Using Life Insurance to Fund the Trust

Life Insurance - Funding a Trust

The Basics

Trusts and life insurance are two powerful tools used in estate planning. When used correctly, they both ensure your estate can fulfill your wishes. Together they can financially provide for your spouse and minor children and fund charitable endeavors long after you leave.

Before writing this article, I tried a few common searches. There were so many contradictory articles that it was overwhelming. Rather than send anyone else down the rabbit hole, we decided to distill the information for you here. Although, that being said, there are still a multitude of complex situations that don't factor into the problem we're solving here today, keep that in mind. A complex estate may require additional resources and planning techniques. However, this article is for you if you're dealing with a straightforward trust-based estate plan.

Common Questions

Let's break down some common questions one at a time. While doing so, let's also keep in mind that most Financial Professionals are working with individuals who will NOT exceed the current estate tax exemption.

- Do I need a separate trust for my Life Insurance?
    - No. Unless you approach the federal estate tax exemption limits. As a Financial Professional, you should know the limits and work with an estate attorney to create another trust for life insurance if needed. If you're unsure, research your federal and state inheritance tax limits: https://www.actec.org/resources/state-death-tax-chart/

  - **Good News!** Either way, our documents are flexible, and at the first death, they are set to allow you to create a second trust if needed.

- Should my Trust be the beneficiary of my life insurance?
  - Short answer: Yes. Almost always, yes. Occasionally, there are extenuating circumstances. But, generally speaking, it's best practice to make your trust the beneficiary.
  - **Good News!** This also gives your trust some quick liquidity when needed.

- If I needed a second trust, what type would it be?
  - Irrevocable Life Insurance Trust (ILIT) - the purpose of the second trust is to avoid federal and state estate tax. So, an ILIT would be necessary.

- Why shouldn't I list my spouse or my children as the beneficiaries of my life insurance policy?
  - I know it sounds cheesy, but we all know this example because, sadly, it does happen. Assume Dad has a life insurance policy for $1m and lists Mom as the Primary Beneficiary, and the Trust is the Contingent Beneficiary. Now, Mom and Dad are in an accident together. Dad passes away immediately. Mom, however, hangs on for weeks, incapacitated. Unfortunately, Mom is unable to file the claim. Her Power of Attorney/The Successor Trustee is also unable to help. Why? Because she is still living, the benefit is hers.
  - Do you see how this could have been avoided? Make the trust the primary beneficiary.

- If you have Age-Based Restrictions in your trust, then list the trust as beneficiary.
  - Your Successor Trustee can't do their job if you give the life insurance death benefit to their 18 and 20-year-old children.

- Funding a Special Needs trust?
  - Putting this in the trust will not prevent someone from receiving financial assistance or entering a government program.
  - There are terms within the trust that allow the Trustee to adapt to these circumstances and do what's in the beneficiary's best interest.

- It's all about control.
  - Putting it in the trust gives you the most control you can have. You can't predict all the issues someone might have in the future either, Addiction, Spendthrift, etc.
  - **Good News!-** There are clauses in the terms of the trust addressing each of these issues.

- What if I am in a state with a separate inheritance tax?
    - If unsure, research your federal and state inheritance tax limits.
    - **Good News!** Our documents are flexible, and at the first death, they are set to allow you to create a second trust if needed.

- What if I want to use my whole life policy for income in retirement?
    - **Good News!** You can do this with a revocable trust. You are still listed as the owner of the policy. The trust is only the beneficiary.
    - An ILIT would not allow you to do so unless you paid significant legal fees to alter the trust.

If you're using term insurance to fund a trust, the period of insurability should not end before the person is at or close to retirement. The trust could be unfunded if the person dies prematurely after the term policy ends. You might leave them financially unstable with nothing significant to provide for minors or adult beneficiaries. Try using a Guaranteed Universal Life or Convertible Term policy instead. Be cautious with any death benefit that can fluctuate during your clients' working years; you do not want to leave the trust underfunded.

Example: Your client, Steve (57y), offers to pay for Matt's, his eldest son's, student loans. If he attends the more prestigious University he was recently accepted at. Matt agreed and was in his second year when his dad died in a car accident. Unfortunately, Dad had an IUL and reduced his premiums recently. This also reduced his death benefit. Mom no longer has the funds to fulfill Steve's wishes. Both the mother and son are now in difficult financial positions.

Words of Wisdom

Trusts, whether you are wealthy or not, can be invaluable when combined with life insurance. They can provide for others while providing control after you're gone.