IRREVOCABLE LIFE INSURANCE TRUSTS[1]

By: Jason R. Handal

Introduction

The irrevocable life insurance trust ("ILIT") has become an increasingly popular estate planning tool. Because a properly structured and administered ILIT allows life insurance proceeds to avoid estate taxes (as well as income taxes), many individuals include this technique as part of their estate plan.

In general, an ILIT is established by an individual or individuals to own life insurance policy on his/her life or their lives (i.e., a second-to-die policy). The ILIT also is designated as the beneficiary of the life insurance policy(s) it owns. Thus, the ILIT will receive the tax-free proceeds after the insured's death(s). Note that the Internal Revenue Code provides that life insurance proceeds are not income taxable when received by the policy beneficiary(s) (subject to certain exceptions that are beyond the scope of this article).

Why establish an ILIT?

When an individual owns a life insurance policy on his life, then upon his death the insurance proceeds will be included in his gross estate for federal estate tax purposes. As a result, those proceeds may be subject to federal and state estate taxes. However, as mentioned above, a life insurance policy owned by an ILIT as of the insured person's death can ensure that the proceeds are excluded from the insured's estate and thus not counted when valuing his/her gross estate for estate tax purposes. This can lead to significant estate tax savings.

Estate tax savings is not the only reason to establish an ILIT, though often it is the primary reason for doing so. The ILIT also provides other benefits, including (but not limited to) (a) gift and generation-skipping transfer tax planning opportunities, (b) a source of tax-free money to assist in the payment of estate taxes and other expenses after death (however, the ILIT must not require its Trustee to pay the decedent's estate taxes; to do so without the requirement would expose the ILIT itself to estate taxes as part of the decedent's estate), and (c) a pool of assets for the insured person's beneficiaries that can be protected from the creditors of such beneficiaries. The liquidity benefit is greater in the case of an estate consisting largely of non-liquid assets (i.e., a closely-held business, farm, or large real estate portfolio) that the family would like to avoid selling simply to raise money to pay estate taxes.

[1] **This article is current as of 2002. Please contact Willms, S.C. for current information on this topic.**

Legal and Tax Requirements

As mentioned above, the ILIT must carefully be drafted and administered in order to attain the intended objectives. In addition to being irrevocable, the ILIT must prohibit the insured person (also known as the "grantor", "donor" or "settlor") from having rights or control over the ILIT (or the insurance policy owned by the ILIT). Specifically, the grantor must retain no "incidents of ownership" over the ILIT's insurance policy, or else the proceeds will be included in the grantor's estate. Examples of "incidents of ownership" include (a) the right to surrender or cancel the policy, (b) the right to change the policy beneficiary, (c) the right to transfer the policy or pledge it as loan collateral, and (d) the ability to borrow against the policy's value. As such, this means that the grantor cannot serve as the ILIT's trustee.

Any insured considering an ILIT must be willing to accept these limitations to achieve estate tax avoidance on the insurance proceeds.

Payment of Premiums

Once the ILIT becomes the owner of the policy(s) (whether by gift or purchase), the question becomes who will provide the cash required to pay the insurance premiums and, thus, sustain the policy? Typically, the grantor/insured continues to pay the premiums, though not directly to the insurance company.

As you may be aware, the law allows each individual to transfer up to $13,000 per year per person free of gift taxes. This is known as the "gift tax annual exclusion." For example, an individual with 5 children can give away up to $65,000 per year to his/her children with no gift tax. The gift tax annual exclusion applies to any gift of a present interest.

In general, a gift to a trust does not qualify for the annual exclusion. However, an important exception to this rule exists. Under the exception, if each beneficiary has the immediate right to withdraw his/her pro-rata share of contributions to the trust for a specified period (ranging from 30-60 days), then the contribution to the trust is deemed to be made to each beneficiary. In other words, the right of withdrawal qualifies transfers in trust for the gift tax annual exclusion. Such a right of withdrawal is known as a "Crummey" power, after the 1969 case from which the exception originated.

To increase the likelihood that the "Crummey" powers will be respected by the IRS, the ILIT Trustee should give written notice to each beneficiary of each gift to the ILIT and of that beneficiary's right to withdraw a portion of such gift. Normally, the beneficiary will not want to withdraw the gift, in light of the significant future benefits of permitting the money to stay in the ILIT and be used to pay life insurance premiums. Once the beneficiaries have been notified of the contribution to the ILIT and assuming

they elect not to withdraw the money, then the Trustee can use the funds to pay the insurance premium.

Second-to-Die Life Insurance

Because many married couples' estate plans elect to defer paying estate taxes until the surviving spouse's death, a second-to-die (or "joint and survivor") life insurance policy may be used in conjunction with an ILIT to assist with payment of those taxes. Because such a policy insures two lives, the premiums are often less expensive than an insurance policy insuring one life.

Conclusion

An ILIT offers a variety of benefits as part of a carefully thought out estate plan, including estate tax reduction and needed liquidity for the estate tax on the insured's other assets. If you would like to discuss its potential applicability as part of your estate plan or have an existing ILIT reviewed, please call us at (262) 238-6996 or email us at firm@willmslaw.com.