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The *WRMarketplace* is created exclusively for AALU members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Another Planning Option: Combining the Benefits of Life Insurance and the Credit Shelter Trust.

MARKET TREND: Credit shelter trusts ("CSTs") preserve a predeceasing spouse's estate tax exemption from subsequent estate tax at the passing of the surviving spouse. Higher estate tax exemptions are providing opportunities to enhance the benefits of credit shelter trusts through the use of life insurance.

SYNOPSIS: A CST created under an individual's will or revocable trust upon his or her passing can serve as a substitute irrevocable life insurance trust ("ILIT") by acquiring life insurance on the surviving spouse. This approach leverages the amount in the CST that passes without estate taxes at the surviving spouse's passing. With proper funding, the CST can provide a ready source of liquid assets for premium payments. For the approach to work, advisors must ensure the insured spouse does not hold any incidents of ownership in the policy.

TAKE AWAYS: Acquiring life insurance on a surviving spouse inside a CST addresses multiple tax issues – it limits income tax associated with the CST assets and efficiently uses the estate and GST tax exemptions. This approach also eliminates the need for annual gifts to an ILIT (and corresponding Crummey withdrawal notices) and more complex funding programs, like split dollar arrangements. As the surviving spouse often is a CST beneficiary and/or trustee, acquisition of life insurance by a CST requires careful planning and the elimination of any powers the insured may have over the policy to prevent the proceeds from being subject to estate tax on the insured's death.

A typical estate plan for a married couple includes the creation of a so-called CST (also referred to as a "**bypass trust**", a "**decedent's trust**" or a "**B trust**") on the passing of the first spouse (the "**Decedent**"). The CST is designed to hold part of the Decedent's estate equal to his or her unused federal estate tax exemption amount ($5,450,000 in 2016, $5,490,000 in 2017). While the surviving spouse generally is a CST beneficiary, the CST assets (including appreciation) are excluded from the surviving spouse's (the "**Survivor's**") estate, passing without estate tax (and possibly generation-skipping transfer ("**GST**") tax) to the couple's descendants based on longstanding and appropriate tax principles. A higher federal estate tax exemption has increased the amount that the CST can shelter, opening the door for a variety of post-mortem strategies to enhance the benefits of the CST. One key approach is the CST's purchase of life insurance on the Survivor.

USING A CST & LIFE INSURANCE

When a CST acquires life insurance on the Survivor, it serves much the same purpose as an ILIT. As long as the Survivor does not inadvertently hold any incidents of ownership in the policy (as a trustee or beneficiary), the insurance proceeds, together with the other assets in the CST, pass to the remainder beneficiaries without estate tax. Acquisition of life insurance through the CST can be illustrated as follows:

> Howard passed away in January 2016. He did not make any taxable gifts during his lifetime. At his passing, his estate was valued at $10,000,000, and his estate plan provided for the creation of a CST to use his federal estate tax exemption ($5,450,000). Howard's wife, Wanda, is the sole beneficiary of the CST. The balance of Howard's estate ($4,550,000) passes to a marital deduction trust for Wanda's benefit. On Wanda's death, the assets remaining in the CST and the marital deduction trust will pass to trusts for Howard and Wanda's descendants.
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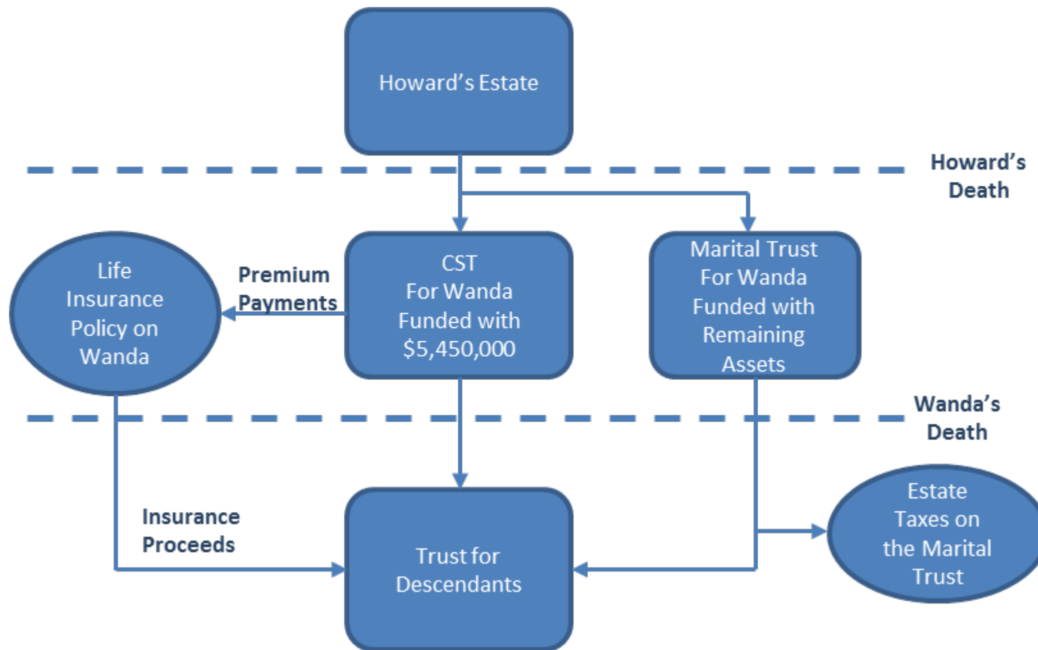
> The CST provides that income and principal of the trust may be distributed as needed for Wanda's health, support, and maintenance. Wanda's own estate, however, is valued at $12,000,000 which, together with the assets in the marital trust, is sufficient to maintain her lifestyle. To ensure a positive tax plan, it is suggested that the CST acquire life insurance on Wanda's life, using the liquid assets in the CST to pay the premiums, as illustrated below.



BENEFITS OF ACQUIRING LIFE INSURANCE BY THE CST

With proper structuring, a CST's purchase of life insurance on the Survivor has many benefits.

- The CST provides a ready pool of assets for the payment of insurance premiums. While an ILIT would require annual gifts, use of the CST allows the Survivor to use his or her gift tax annual exclusion amount for other purposes.

- The approach is simple and reduces the cost and expense of establishing a separate ILIT.

- The **Survivor can be a CST beneficiary** and receive distributions of income and principal as long as such distributions are in the full discretion of the trustee, who should be independent (as discussed below, the Survivor **cannot** be a trustee).[1]

- Life insurance also facilitates income tax planning, as investments within the policy grow on a tax-deferred basis, based on long-standing and appropriate tax principles. Such deferral can reduce the impact of income taxes on the CST and its beneficiaries.

- On the Survivor's passing, the life insurance proceeds pass to the CST's remainder beneficiaries without income and estate taxes and also may be GST tax exempt.

- The CST structure provides creditor protection for the policy and the beneficiaries.

- Since life insurance offers both market and mortality protection, it can optimize the tax plan.

PLANNING CONSIDERATIONS

Several issues should be considered when evaluating a CST's purchase of life insurance on the Survivor, including:

- The Survivor must have sufficient assets outside of the CST to maintain his or her lifestyle, since the policy's purchase will reduce the CST assets otherwise available for the Survivor's benefit.

- The **Survivor cannot have any incidents of ownership in the policy**. For example:

    - The **Survivor cannot serve as trustee of the CST**, and, if appointed or serving as trustee, the Survivor will need to resign before submitting an application for the policy. The Survivor can still serve as trustee of any marital trust and/or control assets he or she inherits outside of the CST.

    - If the CST grants the Survivor a power of appointment over the CST assets, the **Survivor must release the power of appointment** before the CST acquires the life insurance.

- Ideally, planning for a CST's possible acquisition of life insurance on the Survivor begins before the Decedent's passing. A well-crafted will or revocable trust should anticipate the possibility that the CST may purchase life insurance on the Survivor or another beneficiary following the Decedent's death by granting the CST trustee specific authority to purchase such insurance, and by providing for discretionary distributions and other protective language that will preclude an insured beneficiary from having incidents of ownership in the policy.

- Post-mortem planning is also required, including:

    - Consideration of the type of assets that are allocated to the CST, since the CST will need sufficient liquid or income-producing assets to pay policy premiums. For example, allocation of the family home or vacation property to the CST generally would not support the acquisition of life insurance.

    - If needed, restructuring of the CST if it is not otherwise set up to hold life insurance on the Survivor, such as changing the trustee, releasing a testamentary power of appointment held by the Survivor, or decanting the CST into a new trust that has the necessary powers and protections needed for the acquisition of the policy.

TAKE AWAYS

- Acquiring life insurance on a Survivor inside a CST addresses multiple tax issues – it limits income tax associated with the CST assets and efficiently uses the estate and GST tax exemptions.
- This approach also eliminates the need for annual gifts to an ILIT (and corresponding Crummey withdrawal notices) and more complex funding programs, like split dollar arrangements.
- As the Survivor often is a CST beneficiary and/or trustee, acquisition of life insurance by a CST requires careful planning and the elimination of any powers the insured may have over the policy to prevent the proceeds from being subject to estate tax on the insured's death.

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WRM #16-48 was written by Greenberg Traurig, LLP

Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012

NOTES

[1] Note that the insured cannot have a reversionary interest in a policy (a possibility that the policy or its proceeds may return to the decedent or his or her estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him or her) that, immediately prior to the insured's death was worth more than 5% of the value of the policy.