

Credit Shelter Trust with Life Insurance

Current Situation

Susan, 70, is a widow with an estate worth \$10 million. In addition, she is the income beneficiary of a credit shelter trust (CST) created by her deceased husband. The CST is now worth \$3.5 million. Susan's son Robert is the sole trustee of the CST. Susan does not rely on the income from the CST to maintain her lifestyle needs. Each year she makes annual exclusion gifts to her three children and their spouses, as well as to her five grandchildren. She plans to continue making these cash gifts annually. Susan previously used her lifetime gift tax exemption.¹

Susan does not like complex strategies and is looking for an uncomplicated recommendation. She would like to acquire life insurance outside of her taxable estate without using annual exclusion gifts or incurring gift tax.

Recommendation

Use a portion of the CST income to fund a life insurance policy on Susan's life. In this case, Robert, as trustee of the CST, would purchase a hypothetical guaranteed universal life policy on Susan, a preferred nonsmoker, in the amount of \$3,560,089, with a level annual premium of \$75,000.²

A CST, also known as a family trust or bypass trust, often plays an integral role in most married couples' estate plans. Typically, at the death of the first spouse an amount equal to the applicable exclusion is transferred to the CST, free of estate taxes. Often the CST is drafted to provide income and/or principal to a surviving spouse subject to certain limitations.³ Properly drafted, the CST assets remain outside the surviving spouse's taxable estate. At the death of the surviving spouse, the CST assets are transferred to the CST remainder beneficiaries pursuant to the terms of the CST.

FOOTNOTES

¹ The gift tax applicable credit amount is equal to \$1,730,800 (2011), which translates into a gift tax lifetime exemption of \$5 million per individual.

² Guaranteed death benefits are subject to the claims-paying ability of the insurance carrier.

³ Often, during the surviving spouse's lifetime, the principal and/or income of the CST may be used as necessary for the health, maintenance, education and support of the surviving spouse.

Benefit

Because the CST assets reside outside Susan's taxable estate, using the CST assets to purchase life insurance may be a transfer tax-free approach to funding a needed life insurance death benefit. In addition, since a life insurance policy's cash values grow tax-deferred, the CST may reduce the overall income tax liability of the trust and/or Susan. While the CST income is reduced by the amount of the life insurance premiums, the life insurance death benefit adds a stabilizing element to the CST portfolio. With this approach at her life expectancy, Susan has increased the amount of wealth transferred to the CST beneficiaries by \$1,560,470.⁴

Potential Benefits			
Year	Credit Shelter Trust Without Life Insurance	Credit Shelter Trust With Life Insurance	Additional Benefit
1	\$3,591,000	\$7,060,089	\$3,469,089
7	\$4,188,896	\$7,152,402	\$2,963,506
14	\$5,013,385	\$7,279,699	\$2,266,314
20 (LE)	\$5,848,106	\$7,408,576	\$1,560,470
26	\$6,821,807	\$7,558,911	\$737,104

FOOTNOTES

⁴ Hypothetical case study for illustrative purposes only. Individual results may vary. Case study assumes income tax rate of 35 percent and 4 percent annual percentage yield on CST assets. Life insurance premium of \$75,000 annually reduces after-tax CST income with balance added to principal.

⁵ Life expectancy is based on the 2001 Commissioners Standard Ordinary Mortality Table.

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