at the second death. There are several ways to take advantage of each spouse's individual exemption amount among married couples. Keep in mind that a married couple can shelter up to \$3 million from federal estate tax by doing some simple estate planning.

One of the most popular estate tax avoidance strategies is the creation of a trust for the benefit of the surviving spouse and the decedent spouse's heirs. There are a variety of formulae for determining the funding of such trusts, but the gist of the technique is as follows: Upon the death of the first spouse, his/her estate funds a trust (often called a "Credit Shelter" or "By-Pass" Trust) with an amount up to the decedent spouse's federal estate exemption amount, currently \$1.5 million.\* All of the decedent spouse's remaining property is distributed to the surviving spouse either outright or to a marital trust for the exclusive benefit of the surviving spouse during his or her lifetime. Such trusts can be created under a spouse's will, his/her revocable *inter vivos* ("living") trust, or even under an irrevocable *inter vivos* trust. [Note: in the case of an irrevocable *inter vivos* credit shelter trust, the amount that can be funded gift tax-free may be limited to the current lifetime exclusion amount of \$1 million, plus annual exclusion gifts (currently up to \$11,000 plus bequests upon death that would not exceed the total exemption amount of \$1.5 million).]

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By employing and funding a credit shelter trust, the decedent spouse escapes the potential trap of causing or increasing federal estate tax upon the death of the second spouse.

### Credit Trust Funding Alternatives.

By utilizing a credit shelter trust under the funding formula described above, and assuming the trust is properly drafted to prevent the decedent's credit shelter trust from being deemed the property of the surviving spouse, the amount in that trust should be exempt from federal estate tax upon the deaths of both the decedent spouse and the surviving spouse. This begs the question: What is the best type of property to fund a credit shelter trust? Well, there really is no best answer since family and financial circumstances may dictate the solution to the question. But if the surviving spouse needs little or no funds from the decedent spouse's trust, many advisors suggest funding the credit shelter trust with highly appreciating assets such as equities and real estate interests. The reason is that highly appreciating assets will not be subject to estate tax even after the surviving spouse's death. For example, assuming an asset in the credit shelter trust is appreciating at 9 percent annually and generates no income, the value of that asset would double in approximately 8 years. If the credit shelter trust had not been utilized and the asset were part of the surviving spouse's estate, the asset appreciation might be subject to federal estate tax and, in very large estates, possibly be subject to the highest marginal federal estate tax rate.

### Basis and Step-Up Issues.

Currently, assets funding a credit shelter trust receive a stepped-up basis upon the death of the decedent spouse. This is a distinct income tax advantage to the trust beneficiaries but, assuming the appreciation example given above, a significant amount of gain could build up in the trust over time. Eventually, gain will be recognized upon the sale or other disposition of the trust assets, such as liquidation distribution of the trust estate.

### The Life Insurance Solution.

What if the trust could own an asset that generated little or no annually taxable income and generated a benefit at the surviving spouse's death that was not subject to income or capital gains taxation?

By purchasing a permanent life insurance policy on the life of the surviving spouse, the credit shelter trust acquires an asset that possesses liquidity, generates little or no recognizable income, and delivers a death benefit that is subject to neither ordinary income tax or capital gains tax. Basis is generally not an issue since the death benefit is not a capital asset.<sup>1</sup> In other words, the death benefit of a life insurance policy possessing the income tax-free advantages under I.R.C. §101 escapes the basis step-up problems associated with other capital assets.

There are a number of ways to effect the purchase of the policy. If there is sufficient cash in the credit shelter trust, it could be used to pay premiums. If not, and since there is a step-up in basis of the trust's assets upon the death of the decedent spouse, capital assets could be liquidated soon after the decedent spouse's death to provide cash to pay premiums. Premiums could be paid annually, in one lump sum or through a combination of the two.<sup>2</sup> From a tax law and administration perspective, the proper way to purchase a trust-owned policy is for the trustee to sign the application as owner and for the insured spouse to sign as proposed insured. All premiums should be paid by the trustee from trust assets. Unless there are trust provisions requiring the distribution of assets to non-spouse beneficiaries during the life of the spouse, there should be no need for the issuance of so-called *Crummey* letters.

### Authority Of Trustee To Purchase Life Insurance.

A preliminary question is whether the purchase of a life insurance policy would be a legally proper investment by a credit shelter trust. In general, state law governs the types of investments permissible in trusts. These rules are generally broad, intended primarily to limit excessive exposure to risk, and do not limit powers otherwise specifically granted in the trust instrument. A well-drafted trust instrument will delineate the investment powers of the trustee. If the purchase of insurance by the credit shelter trust is contemplated at the planning stage, the trust instrument might contain a clause specifically granting authority to acquire a life insurance policy. Even if life insurance is not specifically mentioned, the trustee is often given virtually unlimited discretionary authority, either by the trust instrument itself or under state law. Most states have abandoned so-called "legal list" statutes, which delineated specific types of permissible trust investments, in favor of a broad standard of prudent judgment on the part of the trustee, exercised in the context of the known objectives of the trust. Thus, in most instances, the purchase of an insurance

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policy would be permissible, as a matter of trustee discretion [See generally, Restatement (Third) of Trusts P.I.R §227 (1990)].

### Who Should Serve As Trustee?

One of the problems associated with the ownership of life insurance is the attribution of "incidents of ownership" in the policy. Most advisors agree that, in the context of a credit shelter trust as owner, the insured spouse should not serve as the credit shelter trustee. By serving as spouse/trustee (which may result be decreed "legal" ownership), there is a good argument that the surviving spouse will possess incidents of ownership, especially if the spouse/trustee can effect policy loans and withdrawals or surrender the contract. This result could have several negative connotations, the most devastating being the inclusion of the policy death benefit in the surviving spouse's estate for estate tax purposes under IRC Section 2042.

Fortunately there are several solutions to this problem. The trust agreement could provide that the trustee be someone other than the spouse. If the trust agreement names the spouse as trustee, provisions could be included in the trust agreement to allow the spouse/trustee to resign in favor of another trustee that could then purchase the policy. Some advisors have also suggested trust provisions that would permit the spouse to serve as trustee, but appoint an alternative trustee or "trust protector" that is given limited powers to purchase policies on the life of the surviving spouse (or any person other than the alternative trustee or trust protector) and to solely administer the policy with respect to premium payments, beneficiary designation, policy loans, withdrawals and surrenders. The IRS has ruled that a trust containing a provision that prohibits any individual trustee whose life is insured by a policy owned by the trust from exercising any power conferred on the owner of such policy did not convey incidents of ownership over the policies to the trustee/insured [Ltr. Rul. 9111028]. The insurance policy was also excluded from the special power of appointment which the trustee held over trust property.

### Incidents Of Ownership If The Insured Holds A Limited Power Of Appointment.

Treasury Regulations provide that "[a] decedent is considered to have an `incident of ownership` in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise)

to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust" [Treas. Reg. §20.2042-1(c)(4)]. Thus, it seems quite clear that if the surviving spouse holds a limited power of appointment over the credit shelter trust, and the trust acquires an insurance policy on his or her life, the insurance proceeds will be included in the insured's gross estate.

This result can be avoided if anticipated in the trust planning and drafting stage. For example, the limited power of appointment can be drafted to specifically exclude any insurance policy on the life of the power holder [see Ltr. Rul. 9111028]. In the alternative, the trust can provide that the entire limited power of appointment is to be voided if the trust acquires an insurance policy on the life of the power holder [see Ltr. Rul. 9602010]. In both of these letter rulings reflecting real life examples, the planners contemplated the potential advantage of life insurance as a trust asset and drafted provisions that would permit the flexibility to acquire such insurance without the risk of the death benefit being included in the insured's gross estate by reason of "incidents of ownership."

### Elimination Of Power Of Appointment Over Trust-Owned Policy.

If the trust instrument grants the surviving spouse a limited power of appointment over the credit shelter trust, this power would have to be eliminated or modified in order to clear the way for the trust to acquire an insurance policy on the life of the spouse without the death benefit being includable in the spouse's gross estate under the incidents of ownership test. Depending upon the terms of the power of appointment and the applicable state law, the power might be eliminated through a formal "release" or disclaimer executed by the power holder.

With respect to a limited power of appointment, there is no gift tax issue connected with release of the power. Unlike the case of a general power of appointment, a release of a limited power is not considered a transfer of the underlying property [Reg. §25.2514-3(e), Ex. (3)]. Thus, should the surviving spouse determine that the acquisition of life insurance by the credit shelter trust is sufficiently attractive to justify giving up (or restricting) his or her limited power of appointment, there would be no tax obstacle to doing so. However, reference must be made to applicable state law to determine whether there are any restrictions and/or procedural requirements with respect to

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releases of powers of appointment.

### Applying the “Right” Insurance Product

Funding a credit shelter trust with life insurance requires substantial investigation and fact finding to determine estate and financial planning objectives and the appropriate product applications. American General Life Insurance Company offers a variety of permanent life insurance products providing guaranteed death benefits at guaranteed level premiums. If clients seek guaranteed death benefits with little need for large cash surrender values, we suggest illustrating our **ContinUL** Flexible Premium Adjustable Universal Life Insurance Policy. This policy provides exceptional death benefits at competitive premiums; provides lowest cost Death Benefit protection within the American General Life permanent product lineup for competitive “limited pay” or minimum-level premium situations, and features an interest free catch-up provision. Clients seeking potential for higher cash surrender values with strong death benefit protection and a no-lapse guarantee (offered as a rider) may consider the **Elite Index UL** Flexible Premium Adjustable Universal Life Insurance Policy or the **Elite Index UL**.

### Conclusion.

An insurance policy on the life of the surviving spouse may be an especially attractive asset for a credit shelter trust. While life insurance has traditionally been used as a funding vehicle to materially leverage the gift tax annual exclusion and the applicable exemption amount in the context of *inter vivos* irrevocable life insurance trusts (“ILITs”), the credit shelter trust may provide similar leveraging with life insurance with significant tax advantages.

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\* This amount may be reduced by the amount of taxable gifts made by the decedent.

<sup>1</sup> Like any other life insurance application, the amount of premium paid creates basis in the policy. In the event policy withdrawals exceed basis, or in the event the policy is surrendered and there is gain in the policy, such withdrawals or gain upon surrender will be treated as ordinary income to the trust.

<sup>2</sup> By paying a single premium for permanent insurance, the policy could be deemed a modified endowment contract (“MEC”). The implications of a MEC are that all withdrawals in excess of basis are deemed gain. In addition, all loans against a MEC are also treated and taxed as gain. Although these income tax attributes are negative to the trust, a MEC

may be acceptable in a context where the trustee has no expectation of accessing cash surrender values during the term of the trust or at least until the insured spouse dies.

*This article is intended to illustrate sales ideas and is not intended to provide tax or legal advice. Prospects are encouraged to seek professional counsel regarding the tax or legal implications of these or other sales ideas.*