



The Irrevocable Life Insurance Trust

Life insurance is something that many of us own. For some, it is simply a means to provide additional support for our family. For others, it may play a greater role in overall estate and tax planning. Unfortunately, many people are unaware of the potential tax consequences of how such policies are held, or in some cases who the beneficiaries are. Life insurance proceeds can fall outside of an insured's estate, which is extremely beneficial from a tax planning perspective. However, this will not always occur, and the ramifications can be extremely costly.

By owning life insurance on their own lives, many people unknowingly risk the possibility of having the proceeds of that policy become subject to estate taxes. When one owns life insurance in her own name, the insurance proceeds are considered part of her estate, because she retains certain controls over the policy and its ultimate payout. These elements of control are described as "incidents of ownership".¹ Inclusion of such insurance proceeds in an estate can cause a federal estate tax² liability where the estate's total value exceeds \$2,000,000, and potentially a state estate tax liability as well.

While outright ownership of a policy is the most glaring example of an "incident of ownership," there are other rights or powers over the policy which should be avoided. For instance, where the insured has the right to change the beneficiary, the insured is seen as having a right over the policy, and therefore the insurance proceeds will be included in her estate, and potentially subject to state and federal estate tax.

Eliminating all incidents of ownership is not the end of the problem, however. Additional concerns spring from situations in which insurance policies pay to a surviving spouse who has no need for the funds, yet now has control of the proceeds and will have them included in her estate at death.

The problems illustrated above can be addressed through the use of a common estate planning tool referred to as an Irrevocable Life Insurance Trust ("ILIT"). This structure offers the benefit of acting as both a separate legal entity to own the insurance policy, and a beneficiary of the policy not subject to estate tax. This trust can also designate the insured's heirs as the trust's beneficiaries to ultimately receive payments from the trust without incurring a tax liability. An additional benefit is that an ILIT eliminates the possibility that a life insurance payout will unnecessarily become subject to estate taxes. Consider the following example:

Case Study:

Jane Doe is a mother of three minor children. There is a \$2,000,000 life insurance policy on her life, and her personal assets equal \$2,000,000.

¹ IRC 2204(2) states that the proceeds of any life insurance policy will be included in the insured's estate if the insured possesses any incidents of ownership in the policy, including, but not limited to: A reversionary interest in the life insurance policy, rights to the economic benefits of the policy, or the power to change the policy terms.

² Estate tax law now allows up to \$2,000,000 of a party's estate excluded from estate tax. Up to \$1,000,000 of this may be from gifts given by the testator during her lifetime excluding certain annual and marital exemptions.

Scenario 1 – No ILIT

Jane passes away and her life insurance company pays the policy to her husband (the policy owner and beneficiary), free from estate tax. During his lifetime, the husband does not spend any of the life insurance proceeds, but lives off the income. When he passes away, he names his children as beneficiaries. His estate is worth the \$2,000,000 from Jane's estate, plus \$2,000,000 from the life insurance policy, a total of \$4,000,000. \$2,000,000 of the estate is exempt from estate tax, but the remaining \$2,000,000 will be subject to state and federal estate taxes of approximately 50%. This means that the estate will pay approximately \$1,000,000 in taxes, leaving \$3,000,000 payable to the children.

Scenario 2 - ILIT

Jane passes away and her life insurance company pays the policy to her Irrevocable Life Insurance Trust which is the owner and beneficiary of the policy. Her husband receives the income from the ILIT pursuant to the terms of the Trust, and if he requires additional funds, the Trust provisions allow for payout of the principal. When the husband passes away, his estate is worth the \$2,000,000 he received from Jane, and the additional \$2,000,000 in the ILIT is payable directly to the children. This results in \$4,000,000 passing to the children, and no estate taxes being paid by the estate.³

Structuring an ILIT

Third Party Owner

As discussed above, outright ownership of the policy or even limited rights to the policy which rise to the level of incidents of ownership will cause the proceeds to be included in the insured's estate. The ILIT solves this problem by acting as the owner of the policy. Either a new policy is purchased by the Trust or an existing policy is transferred into the Trust. In either case, the ILIT is named the beneficiary of the life insurance policy. If an existing policy is transferred, the insured must survive for at least three (3) years beyond the date of the transfer, otherwise the payment will be included in the insured's estate for estate tax purposes.⁴

The Trustee

To avoid any unintended tax consequences, it is important to take careful note of who will act as trustee when creating an ILIT. As mentioned above, the insured herself cannot be the owner of the policy, as this would demonstrate an incident of ownership. This also means that the insured cannot act as trustee of the ILIT that holds a policy on her life, either. Additionally, if a trustee is a beneficiary of the trust, there should be an independent co-Trustee appointed to oversee any discretionary disbursements. The trustee will apply on behalf of the ILIT for a life insurance policy on the insured's life. Upon death of the insured, the trustee either distributes the proceeds paid to the trust or invests the funds and administers the trust for one or more beneficiaries.

Second-to-Die Policies or Individual Policies

Second-to-die insurance is often used in estate-planning for a couple because the cost of insurance is lower than the cost of a single life policy, or when the couple does not see a need for additional funds should one of them die. This is common in situations

³ The \$2,000,000 exemption allows the husband's entire estate to pass tax free to his children, and the additional \$2,000,000 in the Trust is not counted as part of his estate.

⁴ Often referred to as a "look back period". On existing life insurance policies, if there is any change of ownership, whether to a trust or an individual, if the insured does not live for three (3) years after the transfer, the insurance proceeds are taxable.

where the couple have no minor children and are financially stable. Second-to-die policies are often purchased to cover the tax on the estate of the surviving spouse. Alternatively, an ILIT may purchase individual policies on each of the individuals rather than a second-to-die insurance policy for the couple. It is important to note that where individual policies are used, the couple should create two separate ILITs, one for each policy. Two Trusts are used in order to avoid certain tax problems that occur when a single ILIT owns two individual policies on different lives.

Payment of Premiums

One way to fund the cost of life insurance premiums is to make periodic gifts to the ILIT. For the trust to be properly construed as an ILIT, and avoid excessive taxation, the gifts must not exceed the annual exclusion amount and must be a present interest. There are a number of complex tax issues relating to such gifts, and you should consult a professional to ensure that gifts made to an ILIT do not create a tax liability for the donor or the beneficiaries.

Alternatively, one can fund the premiums by making a one time gift to the trust when it is created. This gift will be depleted over time as it covers annual payments. As this contribution is a completed gift to the ILIT, it is a taxable event to the donor. For this reason, a professional should be consulted before funds are transferred to the Trust.

Trust Management

Upon an insured's death, the insurance policy will be paid to the trust. The trustee will manage the funds and invest the money to generate income on the principal. The disbursements of income may be structured in a variety of different methods, depending on the successors' anticipated needs. For example, some ILIT's may direct that all income be paid to the surviving spouse in regular disbursements, whereas others may add it to the principal to be reinvested.

Some people fear that solely receiving income generated each year may be insufficient for a surviving spouse, who may need additional funds held in the ILIT for an unexpected large expenditure. In most situations, the surviving spouse will have a large pool of assets passed to her directly which may be used for such purposes. If the assets are insufficient, the ILIT will generally have a clause that allows for disbursement of additional income and/or principal if it is necessary for the spouse's health, education, maintenance or support. Therefore, if there is a genuine need, the funds will be made available to the surviving spouse. It is important to remember that the ILIT is in place to ensure that the life insurance proceeds are not unnecessarily taxed, not to keep funds from the spouse in a time of need.

As with all trusts, the ILIT allows some flexibility as to what is done with income and under which conditions principal may be paid out. The way such powers are structured can have a significant tax impact. Accordingly, these details should be addressed at the time of the formation of the ILIT with the appropriate estate planning professional.

Conclusion

By creating an ILIT, it is possible to transfer insurance proceeds to one's beneficiaries while avoiding unnecessary estate taxes. The insurance proceeds may be used to provide an income stream for successors or a source to pay taxes and expenses on one's estate. As discussed above, ownership of a policy as well as how the proceeds are held at payout can have a significant impact on the post-tax estate left to one's family. You should discuss an ILIT with an estate planning professional to determine if it is right for you, and the best way to structure the trust to avoid negative estate tax consequences.