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Trusts and Estates

Estate Planning With Life Insurance Trusts and Related Taxes

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May 6, 2016

Twenty years ago, when the exemption from the federal gift and estate tax was "only" $600,000 per taxpayer, estate planners advised nearly all of their clients who owned life insurance policies to implement a life insurance trust to hold such policies. Now that the exemption from such tax has increased nearly 1,000 percent to $5.45 million, and it has become "portable" between spouses, it is significantly less common for clients to need to consider implementing such trusts and they are thus not nearly as ubiquitous as they used to be. In addition, many clients for whom life insurance trusts made sense to only five years ago (when the exemption was scheduled to revert to $1 million per taxpayer) need to consider whether to dismantle trusts that now may seem to be more of a hassle to administer than they appear to be worth.

The term "life insurance trust" is commonly used to refer to an irrevocable trust that is specially designed to take title, as owner, of a life insurance policy during an insured's lifetime. For Pennsylvania residents, under current law, the only reason to implement a life insurance trust is to prevent the imposition of federal estate tax on the policy proceeds upon the insured's death (as could be the case for a policy owned by the insured at death). If there is no concern about an estate being subject to federal estate tax, but a trust to receive the life insurance proceeds is desired for other reasons, a trust can be implemented under a will or revocable trust at the time of an insured's death by properly coordinating the trust provisions under one of such documents with a beneficiary designation form. In such case, there would be no need to transfer ownership of the policy to a life insurance trust during the insured's lifetime.

For circumstances where the use of a life insurance trust is warranted, the ideal situation is for the trust to own the policy from its inception. In other situations, where the insurance policy is transferred to a trust after it has already been in existence (even if only for a few weeks or months), it is advisable to carefully structure the transfer in a manner to avoid both the three-year look back rule and the transfer-for-value rule.

Under the three-year lookback rule, as circumscribed by Internal Revenue Code (IRC) Sections 2035(a)(2) and 2042, if a life insurance policy is gifted by an insured to a life

insurance trust within three years of death, the proceeds of the policy would continue to be included in the insured's taxable estate for federal estate tax purposes. This is why the ideal situation is for a life insurance trust to own a policy ab initio, so the three-year lookback rule would not be applicable.

When an insured, who needs to be concerned about planning for the federal estate tax, owns an existing life insurance policy (insuring his or her's own life), there are generally four options to avert the incidence of estate taxation on the policy proceeds at death:

• Gift the policy to a life insurance trust.

• Gift the policy to children.

• Sell the policy to an insurance trust that is properly structured as a "grantor trust."

• Acquire a replacement policy through a life insurance trust and surrender the existing policy to the insurer or sell it to an investor.

For the first two options, the insured will need to wait out the three-year lookback period to accomplish the goal of avoiding the imposition of federal estate tax on the proceeds at death. For the third option, the three-year lookback rule would likely not apply if the sale is for "full and adequate consideration," but the reason the sale must be to a grantor trust (rather than to a child or a nongrantor trust) is to prevent the imposition of the transfer-for-value-rule under IRC Section 101(a)(2). Under that rule, unless an exception is met, the sale of a policy to a third party results in the policy proceeds becoming subject to federal income tax upon the death of the insured. The use of a grantor trust as the purchaser of the policy from the insured is one method of preventing this undesired potential consequence.

A common feature of most life insurance trusts is the use of Crummey withdrawal powers. These powers are designed based on the taxpayer-friendly 1968 U.S. Court of Appeals for the Ninth Circuit case, *Crummey v. Commissioner*. The purpose of these powers is to qualify trust contributions (generally annual cash contributions by the insured to provide funding for insurance premiums) for the annual exclusion from the federal gift tax, which for 2016 is $14,000 per donee. Without the Crummey withdrawal power, gifts to a trust would not constitute "present" interests as is necessary for a gift to a donee to qualify for the annual exclusion, and would instead use part of the insured's $5.45 million exemption from the federal gift and estate tax.

Crummey withdrawal powers are typically provided to the children of an insured (and sometimes a spouse as well) authorizing them to withdraw contributions to the trust each year. Generally, a beneficiary has a limited window of time to exercise his or her's withdrawal rights since such rights are scheduled to lapse at some point in the future, sometimes before the end of the year of the contribution and sometimes later. In many cases, a beneficiary's withdrawal rights only lapse each year to the extent of the greater of $5,000 or 5 percent of the trust property. So for a power over a full $14,000 annual exclusion contribution to lapse in a given year with respect to any one beneficiary, the trust property would need to be valued at a minimum of $280,000. The reason for this further complexity is because of concern that under IRC Section 2041, the lapse of a power over more than that "5&5" amount is treated as a taxable gift to the trust by the beneficiary. Crummey withdrawal

powers with this additional "5&5" feature are often referred to as "hanging Crummeys" to indicate the withdrawal power may not lapse within one year, but may hang on for a while.

Another important planning consideration for clients implementing life insurance trusts is whether or not to allocate exemption from the federal generation skipping transfer tax (GST tax) to the trust. The GST tax would apply when trust assets pass to a beneficiary of the trust who is a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor, such as a grandchild). Each taxpayer has an exemption from the GST tax equal to the exemption from the federal gift and estate tax (currently $5.45 million). The GST tax, which is imposed at the same rate as the estate tax, is in addition to the estate tax. For every $100,000 subject to both the estate tax and the GST tax, at the current rate of 40 percent, the two taxes together would impose an effective tax of $64,000 (or 64 percent); for a transfer of $100,000 to a grandchild at death that is subject to GST tax, the grandchild might only receive $36,000. Even if the insurance proceeds are protected from the federal estate tax through the use of the insurance trust, they can still be subject to the GST tax unless part of the insured's GST tax exemption is specifically allocated to the trust.

Even where it might seem clear that GST tax exemption should be allocated to a particular trust, because future distributions to grandchildren are nearly certain, there remain complications. For term policies, there is always a very good chance that any exemption allocated will be "wasted" (like the premiums themselves) since most insureds outlive term policies. The same can also be true for permanent policies, because it's never certain that the policies will remain in force down the road. Careful consideration must be given to whether or not—and when—to allocate GST exemption to life insurance trusts. While such allocation can be a waste if the proceeds never come through as envisioned because a policy is abandoned down the road (or "expires" before the insured), the allocation could also provide a great deal of leverage for a policy that is held until fruition, and particularly where there is a premature death.

As for the insured who has an existing life insurance trust but whose asset base—together with the insurance held by the trust—is expected to remain below the $5.45 million exemption, unfortunately it's not so clear that the insured's interests are best served by eliminating the trust. First of all, there is always a chance, however remote, that the insured's asset base will end up exceeding the federal estate tax exemption due to future investment returns, changed spending patterns, or an unexpected windfall. Secondly, and perhaps more importantly, there remains a chance that the $5.45 million exemption will, one day, be reduced below the insured's asset base level. Accordingly, if the life insurance will remain in force, it is generally advisable to keep an existing trust in place, just in case. •

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