

How Often Can I Change My Irrevocable Trust?

Has this ever happened to you? You see a prospect and his spouse who have a net taxable estate of \$3 million, \$5 million, \$10 million or more. You make them aware of the enormous cost of dying imposed by our estate laws; they're appalled that so much of what they spent their lives building up will be torn down and destroyed through liquidation or the sale of liquid assets.

You tell them you know of an alternative, a way to discount the tax payment: It's an option that would allow the tax, which will absolutely come due, to be paid for the estate rather than from the estate.

The technique you describe is tried and true. It's been used thousands of times to maximize the bequest to the estate holders' family or the charity of their choice, rather than enriching the U.S. government. The technique you describe combines a special estate trust and a special estate tax life insurance policy.

The Plan

The life policy is special because it insures two people. Your clients understand that the major estate tax is due not when the first spouse dies but at the death of the second. The timing of the death benefit coincides with the timing of the need for money. It also costs significantly less than a policy on only one person.

The trust is special because, if properly designed, it can keep the proceeds of the estate tax policy from being taxed as another part of the estate. The tax-free death benefit

Keys To Assist The Sale

- ◆ Client creates irrevocable trust
- ◆ Apply for second-to-die policy, naming trust as contingent owner and beneficiary
- ◆ Create a new irrevocable trust if client wants to change provisions

Here is a method of selling survivorship life to an irrevocable trust that can be changed as often as necessary during your client's lifetime.

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can then be made available to the estate through the purchase of assets or by a loan to pay the estate tax that will fall due nine months after the death of the second spouse. The assets purchased by the trust from the estate (or the loan when repaid to the trust) would then pass to your clients' beneficiaries as determined by the wording of the trust.

Your clients love the idea. All they need is an attorney who understands the estate planning process, a preliminary request for insurance underwriting and a medical exam to assure coverage will be available when the trust is completed. The trustee will then sign a formal application allowing the trust to be the owner and beneficiary of the insurance from its inception. They agree to begin the process immediately.

The Process

Over the next few days, your clients are examined and meet with an attorney to begin discussing the terms of the trust. While the underwriting is taking place, you speak with your clients from time to time to keep them informed. A month later you tell them second-to-die coverage has been approved exactly as they wanted it. You ask them if they've signed the trust.

"Not quite yet," they answer. There are still one or two details to work out. Now that they know the coverage is approved, they'll finish it right away.

A week later nothing has changed. You call the attorney, who

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tells you the draft is going out today. A few days later, a call to the clients reveals they're reconsidering the distribution provisions of the trust. They didn't really understand that irrevocable meant irrevocable. They're not sure they can plan for a distribution to their children or grandchildren that may not occur for 20 or more years from now. Their desires could change; their kids could change. They need more time. Just another week or two.

The Problem

The week or two becomes a month or two and soon your carrier notifies you that underwriting will close the case if formal application isn't received in two weeks. You find your clients no closer to a decision than before. In fact, they're more convinced than ever they want to be able to totally control the way funds are passed to the next generation, at least for the next few years. Maybe the insurance isn't right for them just yet.

Ouch!

The Solution

You ask, "What if there were a way to completely control how the funds go to the kids? What if there were a way to change the irrevocable trust any time you wanted to until the first of the two of you dies? After all, at death everything becomes irrevocable anyway."

You explain how they may be able to have the control they want, especially the ability to change their plans as their children and even their grandchildren change. They like this.

"What's the catch?" they ask. "Why didn't you suggest we do it this way first time around?"

So you sit down and explain how to make an irrevocable trust revocable.

How It Works

Of the two spouses, let's assume Harry has the shorter life expectan-

cy. Have Harry create the first irrevocable trust, putting in the distribution provisions Harry wants. Harry has the right to terminate the first trust and create a second or a third—as many as he wants to create. The newest trust Harry creates will be the only trust that defines who the beneficiaries and trustees are. The trust, and that trust alone, will control the distribution of trust assets to the beneficiaries.

You apply for the second-to-die policy with Harry as owner, and the first irrevocable trust as contingent owner. Contractually, through provisions in the policy, the contingent owner becomes the sole owner of the policy immediately at Harry's death. As owner, Harry names the first irrevocable trust as beneficiary. He also has the right to borrow from the policy's cash value and exercise all the rights any policyowner can exercise.

Assume that Harry and his wife, Wendy, decide some time later they want to change the distribution items of the trust, the beneficiaries or the trustee. They simply create irrevocable trust number two and Harry names this second trust as contingent owner and beneficiary. This process allows Harry and Wendy to change their minds as often as they like. They can even borrow from or surrender the policy and recover their cash values if estate protection is no longer required because of changes in tax law or marital status.

Alternative Scenarios

At some time in the future, Harry will die before Wendy, Wendy will die before Harry or both will die together. Let's look at what happens in each situation.

If Harry dies before Wendy, the contract specifies the most recent irrevocable trust becomes the new policyowner. The policy doesn't mature as a death claim since Wendy is still living, so the face amount is not

subject to estate tax. There may, however, be an estate tax due on the interpolated terminal reserve of the policy (approximately the cash value) which is passed from Harry to the trust.

When Wendy dies, even if it's only a second later, the trust would receive the policy's death benefit free from income and estate tax because Wendy, as the only insured at the time of her death, never had an incidence of ownership in the policy. The money was delivered estate tax free, but they still kept control.

If Harry and Wendy die at the same time, the insurer would assume that Harry died first and transfer the policy to the trust as contingent owner before considering the policy as having reached claim. The bottom-line result would be the same as if Harry died first—no estate tax due on the death proceeds from the policy.

If Wendy dies first, Harry should gift the policy to the irrevocable trust as soon as possible after her death. If Harry has used up his \$600,000 exemption, and if there aren't enough trust beneficiaries, a gift tax might be due on the policy's interpolated terminal reserve. After completing the gift, there are two possibilities: Harry could die within three years of making the gift or Harry could die after three years.

If he lives for more than three years after gifting the policy to the irrevocable trust, the proceeds payable at Harry's death would be free from estate taxes.

If Harry dies within three years of the policy transfer, the full face amount of the policy would be included in Harry's taxable estate as a gift in contemplation of death. Harry's estate, however, would be able to recapture the interpolated terminal reserve gift created when Harry gave the policy to the trust. But even with inclusion in the estate, the beneficiaries are still better off than if there was no insurance at all.

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This one fly in the ointment is the reason I don't try to sell this plan right from the start, but there's a solution even for this problem. If Harry is still insurable when Wendy dies, he can buy a term policy and name the irrevocable trust as owner and beneficiary. The term policy would have a death benefit equal to one-half of the survivorship policy transferred to the trust, covering the tax on the survivor policy. If Harry doesn't die within three years of the transfer, the term policy could be canceled or even converted to permanent insurance to cover additional taxes.

At some time, while Harry and Wendy are both alive, they may be ready to finalize trustees, beneficiaries and trust distribution terms. At that time, Harry could gift the survivorship policy to the current irrevocable trust (paying a gift tax on the small interpolated terminal reserve) and start the three-year clock. He could then buy a term policy for half the value of the estate tax on either himself or Wendy (whichever is less expensive to insure) to cover the estate tax due if both were to die within three years of the transfer.

In this way you have it all: control and coverage. There's a small chance of estate inclusion but even then, the net result would be thousands of times better than doing nothing. You're happy, the attorney's happy, the beneficiaries are pleased and—most important—your clients' needs and wants are satisfied. ♦

Contact me if
you have any
questions:
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