WEALTH STRATEGIES

"B" Trust Funding—Paying Life Insurance Premiums Without Impairing Cash Flow

THE CHALLENGE

One of the greatest challenges of estate planning is to design an estate plan to transfer wealth while providing the necessary liquidity to pay estate taxes and other transfer costs. Life insurance is frequently used to provide this liquidity, but paying the life insurance premiums can be a difficult second challenge—especially when one spouse is deceased. You may object to using your personal assets to pay life insurance premiums, particularly if you are already making annual exclusion gifts.

If you find yourself in this situation, you might be wondering whether life insurance premiums can be paid without impairing your current cash flow. Fortunately, there is one solution that makes use of a typical estate planning arrangement.

Typically, the family trust provides lifetime benefits to the surviving spouse with the trust assets ultimately distributed or held for the benefit ofchildren and/or grandchildren.

TYPICAL ESTATE PLANNING ARRANGEMENT

A fairly typical estate planning arrangement for individuals with sizable estates involves dividing the estate into two trusts at the death of the first spouse:

- a marital trust to provide for the surviving spouse and
- a family trust equal to the estate tax applicable exclusion amount.

An estate that is structured this way makes full use of the estate tax applicable exclusion amount and avoids federal estate taxes until the death of the second spouse.

Because assets in the family trust and the appreciation on those assets bypass or are sheltered from inclusion in the surviving spouse's taxable estate, it is often called the "bypass" or "B" trust.

BENEFITS OF PURCHASING LIFE INSURANCE IN A "B" TRUST

The "B" trust may be a place to purchase life insurance on the life of the surviving spouse for the following reasons:

- Life insurance on the surviving spouse owned by the "B" trust can avoid estate taxes.
- Policy cash values can be accessed for the benefit of the spouse and children as provided by the terms of the trust.
- No gift tax is triggered by the purchase of the insurance in the "B" trust because trust assets are used to pay the premiums.
- There are income tax advantages. A primary weakness of the bypass trust for the heirs is that trust assets generally do not receive a step-up in basis at the death of the surviving spouse.

  In addition, gains/income on trust investments are subject to trust taxation which reaches the top income tax bracket of 35% for income in excess of $11,650 (2012, indexed for inflation). In contrast, where trust assets purchase life insurance, income taxes are reduced because of the tax-favored nature of life insurance. Specifically, life insurance cash values grow tax-deferred and death proceeds are generally received income tax-free under IRC §101(a).

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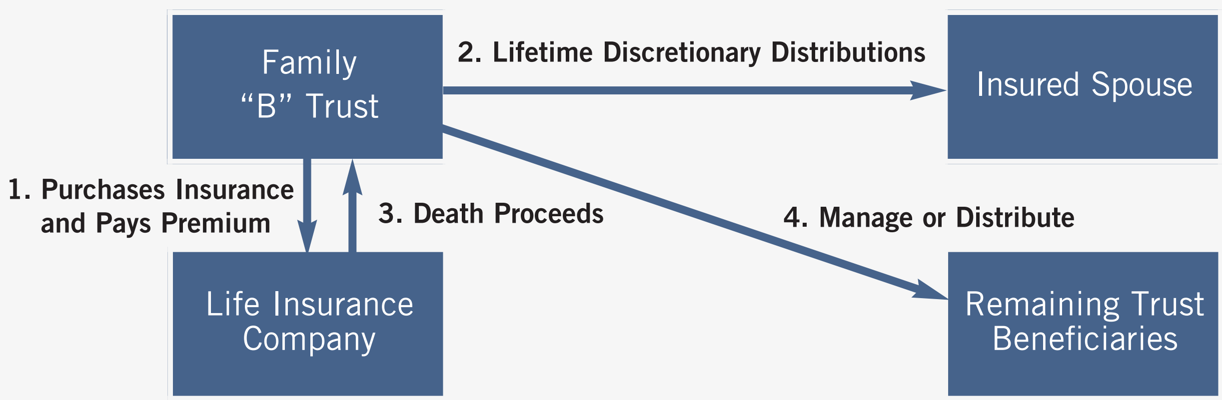
BENEFITS OF PURCHASING LIFE INSURANCE IN A "B" TRUST (CONTINUED)

- Where the surviving spouse has sufficient income from the marital trust and other assets owned outright, distributions of trust income from investments put those assets back into the spouse's taxable estate. Consequently, if the surviving spouse does not need the "B" trust as a source of income, tax and legal advisors often suggest that the "B" trust invest in assets that maximize the growth of principal. Leveraging the applicable exclusion amount by purchasing assets with growth potential inside the "B" trust can significantly increase the value passed to heirs untouched by estate taxes. Life insurance can be an effective vehicle for leveraging the transfer tax exemptions.

HOW "B" TRUST FUNDING WORKS



As indicated in the diagram, the arrangement is relatively easy to implement. The trustee of the bypass trust is the applicant, owner, beneficiary, and premium payer of a life insurance policy on the life of the surviving spouse. During the lifetime of the surviving spouse, the trust assets can be accessed for the benefit of the spouse according to the terms of the trust document.[1] At the death of the insured spouse, proceeds are paid to the trust and distributed to the heirs according to the trust terms.

PLAN B - LEVERAGING THE BYPASS TRUST

Since assets owned by the "B" trust avoid estate taxation, one possible solution for the life insurance premium payment challenge is to utilize the family bypass trust to purchase and own the life insurance. Properly structured, the "B" trust can purchase life insurance on the life of a surviving spouse—even if the spouse is a trust beneficiary and has the right to trust income. In addition, by using the "B" trust to acquire life insurance, you may be able to leverage the trust assets to a larger sum of money to provide estate liquidity on a gift and estate tax-free basis.

FLEXIBILITY AND LEVERAGE IN ONE ARRANGEMENT

Flexibility has always been an important element of an estate plan. Purchasing life insurance in the "B" trust can further leverage the trust assets and maximize bequests to trust beneficiaries. While using the assets in the bypass trust to acquire life insurance is relatively simple, there are technical issues that should be reviewed with legal counsel.

Ask your financial professional how we can work with your tax and legal advisors and how life insurance can help you preserve more of your assets for your family

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[1] Policy withdrawals and loans will reduce policy cash values and death benefits, may affect any policy guarantees against lapse, and may have tax consequences. For policies that are Modified Endowment Contracts, distributions (including loans) are taxed less favorably than distributions from contracts that are not MECs. For distributions from a MEC prior to age 59½, a federal income tax penalty may apply. However, death benefits are still generally received income tax free pursuant to IRC § 101(a). Please consult a tax advisor.