

Critical considerations in matrimonial agreements

INSURANCE TRUSTS



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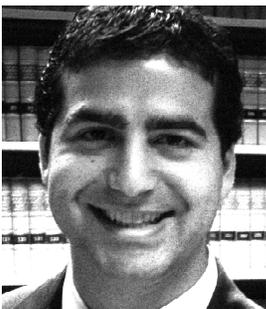
Attorneys that practice matrimonial law invariably will find themselves negotiating agreements — prenuptial, mid-marriage, reconciliation or property settlement — containing a life insurance obligation either on the part of their client or their client's soon-to-be spouse or ex-spouse. Regardless of which party an attorney represents in these negotiations, it is essential all parties consider the significant benefits that can be realized by insurance trusts.

Indeed, many agreements can be altered slightly in order to achieve significantly better results for all involved. For example, when a couple is finalizing a divorce, property settlement agreements (PSAs) are routinely drafted to require the party with an alimony and/or child support obligation to acquire and/or maintain an existing life insurance policy to secure such obligation. The PSAs generally require only that the party upon whose life the insurance is held (the insured spouse) designate their soon-to-be ex-spouse (the non-insured spouse) and/or children as beneficiaries, but provide few specifics concerning the manner in which the insurance policy should be created and held. In most instances, therefore, the insured spouse either purchases or continues to be owner of an insurance policy designating the non-insured spouse and/or children personally as beneficiaries. This almost universally criticized structure can create serious unintended consequences for the insured spouse, the non-insured spouse and their children.

This article identifies potential problems of which all matrimonial attorneys must be aware when negotiating, drafting and implementing matrimonial agreements with an insurance obligation, regardless of who they represent, and highlights a solution for ensuring the diminution of the federal and New Jersey estate tax in these situations.

Problem: Ownership of life insurance by the insured spouse

Under most agreements, the insured spouse purchases an insurance policy for the benefit of the non-insured spouse and/or the parties' children. The problem with this framework is that upon death of the insured spouse, policy proceeds may be included in their gross estate for estate tax purposes. This can result in a significant liability for the estate of a deceased spouse, despite the fact the policy's proceeds will be distributed, for example, to their ex-spouse. (It should be noted the position can be taken that the proceeds represent an obligation of the estate, and would therefore be deducted from the gross estate — thereby resulting in no estate tax being owed on the proceeds.) Drafting the appropriate language in the agreement and utilizing an insurance



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trust removes any potential dispute with state and federal taxing authorities.

Under current estate tax laws, if an insured spouse's gross estate, including insurance proceeds, exceeds \$675,000 in New Jersey, every penny over that amount that does not pass to a surviving spouse or to certain qualifying marital trusts will be subject to state estate tax at rates peaking at 16 percent.

In addition, as of 2006, every penny over \$2 million not passing to a surviving spouse or to certain qualifying marital trusts will be subject to federal estate tax at rates peaking at 46 percent.

To put these numbers into perspective, \$1 million of insurance in a New Jersey taxable estate results in nearly \$40,000 state estate tax being owed; and \$1 million of insurance in a federally taxable estate results in up to an additional \$460,000 federal estate tax. Thus, insurance proceeds payable to ex-spouses and children can create a large tax liability in an insured spouse's estate — about 50 percent of the value of the life insurance proceeds.

Consider the situation where an ex-wife owns a \$2 million home, has \$1 million in liquid assets, and maintains a \$2 million insurance policy on her life for the benefit of her ex-husband. Upon her death, essentially all of her liquid assets — assets she may have planned to leave for the benefit of a new spouse and/or her children — may be exhausted because of the estate taxes owed for the insurance policy maintained for her ex-husband.

In addition, when proceeds are payable to the non-insured spouse outright, any proceeds remaining upon such non-insured spouse's death will be included in such spouse's estate in an amount of approximately 50 percent of the value of the insurance proceeds.

Further, when the insurance policy is designed to provide for child support and the insured spouse dies while one or more of the children are minors, the insurance proceeds, to the extent not expended on child support, will pass outright to the children at age 18. This can result in an 18-year-old having unfettered access to tens of thousands, hundreds of thousands, or in certain cases, millions of dollars.

Lastly, the non-insured spouse has no simple method of ensuring that the insured spouse actually has acquired the insurance (or continues to maintain it), because he or she has no standing to verify the beneficiary designations or status of the policy with the insurance company. Thus, the non-insured spouse has to rely on obtaining information from the insured spouse and, if necessary, must seek intervention of the court to verify the insurance designed to secure alimony and/or child support remains in effect.

Solution: Insurance trust as owner and beneficiary

There is a simple solution to all of the potential problems above. Properly drafting the agreement and having an insurance trust purchase the policy during the insured spouse's life eliminates the potential estate tax liabilities entirely because holding the insurance policy in an insurance trust removes the proceeds from the insured spouse's estate, as long as the insured spouse lives three more years. In addition, when properly structured, insurance trusts exempt the proceeds from estate tax upon the non-insured spouse's death, thereby enabling the remaining

proceeds to pass to the children (or other desired beneficiaries) estate-tax-free. Further, an insurance trust can ensure that the non-insured spouse will receive confirmation the premium payments are current and the policy is in full force and effect.

Life insurance designed for child support payments

An insurance trust is an excellent vehicle for holding insurance policies designed to provide for child support payments. In such cases, the insurance trust should be set up such that the insured spouse is designated as grantor of the trust, the non-insured spouse named a trustee of the trust (along with an agreed-upon co-trustee) and the minor children designated as beneficiaries. In this way, the value of life insurance proceeds will be excluded from the insured spouse's estate and the non-insured spouse, as a co-trustee, will automatically receive statements confirming the insurance remains in full force and effect.

In this context, the insurance trust also provides additional protection for the children — protecting assets from creditors and future spouses. And the non-insured spouse (with a co-trustee) will determine when such amounts are actually distributed, thereby avoiding the potential problem of allowing a teen-ager total control over a large sum of money.

Life insurance designed to provide alimony payments

Similarly, an insurance trust is a fine choice for holding insurance policies designed to safeguard alimony payments. Again, it should be set up so the insured spouse is designated grantor of the trust, the non-insured spouse named as a co-trustee of the trust (along with a friend, relative or trusted advisor chosen by the non-insured spouse), and the non-insured spouse designated as beneficiary of the trust, with the children or other desired beneficiaries in the event of the spouse's death. In this way, the insurance proceeds will not be included in either of the spouses' estates. And again, as trustee, the non-insured spouse will receive statements for the insurance policy confirming the insurance is kept in full force and effect. In addition, holding the proceeds in trust protects them from creditors and future spouses.

Lastly, the insurance trust can be structured to create continuing trusts for children (or other desired beneficiaries) in order to ensure they do not receive property at too young an age, and in order to further protect such assets from children's future creditors and spouses.

Conclusion

We recently were hired to review a prenuptial agreement that obligated the husband to maintain a \$5 million life insurance policy on his wife. Had an insurance trust not been utilized, this structure could have created an almost \$2.5 million liability for her estate upon her death. Given the variety of agreements and life insurance obligations negotiated by matrimonial attorneys, it is essential the issues be assessed and the most tax-efficient vehicle for clients be implemented.

Thus, when negotiating an agreement with a life insurance obligation, matrimonial attorneys must consider the significant benefits of utilizing insurance trusts. If unfamiliar with these issues, they should consider consulting a trusts and estates professional. ©