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White Paper:

Irrevocable Life Insurance Trusts

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Irrevocable Life Insurance Trusts

What is it?

An irrevocable life insurance trust (ILIT), sometimes referred to as a wealth replacement trust, is a trust that is funded, at least in part, by life insurance policies or proceeds. If properly implemented, an ILIT can help minimize estate taxes and provide a source of liquid funds to your estate for the payment of taxes, debts, and expenses.

Generally, assets you own at death are subject to federal estate taxes. This includes life insurance policies and proceeds. Estates in excess of the exemption amount ($2 million in 2008) may have to pay estate taxes at rates as high as 45 percent for estates of persons dying in 2008. If you're an insured individual whose estate will have to pay estate tax, your family may receive less money from your life insurance than you originally planned for.

An ILIT can solve this problem, and may be especially appropriate if your estate would not have to pay estate taxes were it not for the inclusion of the policy proceeds.

> **Tip**: Although this discussion concerns federal estate taxes only, an ILIT can also help minimize state death taxes.

How does it work?

Because an ILIT is an irrevocable trust, policies and proceeds (and any other assets) held by the trust are considered owned by the trust entity and not owned by you. Since you won't own the policy at your death, the proceeds will not be included in your estate. They will be received by the ILIT and ultimately pass to your family members undiminished by estate taxes. Your family members can use the proceeds to pay estate expenses. This may save your family members from having to sell assets at fire sale prices, and allow them to keep assets that may generate needed income or are valued family keepsakes. One key to this strategy is that you must relinquish all power over and benefits from the property in the trust.

In a typical scenario, an insurable person (the grantor) first creates an ILIT, names an independent trustee (e.g., a bank trust department), and names the beneficiaries of the trust (usually his or her spouse and/or children). The trustee then applies for life insurance on the grantor's life and designates the ILIT as the sole beneficiary. The trustee also opens a checking account for the ILIT. The grantor gives the trustee funds for the initial premium, which the trustee deposits into the ILIT checking account. The trustee writes a check from the ILIT checking account, pays the premium to the insurance company, and coverage becomes effective. As premiums come due, the grantor and trustee repeat the same procedure. Whenever the ILIT receives funds from the grantor, the trustee provides a special notice (a Crummey notice) to each of the beneficiaries. This Crummey notice lets the beneficiaries know that they have a right to withdraw the recently deposited funds, but only within a certain limited time frame (e.g., 30 to 60 days). The trustee waits until this time frame passes before remitting the funds to the insurance company. This notice procedure serves to qualify the gift for the annual gift tax exclusion (see the section on Crummey withdrawal rights). At the grantor's death, the ILIT trustee collects the total proceeds and distributes them to the beneficiaries according to the terms of the trust.

Tip: An ILIT can hold almost any type of life insurance policy, including a second-to-die (survivorship) policy. A second-to-die policy covers the lives of yourself and your spouse, and pays off at the death of the survivor. If your ILIT will hold this type of policy, extra care must be taken when drafting and funding the trust.

Why use an ILIT?

There are many reasons to use a trust rather than have an individual own your life insurance policy. For example, having your spouse own the policy may defeat the purpose of the ILIT, as the proceeds will be subject to estate taxes in his or her estate. Having an adult child or any other individual own the policy may expose the policy or proceeds to that individual's creditors, or may create disharmony among family members. An ILIT can accomplish some or all of the following:

- Avoid inclusion of the proceeds in your (and your spouse's) estate
- Make the cash liquidity provided by the total proceeds available to the estate of the insured
- Insulate the proceeds from estate taxes over multiple generations
- Provide professional management of the proceeds
- Protect the policy and proceeds from future creditors and potential ex-spouses
- Provide incentives to beneficiaries

Creating the ILIT

Trust must be irrevocable

To enjoy its benefits, a life insurance trust must be irrevocable. That means you (the grantor) can't change the terms of the trust or the beneficiaries, end the trust, or retain any power over or interest in the trust. Further, any property transfers made to the trust must be complete and permanent. This also applies to your spouse if the ILIT is funded with a second-to-die policy.

Tip: Because it will be difficult, or even impossible, for you to make changes to the trust without adverse tax consequences, it's important to build flexibility into the trust document. Be sure to consult an attorney experienced with ILITs.

Naming a trustee

Your choice of trustee, the person who will administer the trust, is an important decision. For the ILIT to be effective, you cannot serve as trustee, and you shouldn't even retain the power to name yourself as trustee. The IRS has clearly stated that proceeds will be included in an insured's estate if the insured serves as trustee. If the ILIT holds a second-to-die policy, your spouse cannot serve as trustee for the same reason.

> **Tip**: The trust document should expressly prohibit the insured(s) from serving as trustee. Further, the trust document should contain language that limits your power to change the trustee. You can change the trustee so long as the successor trustee is not related or subordinate. The term "related or subordinate" includes spouses, parents, descendants, siblings, and employees, but not nieces, nephews, in-laws, or partners.

A noninsured spouse can serve as trustee, but it is not recommended. Remember, one key to an ILIT is relinquishing all control over and interest in the trust property. If your spouse is administering the trust, you may be regarded as retaining some control, albeit indirectly. If you choose this course, however, your spouse must not make any gifts to the trust. If your spouse is also a beneficiary, a co-trustee is recommended to handle distributions to your spouse, or a successor trustee should assume all duties at your death.

Other beneficiaries can serve without adverse tax consequences, but this is generally not a good idea because there may be conflicts of interest.

Other non-beneficiary family members or friends can serve as long as you trust them to perform their duties competently. A professional trustee may be the best choice because a professional will have the experience to properly administer your ILIT, and you can be fairly assured of competent asset management and impartiality.

The key duties of an ILIT trustee include:

- Opening and maintaining a trust checking account
- Obtaining a taxpayer identification number for the trust entity, if necessary
- Applying for and purchasing life insurance policies
- Accepting funds from the grantor
- Sending Crummey withdrawal notices (see the section on Crummey withdrawal rights)
- Paying premiums to the insurance company
- Making cash value investment decisions
- Claiming insurance proceeds at your death
- Distributing trust assets according to the terms of the trust
- Filing tax returns, if necessary

Naming the beneficiaries

To keep the proceeds out of your estate, do not name your executor, your estate, your creditors, or the creditors of your estate as beneficiaries of the trust. The proceeds will be considered payable to your estate if your ILIT requires the trustee to use the proceeds to pay your estate's debts, taxes, or other obligations. If the ILIT merely gives the trustee the authority to pay such expenses, however, the proceeds will not be included in your estate unless the trustee actually uses them to satisfy such obligations. To make the proceeds available to your estate, the ILIT should include language that permits the trustee to buy property from your estate or make loans to the estate. If the trustee does either, the transaction must be completed in a reasonable, arm's-length manner.

If you want to name your spouse as a beneficiary and also keep the proceeds out of your spouse's estate, the ILIT must be drafted so that access by your spouse to the proceeds is limited. Your spouse can receive some or all of the annual income from the ILIT, but access to trust principal must be limited to ascertainable standards (i.e., for support, health, or education only). Further, your spouse can hold a right of withdrawal not to exceed the greater of five percent of the trust balance or $5,000 each year. Your spouse can also be given a limited (or special) power of appointment, but not a general power of appointment. In other words, your spouse can name subsequent beneficiaries, but cannot name himself/herself, his/her creditors, or the creditors of his/her estate.

Funding the ILIT

You can create an ILIT and leave it unfunded during your lifetime. An unfunded ILIT is one that holds a life insurance policy only, and does not hold any other assets. With an unfunded ILIT, you will need to gift money to the trust so the trustee can pay policy premiums. If the trust holds a permanent life insurance policy and the policy allows it, premiums can be paid with accumulated cash values or dividends, and you may not need to gift additional funds.

Alternatively, you can fund an ILIT during your lifetime with assets in addition to your life insurance policy. Funding an ILIT with income-producing assets can provide the trustee with the money needed to pay the policy premiums. An additional benefit of funding your ILIT is that any future appreciation in the assets will be sheltered from estate taxes, again because the trust is irrevocable. Funding your ILIT also allows you to coordinate the asset's final disposition with the insurance proceeds.

After you die, the ILIT (unfunded or funded) will receive the policy proceeds and the trustee will administer them according to the terms of the trust. The trust can receive other assets at your death along with the insurance proceeds, such as assets poured over from your will, or death benefits paid by your employer or employee benefit plan. The trust terms can direct that the proceeds be distributed to the beneficiaries immediately, or the trust terms can direct that the proceeds remain in the trust and under the trustee's management for a period of time before being distributed. The latter option may be desirable if you anticipate that your heirs might mismanage the funds or if your heirs are minor children.

> **Caution**: Funding an ILIT with assets in addition to your life insurance policy may trigger gift tax and income tax consequences (see the section on Tax Considerations).

> **Caution**: If you live in a community property state and your spouse is a beneficiary, do not fund the trust with community property. If you do, half of the insurance proceeds will be included in your spouse's estate. To avoid this situation, be sure to initially fund the trust and make any subsequent contributions with separate property only.

The three-year rule

You may have existing life insurance policies you want to transfer to an ILIT. While this is possible (merely execute an absolute assignment of ownership form provided by the issuing insurer), it is not advisable because transferring existing policies triggers the three-year rule. This rule states that, if you transfer a life insurance policy to an ILIT within the three years preceding your death, all the proceeds will be brought back into your estate for estate tax purposes. Because of the three-year rule, it is not advisable to transfer policies unless you're no longer insurable or can't afford the cost of replacement policies.

> **Caution**: Funding an ILIT with policies that have accumulated cash values may trigger gift tax consequences (see the section on Tax considerations).

You can avoid the three-year rule by allowing the trustee, on behalf of the trust, to apply for and purchase a new policy. If the trust owns the policy from the outset, the three-year rule will not apply. Because the purchase must be purely discretionary, be sure the trustee is not obligated to buy the policy, but is permitted to do so.

The ownership problem

To keep the proceeds out of your estate and your spouse's estate, you and your spouse must not retain any incidents of ownership in the policies held by the trust. Though the IRS doesn't specifically define incidents of ownership, the phrase generally refers to any rights you retain that might benefit you economically. Those rights include:

- The right to transfer, or to revoke the transfer, of ownership rights
- The right to change certain policy provisions
- The right to surrender or cancel the policy
- The right to pledge the policy for a loan or to borrow against its cash value
- The right to name and to change a beneficiary
- The right to determine how beneficiaries will receive the death proceeds

You must not retain any of these rights. Further, the trust document should expressly state that the trust is irrevocable and that the insured is retaining no rights to the policies held by the trust.

> **Tip**: You can, however, retain the power to change the trustee so long as the successor trustee is not related or subordinate.

Crummey withdrawal rights

Transfers of cash (or any other property, including cash values accumulated in existing policies) to your ILIT may be subject to gift tax. However, you can minimize or eliminate your actual gift tax liability by structuring the transfer so that it qualifies for the annual gift tax exclusion.

Generally, a gift must be a present interest gift in order to qualify for the exclusion, which currently allows you to gift $12,000 per beneficiary gift-tax free. A present interest gift means that the recipient is able to immediately use, possess, or enjoy the gift. Gifts made to a trust are usually considered gifts of future interests and do not qualify for the exclusion unless they fall within an exception. One such exception is when the beneficiaries are given the right to demand, for a limited period of time, any amounts transferred to the trust. This is referred to as Crummey withdrawal rights or powers.

The beneficiaries (or their parents/guardians) must also be given notice of their rights to withdraw whenever you transfer funds to the ILIT, and they must be given reasonable time to exercise their rights. The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice at least 30 to 60 days before the expiration of the withdrawal period. It is the duty of the trustee to provide notice to each beneficiary.

Of course, so as not to defeat the purpose of the trust, your beneficiaries should not actually exercise their Crummey withdrawal rights, but should let their rights lapse. Lapsed withdrawal rights, however, are considered gifts to the other trust beneficiaries, and are generally includible in a beneficiary's estate. To address this problem, the Internal Revenue Code provides an exception, referred to as the five or five power. The Code states that the lapse of rights to withdraw will not be treated as a gift, and will not be included in the beneficiary's estate, to the extent it does not exceed the greater of five percent of the trust balance or $5,000 each year.

Because the beneficiaries' withdrawal powers are limited to five percent or $5,000 of the trust's assets each year, your annual gift tax exclusion is also limited to the five or five amount. If you need to contribute more than this to cover the policy premium, the excess will be subject to gift tax. You may be able to avoid this result with the use of hanging powers. The hanging power throws the excess into future years, until all of it is used.

Tax considerations

Income Tax

Trust's income generally attributed to the grantor

If you fund your ILIT with income-producing assets and the trust is a grantor trust, income from the trust will be taxed to you, and you can use any gains, losses, deductions, and credits realized by the trust (most ILITs are grantor trusts). If the trust is not a grantor trust, the income tax rules are generally as follows:

- Income used to pay premiums is taxed to you (the grantor)
- Income paid to the beneficiaries is taxed to them
- Income retained by the trust is taxed to the trust

If the trust is not a grantor trust, the trustee must obtain a taxpayer identification number (TIN), which can be obtained online, over the phone, or by mail. If the trust is a grantor trust, a TIN is not required while you are alive, but the trust will need one upon your death. That being the case, it may make sense to obtain a TIN at the outset.

Gift Tax

Transfers to an ILIT are taxable gifts

Transfers to an ILIT are taxable gifts. Crummey rights of withdrawal held by the beneficiaries, however, allow the transfers to qualify for the annual gift tax exclusion. Transfers that do not qualify for the annual gift tax exclusion are exempt from gift tax to the extent of your $1 million lifetime gift tax exemption, which is automatically applied.

If existing life insurance policies are transferred to your ILIT, they will be valued at the interpolated terminal reserve value (which is approximately the same as the cash surrender value of the policy). Upon request, your insurance company can give you the exact terminal reserve value. Depending on the size of the policy, your health, and the length of time that the policy has been in place, this terminal reserve value may be quite large.

> **Tip**: One possible strategy to reduce the size of the gift is to take out a loan against the cash value of the policy prior to the gift. Such a loan will reduce the interpolated terminal reserve value.

Community property considerations

If you live in a community property state, special attention should be paid to the drafting and funding of your ILIT. For example, you should create a separate property agreement and fund the trust with separate property.

Beneficiaries may incur gift tax or estate tax due to withdrawal right lapses

When a beneficiary allows his or her right to withdraw money gifted to the trust to lapse, he or she is considered to have made a taxable gift to the remaining beneficiaries of the trust and the funds are includible in the beneficiary's estate. Five percent of the trust balance or $5,000, whichever is greater, is exempted. Gift tax consequences on lapses in excess of this so-called five or five power can be avoided using hanging powers, or by giving the beneficiaries the right to appoint the unwithdrawn amounts in their wills (those amounts will still be includible in their estates, however).

> **Caution**: This is an extremely technical area. You will need to consult your accountant or tax attorney.

Estate Tax

Proceeds from life insurance policy not included in grantor's estate

If the ILIT is drafted, funded, and administered properly, the proceeds from insurance policies held by the trust will not be included in your estate. This is one of the main benefits of setting up this type of trust.

> **Caution**: If an existing insurance policy is transferred to the trust and you die within three years of the transfer, however, the proceeds will be included in your estate.

Generation-Skipping Transfer Tax

Transfers to trust with beneficiaries two or more generations below grantor are subject to generation-skipping transfer tax

An ILIT can be an excellent vehicle for generation-skipping transfer tax (GSTT) planning for life insurance proceeds. If your ILIT has beneficiaries that are two or more generations below you (your grandchildren, for example), gifts to the trust may be subject to both gift tax and GSTT. The GSTT rate is a flat rate at the highest estate tax rate in effect (45 percent in 2008). Fortunately, there is an annual exclusion ($12,000 per skip beneficiary) similar to the annual gift tax exclusion, and a lifetime exemption ($2 million in 2008).

Your ILIT can be designed as a dynasty trust meant to last for several generations, leveraging your GSTT exemption, and avoiding successive generations of taxes. This is a complicated strategy, however, requiring careful planning.

> **Caution**: Unlike the gift tax exemption, which is allocated automatically, you may have to explicitly allocate your GSTT exemption on Form 709.

How do you implement an ILIT?

Contact your insurance professional

Your insurance professional will help you decide what kind of policy is best for you. Do not purchase the policy, however.

Hire an attorney

For an ILIT to work according to your intentions, careful drafting of the trust document is essential. One error can negate all your planning. In addition, there are many complex legal issues that can arise when you set up a trust. You should hire an experienced attorney to draft the trust document and advise you on the complex legal issues.

Fund the trust

You must transfer cash to the ILIT trustee so the trustee can purchase the policy (and additional amounts as premiums come due). As noted before, the trustee should buy the policy in order to avoid the three-year rule. In addition, you may want to transfer other assets to the trust. Your attorney should assist you in properly transferring ownership.

Serve Crummey notice to the beneficiaries

The ILIT trustee must fulfill the Crummey notice requirements to keep the ILIT effective. This means that when the trust is initially funded, and whenever you make any subsequent contributions, the trustee must give actual written notice to each beneficiary at least 30 to 60 days prior to the expiration of the withdrawal period.

> **Tip**: The trustee should consider sending the notices so that the recipient's signature is required, and should keep the signatures on file.

File federal gift tax return (Form 709), if necessary

If the transfers you make to the trust exceed the annual gift tax exclusion and you have used up your $1 million lifetime gift tax exemption, you may have to file a federal gift tax return (Form 709) and pay gift tax. If you want to allocate a portion of your generation-skipping transfer tax exemption, you will also need to file Form 709. You may want to consult your accountant or tax attorney prior to making any gifts.

> **Caution**: If your state imposes gift tax, you may also need to file a state gift tax return.

Include trust income on your personal annual income tax return, if required

Income earned by the trust that is taxable to you (the grantor) must be included on your personal income tax return for the year in which it is earned.

Disclosures

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