

SEARLES LAW OFFICE, P.L.C.

Irrevocable Life Insurance Trusts

Life insurance proceeds on the death of an insured individual are generally includable in the estate of the insured if he or she held any "incidents of ownership" at death. Incidents of ownership include the right to: name the beneficiary of the policy, surrender the policy, borrow the cash value of the policy, or assign the policy to another. If instead of the insured owning an insurance policy, the policy is owned by another person or entity, the proceeds will escape taxation in the insured's estate, so long as the policy was not transferred by the insured to the third party within three years of death.

An Irrevocable Life Insurance Trust (ILIT) is a separate tax-paying entity which is both owner and beneficiary of life insurance policies. Its primary purpose is to keep life insurance proceeds out of the estate of the insured and therefore save federal estate tax. An ILIT also is used for the management and orderly disposition of the trust's assets to beneficiaries.

The insured should retain absolutely no ownership or control rights over the assets that are held by the trustee of an irrevocable trust and must forgo any right to change trust provisions in the future. When an irrevocable trust is properly drafted and established, the assets put into it will be treated as gifts and will no longer be part of the donor's estate except for gifts of existing life insurance policies within three years prior to death.

A properly-established ILIT owns life insurance on the life of the trust maker, thereby keeping the life insurance proceeds outside of his or her estate and avoiding federal estate tax (federal income tax is also avoided for different reasons). An ILIT keeps policy proceeds free of federal estate tax upon the death of the trust maker and also on the subsequent death of his or her spouse. The proper use of this type of trust allows the trustees to satisfy the trust maker's estate settlement costs and death tax obligations without subjecting the insurance proceeds to those costs and taxes. By utilizing this planning vehicle, a 50 percent federal estate tax bracket taxpayer can purchase the same amount of life insurance as he or she would own personally and get double the after-tax insurance benefit for his or her beneficiaries. He or she can effectively double the amount of the coverage passing to his or her beneficiaries without paying a dime more of premium.

Establishment of the Trust

In drafting an ILIT, it is important to determine who should be the trustee under any number of circumstances, who are the beneficiaries, and under what circumstances the beneficiaries may receive income or principal from the trust. These choices, and others, are important because once established, the ILIT cannot be changed. (The power to change the trust would result in the insurance proceeds being included in the insured's estate.) The trust is also the named beneficiary of the life insurance proceeds.

Once the trust is established, the trustee (who should not be the insured) usually applies for and owns a new insurance policy on the insured. In cases where the purpose of the insurance is to provide liquidity for payment of estate taxes, frequently a second-to-die or survivorship policy is the best and most cost-effective insurance policy. The second-to-die policy pays a death benefit on the second death, usually of a husband and wife. It is particularly valuable at the second death because, usually, there is no estate tax upon the death of the first spouse.

Operation of the Trust

Once the trust has applied for and been approved for one or more life insurance policies, the insured will transfer to the trust an amount sufficient to pay the annual premium on the policy. This transfer is treated as a gift to the beneficiaries of the trust (usually the children). To qualify for the \$10,000 annual exclusion from gift taxation for each beneficiary, the trust must provide for "Crummey demand powers" for each beneficiary so that the gifts are gifts of a "present interest." That is, the recipient of the gift has the present right to use or access the gift; he or she has the power to withdraw his or her share of a gift made to the trust. A Crummey demand power will generally lapse after a short period (for example, 30 to 60 days). Trust makers anticipate that the beneficiaries of the trust will let the demand power lapse, thereby permitting the trust funds to accumulate for specified future trust purposes, including the purchase of life insurance policies on the life of the trust maker and payment of future premiums.

Upon the Death of the Insured

At the death of the insured (or the second death, in the case of a second-to-die policy) the proceeds are paid into the trust. The proceeds are not part of the insured's estate and pass to the beneficiaries free of estate taxation. The trustee is given the power, however, to lend money to and purchase assets from the estate of the insured. If the beneficiaries are responsible adults, very often, the trust will provide for immediate distribution of the proceeds to the children. If the beneficiaries are minors, the trust will usually retain the proceeds in trust until the beneficiaries have reached age twenty-one, twenty-five or even as late as thirty or forty.

In the case of adult children, the proceeds may often distribute immediately and permit the children to purchase assets from the insured's estate. This purchase will give the estate the liquidity necessary to pay any estate taxes due without having to sell estate assets under a "fire sale" environment.

<p>NOTE: This discussion is intended to provide a general outline of the establishment, operation and advantages of an Irrevocable Life Insurance Trust. It is not intended as legal advice and the reader should consult with an experienced attorney to implement this or any other estate planning techniques.</p>
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