

LIFE INSURANCE TRUSTS

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What does a Life Insurance trust do? A Life Insurance Trust is a permanent, irrevocable trust that is established to own one or more life insurance policies. It cannot be altered, amended, or revoked once it is established. When the insured named in the life insurance policy dies, the life insurance company pays the policy proceeds to the Life Insurance Trust, instead of to the estate of the insured. The Trustee of the Life Insurance Policy then distributes the proceeds to the beneficiaries of the Life Insurance Trust according to the instructions in the Declaration of Trust.

Benefits of a Life Insurance Trust. (1) **Save estate taxes.** A Life Insurance Trust (LIT) can be set up to keep the death benefit proceeds out of the insured's estate and thus avoid estate taxes that would have to be paid if the proceeds were just to be paid directly to the insured's estate. Any person whose estate is more than \$2,000,000 will save estate taxes by having his or her life insurance owned by a LIT.

(2) **Proceeds distribution control.** A Life Insurance Trust (LIT) sets up a mechanism to control the distribution of life insurance proceeds. For example, instead of just having a \$500,000 policy being paid to children who have not reached maturity, the LIT can provide that the money be held and paid out to the children in installments over a period of time.

(3) **Protection from creditors.** The LIT can be set up to prevent creditors of the Trust beneficiaries from attaching or obtaining their share of the death benefit proceeds. This would be known as a "spendthrift trust" provision which could be written into the LIT. Also, since the LIT is permanent, none of the creditors of the insured can reach the assets of the LIT.

(4) **Permanent guarantee of money to your heirs.** Since the LIT is not owned by the insured, and since it is permanent, the death benefit payment will go to the insured's heirs as the trust

beneficiaries, free of tax and free of any debts or creditors claims against the estate of the insured. The concept is that the insured puts money in trust now and since the gift to the FIT is permanent, it legally remains there and the insurance policy legally remains there until the policy pays off. The only serious risk is if money is not put in to pay the premiums then the insurance could lapse or pay less, depending upon the terms of the policy. Even that risk can be minimized by putting in enough money in the beginning to buy a lump sum/single pay policy or the trust could be funded with investments which produce enough income to pay the insurance premiums.

How is a Life Insurance Trust Established? A LIT is established by having an attorney prepare a Declaration of Trust. The Declaration of Trust states in precise detail exactly how the trust is to be run, who will receive money from the Trust, and when the money will be distributed. Once the Declaration of Trust is signed, the trust is given money to pay for life insurance and then the Trust buys the life insurance policy and owns the policy in the name of the Trust.

Terminology of Life Insurance Life insurance is a legal contract called an insurance *policy* entered into between the policy *owner* and a life insurance *company*. The policy requires the *owner* to pay premiums to the *company*, usually over a period of years on a monthly, quarterly, or annual basis. In return the *company* promises to the policy *owner* that it will pay a sum of money to the policy *beneficiary* upon the death of the *insured*.

Policy owner pays money to the Insurance Company ←	Insurance Company pays policy amount upon death of the insured ←	Beneficiary receives money on the death of the insured .
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Are life insurance proceeds subject to the federal estate tax? If the insurance policy is owned by the insured, or if the insured is the beneficiary

of the policy, then the policy proceeds *are counted* as part of the insured's taxable estate on the insured's death and will be subject to federal estate tax. Thus, if a person who has a million dollar net worth buys and owns life insurance insuring his life for \$1,000,000, then his taxable estate becomes \$2,000,000 on his death. The estate tax on the \$1,000,000 life insurance policy is then about \$450,000 (approx. 45%).

On the other hand, if the same life insurance policy is owned by an LIT that benefits the insured's children, the children will receive the \$1,000,000 life insurance proceeds *free of the estate tax and free of any income tax*. This tax savings can work also if the insured's children own the policy outright.

One key factor to save the estate tax is that the *insured must not be the owner of the policy*. Either way, unless the trust is properly established and maintained, and unless the payment of the premiums are handled in the proper way, the tax savings can be lost and the life insurance proceeds will be drawn back into the insured's taxable estate. For example, it doesn't work for the insured to keep making the premium payments directly each year out of his own checkbook. As with any serious financial investment, *proper administration* and the filing of the proper tax returns for any trust involved over the course of the insured's life *is essential* to maintain the tax benefits.

Another key factor is the *three year rule*. The death benefit proceeds are included in the taxable estate if the insured possessed any incidents of ownership in the policy within three years of death. Thus, if a policy owned by the insured is transferred into a LIT in year one and the insured dies in year two then the death benefit proceeds are included in his taxable estate. Also, if the insured retains or had the right to change the beneficiary on the policy, or if the insured retains the right to change the beneficiaries of the LIT within three years of his death, then the death benefit proceeds are included in his taxable estate.

Choosing a Trustee. The insured cannot serve as the trustee nor can a beneficiary or the creator of the LIT. Also, nobody who is related to the insured or who is employed by the insured or any company he controls can serve as the trustee.

The trustee must be "independent" as defined by the tax laws which means a bank or independent trust company or professional or unrelated person. The only power the insured may retain over the trust is the right to remove one independent trustee and appoint another.

Community Property complications. Since California is a community property state, only separate property can be used to fund the insurance premium payments when a spouse is a beneficiary of the LIT. Otherwise, half of the insurance proceeds get dragged back into the insured's estate. The solution is to have a proper written agreement to convert community property into separate property and then put the premium money into a separate property bank account prior to contributing it to the LIT for the premium payment which is made by the LIT.

Possible annual gift tax exclusion "Crummey Rule". Transfers to a LIT to fund the insurance premiums have gift tax issues. The best way to structure the LIT is to be able to claim the gift is a present interest and hence qualifies for the annual \$12,000 gift tax exclusion. That way, the transfers to the trust don't count against the lifetime exclusion from estate and gift taxes. As a result of the Crummey tax case, if the beneficiaries are given proper written notice each time the premium money is put into the LIT and if that notice gives the beneficiaries the right for at least 30 days to pull the money out, the transfer will qualify for a gift tax exclusion.

Are life insurance premiums tax deductible? Generally they are not but with some types of policies, such as "split dollar", some of the premiums can be deductible.

Cautions. The information in this memo is for general informative purposes and may not fit every situation. You are cautioned to have any LIT situation thoroughly reviewed and appropriate documentation prepared by legal counsel before you actually commit to it. The tax laws and IRS regulations are constantly changing in this area. Strict compliance with the required notices and the filing of tax returns and other administrative requirements are essential to be able to claim the tax benefits of a LIT.