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BASICS[*]

Irrevocable Life Insurance Trusts

Synopsis

If you own a life insurance policy on your life, the proceeds of the policy are subject to federal estate tax at rates up to 40%. An Irrevocable Life Insurance Trust ("ILIT") can avoid the imposition of the estate tax. Using an ILIT thereby maximizes the after-tax value of your life insurance by allowing the proceeds to pass to your beneficiaries completely free of federal estate tax. By designating trust terms that match your estate planning goals, you specify the ultimate disposition of the insurance proceeds.

I. Estate Taxation of Life Insurance Proceeds.

A. General Concepts.

Life insurance death benefits are generally exempt from income tax. However, they are *not* generally exempt from estate tax. Instead, life insurance proceeds are fully includable in the insured's gross estate, subject to estate tax rates as high as 40%. If life insurance proceeds are paid to the surviving spouse, the marital deduction will shield them from estate tax in the estate of the first spouse to die; however, on the death of the surviving spouse, the remaining proceeds will be taxable along with the rest of his or her property.

B. "Incidents of Ownership."

The foregoing rule applies only if the insured person owns or controls the life insurance contract. Therefore, estate taxation of life insurance often can be avoided if the insured is willing to part with all "incidents of ownership" in the policy. The term "incidents of ownership" includes essentially all rights to benefit from or control an insurance policy. Thus, for example, it includes any of the following: the right to change the beneficiary; the right to borrow against the policy; the right to surrender the policy for its cash value; and the right to pledge the policy as collateral for a loan.

C. Using a Third-Party Owner for Life Insurance.

If someone other than you buys insurance on your life and holds all incidents of ownership over the policy, the death benefits will be completely excluded from your gross estate for federal tax purposes; i.e., third-party ownership makes life insurance death benefits estate tax free. By eliminating estate tax at rates as high as 50%, the net value of the policies can be virtually doubled.

II. Selecting the Third-Party Owner.

A. Prior to 1981.

Many people, once they understand the estate tax consequences of insurance policy ownership, select someone other than themselves to own the policy. Prior to the major federal tax legislation of 1981, the insured's spouse was often chosen as the owner. The effect of this arrangement was to defer tax until the death of the surviving spouse. Estate tax law changes in 1981, however, enabled married couples to defer

[*]Davis & Willms, PLLC has compiled the *Basics* series to provide plain-English, summary explanations of fundamental estate planning techniques and concepts. As a result, our discussions may gloss over some of the more complex topics and even ignore a few issues. The Basics memoranda are *not* legal advice. Instead, they are generalized, educational tools designed to help our clients and potential clients develop an understanding of the estate planning process. Before engaging in any estate planning, you should consult a qualified estate planning attorney.

estate tax until the second death, even if their spouse did not own the policy. As a result, most people try to select an owner to avoid *all* estate tax at the death of the insured *and* the insured's spouse.

B. Children as Owners.

If your children are all trustworthy, reliable adults, your children (or any one or more of them) can own the insurance. For example, you could make a gift of cash to your children (subject to the gift tax rules outlined below) who would then use that cash to purchase the policy. As additional premiums come due in later years, you can again make gifts to them to enable them to pay these premiums. If your children purchase and hold insurance on your life from the inception of the policy, the death benefits will be completely excluded from your estate for federal tax purposes. Likewise, if you transfer an existing policy on your life to your children, the death benefits will be estate tax free *if* you survive for three years. (See discussion of the "three-year rule," below.)

C. Using an ILIT to Own Insurance.

Instead of having your children own the policy directly, you may choose to utilize an ILIT to own the insurance. The use of an ILIT offers some significant advantages over ownership of the policy by the children of the insured. For example:

- If you intend for your spouse to benefit from the life insurance, an ILIT can be used to provide for the surviving spouse, with any balance remaining at the spouse's death passing to children. If your children own the life insurance directly, your spouse must depend on their willingness to make gifts of insurance proceeds to your spouse after your death.

- If any child is a minor (or if you want to include minor grandchildren as beneficiaries), outright ownership will be impractical; a minor generally cannot directly own and pay premiums on a life insurance policy.

- If you have more than one child, they each must own an undivided interest in the policy. This arrangement could lead to conflicts; if one or more of the children proves to be uncooperative as cash gifts are made to pay premiums, the entire plan could unravel.

- An ILIT can be structured to continue after your death as a vehicle to manage and preserve wealth for your children (and/or grandchildren). For example, optional management assistance can be provided through a professional trustee or co-trustee. And holding the proceeds in trust can preserve their exemption from creditors' claims[1] and keep them beyond the reach of a divorce court's property settlement powers.[2]

- If properly structured, the trust can avoid estate tax not only at your death, but also--substantially if not entirely--at your children's deaths. Insurance on your life owned directly by your children--to the extent not consumed by them during their lifetimes--will be included in their taxable estates when they die.

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[1]Life insurance proceeds are generally exempt from creditors' claims, but, if the beneficiary fails to keep the insurance proceeds segregated from nonexempt assets, the exemption can be lost. Keeping the proceeds in an ILIT virtually eliminates the risk of commingling with other assets.

[2]Life insurance proceeds are generally treated as separate property when received by a beneficiary--even if the beneficiary is married at the time. However, if the beneficiary commingles the proceeds with other assets or if the income earned by the proceeds is commingled with the original proceeds received by the beneficiary, there is a risk that the proceeds will be classified as community property--owned jointly by the beneficiary and the beneficiary's spouse. Keeping the proceeds in an ILIT virtually eliminates the risk of commingling with other assets and significantly reduces the risk that accumulated income will be classified as community property.

- With an ILIT, you can control the future beneficial ownership of the insurance (e.g., you might provide for trusts that last for your children's respective lives and then continue for their children); however, if your children own the insurance directly, they can sell and/or give their interest in the policy to whomever they please.

- With an ILIT, you can provide a source of cash to the executor of your estate for the payment of estate taxes. (Generally, an ILIT will be coordinated with your Will or revocable trust to facilitate this.) However, if your children own the insurance directly, it may not be possible to force them all to apply their share of the benefits towards the payment of estate taxes.

- With an ILIT, if you die within three years of your transfer of an existing policy, you can avoid the sting of the three-year rule by using a contingent marital trust (discussed below); this option is not available if your children directly own the insurance.

D. A Limited Exception Applies to Existing Policies: The "Three-Year Rule."

1. Explanation of the Rule.

If an individual owns an existing policy on his or her own life and transfers that policy to another, then, as to that policy only, the insured must survive for at least three years after the transfer date in order for the insurance to be estate-tax free; otherwise, the insurance will be treated as if the insured had never parted with it, and the tax savings will not be achieved. (There is no penalty or other direct cost if the three-year rule applies; there is simply a loss of the estate tax savings that would have resulted. Likewise, even though estate tax advantages may be lost, all other advantages of the ILIT will remain.)

On the other hand, if someone other than the insured is the initial purchaser of the insurance, the three-year rule does not apply, and the life insurance will be tax free without regard to how long the insured may survive. Therefore, if you are planning to purchase a new insurance policy on your life and you want that policy to be owned by another person, that person should acquire the policy from its inception. For example, if you use an ILIT to own insurance on your life, *you can avoid the three-year rule if you establish the ILIT before you acquire the policy, and then let the ILIT purchase the insurance as the original owner.*

2. Pushing the Limits of the Rule.

The question is sometimes raised, how far can you proceed in investigating your insurance options before you establish the ILIT? Under the current state of the law, there is no clear-cut answer. We believe it is *always* safe to discuss insurance with your agent to determine whether you are generally insurable, how much insurance you need, whether the premiums fit your budget, etc. Further, it is *generally* acceptable to take a physical and authorize the insurance company to issue a rating and/or commit to issue a particular type of policy for a specified premium. It can be risky but, under certain circumstances, it may make sense to go so far as to file an initial application in your own name and get your specific approval before you create the ILIT; then, if the decision is made to proceed, you create the ILIT, submit a new application in the ILIT's name, and then let the ILIT complete the purchase.[3] Suffice it to say that the "gray area" is large: if you actually purchase a policy in your own name and then transfer the policy to the ILIT, the three-year rule *will* apply (i.e., you must survive for three years in order to obtain the tax advantages of the ILIT); however, short of that scenario, there appears to be no clear point at which the three-year rule will definitely become applicable. In short, the sooner you create an ILIT and get it involved in the process, the safer you are. (And, of course, if you survive for three years, the problem goes away.) When in doubt, contact your attorney or other tax advisor; he or she should be able to help you consider the risks and benefits of when to proceed with creating an ILIT.

3. Selling an Existing Life Insurance Policy to the ILIT.

A sale of an existing policy for adequate and full consideration is an exception to the three-year rule, and therefore, if an insured is transferring an existing policy to an ILIT, the insured should consider selling

[3]For example, if you have qualified for insurance but the period of qualification is about to expire, or if the cost of insurance will increase significantly if an application is not submitted before a certain date, it may be worthwhile to immediately submit an application in your own name.

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the policy to the ILIT instead of gifting the policy to the trust. The insured would gift cash to the ILIT equal to the value of the policy and then the trustee would use that cash to purchase the policy from the insured. The sale must be bona fide and for adequate and full consideration, so a fair market value of the policy must be obtained to determine the sales price. In addition, the trust must be structured as a grantor trust in order to avoid some potential income tax issues.

4. Addressing the Three-Year Rule with a "Contingent Marital" Clause.

As noted above, you generally cannot avoid the three-year rule with an existing policy; if you die within three years of transferring life insurance to an ILIT, the insurance will be subject to estate tax. However, if you use an ILIT to own your life insurance, you can at least delay the tax until the death of your surviving spouse by including language in the trust creating a so-called "contingent marital" gift, providing that all insurance subject to the three-year rule is to be distributed to your surviving spouse (or to a marital trust for his or her sole benefit). This language will ensure that, if you die within three years, the proceeds will qualify for the marital deduction. As a result, there will be no tax on the proceeds at your death, but, as noted above, any proceeds remaining on the death of your surviving spouse will be taxable along with the rest of his or her property at that time. Of course, if you survive beyond the three-year period, the contingent marital clause has no effect.

III. Getting Policies and Premiums into the ILIT: The Practical Issues.

If you decide to create an ILIT, you must ensure that all incidents of ownership over the policy are owned by the ILIT. If an existing policy is involved, you must transfer the policy to the ILIT. You may also transfer some cash to the ILIT as well. This will enable the trustee to open a small checking account, pay miscellaneous bills, etc. If a new policy is involved, you will not transfer any insurance to the ILIT; instead, you will make an initial cash transfer to the ILIT to enable it to purchase the insurance policy.

If you transfer an existing policy into the ILIT and that policy is paid up, you will not have to worry about future premiums. If the existing policy is not paid up, and in virtually all cases involving new policies, you will have to provide the wherewithal for future premium payments. You have two options. First, you can transfer a lump sum to the ILIT up front, and then the trust can use that sum (and the income it earns) to pay the premiums. The second and more commonly used option is to make regular (usually annual) cash gifts to the ILIT that are large enough to cover the premiums as they become due.

IV. Getting Policies and Premiums into the ILIT: The Gift Tax Issues.

On your death, a properly structured ILIT will avoid all estate tax issues (unless the three-year rule applies, as noted above). However, during your life, there are gift tax issues to be addressed.

Every transfer you (or anyone else) makes to the ILIT will be treated as a gift subject to gift taxes. For example, if you transfer an existing policy to the ILIT, you have made a gift roughly equal to the current cash value of the policy. Likewise, when you make additional cash transfers to the ILIT to provide for the payment of premiums, those transfers are treated as gifts, too.

A. Using Your Estate and Gift Tax[4] Exclusion Amount.

As long as the total amount transferred is under the amount of your lifetime gift and estate tax exclusion amount, there will be no gift tax due on any of these gifts. However, you will be required to file annual gift tax returns, and every such gift will use up a portion of your exclusion amount, leaving you with that much less of your exclusion amount available at your death.

B. Using *Crummey* Powers.

You can preserve your entire exclusion amount by including *"withdrawal rights"* (often referred to as "*Crummey*" powers, named after the first taxpayer to prevail in the use of such powers against the IRS).

[4]The estate and gift tax exclusion amount is currently $10,000,000 per person, indexed for inflation from 2011, for transfers between the years 2018 and 2025. The inflation-adjusted exclusion is $12,920,000 per person in 2023 and will be $13,610,000 in 2024. In year 2026, the exclusion will return to its pre-2018 level of $5,000,000, indexed from inflation from 2011, estimated to be $7 to $7.5 million.

Withdrawal Rights work by taking advantage of the per year "present-interest exclusion," which is $17,000 in 2023[5]. The procedure has been used successfully for years; however, the details involved are somewhat complicated.

Under the Internal Revenue Code, every individual is allowed to give this present-interest exclusion amount (or annual gift tax exclusion amount) *per year* to any one or more other individuals without the need to file a gift tax return. Further, these annual gifts up to this amount not use up any portion of your exclusion amount. That is, the annual present-interest exclusion is *in addition* to the lifetime estate and gift tax exclusion amount.

For example, in 2023, if you have three children, you can give each of them up to $17,000, for a total of $51,000 and, next year, you can do it again, and so on. If, in addition, you have five grandchildren, you can give each grandchild $17,000 per year, bringing the total to $136,000 per year, all without reducing your lifetime estate and gift tax exclusion amount. In addition, if you are married, your spouse can make $17,000 per year gifts to the same people, thus doubling the amount that can be transferred tax free. (In the example, you and your spouse together could give $262,000 per year tax free--$17,000 from you plus $17,000 from your spouse to each of eight children and grandchildren.)

Outright gifts of cash to your children clearly qualify for the annual present-interest exclusion. A gift of an existing insurance policy to your children also qualifies for this exclusion (with the value of the gift being approximately equal to the "cash value" of the policy at the time of the transfer). Once your children hold legal title to the policy, you can make cash gifts to them each year within this limit without using any of your lifetime estate and gift tax exclusion amount.

If an ILIT is used, however, the rules are more complex. The gift tax annual exclusion is available only with respect to gifts that qualify as "present interests." A gift of a "future interest" does not qualify. Most trusts, including ILITs, are designed to provide *future* benefits to your family. As a result, most gifts to a trust constitute gifts of a future interest, which typically do not qualify for the exclusion. *To avoid this problem, most ILITs contain withdrawal rights.* By giving beneficiaries the present right to withdraw the amount of any gifts made to the ILIT (up to the gift tax exclusion amount that year), you effectively convert their future interests in the ILIT into qualifying present-interest gifts.

Most ILITs contain a withdrawal-right clause giving each beneficiary a limited window of time to withdraw the cumulative amount of the gift(s) to the ILIT for that year (not to exceed the gift tax annual exclusion amount). If the beneficiary is a minor, then his or her guardian exercises (or elects not to exercise) the right for the beneficiary. Thus, for example, when you make gifts in trust for the benefit of your own minor children, your spouse, as their natural guardian, is generally the one to decide whether to withdraw the gifts.

Adult beneficiaries with withdrawal rights may either exercise the right (i.e., take the money) or choose not to--in their own, absolute discretion. This is one aspect of the ILIT that can be troubling to clients: understandably, clients are concerned about giving their 19-year-old child the right to take $17,000 out of the trust (or $34,000, if you and your spouse have both made gifts) - or whatever the gift tax annual exclusion amount is that year. However, in the vast majority of cases, the child will understand your estate planning goals (that is, that you are trying to minimize taxes and maximize the child's inheritance). As a result, he or she will choose not to make a withdrawal. If a particular child does not cooperate, *next year* you can leave that child out. Therefore, even an uncooperative child often will ultimately choose not to make a withdrawal. Further, even if you expect your intended beneficiaries to be uncooperative, you can simply leave out the withdrawal-right clause, and use your lifetime estate and gift tax exclusion amount to cover transfers to the ILIT.

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[5] The federal gift tax annual exclusion is $10,000 per person per year, adjusted for inflation after 1997, but always rounded down to the nearest multiple of $1,000. The inflation-adjusted annual exclusion for 2023 is $17,000 and will be $18,000 in 2024.

V. Understanding the Significance of the ILIT.

A. The ILIT is Irrevocable.

It is important to appreciate that an irrevocable insurance trust is *irrevocable;* once in place, you cannot amend it. However, an ILIT can be drafted to be flexible (e.g., to include after-born or after-adopted children and/or grandchildren as beneficiaries). Further, you can stop making transfers to the ILIT at any time. If the ILIT needs your continued gifts to pay premiums on the insurance it owns, your decision to discontinue your gifts will mean that, in all probability, the policy eventually will lapse, and the ILIT will be left with no property. A trust without property terminates automatically. Thus, even though you cannot amend an ILIT, you can essentially "kill" it (by "killing" the insurance it holds).

B. The ILIT is a Separate, Real Entity.

An insurance trust is not just a piece of paper. By creating an ILIT, you create a new trust--a new entity, with numerous consequences. It must be accounted for as a separate taxable entity. If the ILIT earns taxable income, it will be required to file its own income tax return. The trust's undistributed taxable income can be subject to substantial marginal income tax rates. (Under current law, a trust becomes subject to the maximum 37% income tax bracket once its undistributed taxable income reaches approximately $14,450.[6]) In addition to regular income taxes, trusts must pay a 3.8% Medicare surtax on their undistributed net investment income, to the extent the trust's undistributed income exceeds the top tax bracket amount ($14,450 in 2023 and $15,200 in 2024). Of course, the internal cash build-up within a life insurance contract (as well as insurance death benefits) are income-tax-free to an ILIT, just as they are to any other taxpayer. In addition, if an ILIT uses its taxable income from other assets in the ILIT to pay insurance premiums on your life, the Internal Revenue Code prescribes the (rather surprising) result that you, and not the trust, will pay the tax on that income.

C. Administration of the ILIT.

In addition to the tax rules discussed above, the proper administration of an ILIT effectively requires the trustee to follow certain technical procedures. For example, the trustee must give notice to each trust beneficiary who holds a withdrawal right each year when gift(s) to the trust are made. In addition, the trustee must keep accurate records of the trust's receipts and disbursements. Therefore, it is important that you select a responsible party as trustee of the ILIT.

Our attorneys are always available to help with any aspect of the ongoing administration of your ILIT. Our continued involvement--especially in the first year or two--can help ensure that all the right steps are taken and that all necessary records are maintained. In addition, we provide an explanatory memorandum that includes a detailed checklist for the ongoing maintenance of the ILIT. By following the steps outlined in that memo, the client and trustee frequently are able to handle matters without having to incur any legal expenses beyond the cost of initially creating the trust.

VI. Creating an ILIT Involves Many Options.

Once you have determined that your estate planning circumstances warrant an ILIT, there are many important decisions to be made. You select the beneficiaries of the trust. Typically, the surviving spouse and/or your children (and other descendants) will be named as beneficiaries, but there are other beneficiary options (such as your parents or other loved-ones). You also specify the terms of the ILIT as well as the terms of any sub-trust that may be created on your death. For instance, if your children are the beneficiaries, you may choose to hold their shares in either a single "pot" trust or in separate trusts (one for each child); you may choose to have these trusts last for your children's lifetimes or you might provide for an earlier termination. You select the initial trustee(s) and one or more successor trustee(s). Because the trustee will be responsible for administering the ILIT--receiving gifts, sending out withdrawal right notices, paying premiums, making distributions to beneficiaries, etc.--this should be a trusted, responsible person. Frequently, an adult child will be chosen to serve as the trustee; sometimes a brother or sister, or a trusted business associate is available and willing to serve. If the trust continues for an extended period after your death, you may choose to phase your children into control, either by distributing the trust to them in specified

[6] The income tax brackets for trusts are adjusted annually for inflation. The top ordinary income tax bracket for trusts in 2023 is $14,450 and will be $15,200 in 2024.

fractions as they attain given ages, or by permitting them to become a co-trustee or the sole trustee of their respective trusts at ages designated by you.

When an ILIT is prepared in conjunction with a complete estate plan (e.g., along with a Will and/or a Revocable Trust), these decisions are usually easier: for the most part, the ILIT can be structured to "mirror" the provisions of your Will. However, as noted above, while a Will can be amended at a later date, the ILIT is irrevocable and cannot be amended, even though your estate planning goals may change over time. For this reason, many attorneys recommend that you reach some decisions regarding your Will before finalizing the ILIT. This gives you the chance to consider the various issues and structure a well-coordinated estate plan.

VII. Types of Insurance Used in an ILIT.

A. "Permanent" Versus "Term" Policies.

Where the potential for tax savings is high enough, the effort involved in establishing and maintaining an irrevocable life insurance trust is well worth it. This is particularly true when whole life, universal life, and other "permanent" life insurance policies are involved. These policies are often designed so that at some point they become paid up. At that time, administration of the trust becomes much simpler yet the tax-free nature of the insurance remains intact until your death. "Term" policies can be used within an insurance trust; however, term policies never become paid up and are often cancelled at some point in time. If the policy lapses before your death, the effort involved in creating and maintaining the trust will, to a certain extent, have been for naught.

B. "Second-to-Die" Insurance.

Perhaps one of the most popular types of permanent life insurance to use in an ILIT is a so-called "second-to-die" policy (also known as "survivorship" insurance). A second-to-die policy, as the name implies, insures two lives (typically a husband and wife) and pays a death benefit at the death of the second insured to die. Usually, second-to-die life insurance is designed to provide the liquidity necessary to pay death taxes due on the death of the surviving spouse, and therefore, it is primarily an estate planning tool. (Often the estate plan for a married couple will defer all death taxes until the death of the second spouse to die by properly using the unlimited marital deduction and the lifetime estate and gift tax exclusion amount of the first spouse to die, so second-to-die insurance is a natural fit for many married couples.) Moreover, because a second-to-die policy is based on the life expectancy of two lives, the premiums for this policy will total less than the premiums for two individual policies insuring the same lives; this feature, too, ties in well with typical estate planning objectives, for lower premiums translate into minimum, efficient use of your annual gift tax annual exclusion amount, your lifetime estate and gift tax exclusion amount, and the exclusion that can insulate life insurance proceeds received in trust from death taxes at the deaths of your children.

VIII. Summary.

Third-party ownership of life insurance can maximize the benefits passing to your family by avoiding estate taxes at your death. Using an ILIT to own the insurance can enable you to provide management help for children, maintain maximum creditor and marital property protections for your children, and facilitate the coordination of life insurance with your overall estate plan. An ILIT also can avoid estate tax at your children's later deaths, maximizing potential benefits to grandchildren. Although an ILIT involves some complexity, it also provides considerable estate tax benefits and flexibility. The ILIT is a valuable tool for insurance ownership.

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