PETER McCARTHY

JD, MBA, CLU, ChFC, is a senior advanced marketing attorney for ING's national sales support team. He has over 20 years of experience in advanced marketing and has previously worked as advanced marketing counsel for Minnesota Life, Prudential Insurance Company, and American Express Financial Advisors.

McCarthy practiced law as an estate planning attorney with a large Minneapolis law firm. He earned his JD degree from the University of Miami (FL) School of Law and an MBA from Rollins College. A number of his articles on estate, business, and charitable planning concepts have been published in national financial journals and magazines, and he frequently speaks about estate and business planning concepts to industry groups and continuing education forums for the legal and accounting communities.

McCarthy can be reached at ING, 20 Washington Avenue South #5750, Minneapolis, MN 55401. Telephone: 612-342-7699. Email: ***peter.mccarthy@us.ing.com****.*

Practical Strategies For Selling Life Insurance Through Credit Shelter Trusts

There is big potential for life insurance sales through credit shelter trusts. Unfortunately, this potential is often overlooked by estate planning professionals and financial planners.

What Is a Credit Shelter Trust?

A credit shelter trust (CST) is a trust created during life or at death to reduce or avoid federal estate taxes. It seeks to take advantage of the tax credit that offsets federal estate or gift taxes when property is transferred to non-spouses. It is commonly used by married couples to avoid estate taxes on property transferred to children at the first spouse's death.

The estate tax credit can be quite valuable. Between 2006 and 2008 the credit is worth $780,800; that's equivalent to the estate tax on $2 million in property. The gift tax credit is smaller, and it applies to transfers during life that either don't qualify for the $12,000 annual gift tax exclusion or exceed it. The maximum credit against gift taxes on lifetime transfers is $345,800; that's the equivalent of $1 million in property. When the gift tax credit is used, there is a corresponding reduction in the estate tax credit.

Tax advisors often advise married couples to have a wealth transfer plan that uses the estate tax credit when the first spouse dies. Spouses who die between 2006 and 2008, and who properly utilize their estate tax credits, can pass as much as $4 million ($2 million each) to their children and other loved ones.

The Standard CST Sales Idea

Most industry literature paints an unnecessarily narrow picture of the CST sale. The standard sale involves an existing trust, one that has usually been created after the death of the first spouse. If the surviving spouse is a beneficiary of that trust, and if the surviving spouse doesn't need the income or principal of the trust for financial security, then the spouse and trustee may agree to purchase a life insurance policy on the surviving spouse's life to increase what the trust can pass on after the surviving spouse's death.

On paper this seems an interesting idea; however, in reality, it lacks significant sales potential. This standard CST sale can be hard to make because many things need to fall into place:

1. The decedent must have had a credit shelter trust as part of the estate plan.
2. The surviving spouse must either not be a beneficiary of the trust or must believe he/she is financially secure and won't need assets or income from the trust.
3. The surviving spouse must be insurable at a reasonable rate.
4. The surviving spouse must not be a trustee of the trust; otherwise he/she will have incidents of ownership in the life insurance policy the trust owns.
5. The terms of the trust must permit the purchase of the life insurance policy.

All of these factors must be present before the standard sale can take place. It seldom happens, because the agent comes in too late. Death has already occurred and the estate

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planning documents are already in place. Those documents can't be changed, and the surviving spouse may be rated or uninsurable. The agent has to hope the spouse is financially secure from other resources and doesn't need any trust assets. It can happen but, in my experience, it's a long shot.

> *"Most industry literature paints an unnecessarily narrow picture of the credit shelter trust sale."*

The Living CST Sale

I believe it's much easier to make the CST sale on the front end, before the first spouse's death. Then the documents could be customized, the spouse's financial security could be enhanced, and the underwriting could take place earlier when the applicant is younger and healthier. Further, there are two possible insureds. Here are four compelling sales strategies for making the living CST sale.

The Discounted Credit. Between 2006 and 2008, the current federal estate tax law gives everyone the opportunity to transfer up to $2 million to their non-spouse heirs estate tax-free at death. If the spouse is a U.S. citizen, an unlimited amount of money can be passed on to him/her under the unlimited marital deduction. Life insurance has the potential to pass on $2 million in income tax-free death benefits for less than $2 million in premiums. This is true because to qualify as "life insurance" under the tax code, death benefits must always exceed premiums. Some writers call this "the inevitable gain of life insurance." The exact difference between a policy's death benefits and total premiums depends on many factors and is difficult to predict in advance. Still, in most estate planning cases, the difference will be substantial.

The discounted credit approach can make for a compelling sales proposition: "Mr. Smith, Congress and the IRS will let you pass on up to $2 million to your children—estate tax-free—at your death. And the balance of your estate can go to your spouse—estate tax-free—if she survives you. How would you like to pass on the $2 million to your children at a 50 percent discount?"

Depending on Mr. Smith's age and insurability, a universal life insurance policy on his life may be purchased for total premiums of $1 million or less. This would produce the 50 percent discount. If Mr. Smith is elderly or rated, total premiums of $1.5 million would still produce a 25 percent discount.

Using life insurance to create the funds that qualify for the credit may help both Mrs. Smith and the children. It helps Mrs. Smith because more of Mr. Smith's estate is left over for transfer to her under the marital deduction. Thus, it increases her financial security. Mrs. Smith can also be a limited beneficiary of the CST, and its funds can be made available to her in the event she has a legitimate financial need. It helps the children because the life insurance death benefits are paid in cash, not property. With a $2 million death benefit, there won't be any property flowing into the CST from Mr. Smith's estate.

The transfer of property (stocks, real estate, collectibles, etc.) into the trust could require the payment of fees, commissions or transaction costs to convert them into the cash that would be needed for distribution to the beneficiaries. Transferring cash in the form of life insurance death benefits is more efficient and economical.

This sale can be implemented simply and easily. Mr. Smith purchases a $2 million policy on his own life, he pays the premiums from personal funds and names his CST as the policy beneficiary. During his life he controls the policy and does what he wishes with it. Upon his death, the policy proceeds are paid to his CST. The trustee makes distributions according to the terms of the trust. The $2 million death benefit is in his estate for estate tax purposes, but the estate taxes on it are offset by the estate credit. Thus, no estate taxes will be due, no lifetime gifts are required, and no notices have to be sent out. He gets to use his estate tax credit and retains both privacy and total control over the policy during his lifetime.

This approach can be popular for spouses in second or third marriages. They may want to leave the bulk of their estate to their current spouse, but they want their children from previous marriages to receive their inheritance immediately. By funding the property equivalent of the estate tax credit with life insurance, Mr. Smith can leave his children a substantial instant inheritance at a discount and transfer the rest of his estate to a qualified terminable interest property (QTIP) trust for his spouse. If Mr. Smith doesn't have a CST in his estate plan and doesn't want to add one, he can use the credit by naming his children as the policy beneficiaries.

Suppose Mr. Smith is concerned that transferring $2 million to his children is too much or he finds the required premiums are more than he wants to pay. Or suppose he believes the property equivalent will only be $1 million at his death (after the estate tax reform provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 [EGTRRA] sunset in 2011). *What do you do?*

Simple: propose he purchase a $1 million policy instead (or $1.5 million or even $500,000). If he wants to, he doesn't have to pass on his entire credit; if it makes him comfortable, he can do something smaller.

The Bare Bones Credit. Some people choose not to focus on the property value of the credit. Instead, their focus is on the estate taxes the credit will save if it is used at the first spouse's death. To quantify the extra estate taxes that would be due if the credit isn't used, two estate tax calculations should be made.

First, compute the estate taxes on the estimated taxable estate at the second death, assuming all assets are passed to the surviving spouse under the unlimited marital deduction. Then, compute the estate taxes on the estimated taxable estate at the second death assuming the credit's property equivalent is passed to the children at the first death and the balance of the estate is passed on to the surviving spouse.

The difference between the first amount and the second represents the increased estate tax costs the family will incur from not using the credit at the first death.

Here's an example. John and Jane Smith have a $4 million estate. Assume John dies in 2008 at age 70 and passes all his property to Jane. At her death 10 years later, at 4 percent annual growth, Jane's taxable estate is $5,920,977 and the total federal estate taxes would be $2,551,537. If John had used his credit, Jane's taxable estate would be $2,960,489 and the federal estate taxes would be $924,059. John's failure to use his credit at his death will cost his family $1,627,478 in extra estate taxes. A life insurance policy with that face amount will replace what John and Jane's children will lose because John didn't use his estate tax credit. This sum includes both the amount of taxes the credit could have offset and the additional estate taxes at Jane's death, because of the property's growth in value during the 10 years preceding her death.

The IRA Credit Catch Up. Sometimes pe ople have few personal assets that they can use for their estate tax credit. In these cases an IRA or other tax-qualified account is sometimes used to qualify for the credit. The account owner simply names the children as the beneficiaries. Unfortunately, tax-qualified accounts can't efficiently use the estate tax credit. That's because income taxes will cause the account's spendable value to shrink after it qualifies for the credit. Life insurance on the account owner can help recover the loss.

Here's an example. Suppose John Smith has a $2 million IRA he wants to use for his estate tax credit. He names his children as the beneficiaries. At his death, the $2 million IRA balance maxes out his estate tax credit. Unfortunately, before his children can actually spend the money, they have to pay income taxes to get money out of the IRA. If their average income tax bracket is 25 percent, they will only have $1.5 million left to spend after taxes. The $2 million credit will produce only $1.5 million in actual spending power and 25 percent of the estate tax credit will have been wasted. A $500,000 life insurance policy on John's life can make up for the loss. The children (or a trust for their benefit) should own the policy so it stays outside John's taxable estate.

The Expanded Credit. For some people today's $2 million estate tax property equivalent isn't enough. Their goal is to pass on as much money as possible to their children and grandchildren. You can help by showing them how to do this by effectively using their $1 million lifetime gift tax exemption.

Mr. Smith can create a CST during his lifetime and transfer in $1 million gift tax-free by using his lifetime gift tax exemption. He can do this in one lump sum or in installments over time (e.g., $100,000 per year for 10 years). He can supplement these gifts by making additional gifts using his $12,000 annual gift tax exclusion for each trust beneficiary.

Mrs. Smith can add her $1 million lifetime exemption to the trust through a "split gift" to bring the total to $2 million. She can also agree to allocate her $12,000 annual exclusion gifts to the CST through gift splitting.

The CST trustee would purchase a life insurance policy on Mr. Smith. Depending on Mr. Smith's age and health, it might be possible to purchase a policy on his life with a death benefit of $3 million to $5 million without gift splitting. This strategy can leverage Mr. Smith's lifetime gifts into significantly greater wealth for the CST beneficiaries. Leveraging the lifetime gift tax exemption into income and estate tax-free death benefits may substantially increase family wealth.

The Expanded and Delayed Credit. Most CSTs are written so that the surviving spouse is a discretionary beneficiary. This means the trustee has the ability to make distributions to the spouse during the balance of the spouse's lifetime. This protects the spouse's financial security without causing the CST assets to be taxed in the spouse's estate. It means that there will probably be no distributions to the children until the surviving spouse's death.

If there aren't likely to be any distributions before the surviving spouse's death, it may make sense to fund the CST with a survivorship policy that pays benefits at the last spouse's death. This can be an excellent wealth transfer strategy if the non-grantor spouse is financially secure and is unlikely to need money from the CST. It can be attractive for two reasons:

First, a survivorship policy usually produces more death benefits per dollar of premiums paid than a policy insuring a single life. Thus, there is an opportunity to leverage the first spouse's credit into more income and estate tax dollars for the children.

Second, after the grantor spouse's death, another $1 million, plus any part of the $1 million lifetime gift tax exemption that was not used during his life, can be contributed to the CST. The trustee can pay these extra funds into the policy to further increase the death benefits it will pay. The addition of these extra funds to the life insurance policy would be like giving it a "booster" shot to increase its performance.

Life insurance and the credit shelter trust can be tremendous partners. They can work well together in the standard CST sale after the first spouse's death. But they can provide greater benefits if the policy is purchased while both spouses are alive and in good health. In a lifetime CST sale, the policy death benefits can pass on the value of the credit at a discount or they can leverage the credit's property value into an even greater sum. The potential for leverage can be increased if a survivorship policy is used insuring both spouses.

Ask your clients and prospects this question: "Congress and the IRS will let you pass on as much as $2 million to your children tax free; what are you doing to take advantage of this great opportunity?"