

Irrevocable Life Insurance Trusts

In last month's article, the income and estate tax benefits of Charitable Remainder Trusts (CRTs) were addressed. In one example, the distributions from a CRT were contributed to an Irrevocable Life Insurance Trust (ILIT) to "replace" the property transferred to the CRT. This month's article will address the estate tax benefits of ILITs and the proper administration of them.

ILITs are designed primarily to save estate taxes. If an insured maintains any of the "incidents of ownership" over a life insurance policy on his/her life, at his/her death, the insurance proceeds are included in the insured's gross estate for estate tax purposes. The six incidents of ownership (sometimes referred to as "strings" over the policy) are the right to;

1. Designate the beneficiary,
2. Change the beneficiary designation ,
3. Borrow against the value of the policy,
4. Pledge the policy as collateral to secure a loan,
5. Assign the policy, and
6. Surrender the policy.

Thus, even though you will never enjoy the proceeds from your life insurance, they are included in your gross estate if you have any of these "strings" over the policy.

The Three Year Rule

Moreover, even if the insured irrevocably transfers all of the incidents of ownership (cuts all the strings), the proceeds will be included in the insured's gross estate if he/she dies within three years of the transfer. The three year rule prohibits Grandpa from removing the life insurance proceeds from his gross estate with a death bed transfer of the policy to his grandson.

The inclusion of the value of the proceeds in one's gross estate without the inclusion of the actual proceeds can cause unintended consequences. For example, if one named Aunt Polly as the beneficiary of life insurance, the value of the proceeds would be included in the insured's gross estate and may generate estate tax even though Aunt Polly, not the estate, would have the proceeds. Without careful drafting, the estate taxes generated may come out of the estate residue that was intended for his children, not Aunt Polly's share.

An ILIT is an irrevocable trust designed specifically to own life insurance. It is created by the person on whom insurance will be purchased (the insured). The beneficiaries of the trust are often the insured's spouse and children. The insured transfers property to the trust in the form of gifts to the beneficiaries. The tricky part of an ILIT is the qualification of these transfers for the annual exclusion from gift taxes. Generally, there is an annual exclusion from gift taxation for the first \$11,000 given by one donor to one beneficiary in a calendar year. However, the exclusion only applies to gifts of present interests. If the beneficiaries do not have present interests but only have

future interests in the property contributed to the ILIT, all contributions will be taxable gifts.

Qualifying Gifts for the Annual Gift Tax Exclusion

To convert the contributions from otherwise future interest gifts to present interest gifts, the beneficiaries are given the power to withdraw a portion of the contribution for a limited period of time (often 30 days). If the beneficiaries elect not to exercise their powers of withdrawal, the powers lapse after the specified period of time. Then the trustee is free to use the contributions to pay premiums on a life insurance policy on the insured. (Note that there are potential gift tax implications of the lapse of the powers of withdrawal that often cause the lapse of the power to be limited. These are beyond the scope of this article).

The powers of withdrawal are critical for the tax efficient operation of an ILIT. The beneficiaries must really have the power to take the contributions. There can be no prearranged deal that the beneficiaries will not take the contributions. Each beneficiary must have knowledge of the existence of the right. The contributions should be carefully documented and notices sent to the beneficiaries advising them of their withdrawal rights. When I serve as Trustee, I require the beneficiaries to sign a copy of the letter notifying them of their rights. This will be my ammunition if the IRS argues that the proceeds of the life insurance should be included in the estate of the insured because the rights of withdrawal were illusory.

Life Insurance in an ILIT

There are two ways for an ILIT to become the owner of life insurance on the insured. First, the insured can transfer a policy to the trust; however, as discussed above, if the insured dies within three years, the proceeds are included in the insured's estate even though all the "strings" were cut. To avoid this consequence, the insured can transfer money to the ILIT and, if the beneficiaries do not exercise their powers of withdrawal, the contributions can be used by the Trustee to purchase a brand new life insurance policy which replaces the one currently owned by the insured. Because the insured never owned the new policy, the three year rule does not apply.

This second technique, purchasing a replacement policy, works great if term life insurance is involved, but, if the insured has a whole life policy with a substantial cash value, the insured will not want to lose the cash value by replacing the policy. In this circumstance, the whole life policy will often be transferred to the ILIT and either the insured waits three years or concurrently a term life insurance policy is purchased for three years that would pay to the estate of the insured the amount of estate tax that resulted from the application of the three year rule (inclusion of the value of the proceeds in the insured's gross estate).

Often life insurance proceeds are one of the largest values included in one's gross estate. Utilizing an ILIT can relatively easily remove that value and save substantial estate taxes. Following the insured's death, the proceeds often remain in the ILIT for the spouse's lifetime and then are distributed outright to the children. Thus, the use of the

proceeds, primarily for the surviving spouse and secondarily for the children, usually satisfies the insured's objectives. In next month's article, I will address why life insurance is so often used in estate planning.

The author of this article, Joseph G. Imbriani, Esq., CPA/PFS, practices in the areas of taxation and estate planning and is a partner of the Boston law firm of Taylor, Ganson & Perrin, LLP.