



## **Estate Planning With Life Insurance, Annuities And Trusts**

### **Life Insurance**

For most families, life insurance is an important tool in an estate plan. Its uses include:

**Increasing an estate** — This is done by adding insurance protection. Proceeds can be used to support surviving family members and to continue the decedent's family business.

**Paying expenses and debts** — A variety of items — funeral expenses, debts (including mortgages against land) and administration costs must be paid when an individual dies. Life insurance provides immediate cash for the estate to meet these liabilities.

**Paying estate taxes to avoid liquidating a business** — Federal and Virginia estate taxes are due 9 months after date of death, unless the executor is granted permission to pay the estate taxes in installments.

**Paying Income Taxes** — Qualified retirement plans, like IRAs or 401k plans may be subject to large income taxes on all of the value of these plans on the death of the plan owner.

**Providing management** — If it is not advisable for beneficiaries to administer insurance proceeds, as in the case of minors or an incompetent spouse, the funds may be put into a trust.

**Providing a way to treat all heirs equally** — Mr. Doe has a son and daughter, but only the son wants to run the family business. Through life insurance, Mr. Doe can acquire assets that would enable him to leave his son the business and his daughter an equal (or nearly equal) amount of property in the form of life insurance proceeds. Alternatively, the son can buy life insurance on his father's life so he can buy out his sister's proportional interest in the family business after their father's death.

## Is Life Insurance Subject to Estate Taxes?

Many people are not aware of the taxable status of life insurance proceeds. They assume the proceeds are automatically tax-free in all cases.

Life insurance is subject to federal and state estate taxes if the policy holder has "incidents of ownership" in the policies (such as the right to change beneficiaries, to borrow cash value, to select dividend options, or to change premium payment schedules) or if the proceeds are payable to the estate. Any unpaid dividends also are taxable to the estate.

### Change of Ownership

To make sure beneficiaries fully benefit from each dollar of life insurance, the insured may find it advisable to establish ownership in someone else's name (spouse or children for example) of all or some of his insurance. Then if he does not retain "incidents of ownership," policy proceeds will not be included in his gross estate.

**Example:** Mary is the owner of a \$500,000 insurance policy on her husband Frank. Upon Frank's death, the \$500,000 will not be included in his estate since his wife is owner of the policy. If the estate has been named as beneficiary or if the policy transferred within three (3) years of Frank's death, then the proceeds would be included in his estate.

The transfer of a life insurance policy is considered a gift if a policy is transferred to a spouse or other person after the initial purchase. The value of the gift is the replacement cost of the policy at the time of the transfer. Any premium payments made by one spouse or other person on a policy owned by the other spouse or person also are considered a gift for taxation purposes.

If your total estate, including life insurance proceeds, is less than the amount subject to federal estate taxes (currently \$2,000,000), the form of ownership may not be of concern to you. As soon as your estate reaches this amount, you may want to review the situation with your insurance representative or a competent estate planning attorney to evaluate the estate tax consequences of owning life insurance.

### Annuities

An annuity is another useful tool to help plan your estate if the annuity is properly designed and implemented. Costs vary, depending on the type of annuity and on the age of the person making the purchase.

Here's how it works: An owner exchanges property or cash for an annuity income based on the fair market value of the property transferred and his projected life expectancy, as calculated according to actuarial tables.

There are two types of annuities — **commercial** and **private**.

## **Commercial Annuity**

A commercial annuity is typically issued by an insurance company for cash. The annuitant pays a sum of money to the company (the insurer) which promises to make periodic payments for the remainder of the annuitant's life. An annuitant can choose to have the annuity continue for his survivors. For example: the approximate cost of a straight-life annuity on a man aged 65, which returns \$100 per month in income for the man's life, is \$13,000.

## **Private Annuity**

A private annuity differs from a commercial one in two respects: Usually, property other than cash (for example, real estate) is used to acquire the annuity, and the promise to make the payments is made by an individual (often a relative) rather than an insurance company. A private annuity usually ceases upon death.

A private annuity can be used if parents want to transfer a home or land to a child in exchange for a guaranteed income for life. However, no mortgage or other security (except life insurance in event of death) may be given to the parents to guarantee payment of the annual amounts required to be made. This could be considered a serious drawback for some parents. In addition, there may be serious income tax consequences to the child should he sell the real property acquired by the annuity.

## **Annuities for Me?**

Annuities can be effective as an estate planning tool if proper guidance and advice are secured before setting up the annuity. Consult a life insurance agent, or tax accountant for further information and an estate planning attorney for legal implications.

## **Trusts**

A trust is a legal arrangement by which an individual transfers assets to a trustee who manages the assets for the benefit of those designated in the trust instrument.

There are two basic kinds of trusts: **testamentary** and **living** (inter vivos).

Any type of asset, cash, stocks, bonds, life insurance, and real estate, can be put into a trust.

A trust can be created by an individual for the benefit of himself, friends, family members, college, hospital, library, charitable organizations, or any other type of institution.

The person providing assets for the trust is the **trustor** or **grantor**.

The **trustee** manages the assets according to the directions in the trust agreement. The trustee can be an individual (even the person creating the trust), several individuals, or corporate entity (bank or trust company), or any combination of these.

A **trust agreement** is a document containing the instructions to the trustee, stating, for example, who is to receive income from the trust and when and how it is to be distributed. When the trust terminates, the trustor's instructions control the distribution of the assets in the trust and the transfer of those assets to the "remainder beneficiaries."

## Testamentary Trust

A testamentary trust is created by a will and does not take effect until the will is probated by the court. Such a trust places assets with a trustee who has good management and investment skills and who will use them for the beneficiaries.

Parents with minor children could create a trust to provide a way for their assets to be managed until their children are old enough to do it themselves.

A surviving spouse may not have the ability to manage the deceased's estate. A trust may provide a desirable method of arranging for the distribution of the assets and management for the spouse.

Another form of the testamentary trust is the "A—B" trust sometimes called the "credit shelter" trust. It provides a way to reduce taxes on the estates of married couples. The marital deduction, or A trust, is set up by transferring the amount of the desired estate marital deduction into the A trust.

The A trust passes to the surviving spouse, free of estate tax. The surviving spouse may have the power to do anything with this share of the property or can have rights of access to the property limited, depending on the grantor's wishes. The A trust is taxed only in the surviving spouse's estate upon death.

The non-marital (or B trust or credit shelter portion) contains the portion of the estate not going into the A trust equal to the maximum amount of assets that can be transferred free of the estate tax. The B trust is taxed in the estate of the first spouse to die but the estate tax credit is used to eliminate the payment of tax. The surviving spouse can have all of the income, limited power of invasion for health, maintenance, support, or support and education of minor children. The spouse can also be granted the right to withdraw up to \$5,000 or 5 percent of the B Trust annually. A properly formed B trust is not taxed in the surviving spouse's estate.

## Living Trust

A living trust is created by a person during his lifetime to operate for his own benefit or for the benefit of another person.

**Example:** A living trust could be created by a person who is too busy to worry about investment responsibilities. He may want an expert's help and assistance in the management of investments. He could have the income from the trust himself or have it distributed to a relative.

There are two kinds of living trusts, **revocable** and **irrevocable**.

A **revocable living trust** is as its name implies — one created during the grantor's life which can be changed or terminated at any time by the method described by the grantor in the trust agreement. There is no gift tax payable upon the creation of a revocable trust, because the trust can be changed at any time. Because of the power to revoke, no new taxpayer is created and the grantor will be taxed on income earned by the trust the same as if the trust did not exist.

In a revocable trust, the following rights are reserved: to amend the trust, to change the beneficiaries, to change the trustee, to change the date of termination, or to change the entire trust by revoking it and asking for the return of property.

An **irrevocable trust** cannot be terminated. The grantor gives up forever the assets assigned to the trust. Gift taxes, if any, are due when the trust is created. Generally, no estate tax accumulates on life insurance when the grantor dies if he lives 3 years or more after creating the trust. If the grantor retains income for life on the trust, no estate tax savings are realized.

An irrevocable trust can be used when an individual wants to make a gift so that persons will receive **income before** the donor's death, but not the **property until after** his death.

With creation of an irrevocable trust, a new taxpayer (the trust) is created and that new taxpayer can be authorized to distribute income to other beneficiaries (children, grandchildren, parents, dependent relatives, and so forth). By dividing assets between two taxable entities, the taxable income of each may be reduced if each is in a lower tax bracket.

## Powers of Trustee

Broad administrative and investment powers usually are given the trustee. These powers are important, because investment and business conditions change and the trustee should be able to adapt to the pressures created by a changing economy. The needs of beneficiaries may also change, and the trustee should be free to meet the needs (within limitations) of the assets in the trust.

Examples of the more common powers that can be written into testamentary trusts to give them flexibility include:

1. **Power to buy and sell.** The trustee may be authorized to buy and sell or reinvest the assets when it is beneficial to the trust.
2. **Power to apply income.** In case of unusual circumstances, the trustee may be given the discretion to apply the income for the use of the beneficiary. This authorization permits payment, when necessary, directly to creditors, including hospitals and doctors. This is especially important when the beneficiary is a person of advanced years or is physically or mentally incapacitated.
3. **Power to use principal.** The trustee also may be authorized to draw funds from the trust principal if income from trust is insufficient to meet the beneficiary's needs. Many trust agreements limit use of the principal to special circumstances -- e.g., illness, education of children, and hardship.
4. **Power to "sprinkle" income unequally.** This power gives the trustee the authority to make unequal payments among several beneficiaries, depending upon their individual needs. For example, the cost of a college education for one child could be paid directly from the trust instead of being paid by the surviving spouse from income after taxes. This procedure could reduce the total amount of taxes paid and increase the surviving spouse's spendable income.
5. **Power to accumulate income.** Whenever some or all of the income from a trust is accumulated, it may be taxed to the trust as a separate taxpayer. This means there are two taxpayers instead of one. Because the trust is a new taxpayer and may be in a lower tax bracket than the beneficiary, there is the opportunity for income splitting with possible substantial tax savings.

## Pointers for Trust Makers

The decision to form a trust has consequences for the trust maker and beneficiaries. Explore these consequences with an experienced estate planning attorney to insure the proposed arrangement is not in violation of existing tax laws. Be cautious of proposals (such as the "pure equity trust") that "guarantee" freedom from payment of **all taxes in all circumstances**.

If tax minimization is a major objective, ask about the tax consequences of the trust, at the time it is created, while it is in operation, and when it terminates, before you create a trust.

The trust agreements or the trust documents provide the opportunity for complete specifications of trustee duties, trust operations, distribution of income, and distribution of principal. All of these duties must be carried out by the trustee. The powers of the trustee may be made as liberal or as specific as the individual chooses, but the more restrictions placed upon a trustee, the more difficult a trust may be to administer, and you may be unable to obtain a qualified trustee.

It is possible to include in the trust document the right of the beneficiaries to change trustees if for any reason the trust operation is not going smoothly; for example, personality conflicts or the trustee's inattention to the responsibilities of the trust.

Trustees are entitled to compensation for their services in the same way executors are entitled to compensation for settling an estate. Inquire about the costs of administering the trust, the trustee fees, and the other costs imposed before creating the trust. The fees involved vary, depending on the size of the assets of the trust. Fees are often based on a percentage of the market value of trust assets.

## **Trusts For Me?**

When you have considered your needs and the needs of your beneficiaries, and discussed with experienced professionals the tax consequences and the costs of trustee operation and management, you will be prepared to make decisions about advantages and disadvantages of trusts for you and your family.

If you decide on a trust, select the best legal and financial advice available to create the trust documents and put them into effect.

*This article was prepared by Midgett & Preti PC and is intended to provide general advice only. For answers relating to a specific situation, you should consult a competent estate-planning lawyer.*