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IRREVOCABLE LIFE INSURANCE TRUSTS

What is an Irrevocable Life Insurance Trust?

An irrevocable life insurance trust ("ILIT") is an estate planning vehicle used to eliminate federal transfer taxes on the proceeds of life insurance policies on the insured's life. The insured generally transfers an insurance policy on his or her life to the trustee of an irrevocable trust, the trustee becomes the owner and beneficiary of the policy, and when the insured dies, the proceeds are paid to the trustee, who disposes of the proceeds in accordance with the instructions in the trust agreement. The ILIT may provide for distribution of trust assets to or for the benefit of the insured's spouse, children and more remote descendants. The trust also can be a source of liquid assets when estate taxes and debts become due.

Federal Estate Taxation of Life Insurance Proceeds

The proceeds of a life insurance policy on an insured's life that is owned by the insured at his or her death are includible in the insured's gross estate for federal estate tax purposes if the insured holds any "incidents of ownership" in the policy. "Incidents of ownership" include the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to borrow against the policy. If the insured owns a policy on his or her life, generally the insured holds the incidents of ownership, and, therefore, the proceeds of the policy will be subject to estate tax at the insured's death. If an ILIT is structured correctly, however, the insured will not hold any incidents of ownership over the insurance policies held in the ILIT, the result of which is that the policy proceeds are not included in the insured's gross estate for federal estate tax purposes.

If an insured transfers an insurance policy, whether to an ILIT or another individual or entity, the insured must survive the transfer by three years in order for the insurance proceeds to be excluded from the insured's gross estate.

Creating an ILIT

In order to take advantage of the tax savings, the insured must create an irrevocable trust. The insured who creates the trust, known as the "grantor," must depart with ownership and control of the property transferred to the trust. Because the trust is irrevocable, the grantor does not reserve the right to amend, revoke or terminate the trust. The grantor also does not have any interest in the property in the ILIT that would cause the property to be included in the grantor's gross estate for federal estate tax purposes.

The trustee becomes the owner of the policy, and, as such, holds the incidents of ownership of the policy. The grantor must give up any incidents of ownership. The grantor cannot act as trustee because doing so would give the grantor the incidents of ownership in the policy. The grantor may, however, designate his or her spouse or adult children as the trustee(s) of the ILIT or choose a bank trust department or trust company. A bank or trust company, however, will charge a fee to administer an ILIT.

The grantor may transfer an existing life insurance policy to an ILIT. If the grantor transfers an existing policy to the ILIT, however, the grantor must survive the transfer by three years in order for the insurance proceeds to be excluded from the grantor's gross estate. Alternatively, the trustee may purchase a life insurance policy on the grantor's life. With respect to the proceeds of any policies purchased directly by the ILIT, the three year survivorship rule does not apply. Therefore, it is preferable for the ILIT to acquire insurance on the grantor's life directly.

The ILIT is designated as the beneficiary of the life insurance policy. When the insurance proceeds are paid to the trust after the grantor's death, the trustee will collect the funds, make them available to pay estate taxes and other expenses (if so directed), and then distribute them to the trust beneficiaries according to the grantor's instructions under the trust agreement.

Administration of an ILIT

The grantor's transfer of an existing policy to an ILIT is a completed gift that may be subject to gift tax, as are future contributions to an ILIT. Transfers to an ILIT are, however, generally structured to qualify for the gift tax annual exclusion. The gift tax annual exclusion amount is $13,000 (originally a $10,000 annual exclusion, it is adjusted for inflation each year, rounded down to the nearest 1,000). Any individual can give $13,000 to any number of donees each year, or $26,000 per donee if the gift is split between spouses (i.e., someone who is married, with the consent of his or her spouse, may give $26,000 per donee each year, and one-half of the gift is deemed to have been made by the spouse). Because an existing life insurance policy may have a cash surrender value, the transfer of an existing policy to an ILIT may result in a taxable gift unless the gift is sheltered by the grantor's gift tax annual exclusion.

In order for a gift to qualify for the gift tax annual exclusion, the gift must be a gift of a "present interest." A "present interest" is an interest in which a beneficiary has possession or enjoyment of the property immediately rather than at some future date. Accordingly, gifts in trust generally do not qualify for the gift tax annual exclusion. Each time a contribution is made to an ILIT (including the original transfer of an insurance policy to the ILIT), however, the trust beneficiaries have a period of time, generally at least 30 days, during which they may withdraw assets of the trust having a value equal to the gift. This temporary right of withdrawal allows the gift to the trust to qualify for the federal gift tax annual exclusion as a gift of a present interest and is known as a "Crummey power" (the name originates from the court case allowing such withdrawal rights).

The grantor will make contributions to the trust in sufficient amounts on an annual basis to permit the trustee to pay premiums on the insurance policies owned by the trust and to cover any administrative costs for the trust such as bank charges, check fees, etc. When the grantor transfers funds to the trust, the trustee must send the beneficiaries notice of such transfer (or, if the beneficiary is a minor, to the minor's guardian or parent, unless the trustee is the minor's guardian or parent) and inform the beneficiaries of their right to withdraw their portion of the transfer for a certain period of time. If the beneficiaries do not withdraw the value of the gift within the allotted time, the Crummey power lapses, and the gift remains in the trust. The trustee then uses the gifted funds to pay the premiums on the life insurance policy owned by the ILIT. Of course, the beneficiaries must understand not to take the gift now so the gift may be used to pay the premiums on the life insurance policy, which may result in a larger benefit in the future.

Advantages and Disadvantages of an ILIT

The primary advantage of an ILIT is that the proceeds of a life insurance policy may pass to the grantor's beneficiaries free of federal transfer taxes. Additionally, the proceeds may be available to provide liquidity to the estate for payment of estate taxes and debts of the estate. The use of an ILIT also may allow the insured's surviving spouse to enjoy the benefits of the proceeds as a trust beneficiary, while keeping the proceeds out of the surviving spouse's gross estate for federal estate tax purposes. Creditor's claims and the elective share rights of a spouse (depending on state law) may not be able to reach the funds held in the ILIT.

The primary disadvantages of an ILIT are that, because the grantor cannot hold any incidents of ownership in the policy, the grantor gives up the power to change the trust beneficiaries and their interests, gives up control of the assets (life insurance policies) contributed to the trust, and may not retain any economic benefit in the life insurance policy. For example, the grantor would no longer have the ability to cash in or borrow against the cash surrender value of any policy transferred to an ILIT. Any decision to do so would be made by the trustee.

Additionally, an ILIT may be somewhat difficult to administer because, as discussed above, each time the grantor makes a gift to the trust, the trustee must send notices of withdrawal rights to each holder of the Crummey powers. Another disadvantage is that, for some period after the grantor makes a gift, the beneficiary or the beneficiary's parent or guardian has the power to withdraw trust assets. In practice, however, beneficiaries rarely exercise their Crummey powers.

An ILIT does, however, provide a flexible vehicle for the administration and distribution of the life insurance proceeds after the grantor's death, as the grantor of the trust dictates who and when an individual will receive any part of the insurance proceeds. The dispositive provisions of the irrevocable life insurance trust may follow the dispositive provisions of grantor's other estate planning documents.

Trustee's Duties

The trustee's primary duty is to pay all premiums on the policies owned by the trust as they become due. As the owner of the life insurance policies, the trustee is responsible for taking all actions with respect to the policy that an individual owner could take. This includes the exercise of settlement options, application for policy loans, collection of dividends, purchasing additional insurance with dividends, and making beneficiary designations. It is very important that the trustee, not the grantor, take these actions, which are considered "incidents of ownership," in order to protect the tax planning aspect of the trust.

Generally, the only trust assets will be the life insurance policies that will be transferred to the trust or the policies the trustee will acquire. With respect to insurance policies, the trustee's duties are relatively limited. The trustee is required to provide safekeeping of the original policy contracts, and the trustee should keep books and records for the trust recording all receipts and disbursements of the trust. These transactions are likely to consist only of cash gifts made to the trust to pay insurance premiums and/or premium payments made by or on behalf of the trust.

Additionally, as discussed above, the trustee must send Crummey notices to the beneficiaries when transfers are made to the trust and then must use the gifted funds to make the annual premium payments. The trustee must keep records of the notices and the beneficiaries' receipt of the notices with the trust records.

Income Tax Consequences

The ILIT is a "grantor trust" for federal income tax purposes as long as it owns insurance on the grantor's life. This means that the grantor will be treated as the owner of the trust and that income and/or deductions of the trust will be reportable by the grantor on his or her personal income tax return. The trust will not file income tax returns as a separate taxable entity. As long as the trust is invested only in insurance policies, the trust will not have any taxable income, and, therefore, the grantor will not report any income.

Conclusion

An irrevocable life insurance trust may not be an attractive tool for everyone, but it may allow individuals with large estates (in excess of the available unified credit) to save a significant amount of federal estate taxes. Family business owners may also find the liquidity provided beneficial in transferring ownership to the next generation. Estates of smaller size may have little or no tax savings, but the trust may be used to preserve and protect family assets, manage investments and provide income to family members.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information regarding irrevocable life insurance trusts or any other estate planning options.