

Life Insurance Trusts

Life insurance is an important and beneficial asset in an estate planning setting, but it is crucial to ensure that the arrangements are made properly in order to avoid sometimes disastrous consequences. The policy proceeds are normally not subject to income tax, but they are a part of the taxable estate of the owner. The death benefit can meet liquidity needs of an estate, including estate taxes, debts, financial support for the surviving spouse and children, and cash bequests under the will or trust of the insured. Life insurance is often used for special purposes in the context of business planning, such as cash for continuity of operations or a buyout. Where the family business is the largest estate asset and it passes to one of several children, policy proceeds can be used to equalize the inheritance shares passing to the others.

One method of avoiding estate taxes on the policy proceeds is the purchase or transfer of a policy in the name of a child. This is an unacceptable strategy, in most cases, for many reasons:

- The child may not continue payment of premiums
- The child's creditors will have access to policy values
- The child might predecease the insured parent, so that policy is in estate of child
- The child may change beneficiary designation on policy or fail to distribute proceeds as intended in parent's estate plan
- Proceeds may not be available when needed for payment against estate tax liability or other claims against parent's estate

The best and most common strategy for life insurance ownership is the irrevocable life insurance trust, which is established by the insured to coordinate with the overall estate plan. Once the trust is created, it is funded with cash to cover the initial premium on the policy. The trustee (who must not be the insured and should not be a trust beneficiary) applies for the policy and serves as owner and beneficiary of the policy. The trustee must also provide the beneficiaries with written notice of their right to withdraw, for a limited time, a share of any cash contributed to the trust. While most do not exercise this right, the notice is required in order to qualify the contributions for the annual exclusion from gift tax.

Life Insurance Trusts (cont.)

If properly structured and administered, the irrevocable life insurance trust allows the policy proceeds to avoid taxation in the estate of the deceased insured, and they may even be held in trust for the continued benefit of generations of heirs of the decedent without estate taxation (sometimes referred to as a “Dynasty Trust”).

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