

“B” Trust Funding- Paying Life Insurance Premiums Without Impairing Cash Flow

The Challenge

Designing and building an estate plan, with your attorney and advisors to transfer wealth while providing the liquidity you need to pay estate taxes and other transfer costs can be a difficult challenge.¹ 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.

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.

Typically the family trust provides lifetime benefits to the surviving spouse with the trust assets ultimately distributed, or held, for the benefit of children and/or grandchildren. Because assets in the family trust, as well as their appreciation, bypass or are sheltered from inclusion in the surviving spouse's taxable estate, it is often called the “bypass” or “B” trust. And therein is the opportunity.

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.

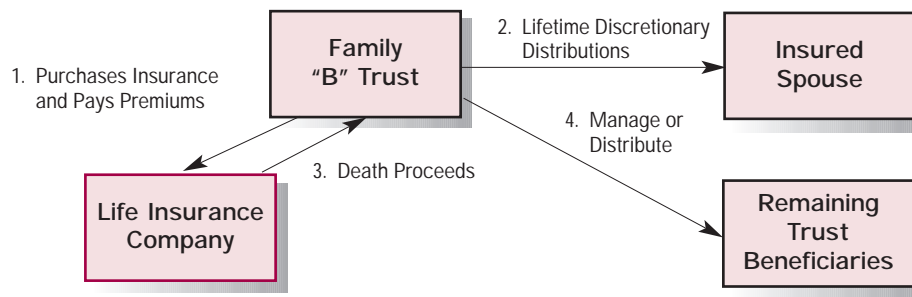
How “B” Trust Funding Works

As indicated in the following 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.² At the death of the insured spouse, proceeds are paid to the trust and distributed to the heirs according to the trust terms.

¹ Pursuant to Economic Growth and Reconciliation Act of 2001 (EGTRRA), the estate tax rates gradually decline beginning year 2002 until 2009. In 2010 the estate tax is repealed for one year only. In 2011 the estate tax will be fully reinstated with the rules that were in effect prior to the act.

² Policy withdrawals and loans will reduce policy cash values and death benefit, may affect any policy guarantees against lapse, and may have tax consequences. For policies which are Modified Endowment Contracts, distributions (including loans) will be subject to income tax to the extent of policy earnings and there

“B” Trust Funding To Purchase Life Insurance



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.²
- 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 \$10,050 (2006 indexed for inflation).³ 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).

- 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, where 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.

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 licensed financial professional for more information about how life insurance can help you preserve more of your assets for your family.

³ The Economic Growth and Tax Reconciliation Relief Act of 2001 (ECTRRA) repeals the step-up in income tax basis regime in exchange for a carry-over in income tax basis tax regime for taxpayers transferring property at death during year 2010.

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