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ADVANCED MARKETS **BLOG**

Estate planning simplicity with survivor standby trusts

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We frequently discuss the value of using life insurance to provide estate tax liquidity and effectuate wealth transfer goals. When that insurance is owned by an irrevocable life insurance trust (ILIT), benefits may include increased creditor protection, transfer tax advantages, and the enhanced ability to direct how and when distributions are made to trust beneficiaries. But when it comes to modern wealth transfer planning, many advisors we work with echo a similar concern — the need to build flexibility and control into their clients' plans. High federal exemptions ($22.8M for a married couple) paired with competing financial priorities and a variety of risks that can deplete assets more quickly than anticipated, can make it difficult to convince a client to irrevocably and permanently transfer assets to a trust, even if ILIT ownership otherwise makes a lot of sense. While there are ways to build greater access and control into trust drafting, such as spousal access language, some clients still prefer personal ownership.

What if you could offer a solution that provides flexibility today while mitigating estate tax concerns tomorrow? For married couples, use of a survivor standby trust may be an excellent solution. With this technique, the life insurance is initially personally owned and later becomes trust-owned.

Here's how it works

1. The spouse most likely to die first purchases a survivorship life insurance policy. The policy is personally owned by that spouse and he pays the premiums out of his personal funds. The owner-spouse is named the policy beneficiary.
2. Working with his estate planning attorney, the client creates a credit shelter trust. The trust can be funded during the client's life or at death via the terms of his will or revocable trust.
3. The owner-spouse names the credit shelter trust as the contingent owner and beneficiary of the policy (i.e., the credit shelter trust "stands by" as the owner/beneficiary after the owner-spouse's death).
4. During his life, because the policy is personally owned, the owner-spouse maintains full control over the policy, including the ability to fully access potential policy cash value for supplemental income needs.

5. If the owner spouse dies first (as anticipated), the credit shelter trust becomes the policy owner. *(Note: the fair market value (FMV) of the policy will be included in the owner's estate.)*
6. At the surviving spouse's death, the death benefits are paid to the credit shelter trust estate tax-free.
7. The trustee distributes the death benefit and any other trust assets according to the trust terms.

Benefits

- **Flexibility and control** — The owner-spouse has unencumbered access to policy cash values and the plan can be changed to meet changing planning goals during the client's life.
- **Gifting** — No gifting is required today because premiums are paid out of personal funds.
- **Limited estate tax exposure** — If the owner-spouse dies first, only the FMV is included in his estate.
- **Low cost death benefit protection** — The survivorship policy can offer enhanced legacy protection and liquidity for estate planning needs at an affordable price.
- **Spousal access language** — The surviving spouse can be a beneficiary of the credit shelter trust *(Note: there are several considerations that should be discussed with counsel to ensure the death benefit is not includable in the survivor's estate.)*

Considerations

- After the owner-spouse's death, the surviving spouse loses direct access to the trust assets (indirect access may still be possible via spousal access language).
- The trustee may have to pay additional premiums on the policy at the first spouse's death.
- If the non-owner-spouse dies first (i.e., out-of-order death), the full death benefit will be subject to estate taxes at the owner-spouse's death. To rectify this, the owner spouse can gift the policy at the first death to the trust (note, transfers within three years of death will be included in his estate).
- This technique may also work with a single-life policy (the spouse most likely to die first is the owner/beneficiary of a policy on the other spouse's life).
- The credit shelter trust must be drafted by experienced counsel taking applicable state law into consideration.

Policy Designs

To minimize the risk of premiums due after the owner's death, these policies can be funded on a limited pay basis (3-10 years). This type of strategy works well with survivorship policies, but can also work for single-life cases. Consider two types of plan design:

- **Protection focus** — For those clients who want to maximize the internal rate of return on the death benefit, a minimum premium protection design would provide the highest death benefit in relationship to premiums paid. Generally, access to cash value is not a primary concern.
- **Accumulation focus** — For those clients who, in addition to death benefit protection, want the potential for tax-favored access to policy cash value, the accumulation design will allow the owner, during his/her lifetime, access to the cash value. Upon transfer of the policy at the death of the owner, if drafted properly, the Stand-By or Credit Shelter Trust can make periodic distributions to the surviving spouse.

Conclusion

Building flexibility into plans is often the driving force to get our clients to engage in planning. This type of technique offers married couples many options to address evolving needs. For example, if their financial circumstances change, they have access to the policy cash values for personal use. Alternatively, if they do not need the policy for personal needs and/or their estate tax exposure increases, the owner-spouse has the option to gift the policy to the trust for its FMV at any time. Or, if the owner-spouse dies first, the policy will be transferred to the credit shelter trust and the death benefit will ultimately be received by the trust estate tax-free, enhancing the total amount left to heirs.

Contact Advanced Markets for more information!

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