Trusts With Insurance Find New Life

Life Insurance Trust Can Shield an Estate From Federal Taxes

YOUR
MONEY
MATTERS

By Sonja Steptoe
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After rummaging the federal tax code for shelters that avoided the reformers' ax and finding few survivors, estate planners have dusted off an old standby: the life insurance trust.

Trusts that contain life insurance policies are "the best game in town right now" for people who need a federal estate-tax shelter, says Stephan R. Leimberg, a professor of taxes and estate planning at American College, a specialized school for insurance agents and financial planners in Bryn Mawr, Pa.

But the trusts are complex arrangements with serious tax and legal implications that must be carefully considered. "Proper planning is extremely important," says Mr. Leimberg. The Internal Revenue Service "is going to make sure you toe the line."

Estate planning is an important part of personal financial management because death taxes can take such a huge bite out of the assets people struggle all their lives to accumulate. To be sure, the first $600,000 of assets escapes federal estate taxes, and all property left to a spouse, regardless of value, is exempt. But when the property passes beyond husbands and wives, federal estate taxes can be steep. Marginal rates start at 18% and rise to 55% for estates valued at more than $3 million.

Between 2.5 million and three million people living now will owe federal estate taxes when they die, according to government statistics. Many states impose estate taxes as well.

One common estate-planning device is life insurance. People regularly buy policies, naming a spouse or child as beneficiary, to provide future income or to help pay estate taxes.

Trouble is, although death benefits from the policies generally are not subject to income tax, the IRS considers them part of the dead person's estate. So, the insurance can actually increase the federal estate-tax bill. In some cases, heirs are forced to sell property from the estate to pay the levies.

That's where life insurance trusts come in handy, financial consultants say. They allow people to set aside assets, shielding them from estate taxes and making them available to family members immediately after the property-owner dies.

In exchange for those benefits, a property owner surrenders control of the assets, which are managed by an administrator, or trustee, for the beneficiaries of the trust. When the insured dies, the trustee collects the death benefits and distributes them to the beneficiaries according to the directions in the trust.

The estate-tax savings of such an arrangement can be significant. Jane Ann Schiltz, an assistant marketing director at Milwaukee-based Northwestern Mutual Life Insurance Co., says a woman with $2.5 million in assets who wants to leave her property to her husband and then to her children after he dies, saves her heirs about $517,000 in taxes by establishing a life insurance trust that purchases a $500,000 policy.

If a woman simply leaves the entire $2.5 million bundle to her husband, and then to her children after his death, the kids will owe a whopping $833,000 on the assets when their father dies. The husband won't owe any taxes when the wife dies because of the exemption for property left to a spouse.

Despite such advantages, life insurance trusts haven't been very popular because of the rigorous

scrutiny they get from the IRS. The agency carefully examines the arrangements to ensure that the person who puts assets in the trust doesn't continue to exercise control over them or retain any rights to ownership. Structuring a trust that will pass muster can be a complicated, laborious process.

For instance, assets in a trust won't get federal tax breaks if the insured person reserves the right to change the terms or borrow against the policy. Trusts that are part of a will don't qualify for the exemption, either. And the IRS will withhold tax benefits if the insured person dies within three years of buying the policy for a trust.

Because of these and other nettlesome technicalities, estate planners avoided the trusts and found other shelters for client assets. But a few years ago, Congress began chipping away at other estate-tax havens and by 1987, many of them had disappeared. Now, the trusts are flourishing. "With everything else in a state of flux, (trusts) are a clear beacon that taxpayers can use," says Mr. Leimberg.

Court Ruling

The trusts got another boost last year when a federal district court in Oklahoma ruled that death benefits from an insurance policy in a trust are tax-exempt as long as the trust, rather than the insured person, buys the policy -- even if the insured person pays the premiums.

"The decision allowed tax planners to use the trusts with more certainty as to tax consequences," says Ms. Schiltz. Although the IRS has appealed the decision, many estate planners are confident that the decision won't be reversed.

Estate planners say it's best to work with a lawyer to establish a trust because the documents are so complex. Mr. Leimberg says the trust terms should authorize the administrator, or trustee, to buy the policy. The insured party should then make annual gifts to the trust, and the trustee should buy the insurance and pay the premiums from the gift. Such a setup is less likely to be challenged by the IRS, he says, because the trust -- not the insured person -- owns and controls the assets.

The trusts can also be established for policies that are already in force. But the insured person risks having the proceeds swept back into the estate if he dies within three years of putting the policy in the trust.

Not surprisingly, people generally spend many hours with family members, lawyers and insurance agents hammering out the details of a trust. So, estate planners also advise their clients to wait until they are older before setting one up.

"We look at trusts for people who are a little more mature," says Ms. Schiltz of Northwestern Mutual. "When you're between 40 and 60, you have a good idea how you feel about your children and relatives, and it's easier to (make a decision) that's irrevocable."

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