SURVIVORSHIP STANDBY TRUST

A flexible trust arrangement for young, wealthy married couples

A survivorship standby trust (SST) is a flexible solution that is intended to preserve access to trust assets in the short-term while minimizing estate tax exposure over the long term. The SST strategy may be enhanced by the use of a survivorship variable universal life insurance policy (SVUL). Properly structured and managed, the SST + SVUL strategy will preserve access to the SVUL policy cash values for both spouses with the intent of removing the life insurance from the estate of the surviving spouse.

A COMMON CONCERN FOR THE WEALTHY

Balancing the present and future concerns of high net worth (HNW) clients is a priority. This may be particularly acute for younger HNW families because they have a longer time horizon to plan through. While these families may recognize the need to plan for the long term, their attention is often focused more on short-term concerns.

For example, a wealthy couple may be a good candidate for an irrevocable life insurance trust (ILIT). The ILIT provides a number of important benefits, most notably, the reduction of the taxable estate through annual gifting and the purchase of a life insurance policy outside of the couple's taxable estate. ILITs have significant considerations as well. Gifts made to trust must be complete and irrevocable. The client must relinquish all control over the life insurance policy's management and will generally lose access to policy cash values during life.[1]

When dealing with young HNW families, it is no wonder that some will want to "keep their options open" and not commit to an irrevocable strategy like an ILIT. This is where a survivorship standby trust (SST), sometimes referred to as a "wait-and-see-trust," becomes a compelling option.

HOW DOES THE SST WORK?

The older spouse, or the spouse with the shorter life expectancy, will establish a revocable living trust to purchase a life insurance policy insuring both spouses' lives. As this is a revocable living trust, our clients own all trust assets for legal and tax purposes and have full access and control. During life, the SST trustee (the grantor, typically) can access policy cash values on a tax-advantaged basis[2], and distribute those funds to the insureds.

While the grantor spouse is alive, the couple will pay premium on the SST-owned policy. There are no gift tax implications at this time because the SST is revocable. Additionally, trust terms can be adjusted to reflect any changes in lifestyle or family dynamic (e.g., new beneficiaries) that may need to be reflected in the couple's

[1] When drafting and administering an ILIT, care must be taken to avoid inclusion of trust assets in the estate of the grantor(s)/insured(s) under IRC Sec. 2036, 2038, and 2042.

[2] This assumes the policy passes the testing requirements of IRC 7702, and is not a modified endowment contract (MEC).

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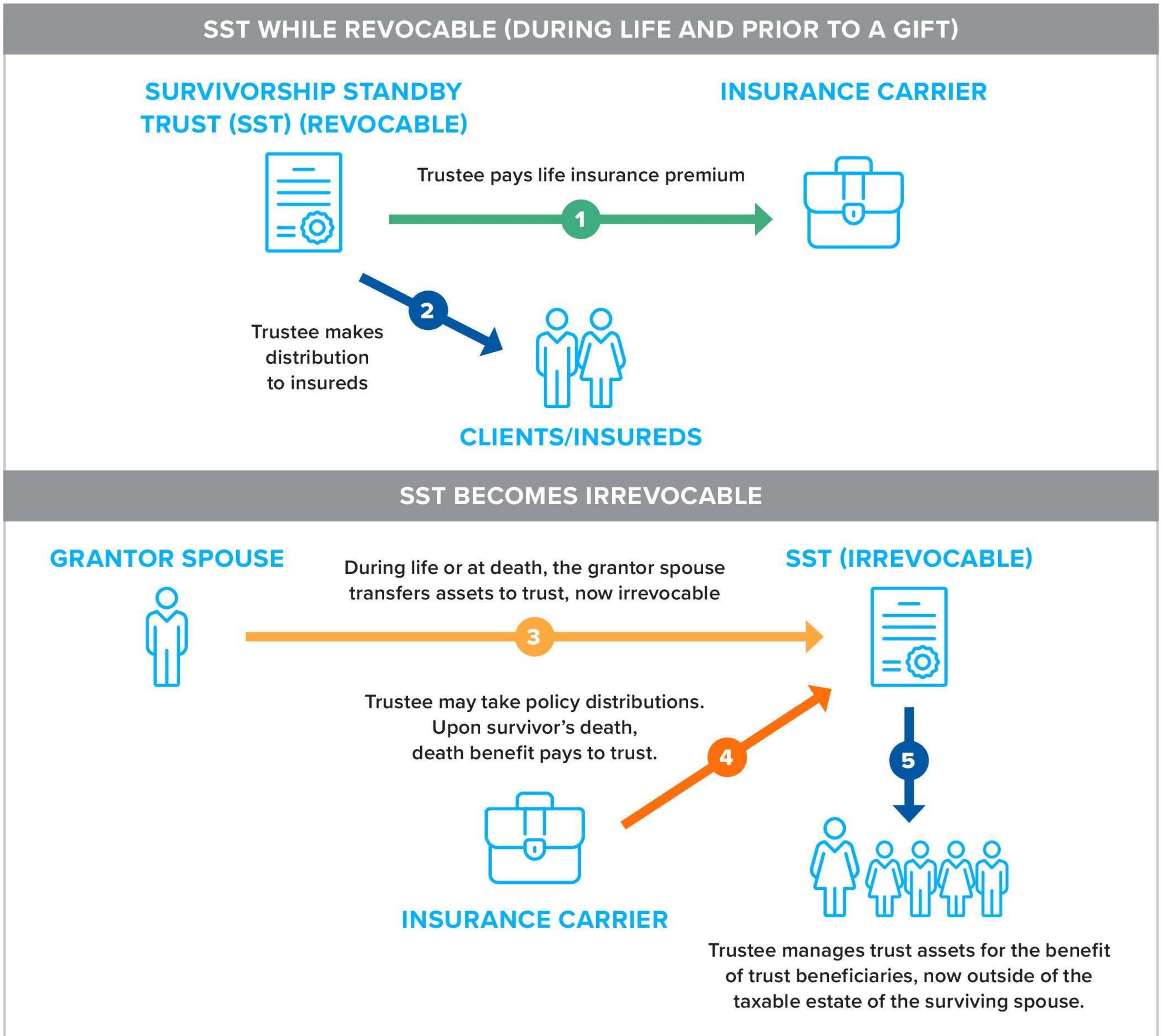

estate plan. Should it be prudent to do so during life, the grantor could render the trust irrevocable by making a completed gift of trust assets. Alternatively, should the grantor spouse predecease the non-grantor spouse, the trust will become irrevocable, and the value of trust assets will be includable in the decedent's (grantor spouse's) estate.

Once irrevocable, the trustee[3] will manage the policy and any other trust assets for the benefit of the surviving spouse and the couple's children, grandchildren, or other trust beneficiaries. Upon the death of the surviving insured, the survivorship policy's death benefit pays income-tax free to the trustee, who then manages trust assets per the terms of the trust, for the benefit of the remaining beneficiaries. Properly managed, trust assets (including the life insurance death benefit) should be outside of the surviving spouse's estate.

BENEFITS OF A SST

A SST is a flexible way for clients to purchase survivorship insurance and may provide the following advantages:

- **Access to policy cash values.** When the trust is revocable, the family has unfettered access to trust assets. After the passing of the grantor spouse, spousal access provisions may enable the surviving spouse to be a beneficiary of the trust.

[3] In order to avoid implication of IRC Sec 2042, the insured(s) should not have any incidents of ownership on the trust-owned policy. This includes being trustee of a trust which owns a policy on their life. Thus, a third-party trustee is advisable to prevent the inclusion of the policy proceeds in the estate of the insured.

- **Estate tax exposure is limited.** When the grantor spouse dies first, the fair market value of the policy is includable in their estate, which will generally be far less than the policy death benefit. Properly structured and managed, the death proceeds will be excluded from the estate of the survivor.
- **Flexibility.** A SST begins as a revocable trust and may be amended without penalty while the grantor lives. When circumstances dictate, the grantor can render the trust irrevocable (a reportable gift of the value of trust-owned assets).
- **Gifting.** While the trust is revocable, premium payments are not considered gifts. Unlike transfers to an irrevocable trust, clients are not required to file gift tax returns, nor will the trustee be required to draft and mail "Crummey notices" to the beneficiaries.

CONSIDERATIONS

The SST straddles two competing goals by providing flexibility and access to policy values while still providing partial estate tax protection. Like most compromises, it has its drawbacks:

- If the grantor spouse dies during the premium payment period, the trustee may have to pay additional premiums.
- If the trust remains revocable upon the second death, the policy's death benefit will be includable in the survivor's estate.
- If the insured gifts the policy to an irrevocable trust, they must survive three years to avoid inclusion in their estate.[4]
- Policy withdrawals and loans should be closely monitored to avoid lapse.
- If the policy has outstanding loans in excess of basis, the transfer may not qualify as a gift and may trigger income tax liability for the donor.[5]

POTENTIAL CLIENT

When evaluating whether a client and their family may benefit from introducing a SST into their estate or financial plan, consider the following client characteristics:

- Typically, a younger, married couple, ages 35–55, but there is no age limitation
- Have children, may have children in the future, or have other family/friends they would like to benefit at their passing
- Are concerned with the potential that tax law could change and cause their current or future estate to be taxable
- Appreciate the flexibility to access trust assets for supplemental income should their financial needs dictate, as well as the ability to change a trust beneficiary as their personal circumstances dictate
- Insurable with a demonstrable life insurance need

CONCLUSION

A SST may be a useful option for young and wealthy families who want to begin the estate planning process but don't wish to make irrevocable transfers quite yet. Importantly, the flexibility inherent in this trust design may give younger clients sufficient comfort to begin planning earlier. This provides an added advantage when life insurance is taken into consideration as policies purchased on the lives of younger, healthier insureds are generally less expensive than policies purchased later in life. For the right clients, incorporating a SST into the discussion can help provide the comfort to begin the planning process early, and the flexibility to be responsive as needs evolve.

[4] IRC Secs. 2035 and 2042.

[5] Rev. Rul. 69-187

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