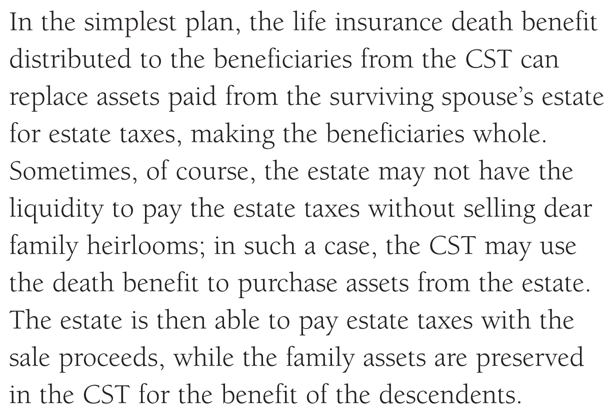
Leveraged Credit Shelter Trusts

Often, once a need for life insurance has been identified, the greatest challenges facing the client are finding liquidity to fund the life insurance policy and then getting the money to the policy in a tax-efficient manner. Complicating this planning, when the estate is large enough to be subject to estate taxation, it is usually best for the client to own the insurance in a trust outside of the taxable estate (refer to "Basics of Irrevocable Life Insurance Trusts" on page 26, as a primer). Thus, not only do the clients have to find the cash to pay for the life insurance, they have to get it into a trust with a minimum of cost (such as gift tax or interest expense).

Married couples, especially those with estates that are, or may someday become, large enough to be taxable, routinely begin their estate planning with the "plain vanilla" foundation built of twin transfers to take place at the death of the first to die: a marital deduction transfer (sometimes to a marital deduction trust) together with a transfer to a Credit Shelter Trust (CST). The CSTs[1] allow the couple to maximize the use of both partners' applicable exclusion amounts, presently $2,000,000 each (scheduled to increase to $3,500,000 in 2009). The marital deduction transfer/trust allows the couple to avoid all estate tax until the death of the survivor. After the death of the first spouse to die, the survivor typically relies primarily upon the marital deduction transfer or trust, turning only to the Credit Shelter Trust if this transfer is exhausted; while marital deduction trust assets generally must be made productive and income paid out to the surviving spouse, distributions from CSTs are typically discretionary by the trustee. Upon the death of the survivor, the assets in the CST are typically paid out to the children and grandchildren of the clients.

As this shows, the Credit Shelter Trust is sometimes expected, even intended, to lie fallow, little used, during the period of survivorship. The surviving spouse is looking first to the assets transferred under the marital deduction, and the next generations have no enforceable interest in the Credit Shelter assets until after the death of the surviving spouse. Given that, with proper planning, all estate taxes have been deferred until the end of this survivorship, this funded CST can be the perfect spot to place the life insurance policy. The assets in the trust are already outside of the surviving spouse's estate for estate tax purposes and generally available until his or her death. The trustee may use these assets to purchase life insurance on the life of the surviving spouse during the period of survivorship, and pay out the death benefit to the children and grandchildren completely free of gift and estate taxes.



In the simplest plan, the life insurance death benefit distributed to the beneficiaries from the CST can replace assets paid from the surviving spouse's estate for estate taxes, making the beneficiaries whole. Sometimes, of course, the estate may not have the liquidity to pay the estate taxes without selling dear family heirlooms; in such a case, the CST may use the death benefit to purchase assets from the estate. The estate is then able to pay estate taxes with the sale proceeds, while the family assets are preserved in the CST for the benefit of the descendents.

Of course, very often (most often), the surviving spouse is named as the initial trustee of the Credit Shelter Trust. If the surviving spouse, acting as trustee of the trust, were to purchase life insurance on his or her own life, the value of that insurance, including the death benefit, would be includible in the surviving spouse's estate under §2042 of the Internal Revenue Code. Thus, if the insurance is to be purchased in the Credit Shelter Trust, it is necessary for the surviving spouse to resign as trustee of the trust. (Successor trustee provisions should be examined in any Credit Shelter Trust being considered for use for these purposes.)

While it is beyond the scope of this article, it is important to note that the **Credit Shelter Trust can often be used to overcome many of the otherwise insuperable issues surrounding owning long term care policies or riders in trust**. (See "Credit Shelter Trusts, Sales Strategy" John Hancock Advanced Markets.) Consequently, John Hancock's new Protection Whole Life (PWL) policy may fit well within the context of leveraging a funded CST since it was specifically designed to allow flexibility as an "asset protector," not only from a death benefit perspective, but from the perspective of protecting estate assets from being spent down to cover long term care expenses. That is, when and where appropriate and available, a LifeCare Benefit rider[2] may be included in the PWL policy, potentially helping to fund qualifying long term care expenses through the acceleration of the death benefit.

Sometimes it will not be practical or possible to have the surviving spouse resign as trustee. Likewise, in some cases the funding in the CST will not be, by itself, enough to fund the amount of life insurance needed for estate tax liquidity or for other purposes it is purchased. Sometimes the CST may contain imperfect distributive provisions or omit beneficiaries that the clients wish to provide for. In none of these cases is the cause lost (nor need be the use of the Credit Shelter assets). Each of these challenges may be addressed by having the Credit Shelter Trust lend its assets to a new (or existing, but unfunded) trust drafted to meet the needs of the clients' plans more perfectly. As the beneficiaries of the new trust are substantially similar (if not identical) to the beneficiaries of the Credit Shelter Trust, there will be little consequence to the fact that the new trust will pay interest and repay principal to the Credit Shelter Trust. All the assets will ultimately be paid out to the beneficiaries designated by the clients, from one trust or another.

A great deal of energy and creativity is expended by clients and their advisors finding the money to pay for a discerned life insurance need and, once located, getting that money from where it was found to the ideal owner of the policy (often a trust). Where the client is a surviving spouse, one of the first things an advisor should look for is the existence of a funded Credit Shelter. Very often, a perfect (or near perfect) place for the life insurance policy to be purchased and held already waits with available funds. The assets in this trust can even be considered available to be applied to life insurance premium even when the Credit Shelter Trust is not determined to be the perfect place for the life insurance to be owned. Clients' advisors should not overlook this very valuable resource, especially when it can almost single handedly address multiple estate planning issues.

CASE STUDY: MARY GERTRUDE MULLINS

Situation

Mary Gertrude Mullins lost her husband Loren last year. He left $2,000,000 of his assets to a CST which is expected to produce a net return of 5% annually. The balance of his assets was directly transferred to Mary, who is a 67-year-old healthy non-smoker. Mary is aware that the assets in a CST usually remain untouched, but in discussing the situation with her financial advisor, she would feel more comfortable with an option that allows her access to cash in the trust if it becomes necessary. Mary's net worth, including what she received from her husband, is approximately $14,000,000, meaning that she faces an estate tax of approximately $5,400,000 if she were to die today.

Opportunity

The CST balance is currently $2,000,000. The trust can purchase a **John Hancock Protection Whole Life (PWL)** policy on Mary's life by either using the entire trust balance as a single premium or paying an annual premium to meet a specific death benefit need. If the trustee elects to purchase a single premium PWL policy, the death benefit would amount to $3,987,137, almost doubling the value of the Credit Shelter immediately.

Now, let's take a look at paying the premium annually on the PWL policy. Assuming an annual premium of $107,000, the trust could purchase $3,737,370 of death benefit. The policy death benefits will be guaranteed for Mary's lifetime, provided that there are no withdrawals or loans and the premiums are paid in full. The children, as beneficiaries of the trust, will receive the life insurance and the remaining CST assets at Mary's death. The following chart compares the net amount transferred to heirs with and without life insurance based on an annual premium for a 67-year-old female, Standard Non Smoker.

End of Year	CST W/O LI	CST W/LI
1	$2,100,000	$5,725,020
5	$2,552,563	$5,669,128
10	$3,257,789	$5,582,033
15(LE)	$4,157,856	$5,470,875

The data shown is taken from a hypothetical calculation. It assumes a hypothetical rate of return and may not be used to project or predict investment results.

The Results

Leverage! Through the use of life insurance in a CST, Mary can increase the amount transferred to her children outside her taxable estate and eliminate any reduction due to estate taxes at her death. Best of all, the funds are already in the trust just waiting to be leveraged with John Hancock's Protection Whole Life policy. Now that's asset protection!

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1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. The LifeCare Benefit and LifeCare Benefit Max (LMAX) riders are accelerated death benefits and may not be available in all states. Maximum face amount: $5 million with LifeCare Benefit; $1 million with LMAX rider. The LifeCare Benefit riders are not considered long term care insurance in some states. When the policy death benefit is accelerated for long term care expenses, the death benefit is reduced dollar for dollar, and the cash value is reduced proportionately. There may be additional costs associated with this rider. The LMAX rider is not available in all states including New York. Please go to www.jhsalesnet.com for a complete list of up-to-date state approvals. **For prospective policyholders in New York, this product is a life insurance policy that accelerates the death benefit for qualified long term care services and is not a health insurance policy providing long term care insurance subject to the minimum requirements of New York law; it does not qualify for the New York State Partnership for Long-Term Care program and is not a Medicare supplement policy.**

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