



Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services

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Dear Reader,

Congress appears ready to go forward with some debate about tax proposals. Although it is unlikely that major tax legislation will be accomplished in an election year, it is quite likely that some expiring provisions will be renewed. Specifically, legislation will probably include maintaining the \$1,000 child tax credit, keeping the 10 percent bracket, and moving ahead with the process to eliminate the marriage income tax penalty. House and Senate Republicans reached an agreement last month with respect to the "PAY-GO" provision for tax legislation. This provision requires that any tax cuts must be coupled with federal spending decreases to be enacted. The agreement the Republicans reached would require PAY-GO for one year but exempt the three extension provisions discussed above. Another extender passed in the House would carry forward the increased 2004 exemptions against the alternative minimum tax through 2005. Any movement on these extensions in the Senate will face a narrower margin and is not expected before the end of the summer.

The budget debate over PAY-GO has been going on for some time. The President would prefer that this restriction apply only to new tax relief and not to provisions that were enacted previously but scheduled to "sunset" or expire. The hope is to make the 2001 tax cuts permanent without the budgetary and procedural constraints that forced the initial sunset provisions. Senator McCain recently blasted economists who support tax proposals of both the Democrats and Republicans for the fiscal irresponsibility that "unites both parties." He was clearly opposed to tax cuts during a time of war and referred to the fiscal future as "bleak." Any significant tax cuts will face a strong challenge in light of the projected deficit.

Congress is considering legislation (HR 1779) to allow members of the Army Reserve and National Guard to take withdrawals from IRAs and Sec. 401(k) or 403(b) plans without the 10 percent penalty. The funds can be repaid later without the normal contribution maximums applicable to these plans. The relief applies to distributions taken during an active duty period that extends beyond 179 days.

Knowledge is not power. Only knowledge in use is power.

LIFE INSURANCE TRUSTS OFFER MANY ESTATE PLANNING BENEFITS

REVOCABLE LIFE INSURANCE TRUSTS

Living revocable trusts are often recommended because of their many advantages for managing an individual's estate during lifetime and disposing of the estate at death outside of probate. These vehicles are often overlooked for their potential advantages for life insurance benefits. A revocable trust provides no current tax advantages and is an incomplete "defective" gift for income, gift, or estate taxes. The revocable life insurance trust is used when the estate tax advantages of an irrevocable trust (discussed below) are not necessary. For example, the insured may be younger and/or have a modest estate. Remember, the federal exemption amount against the estate tax is \$1.5 million in 2004 and 2005.

The important advantage of the revocable trust for life insurance benefits is the valuable dispositive flexibility, control, and privacy it gives the grantor of the trust. The revocable trust permits the grantor to provide for the life insurance benefits payable at his or her death to be held by the trustee and distributed to the beneficiaries at specified ages and for purposes chosen by the grantor when the trust is formed. The proceeds can be invested in the manner that the grantor directs in the document or according to the state's prudent investor standards. Without the use of a trust, the life insurance proceeds would be distributed directly to the policy's designated beneficiary, held by the guardian for a minor beneficiary and distributed in a lump sum at the age of majority, or distributed over time by the insurance company through policy settlement options.

HOW A REVOCABLE LIFE INSURANCE TRUST WORKS

Suppose we have a married couple, David and Shirley, who have two children, ages 5 and 3. Both Shirley and David are employed and are concerned about the costs of their children's education should either parent die prematurely. They have some insurance to cover part of the income-replacement problem, but they are particularly risk averse about investment return and the inflation rate with respect to the future educational costs for their children. They do not currently have estate tax concerns and estimate that the costs of education would be \$150,000 for both children. Shirley and David each purchase a \$150,000 term insurance policy and name a revocable trust as beneficiary.

The revocable trusts provide broad investment powers and direct the chosen trustees to hold the proceeds in a common trust fund until the younger child graduates from college. The trustee is directed to distribute income or principal as needed for education costs. After the younger child graduates, the trustee is directed to hold the remaining fund in equal separate shares for later distribution? let's say when the beneficiary reaches age 30. The trust is also named as contingent beneficiary of the other policies, including any group term life insurance David and Shirley have from their employer. The benefit of the revocable trust is that the investment of the funds can be much more creative and appropriate for the time horizon than under a court-supervised guardianship for the minor children and distributions can be delayed beyond the age of majority. In some states, some nominal funding may be required to create a valid living trust. In the alternative, a testamentary trust created under David or Shirley's will could be designated as the beneficiary or contingent beneficiary of life insurance policies to accomplish a similar purpose. However, state probate law should be examined to determine if paying life insurance to a testamentary trust causes any disadvantages, such as greater probate costs or exposure to creditors.

IRREVOCABLE LIFE INSURANCE TRUST

The irrevocable life insurance trust has long been an important strategy of wealthy individuals. There are many potential benefits of a properly designed life insurance trust, including the following:

- Death proceeds avoid federal estate or generation-skipping transfer taxes.
- Relatively small premium payments maximize the value of the annual gift tax exclusion since the entire policy proceeds will be sheltered from transfer tax.
- Estate liquidity problems can be solved.
- The estate left heirs can be enhanced by the life insurance proceeds.
- Trust assets invested in life insurance avoid income tax.
- Death proceeds avoid the expenses and publicity of probate.
- Death proceeds are managed for the heirs by a trustee according to the grantor's directions.
- Flexibility for an irrevocable gift is possible if the trust is properly designed.

DESIGNING AN IRREVOCABLE LIFE INSURANCE TRUST

To meet the tax goals described above, the life insurance trust must be truly irrevocable? that is, the trust must be a completed gift and the grantor cannot later amend its provisions. The grantor should be secure with his or her choices for trust beneficiaries and willing to give up access to and control over the life insurance policy held by the trust. The dispositive provisions (the terms that specify how the beneficiaries will receive their shares of income and principal) should be selected carefully and specifically to address the needs of the grantor's family.

The dispositive provisions will also vary with the type of policy. A policy covering the life of the grantor will often provide an income interest and some limited invasion rights for the grantor's surviving spouse, which means the benefits to children and/or grandchildren will often be delayed until the surviving spouse dies. If the trust is properly designed, the death benefits will also avoid inclusion in the surviving spouse's estate. Survivorship policies (policies that pay the death benefit at the second death of a married couple) are often used in life insurance trusts because these policies are a good match for the federal estate taxes. Often, the marital deduction available to an estate will cause the lion's share of family estate taxes to be paid at the second death of a married couple. The life insurance trust holding the survivorship policy will benefit children and/or grandchildren when the death benefit is paid.

The life insurance trust is a fairly complex document, and because it is irrevocable, it should be designed carefully with the assistance of experienced estate planning counsel.

AVOIDING GIFT TAXES FOR PREMIUM PAYMENTS

Another significant goal of the grantor in creating a life insurance trust is to avoid incurring a taxable gift when premium payments are made. This goal is perhaps the most difficult drafting and trust administration problem. Premium gifts will qualify for the \$11,000 (as indexed for 2004) annual gift tax exclusion only if they create a present interest for the beneficiary. Tax rules provide that a gift in trust will qualify for the annual exclusion if the beneficiary holds demand rights to the gift. These rights give a beneficiary the power to demand the lesser of (1) such beneficiary's proportionate share of the annual premium payment to the trust or (2) \$11,000 for a temporary time period (e.g., 15 days). After the demand period lapses, the gifts to the trust are no longer subject to withdrawal and can be used by the trustee to pay the policy premium. The trustee should give the beneficiaries actual written notice of their withdrawal rights at the time of any gifts to the trust.

If the grantor is married and his or her spouse elects to split gifts, as much as \$22,000 per beneficiary will qualify for the annual exclusion. If the premiums for the life insurance trust exceed \$5,000 per beneficiary, however,

some specialized trust drafting will be required to avoid gift tax problems for the beneficiaries who are expected to allow their withdrawal rights to lapse.

AVOIDING ESTATE TAXES FOR DEATH BENEFITS

After several setbacks in tax court, the IRS has stopped challenging the estate-tax-free status of the life insurance trust. To avoid problems, the grantor should adopt an irrevocable trust and the trustee should be designated as the owner and beneficiary of the policy. When premiums are due, the grantor can make gifts to the trust that the trustee will use to pay the policy premiums. If the grantor, rather than a third party, owns the policy and transfers it to the life insurance trust, the proceeds will escape estate taxation only if the transfer occurs more than 3 years prior to the grantor's death.

The death benefits paid to the trust cannot directly be used to pay estate taxes and other costs of settling the insured's estate. However, the proceeds can replace the family wealth used to pay estate taxes, or they can be used indirectly to provide estate liquidity. For example, the trustee can be given the power to loan cash to the grantor's estate or to buy assets from the estate. In either event, the estate could use the cash received from the life insurance trust to pay its expenses.

PROVIDING FLEXIBILITY IN AN IRREVOCABLE LIFE INSURANCE TRUST

One of the difficulties associated with this estate planning technique is that the trust is irrevocable. However, there are some methods or alternatives that can be employed to increase flexibility. This may be particularly important if Congress amends the estate and gift tax laws. The possibilities for retaining flexibility in the trust include

- *trustee investment powers.* The trustee should be enabled to change the policy type, withdraw or borrow from the policy, or surrender the policy for cash and invest in other types of assets.
- *trustee distribution powers.* The trustee can be given the power to distribute the principal of the trust to the grantor or other beneficiaries while the insured is still alive. The trustee should not be bound to follow the directions of the grantor-insured in making this decision.
- *trust protectors.* The trust could include a "protector" who can terminate the trust and appoint the principal to family members if circumstances, such as the tax laws, change.
- *court-authorized amendment.* Local courts will generally authorize the amendment or termination of an irrevocable trust as long as all parties with an interest in the trust consent and are represented in the proceedings.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

**Positioning our clients
for the future**



Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES

1288 Valley Forge Road, #53
Phoenixville, PA 19460
Tel. (610) 917-8940
Fax. (610) 917-8962
Email. algibbons@algibbons.com
Web. www.algibbons.com