



ALASKA TRUST COMPANY

Complete Trust and Investment SolutionsSM

Is Your Life Insurance Trust Well Placed?
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Introduction

Life insurance was a key element in estate planning long before the Federal government adopted the estate tax and income tax systems. And the adoption of those tax regimes has made life insurance even more important in both estate and lifetime financial planning. Life insurance is the only investment that offers true income tax free growth, both during lifetime and at death. Although some perceive municipal bond interest as income tax exempt, it actually is really post-tax income where the government agency that has issued the bond keeps part of the interest in lieu of the bondholder paying income tax. Some may think IRAs and other retirement plans are tax free, but they actually are tax deferral mechanisms, except for Roth IRAs. Even death does not eliminate the tax.

Life insurance is used, among other reasons, to provide a fund to generate income to replace lost earnings when a breadwinner dies, to secure the repayment of a loan outstanding at death, to provide a mechanism for income tax free growth, to provide liquidity to pay estate tax and other charges that arise at death, to insure funds are available for the education of descendants and to effectuate more effective estate tax planning. This article will focus primarily on the latter. But to do that, it is appropriate first to discuss some fundamental estate tax rules.

Basic Estate Tax Rules

The Federal estate tax is very encompassing. It requires inclusion in the gross estate of a decedent much more than the assets he or she owned at death.¹ [See sections 2035, 2036, 2037 and 2038 of the Internal Revenue Code of 1986 as amended (“Code”).] Transfers long before death may be subject to estate tax even if they have already been exposed to gift tax. [See, for example, section 2038.] Even property never owned by the decedent may be subject to estate tax. [See sections 2039 and 2041.] The rules relating to the estate tax of life insurance are unique. [See section 2042.] That is, they apply only to life insurance proceeds and no other type of property, not even life annuities.

Estate Taxation of Life Insurance Proceeds

Proceeds paid upon death are included in the gross estate of the insured if one of two conditions exist. If the proceeds are paid to the insured’s estate, they are included in his or her gross estate for Federal estate tax purposes and, accordingly, subject to estate tax unless the estate is less than the estate tax exemption (currently,

¹ The material in bracket could be removed if article is not published in a “legal” or “professional” magazine.

as great as \$3.5 million) or pass to the insured's spouse under the protection of the marital deduction or to charity under the protection of charitable deduction. The marital deduction, by the way, is not a true tax avoidance opportunity but only a tax postponement mechanism: the property excluded from tax in the estate of the spouse dying first is included in the gross estate of the surviving spouse. [See sections 2056, 2041 and 2044.]

The second way proceeds will be included in the insured's gross estate is if the insured held any "incident of ownership" in the policy at death. Incident of ownership is not precisely defined in the tax law but includes the ability to name the beneficiaries of the proceeds, the power to borrow against the cash value of the policy or the right to control the benefits of the policy. Incidents of ownership can be attributed to the insured directly or through a trust, corporation or partnership.

Avoiding Estate Taxation of Insurance Proceeds

It is relatively simple to avoid having proceeds paid at death be included in the insured's gross estate. Simply providing for someone other than the insured's estate to receive the proceeds and having someone other than the insured hold the incidents of ownership at death block the estate tax inclusion with one important exception. The tax law provides that, if the insured transfers any incident of ownership in the policy within three years of death, the proceeds are still included in his or her gross estate. [See section 2035(a).] It is best, in order to avoid the transfer-within-three-years-of-death rule, to have someone other than the insured initially acquire the policy. And that too is relatively easy to accomplish when acquiring a new policy of insurance.

Although having a family member initially acquire the policy, own it until the insured dies and be the beneficiary may avoid estate taxation of the proceeds, that usually is not the best choice. That family member may die before the insured does and someone else (such as an in-law) may succeed to the policy's ownership. Also, even if the family member survives the insured and receives the proceeds, they will then be subject to the claims of creditors of the family member, to estate tax when the family member dies and the proceeds may be inherited by someone other than family members such as grandchildren. In fact, the policy itself may be subject to the attachment of the creditors of the family member who owns the policy. None of these possibilities is desirable. For that, and other reasons, informed insured persons almost always have the policy acquired and owned by an irrevocable trust the insured creates for family members. Most estate planners call that type of trust an "irrevocable life insurance trust" or "ILIT."

Some Challenges of ILITs

The ILIT usually is the preferred arrangement to acquire and hold a policy of insurance. But several factors suggest that real thought be given to where the ILIT will be created and administered. First, in most cases, the insured will provide

the funds to pay for the premiums on the policy. Whenever someone other than the insured owns the policy, the insured will be treated as making a gift if he or she pays the premiums. In most cases, it will be desirable to have those gifts qualify for the gift tax annual exclusion. The annual exclusion allows an individual to give to as many individuals as he or she wishes up to \$13,000 each year (or \$26,000 if the individual is married and his or her spouse agrees to pretend, through a concept called "gift splitting," to make half of each gift). Hence, an individual who has two children, one child-in-law and two grandchildren could give them \$65,000 in each calendar year (or \$130,000 if married and the other spouse will gift split).

Some individuals use part or all of the annual exclusions by gifts of property other than life insurance but most do not. The annual exclusion is a "use it or lose it" arrangement. That is, if the individual does not use an annual exclusion in a particular year, it is forever lost. Using the otherwise unused annual exclusions for family members by paying for premiums of life insurance on a policy owned by family members or an ILIT makes good sense.

However, the tax law provides, as a general rule, that a gift to a trust does not qualify for the gift tax annual exclusion unless the beneficiaries have the right to withdraw the gift from the trust. But giving a beneficiary the right to withdraw the gift means the beneficiary will be treated as owning it for creditor attachment and estate tax purposes. Fortunately, the law permits a trust beneficiary's right to withdrawal that property from the trust to expire free of adverse tax consequences at a rate, as a general rule, of \$5,000 each calendar year. This expiring or lapsing right of withdrawal is known as a "Crummey power," named after the famous case with that name. [See *Crummey v. Commissioner*, 397 F2d 82 (9th Cir. 1968).] An ILIT that uses Crummey powers is usually called a "Crummey trust."

The Crummey trust can even be used to avoid the generation-skipping transfer tax (the functional equivalent of an estate tax) that is imposed as property in a trust moves down to benefit one generation after another. [See sections 2601 et seq.] And the avoidance of the generation-skipping transfer tax can be avoided without allocated any part of the limited GST exemption to the trust but rather by using "Cascading Crummey Powers(sm)."

State Law Problems of Crummey Powers

So the ILIT accomplishes many things. It provides a vehicle that is protected from claims of the creditors of the insured and the beneficiaries. It prevents the proceeds from being subjected to estate tax in the estates of the insured, the insured's spouse, the insured's children and other descendants. It provides a way to use otherwise unused gift tax annual exclusions. It guarantees that the proceeds will benefit the insured's family members rather than others. So are there any problems? Unfortunately, there are a few and most arise because the ILIT is not formed under the laws of a state that has advanced trust law provisions.

Problems With Self-Settled Trusts

It usually is easy to protect property from the claims of a person's creditors by transferring the property to a so-called "spendthrift" trust. And all states permit one person to create or "settle" a spendthrift trust for another. However, until 1997, no state permitted an individual to create or settle a spendthrift trust for himself or herself. In other words, under the law of all states, a trust a person created for his or her own benefit (a so-called "self-settled trust") was forever subject to claims of his or her creditors. One of the collateral effects of that is that the trust property would be included in the individual's gross estate at death. [See, e.g., Rev. Rul. 77-378; 77-2 CB 247; *Palozzi v. Commissioner*, 23 TC 182 (1954), acq. 1962-2 CB 5.] However, the law seems relatively certain that if creditors of a self-settled trust cannot attach the trust assets they will not be included in the tax estate of the person who created the trust. [See *Estate of German v. United States*, 7 Ct. Cl. 641 (1985); Rev. Rul. 2004-64, 2004-2 CB 7.]

Of course, in most cases, the insured will not be a beneficiary of the ILIT he or she creates. But, as mentioned above, each beneficiary will have a right to withdraw the gifts to the trust which right will expire or lapse over time. The law suggests that if an individual has a right to withdraw trust property and turns his or her "back" to it, then he or she becomes a settlor of the trust and the self-settled trust rules will apply. That has two adverse consequences. First, the beneficiary's creditors (including a spouse in divorce) can make claim to the trust property. Second, it will cause the trust property (such as insurance proceeds received when the insured died) to be in the beneficiary's tax estate.

Fortunately, now approximately 12 states exempt self-settled trusts from the claims of creditors of the person who creates a self-settled trust. That means the creditors of the beneficiaries whose Crummey powers have expired will not have creditor or estate tax inclusion problems that would exist if the trust had been created under the law of other states. Two of the leading states that permit such self-settled trusts are Alaska and South Dakota. And although about ten other states offer protection for self-settled trust, other provisions of Alaska and South Dakota law suggest they are the preferred jurisdictions within which to create an ILIT. (Note, also, that creating the trust in a state such as South Dakota or Alaska should allow the insured himself or herself to be a discretionary beneficiary of the ILIT without causing the proceeds to be in his or her gross estate for tax purposes, which would allow the trustee to benefit the insured from the cash value in the policy.)

Other Favorable Aspects of South Dakota and Alaska Law for ILITs

Low State Insurance Premium Taxes. All states impose a tax on insurance premiums. That reduces the amount used to build cash value or the amount available to buy pure insurance protection. The average in the United States is about two percent. But South Dakota and Alaska have rates on insurance

premiums substantially lower than any other states. In Alaska, the tax is 10 basis points (.1%). South Dakota is even lower at 8 basis points (.08%). That may provide a mechanism to provide more cash for funding investment growth for a cash value policy or more insurance protection for a term policy.

Perpetual Trusts. Traditionally, the law of each state limited how long property could remain in trust under an ancient doctrine known as the “rule against perpetuities.” This essentially required that the trust end in about 90 or 100 years. Although that may seem like a long time, it is not for a family seeking to secure financial security for its posterity. Fortunately, several American states now permit trusts to last much longer. Some, including Alaska and South Dakota, permit them to last perpetually. And by creating a perpetual trust, the trustees for the family can determine when, if ever, the trust will end rather than having it end at some arbitrary time prescribed by an ancient law.

No Income Tax. Neither South Dakota nor Alaska imposes an income tax on trust income. Through careful planning, that typically permits a family, even if residing in a jurisdiction with state or local income taxes, to avoid those taxes. Tax free compounding is a most powerful force in financial planning and having a trust located in one of those tax free states, such as South Dakota or Alaska, provides the best opportunity to avoid state and local income taxes.

Flexibility in Trust Administration. Although not always considered when drafting a trust, the manner in which state law permits a trust to be administered, such as without court interference, is extremely important. Some states, such as New York and California, intrude, to a significantly greater extent than others, into the administration of trusts subject to the jurisdiction of their courts. Alaska and South Dakota allow nearly completely independent administration of trusts under their laws.

Conclusions

The greatly preferred way to own life insurance is through an ILIT. It may be structured to avoid gift, estate and generation-skipping transfer taxes and to protect property from claims of creditors of the insured and the trust beneficiaries. Unfortunately, to avoid gift tax, the beneficiaries must be granted Crummey powers of withdrawal which expire over time. Also, unfortunately, in some states, the trust property may remain subject to the claims of a beneficiary’s creditors and be subject to estate tax in the beneficiary’s estate even if the Crummey powers have fully expired. That suggests an ILIT only be created in a state, such as South Dakota or Alaska, which permit self-settled trusts to be protected from creditor claims. Furthermore, Alaska and South Dakota have the lowest state taxes on life insurance premiums, impose no income tax on trust income and permit great flexibility in drafting and administering trusts. Those two states seem like the preferred choices to place an ILIT.