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Life Insurance Opportunities in Second Marriages

The American family has gone through dramatic changes over the last 30 years. Among these changes, two in particular stand out. First, it has become acceptable for adults to live together in long-term relationships without getting married. Second, remarriage, whether after divorce or being widowed, has become commonplace. In fact, a 2001 study by the US Department of Health and Human Services found that nearly 75% of divorced women eventually remarry.

The addition of a new spouse to a family can create interesting opportunities for life insurance sales. We'll explore applications of these opportunities through the example of James and Barbara Brown (both age 60) who have been married for three years. This is the second marriage for both. James and Barbara have three children each from their first marriages. James has a net worth of $1 million and Barbara has a significantly higher net worth of $6 million. They have agreed to keep their assets separate and divide them equally among their own children at their respective deaths.

Example Reference

Stats for James and Barbara Brown

- Both age 60
- Married for three years
- Second marriage for both
- Both have three children from first marriages
- James net worth = $1 million
- Barbara net worth = $6 million

Mutual "Back Scratching" Strategies

There are a number of interesting ways spouses can help each other increase the efficiency of their individual wealth transfer plans while keeping their assets separate. The rights afforded married couples under the federal gift and estate tax laws can help them both pass on more wealth to their individual children and grandchildren. Let's look at several opportunities.

1. The "Reverse" Spousal Limited Access ILIT

One of the biggest objections to creating and funding an irrevocable life insurance trust (ILIT) is that once a parent gifts money to the trust, he or she can never get it back. Spousal Access ILITs were developed so the spouse of the trust's grantor could remove money from the trust if a need arose. The trust is established with the non-grantor spouse as a trust beneficiary. This spouse is usually given a "5 and 5" withdrawal power in the trust. This means the spouse can demand a distribution equal to the greater of $5,000 or 5% of the trust assets annually. Spousal Access Trusts often have another provision which gives the trustee the discretion to pay to the non-grantor spouse any of the trust's income for any reason, if the trustee is an independent party, or principal for health, education, maintenance and support (often called an "ascertainable standard") if the trustee is also a beneficiary. This power can potentially be used to distribute a portion of the trust assets to the non-grantor spouse if the need arises.

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Those who want to maximize what they transfer to their respective families while keeping their assets separate have powerful gift and estate tax benefits from the IRS Code at their disposal.

In most cases, the wealthy spouse is the grantor of the ILIT and these "access rights" are given to the poorer spouse. But it doesn't have to be this way. When the parties are married, there is no reason the "poor" spouse can't be the grantor who creates the trust. He or she can fund it with money given by the "wealthy" spouse gift tax free under the unlimited gift tax marital deduction. If the poor spouse agrees to create the trust and fund it, the wealthy spouse can be named as the spousal beneficiary who has the "access rights." The 5 and 5 power and the trustee's power to make discretionary distributions give the wealthy spouse opportunities to recover funds he or she has previously gifted to the spouse that were contributed to the trust should personal objectives, tax laws or other circumstances change.

Suppose Barbara wants to create an ILIT to provide her estate the liquidity to pay her estate taxes. If Barbara wants the ability to access some of the ILIT's funds (for example, if her personal financial situation or the tax laws change), she can ask James to establish the ILIT as grantor and name her as the non-grantor spouse beneficiary. She then gives him cash and he in turn gives that cash to the trust to fund it. The ILIT will purchase a policy on Barbara's life and be the beneficiary. Assuming the ILIT is well drafted and does not give her any control or incidents of ownership in the policy, then Barbara can have the "access rights" without risking that the policy death benefit will be included in her taxable estate.

2. Sharing Insurability

A survivorship policy insuring both spouses together is usually less expensive than two single life policies insuring each of them individually. Thus, the spouse who is actuarially most likely to die last may be better off purchasing a survivorship policy. In our case, both Barbara and James are 60 and in average health. Being a woman, Barbara probably has a longer life expectancy than James. Since she also has a federal estate tax problem due to her $6 million net worth, it could make sense for her to use a survivorship policy that insures both of them. The premiums will be smaller and if she actually were to be the last to die, the survivorship policy would pay death benefits at the same time as a policy insuring her life alone. If Barbara is not healthy enough to qualify for life insurance coverage (or the premiums were too high), it could be advantageous to use James' insurability (assuming his good health) to purchase a survivorship policy. If Barbara were to predecease James, additional premiums might be required to keep the policy in force. Those premiums could potentially be supplied by Barbara's credit shelter trust or by loans to the ILIT from Barbara's children.

3. Split Gifting

The potentially powerful right to "split gifts" to others is available to spouses under IRC Section 2512. It can help the spouses make larger gifts while still keeping their assets separate. The poor spouse can consent to join in gifts the wealthy spouse makes to his or her family members by filing a Form 709. All the funds for the gift can be supplied by the wealthy spouse, but for gift tax purposes, each spouse will be treated as having made 50% of the gift.

Suppose Barbara wants to create an ILIT for estate liquidity and to benefit her children and grandchildren. Unfortunately the premium on the life insurance policy will be twice as much as she can cover under her own gift tax annual exclusions. Or perhaps she is already giving the maximum annual exclusion amount to each child each year at birthdays and holidays and wants to preserve this tradition. If James consents to gift split, then in addition to her own annual exclusions, Barbara can use James' annual exclusions to gift up to an additional $13,000 per child (in 2009) to fund the new ILIT. Of course, the ILIT must have a Crummery withdrawal provision to create the present interest needed to qualify for the gift tax annual exclusion. The beauty of split gifting in second marriages is that James (the poor spouse) doesn't

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have to supply any of the money. Barbara can supply up to $13,000 of extra cash that James will be deemed to have contributed to the ILIT for each of her children. James' annual exclusions may make these contributions gift tax free even though he never had any intention of making gifts to Barbara's children. By consenting to gift split, James permits Barbara to use and leverage gift tax annual exclusions he never would have used on his own.

Suppose Barbara wants to fund her ILIT but prefers not to make annual exclusion gifts that require the trustee to notify her children annually of their temporary Crummey withdrawal rights. She could fund the trust with gifts that would use part or all of her $1,000,000 lifetime gift tax exemption. James could help her by agreeing to split gift with part of his own $1,000,000 gift tax exemption. If Barbara decides to gift $1,000,000 to the ILIT and James agrees to split gift, she could allocate $500,000 of the gift to James' lifetime gift tax exemption. This conserves $500,000 of Barbara's exemption. James' decision to split this gift with Barbara should not result in any loss for James or his children as long as his taxable estate at death is worth less than $3,000,000 and he doesn't need to use more than $500,000 of his own lifetime gift tax exemption (in 2009).

4. Using the Wealthy Spouse's Money

It's a nice gesture for the poorer spouse to help the wealthy spouse pass on more wealth to his or her children. But a poorer spouse might say, *"I'm glad to help, but in return is there something we can do to help me pass more money to my children?"*

Personal Life Insurance

There is a simple approach that leverages marital deduction gifts to pass on more wealth to the poor spouse's children, while keeping the value of these gifts in the wealthy spouse's family. If the poorer spouse, James, is insurable, he can purchase a life insurance policy on his own life. This can be a useful strategy as long as the policy death benefit doesn't increase James' taxable estate to the point where it will trigger estate taxes. Barbara can provide funds to pay the premiums through gifts that qualify for the unlimited gift tax marital deduction. James can use these funds to pay the premiums. To make sure the gifts don't result in a financial loss to Barbara and her family, she can be named a partial beneficiary to the extent of the premiums paid. Barbara's children will be contingent beneficiaries of this portion of the death benefit if Barbara pre-deceases James (the insured). The remaining policy death benefits will be divided among James' children. To make sure that James doesn't change the beneficiary designation, it can be made irrevocable.

Private Loans

Ownership of the policy by the poorer spouse won't work if the wealthy spouse wants to control the policy or the death benefit is large enough to create an estate tax problem for the poor spouse. In the alternative, the wealthy spouse can supply premium dollars to the poor spouse through personal loans which would be repaid at the poor spouse's death with a portion of the policy death benefit. A collateral assignment may be executed and filed with the insurer preserving the wealthy spouse's interest in the policy for the premiums paid with personal loans. In this strategy Barbara allows James to use her cash so he can increase his financial legacy. The borrowed funds will eventually be repaid to Barbara or, if she dies before James, to her children.

The loans should be fully documented and carry an interest rate at least equal to the applicable federal rate. The loans could be term loans with a fixed interest rate or demand loans with a rate that changes from year to year. James could use personal funds to pay the annual interest costs. Or, as an alternative, Barbara could make an annual cash gift to James in the amount of the interest due. James would use the gift to pay the interest obligation. Interest payments from James to Barbara could be treated as taxable income. The income tax on the interest payments can probably be avoided if Barbara establishes an ILIT to purchase and own the policy for the benefit of James' children. The loans would then be made to the ILIT trustee as would any gifts used to pay the interest. If such a trust were drafted as a grantor trust, then any interest the trust might pay back to Barbara as grantor would be income tax free under the grantor trust rules.

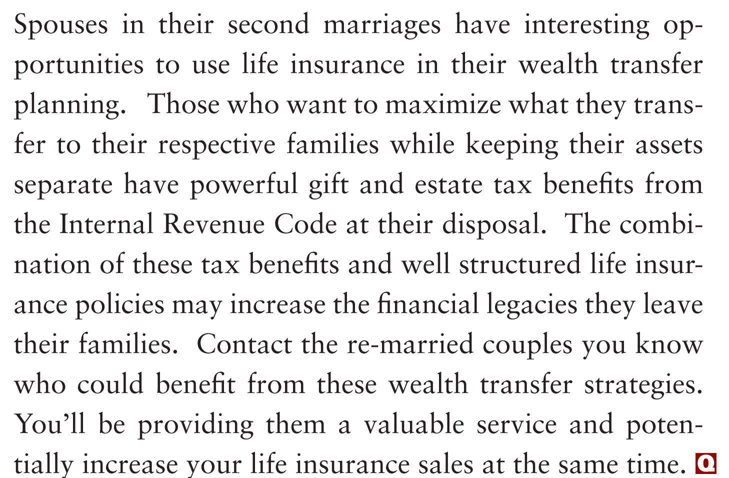
Suppose Barbara is willing to help James increase his financial legacy to his children. She creates an ILIT for his children and lends it $50,000 per year for five years in demand loans. The ILIT trustee purchases a life insurance policy with a $600,000 level death benefit and uses

the loans to pay the premiums. Barbara receives a collateral assignment against the policy to assure repayment of the $250,000 in loans. Barbara makes annual gifts to the ILIT so the trustee has the funds needed to pay the annual loan interest. The ILIT is a grantor trust so these interest payments are income tax free to Barbara. At James' death, $250,000 of the $600,000 death benefit will be used to repay the outstanding loan balance. The remaining $350,000 will be divided equally among James' children. In this scenario, by allowing James the use of some of her money, Barbara helps him increase his financial legacy to his children by $350,000 without substantially reducing the inheritance she leaves her own children.

Private Split Dollar

Another strategy which James and Barbara could utilize is a private split dollar arrangement. This is a strategy in which James creates an ILIT for the benefit of his children. Barbara agrees to advance funds needed to pay premiums to the ILIT by entering into a private split dollar arrangement with the ILIT trustee. She will pay the premiums needed to fund the policy, but the ILIT must pay back to her (or to her estate) the greater of the policy cash values or the total premiums paid. The advantage to James is that his children will receive a larger inheritance at his death without requiring any funds from him other than the cost of establishing and administering the ILIT. Each year the arrangement is in place, Barbara is treated as making an annual gift that equals the economic benefit value of the portion of the death benefit the trust would receive if James were to die during the course of the year. She is deemed to make these gifts to James' children since they are the beneficiaries of this ILIT. If the economic benefit costs get too high, Barbara and the ILIT trustee could agree to convert the private split dollar arrangement into a private loan arrangement.

Suppose the policy the ILIT owns on James has a $1,000,000 death benefit and requires $30,000 of premiums annually for 20 years. If James dies in the 20th year, Barbara will have paid $600,000 in premiums. She will recover that $600,000 from the policy death benefit. The trustee will distribute the remaining $400,000 to James' children. That's $400,000 more than they would have received if the private split dollar arrangement had not been put in place. There may be some potential costs to Barbara and her family: lost earnings those funds could have produced if they had been invested elsewhere, reduced gifting capacity and possible use of some of her unified credit.



Conclusion

Spouses in their second marriages have interesting opportunities to use life insurance in their wealth transfer planning. Those who want to maximize what they transfer to their respective families while keeping their assets separate have powerful gift and estate tax benefits from the Internal Revenue Code at their disposal. The combination of these tax benefits and well structured life insurance policies may increase the financial legacies they leave their families. Contact the re-married couples you know who could benefit from these wealth transfer strategies. You'll be providing them a valuable service and potentially increase your life insurance sales at the same time.

These hypothetical results are based on current assumptions, are for illustrative purposes only and should not be deemed a representation of past or future results. The results would generally be lower using guaranteed assumptions, including earlier policy lapse and the inability to take any assumed policy loans or partial withdrawals. This example does not represent any specific product sales charges or other expenses that may be required.

These materials are not intended to and cannot be used to avoid tax penalties and they were prepared to support the promotion or marketing of the matters addressed in this document. Each taxpayer should seek advice from an independent tax advisor.

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