Insurance Trusts

Removal of insurance death proceeds

Death proceeds from insurance provide cash for estate taxes and for expenses of a last illness, burial, and administration of the estate. The value of such death proceeds can be greatly enhanced if they are not included as part of your taxable estate. If you own the insurance, the death proceeds are included in your estate and, because the estate tax is a tax-inclusive tax, the estate pays tax on the insurance proceeds used to pay the tax. In other words, when the amount of insurance needed to pay the tax is added to the taxable estate it will increase the tax and therefore the amount of insurance needed to pay the tax. For example, if your taxable estate is $1,000,000 with an estate tax of $400,000 at a 40% rate, you will need roughly $667,000 of insurance to pay the tax. If it is possible to remove the insurance proceeds from your taxable estate, the estate tax can then be paid with insurance proceeds that do not increase the value of the taxable estate. Although there are several methods of removing insurance death proceeds from a deceased's estate, insurance trusts best accomplish this end.

Insurance death proceeds will be included in a deceased's estate if the deceased had any ownership interest in the insurance policy at the time of his or her death. If the policy was never owned by the deceased or he or she gave up ownership more than three years before death, the death proceeds will not be included in the estate.

One method of removing insurance death proceeds from an estate is to have the policy owned by the insured's spouse. However, if your spouse owns a policy on your life and he or she receives the death proceeds, estate tax is only deferred until the second death. Plus, if your spouse dies before you, the cash value of the policy will be included in the estate assets of the spouse.

If children own insurance policies on their parents' lives, the death proceeds will not be included in the estate of either parent. However, having children own the policies gives up control of how and when the death proceeds are paid to the children and may cause other problems. If one of the purposes of the insurance is to assist your spouse during his or her lifetime, such assistance will require the cooperation of the children and may require taxable gifts from them to your spouse. If another purpose of the insurance is to pay estate taxes and other expenses at your death or the second death, the children may refuse to use proceeds for these purposes.

If an irrevocable insurance trust owns insurance policies, the death proceeds will not be included in your estate and you will control how the death proceeds are used. A person creating an insurance trust may provide in the trust that the surviving spouse will have limited rights to the trust property. The surviving spouse may be the trustee and be entitled to all the income of the trust and be permitted to withdraw trust property for health, education, support, and maintenance. The trust terms may also permit the children to receive income and trust property during the surviving spouse's lifetime. Upon the surviving spouse's death, the children's interest may be paid to them or continued in trust to provide creditor protection and protection from divorces. The provisions of an insurance trust may also permit use of the death benefits to pay estate taxes and expenses with untaxed money.

Certain technicalities must be followed for insurance trusts to work properly. However, if insurance trusts are properly prepared and the formalities followed, they can be valuable tools to plan for the estate taxes due on the second death of a married couple.

Insurance trusts can be used in combination with charitable trusts as wealth replacement trusts. When used as a wealth replacement trust, an insurance trust is combined with a charitable trust that removes property from your estate and pays you income during your lifetime. The income tax deduction from the charitable gift and the income paid to you from the charitable trust can be used to pay the premiums for the insurance. After the second death, the insurance death benefits replace the property given away by the charitable gift and pass to the children without any reduction for estate taxes or income taxes.