Do You Still Need an Irrevocable Trust for Life Insurance?

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ABSTRACT

The heart of the question includes whether clients who are affluent, but not going to be subject to federal estate tax, should maintain an existing irrevocable trust in view of the current estate tax law. Closely related is the question of what the future estate tax law might be. Predictions on that score are dicey, especially when one projects a client's own life expectancy and tries to match it with a projection as to future asset values and the estate tax law.

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For many years, an irrevocable trust has been the preferred vehicle for ownership of life insurance otherwise included in the insured's estate for federal estate tax purposes. Preferred, that is, by those otherwise concerned that the insurance proceeds would be subject to estate tax at the death of the insured (or the subsequent death of the insured's spouse). The popularity of these trusts was easy to understand. Giving up ownership of a life insurance policy was a palatable choice because there was often no compelling reason to own it in any event. Certainly, if the policy were purchased for its death benefit and the insured did not require access to its cash value, ownership by an irrevocable trust offered great tax planning leverage. A policy worth little during life but a lot at death could be put into the trust altogether beyond the tax man's reach. The prospect of a major change in value as a policy matured upon the insured's death offered a growth in value not typically available in any other class of asset.

New Irrevocable Trusts

Those who are wealthy, which I will define as a couple having gross estates in excess of the combined federal estate tax exemption amount ($10.86 million, i.e., 2 X $5.43 million) are well advised to have life insurance owned by an irrevocable trust. The universe of those concerned about estate taxation is a lot smaller than it used to be. However, the wealthy, thus

defined, will still establish irrevocable trusts to hold their life policies, and the beat goes on, for them and their advisors. Those who are married, bothered by the loss of value created by the estate tax, and realistic about investment prospects and tax leverage will still buy last-to-die policies. These policies will usually be owned in separate irrevocable trusts, with a different rationale and purpose than those trusts which hold policies that insure only one life.

Existing Irrevocable Trusts: Now What?

Before anything else, I should add a disclosure as to how my professional experience influences my views. I have served as the trustee of many irrevocable trusts for many years. Once upon a time, I would advise an estate planning client that "Uncle Harry" could serve as trustee and we would provide him with guidance as to trust administration, set up a bank account, obtain a tax ID number, send *Crummey* letters, etc. After seeing Uncle Harry fail miserably in fulfilling his duties, I offered to serve as trustee for other clients to ensure that a trust could actually walk the walk of estate and gift tax exclusion. Insurance-funded irrevocable trusts were a regular staple for affluent clients until several years ago when the death of the "death tax" looked like it might actually happen. At this juncture, it looks like the estate tax will be with us for the foreseeable future. Political winds can always blow tax planning off course, but we have had relative stability in the estate tax arena for the past few years, so maybe that will continue.

With that perspective in mind, let me jump back to my definition of those who are wealthy. There is an even larger group of people who are not wealthy by my definition, and I will refer to them as "affluent." As a demographic group, they are baby boomers with perhaps "several" million dollars who expect that the (estate) tax man will ask the kids for nothing after both parents have stepped off the stage. In the past these folks had recognized good advice—yours and mine—and set up irrevocable trusts funded by life insurance policies. Now, what should they do?

The heart of the question includes whether these clients should maintain an irrevocable trust in view of the current estate tax law. Closely related is the question of what the future estate tax law might be. Predictions on that score are dicey, especially when one projects a client's own life expectancy and tries to match it with a projection as to future asset values and the estate tax law. However, keep in mind that it took a fair amount of Congressional negotiation to reach the present state of the law. We should also note that the estate and gift tax exemptions are indexed for future increases in the cost of living, which further suggests that the larger structure of the law will remain stable. Having said that, no one can ignore that tax legislation is a function of the political process. With that, my bottom line advice to a wealthy client is to expect that the estate tax will be with us for the future. Also, keep in mind that the moment the estate tax seems apt to disappear, it's not tax relief for the wealthy, just a shuffling of legislative tools: witness the proposals with a recycling of a carryover basis as an income tax replacement for a tax on the wealthy.

Whatever assessment we may make at a macro level, working with individual clients necessarily means that the likelihood of estate taxation requires a close look at each client's circumstances. What is the client's life expectancy, considering present health factors? Are the client's assets likely to grow, or to be consumed slowly, over time? And, perhaps most importantly, how motivated is he or she to avoid estate taxation in the future? On the latter point, consider that those who have established irrevocable trusts in the past represent a more motivated subset of a larger group of estate planning clients. Whether that motivation persists in view of current legal and personal circumstances is another question, but one that must be answered.

So, let's throw all of the planning factors into the hopper and imagine that the client's conclusion is to terminate the irrevocable trust. Let's assume that the trust is funded by a policy on husband's life, that husband would just as soon own the policy, and that

wife will be the beneficiary of the policy. The possible termination of the trust begins with its terms. Often, but not always, a trust will permit the policy to be distributed to the wife. She may then own it and name herself as beneficiary. However, if the trustee distributes it to her, she could just as easily assign ownership to her husband and he would then name her as its beneficiary. The assignment would qualify for the gift tax marital deduction.

In the meantime, before the policy is distributed, a prudent trustee would require all of the trust beneficiaries to sign releases in which they agree to hold the trustee harmless from any liability pertaining to the trustee's administration of the trust, including the distribution of the policy which is the primary asset of the trust. (The trust may also hold a bank account with a few dollars in it, which would be distributed to the wife in our example when the policy is distributed.)

Distinguish Termination of the Trust from Termination of the Policy

It often happens that a client may consider reducing or terminating life insurance coverage, rather than considering how it is owned. For example, suppose that your client contemplates retirement, and decides that less coverage is warranted. The end of a policy may lead to the termination of a trust, but the termination of a trust need not affect the continuation of the policy. Whether a trust remains viable may be considered in conjunction with an estate planning update. While the trust and the policies it owns are separate topics, a discussion regarding the trust may lead to consideration of the coverage it holds. For that matter, the review of the coverage may reveal that more is needed when the broader planning process is addressed.

Last-to-Die Policies

The risk of conflating the need for the policy with the need for the trust is perhaps even greater when the policy insures both husband and wife. While a single-life policy may have been purchased for a variety of reasons, a last-to-die policy is usually obtained to exchange assets with the executor for the payment of estate tax. It is, of course, possible that the trust will be terminated and the policy will be transferred to the beneficiaries. If, for example, the insureds' children become the owners of a policy, the payment of premiums could become awkward if the children need gifts from the parents to cover the premiums. It is also possible that the trust will be terminated and that the parents would like to own the policy. While the children would be the trust beneficiaries, they might agree to make a further transfer of the policy to the parents. If the policy's gift tax value exceeds the $14,000 annual exclusion per person limit, the children will have made a taxable gift to the parents. If so, they are probably able to do so without qualms, given a $5.43 million gift tax exemption available to absorb the gift. The parents might surrender the policy, or, if preferable under the circumstances, sell it on the secondary market for more than its surrender value. If the policy is no longer needed to offset lost value because of estate taxes, the decision as to what should be done with it, apart from the trust, becomes an investment decision. The choice of maintaining, surrendering, or selling the policy should be carefully considered for the benefit of all persons affected. ■

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