Irrevocable Life Insurance Trusts

Many people are attracted to life insurance by the promise of security a life insurance policy can provide. Advertisements for life insurance policies frequently point out that life insurance proceeds can help the survivors of the insured accomplish a number of objectives, including paying off a mortgage, providing the funds required for the complete education of children and providing family members with an additional source of income. In addition, if estate taxes must be paid, life insurance policy proceeds can provide a source of liquidity with which to pay such taxes.

Although life insurance proceeds generally do not constitute taxable income, absent proper planning the full death benefit of life insurance policies will be included in the insured's federal gross estate and subject to estate tax. An Irrevocable Life Insurance Trust ("ILIT") can be used to avoid the estate taxation of life insurance proceeds and ensure that the full proceeds pass to the intended beneficiaries.

An ILIT is a trust designed to both own a life insurance policy and be the beneficiary of the insurance proceeds. With proper planning, this structure eliminates federal estate tax on the insurance proceeds at the death of the insured. It also grants the insured an additional measure of control over the eventual disposition of the policy proceeds to his or her spouse and/or other beneficiaries.

TERMS OF AN ILIT

An ILIT can be drafted with flexible terms designed to suit the needs of the insured and the intended trust beneficiaries. If the insured is married, the spouse will almost always be named as a beneficiary of the ILIT. The insured can elect to name his or her spouse as the sole beneficiary of the trust or might prefer a more flexible trust that authorizes trust distributions to be made among the insured's spouse, children and grandchildren.

After the death of both spouses, separate trusts for the benefit of the children can be established, although an insured with minor children frequently will stipulate that the trust funds be held in one trust until the youngest child attains a particular age (i.e., 18, 21, 25, etc.). The ILIT provides clear instructions for these trusts and for the ultimate disposition of trust property. Because the options for designing an ILIT trust are numerous and flexible, the terms of an ILIT can be carefully designed to meet the needs of the family.

ILITs ordinarily are drafted in a manner that permits gifts made to the trust (and premium payments made on behalf of the trust) to be treated as gifts to the trust beneficiaries. In a properly administered ILIT, these payments will qualify for the $15,000 per donee "annual exclusion" from the federal gift tax and thus may avoid the imposition of gift tax on such amounts. In order to accomplish this objective, the beneficiaries of the trust must be given certain rights to withdraw the annual gifts made to the trust on their behalf and must be given notice when gifts are made to the trust. This withdrawal right and notice mechanism frequently is referred to as a "Crummey" provision, named after a famous court case that approved use of this technique.

FUNDING AN ILIT

Even the best ILIT can prove ineffective if it is not properly funded. If <u>new</u> life insurance is to be purchased, the ILIT should be the initial applicant for, owner and beneficiary of the new policy. Thus, the Trustee, rather than the insured, should sign the application for a new life insurance policy which will be owned by an ILIT. The Trustee should also sign the beneficiary designation form for the new policy in order to name the ILIT as the initial beneficiary of the policy. Following these steps will ensure that the new policy will not be included in the insured's estate. Accordingly, it is crucial to consider implementing an ILIT as soon as you are contemplating the purchase of any new life insurance and to sign the trust before formally applying for the insurance.

To remove an <u>existing</u> policy from the estate of an insured, an insured can sign an absolute assignment of ownership form transferring ownership of the policy to an ILIT, and the Trustee can complete the beneficiary designation paperwork required to name the ILIT as the beneficiary of the policy proceeds. However, the tax code provides that in the event that the insured dies within three years of the transfer, the proceeds of the transferred policy will continue to be subject to estate tax. Therefore, once an estate planning professional has identified an <u>existing</u> insurance policy as an attractive candidate for an ILIT and the new ILIT has been signed, the insured should transfer ownership of the policy into the ILIT as soon as possible to trigger the clock on this "three-year" rule. Moreover, a married insured should make sure that his or her ILIT contains a specific provision to dispose of insurance policy proceeds in the event of death within three years of the transfer of the policy into the ILIT. Most ILITs drafted for married individuals simply take advantage of the unlimited marital deduction under these circumstances by providing that if death should occur during this three-year window the policy proceeds will pass to the surviving spouse either outright or in trust, thus postponing the tax that would otherwise be due at the death of the insured.

Both term life insurance policies and whole life insurance policies can be used to fund an ILIT. To the extent that a policy gifted to the ILIT has monetary value, the transfer of that policy into an ILIT is a taxable gift. A transfer of an existing term policy rarely raises significant gift tax implications, as the value of a term insurance policy is generally minimal. On the contrary, a whole life policy is far more likely to have significant cash value. Therefore, the insured must work closely with his or her estate planning professionals in order to minimize the gift tax consequences of the transfer of a whole life policy into an ILIT and coordinate the transfer with the payment of the policy premiums and other gifts made by the insured.

SURVIVORSHIP ("JOINT") LIFE INSURANCE

Depending on the structure of the trust, an ILIT may be funded with most types of life insurance policies. Some types of ILITs can even hold a joint and survivor life insurance policy (also referred to as a "second-to-die" or a "survivorship" policy). Joint and survivor life insurance is a single policy that insures two lives (generally at a cost less than other types of life insurance), with the proceeds payable only upon the death of the survivor. The insurance industry developed joint and survivor life insurance in response to the unlimited marital deduction, which had the effect in most estate plans of postponing federal estate taxes until the death of the survivor of a husband and wife. By paying the proceeds at the death of the surviving spouse, joint and survivor life insurance provides estate liquidity at the time when significant estate taxes may be due.

Neither spouse should be a beneficiary of a trust owning joint and survivor life insurance. Accordingly it is generally not advisable to add such insurance policies to a trust designed to own traditional single life insurance. Rather, a separate "joint life insurance trust" should be created to own such policies.

ILITS AND "MULTI-GENERATIONAL ESTATE PLANNING"

The effectiveness of ILITs that own either single life insurance policies or survivor life insurance policies can be enhanced through effective use of the insured's exemption from the generation-skipping transfer-tax ("GST exemption"). Each individual currently has $11,700,000 of GST exemption, which means that $11,700,000 can be left in trusts for that individual's children, with the assets of those trusts not being subject to tax when they pass to the children's children. The GST exemption provides an attractive opportunity for "multi-generational estate planning" because an individual who has already taken advantage of the techniques designed to maximize the inheritance of his or her children can, by taking advantage of the GST exemption, plan to maximize the inheritance of his or her grandchildren.

This opportunity is particularly attractive in the ILIT context because if the insured effectively allocates GST exemption to all <u>premium payments</u> for a policy owned by the ILIT, all of the <u>proceeds</u> of that policy will be exempt from the generation-skipping transfer-tax. Thus, through the use of a modest amount of GST-exemption, the insured can protect assets well in excess of his or her $11,700,000 of GST-exemption. This technique offers the opportunity to significantly "leverage" the original $11,700,000 of GST exemption so that assets with a value well in excess of that amount might escape exposure to the estate tax upon the deaths of the children of the insured.

It is worth noting that the rules regarding the allocation of GST exemption are enormously complex. Ordinarily, it is necessary to file a gift tax return in order to report the allocation of GST exemption to a premium payment on a life insurance policy owned by an ILIT. Automatic allocation default rules eliminate this requirement in some circumstances. However, these same default rules may serve to allocate GST exemption to ILITs that were not designed for that kind of planning. Therefore, any discussion of an ILIT should include a discussion of the intended use, if any, of GST exemption and of the gift tax returns that might be required to properly implement the intended plan.

SUMMARY

An ILIT can be a highly effective means of sheltering insurance proceeds from your taxable estate. If you are married and have a combined estate of over $23,400,000 which includes the proceeds of life insurance (or if you are single and have an estate of over $11,700,000) or if your estate is potentially facing state estate taxes an ILIT should be considered to own your life insurance policies. If you are considering the purchase of "second-to-die" life insurance, you should consult with your Cummings & Lockwood attorney as to whether or not a separate ILIT should be established to own that policy as well.

Revised January 2021