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Life Insurance Trusts

What is a life insurance trust?

A life insurance trust is a trust set up for the purpose of owning a life insurance policy. If the insured is the owner of the policy, the proceeds of the policy will be subject to estate tax when he dies. But if he transfers ownership to a life insurance trust, the proceeds will be completely free of estate tax. (The proceeds will be exempt from income tax either way.) Given the current estate tax rate of 46%, a life insurance trust can save hundreds of thousands of dollars in estate taxes. However, there are several drawbacks to such an arrangement:

1. **You can't change the beneficiary of the policy.** The insured must give up the right to change the beneficiary of the policy (the trust itself will be the beneficiary). The trustee alone has that right, and the insured cannot serve as trustee of his own life insurance trust. Of course, the insured will designate the beneficiaries of the trust (for example, his children). But because this designation cannot be changed after the life insurance trust has been set up, the insured will lack the flexibility to deal with changed circumstances with this particular policy.

2. **You can't borrow from the policy.** The insured can no longer borrow against the policy. If the trust allows him to borrow against the policy, he will be deemed to be an owner of the policy for estate tax purposes.

3. **You can't transfer an existing policy to the trust – unless you live for at least three more years.** If the insured transfers an existing policy to a life insurance trust and dies within the next three years, he will be treated as the owner of the policy and it will be taxed in his estate. Even if he survives another three years, he will have made a taxable gift in the amount of the cash value of the policy (of course, this is usually preferable to having the entire face value subjected to estate taxes.) If the life insurance trust takes out a new policy on the insured's life, however, the insured will never be deemed to own the policy. Furthermore, no cash value will have built up yet, so no taxable gift will be made.

4. **The life insurance trust must be irrevocable.** Once you set up and fund the trust, you cannot get the policy back. If you become uninsurable, you will be committed to this trust as your only life insurance.

5. **Premium payments may use up your estate tax exemption.** If the policy has not yet endowed, you must find a way to pay the premiums without using up your estate and gift tax exemption. If you transfer securities to the trust so that the trustee will have income with which to pay the premiums, the full value of the securities will be a taxable gift. If you transfer cash to the trust each year to pay the premiums, each transfer will be a taxable gift. However, you may be able to exempt these premium payments from gift or estate taxes by setting the life insurance trust up as a Crummey Trust (see the FAQ on Crummey Trusts). Then each premium payment can be sheltered by your annual gift tax exclusion, which is $12,000 (indexed for inflation) per trust beneficiary.

6. **You must find or hire a trustee.** The insured cannot serve as trustee of the life insurance trust. That means that he will have to find or hire a third party trustee. However, many banks and trust companies offer reduced fees for life insurance trusts because they involve essentially no investing decisions. Despite these drawbacks, many people find that the tax saving potential of a life insurance trust is worth the cost and hassle. It allows you to remove from your estate a significant asset that you are unlikely to want access to during your life. And it ensures that the life insurance proceeds to 100% to the beneficiaries, not the federal government.