

Thursday, September 23, 2010



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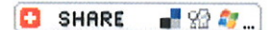
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❖ Opinion

Buy-sell arrangements and irrevocable insurance trusts

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A common estate planning strategy for people with taxable estates is to have an irrevocable trust own life insurance, rather than owning it themselves. Because the amount an individual can protect from the estate tax is dropping to \$1 million in 2011, more taxpayers will benefit if irrevocable trusts own these policies. For example, assume Mr. Client has a \$1 million policy on his life. Upon his death, if he has a taxable estate, his beneficiaries could receive only \$450,000 (2011 maximum estate tax rate

of 55 percent). However, if Mr. Client's irrevocable trust owns the policy, then the full \$1 million is available for Mr. Client's wife and children.

For closely held business owners, life insurance becomes even more important: it is often the source of most or all of the funding for a buy-sell agreement. For example, Mr. Client and Mr. Partner are 50 percent business owners, each owning 100 shares. They have insurance on each other's lives to fund the purchase of the deceased's 100 shares. If we assume Mr. Partner dies first, his estate will be required to sell his 100 shares to Mr. Client. Mr. Partner's spouse needs the cash, provided by the insurance death benefit, and Mr. Client ends up with 100 percent of the business by purchasing from Mr. Partner's estate his 100 shares.

This is the desired business strategy. But because Mr. Client has a taxable estate, it will now become more difficult to protect the value of the business upon his death because he now owns 100 percent of the business. Here is the question: can we combine the advantages of the irrevocable trust, whereby the assets are not in Mr. Client's estate, with the common business practice of a buy-sell arrangement?

Yes. This is how it would work. Upon Mr. Partner's death, the purchaser would be Mr. Client's irrevocable trust, the owner of the life insurance, not Mr. Client. Thus, Mr. Partner's stock would be owned in the irrevocable trust after transfer. Mr. Client would not be the trustee, but he could appoint a friendly trustee to work with him on managing the business. Then, upon his death, or if the business was sold prior to his death, 50 percent of the business value would not be in his estate, providing huge estate tax benefits for Mr. Client's family.

The irrevocable trust provides other benefits. It could be designed as a dynasty trust to provide asset protection and estate tax benefits for Mr. Client's children. The trust could be designed as a "grantor trust" (a so-called "intentionally defective trust"), thus providing income tax benefits to Mr. Client and his family. A grantor trust would preserve Mr.

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Client's S corporation status if the business operated as such. Mr. Client would be considered the owner of the grantor trust for income tax purposes but not for estate tax purposes.

One technical issue to consider is whether the irrevocable trust would have an insurable interest in the policy on Mr. Partner's life. Without an insurable interest, no one can obtain insurance on another's life. Common insurable interests are spouses, parents and children. Insurable interests are determined under state law. For example, under Virginia law, an insurable interest means a "lawful and substantial economic interest in the life, health and bodily safety of the insured." In the case of a trustee of a trust that owns a life insurance policy, the trustee will have an insurable interest in each individual in whose life the owner of the trust for federal income tax purposes has an insurable interest.

If the irrevocable trust in Mr. Client's case is a grantor trust, so that Mr. Client is treated as the owner, he would have an insurable interest in Mr. Partner because it is generally accepted that business partners have an economic interest in each other's lives. Thus, the irrevocable trust, treated as a grantor trust, could purchase the insurance policy on Mr. Partner's life and thereby Mr. Client would receive both estate tax and business advantages.

Where would the cash come from for the irrevocable trust to pay the premiums? If Mr. Client pays the premium on the life insurance, there would be gift tax consequence. The gift tax consequence on the premium payment could be handled by annual exclusion gifts, with the help of a "Crummey" letter. Or, if Mr. Client made a one time gift to the insurance trust, using up a portion of his exemption amount, and income was then derived from the gift, perhaps there would not be the need for annual exclusion gifts. For example, Mr. Client could gift S corporation stock that produced dividends, or real estate that produced rental income, which could be the source of the insurance premium payment. There are a number of different ways to combine the premium payment with gifting strategies to further enhance the benefit of the irrevocable trust.

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