

## Irrevocable Life Insurance Trust

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### What is it?

An irrevocable life insurance trust (ILIT) is a legal entity primarily set up to hold a life insurance policy. The broad terms of the trust are similar to any other irrevocable trust. However, as the name implies, this particular type of trust usually holds only a life insurance policy (or policies). The main purpose of an ILIT is to remove the proceeds of a life insurance policy from your gross estate and avoid estate taxes. If the trust is drafted and funded properly, then the proceeds from the life insurance policy should not be included in either your gross estate or your spouse's gross estate. (Most irrevocable life insurance trusts provide for the spouse as well.) Your beneficiaries, usually your children, will then receive the necessary funds (free of estate and income taxes) to pay whatever estate taxes may be due on the remainder of your estate. A similar result can be obtained if you simply gift an insurance policy or give cash to purchase a policy directly to your children. However, many people use a trust to hold the policy if their children are too young or irresponsible to hold the policy in their own names. With a trust, an independent trustee can be selected who understands that you want the trust to purchase and hold a life insurance policy on your life to provide liquidity to your beneficiaries.

### When can it be used?

#### ***ILIT should only be used when you expect to have substantial taxable estate***

An ILIT should only be used when you expect to have a gross estate (including the value of all life insurance policies that you own) substantially in excess of the estate tax applicable exclusion amount (\$1.5 million in 2004 and 2005). If the value of your estate is less than these amounts, then it may not be worth the trouble and expense to set up an ILIT.

**Example(s):** You and your spouse have a very modest estate. You expect that at the time of your death, your estate, including all life insurance policies owned by you, will be worth around \$1.5 million. You have two children. In this case, it probably does not make sense to set up an ILIT. Only people who expect to have estates substantially in excess of the applicable exclusion amount should use an ILIT. The primary purposes of an insurance trust are to remove the proceeds of the insurance policy from your gross estate and to give your beneficiaries some cash to pay the estate taxes.

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### ***Donor must create trust entity to receive or to buy life insurance policy***

You must first set up the irrevocable trust to receive the life insurance policy. If you do not already have a life insurance policy that you want to transfer to the trust, then you will have to make cash gifts to the trust to enable the trustee to make the purchase. An estate planning attorney should be hired to draft the trust document. Along with drafting the legal documents to set up the trust, you must also select the trustee and beneficiaries of the trust. The trustee must be completely independent of the creator of the trust. You should not name yourself, your spouse, your children, or anyone else beholden to you as the trustee. You must also decide who the beneficiaries of the trust will be. Typically, it will be either your children or grandchildren.

### ***Donor must either make irrevocable gift of insurance policy to trust or make cash gifts to trust to purchase insurance policy***

Once the trust has been established, the independent trustee appointed, and the beneficiaries named, you must then transfer the insurance policy on your life (assuming you already have an insurance policy) to the trust by signing an irrevocable assignment of the policy to the trustee of the trust. An irrevocable assignment means that once you have transferred the policy to the trustee, you do not have the right to get the policy back. If you do not already own a policy, then you will have to make cash gifts to the trust so that the trustee can purchase a policy on your life.

**Caution:** If you donate an existing life insurance policy to the trust, then you must live for at least three years after the transfer of the policy to remove the policy proceeds from your taxable estate. In other words, if you die within three years of the transfer, then all of the insurance proceeds will be pulled back into your taxable estate. This three-year rule does not apply to new insurance policies that are purchased by the trustee.

### ***If cash gifts are made to trust, then beneficiaries must have Crummey withdrawal rights to qualify gifts for annual gift tax exclusion***

If you make cash gifts to the trust to either purchase a new life insurance policy on your life or to continue premium payments on an existing policy, then the trust must be drafted so that the beneficiaries have Crummey withdrawal powers. These withdrawal powers allow the cash gifts to qualify for the \$11,000 federal annual gift tax exclusion. These powers are referred to as Crummey powers in reference to a taxpayer named Crummey who was involved in a tax dispute with the IRS. The Crummey case held that to qualify for the annual gift tax exclusion, the beneficiaries of an ILIT must have a temporary right to withdraw the money that has been gifted to the trust.

### ***Beneficiaries should be notified of Crummey withdrawal rights in writing and given minimum length of time to withdraw money***

At the time the gift is made, a written notice should be sent to all beneficiaries informing them that the gift of cash has been made to the trust and that each one of them has the right to withdraw that money. Each beneficiary must also be given a minimum length of time to withdraw the money, usually 30 to 60 days. If the beneficiary is a minor, then the right to withdraw the money must be given to the child's guardian. The withdrawal rights allow the cash gifts you make to qualify for the annual exclusion from gift tax. In other words, you can make up to a \$11,000 gift, or \$22,000 if split

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with your spouse, to the trust for each beneficiary of the trust and owe no federal gift tax. In most situations, the beneficiary will not withdraw the funds from the trust. The trustee can then use the funds to purchase a life insurance policy on your life.

**Example(s):** You are 55 years old and have three children all under the age of 18. You expect to have a taxable estate of \$4 million to \$6 million when you die. You are concerned about the tax liability that the estate will cause for your children. One solution is to set up an ILIT. You name your three children as the beneficiaries of the trust and appoint an independent person or institution as the trustee. You then begin to make cash gifts to the trust for each beneficiary. You can give up to \$11,000 (\$22,000 if you split the gift with your spouse) for each beneficiary and pay no federal gift tax. The beneficiaries should be given written notice of their right to withdraw money from the trust for a specified period of time. If the money is not withdrawn, then the trustee can use the money to purchase a life insurance policy on your life. When you die, the proceeds from the policy will not be included in your taxable estate, and the beneficiaries (your children) of the trust will receive the funds free of income tax. They can then use the proceeds to pay the estate taxes on the rest of your assets.

## Strengths

### ***Proceeds from insurance policy held by irrevocable trust not included in taxable estate of decedent***

One of the main benefits of using an ILIT is that the proceeds from the life insurance policy will not be included in your taxable estate when you die. Thus, the life insurance policy will provide liquidity (free from estate and income taxes) to your beneficiaries to pay whatever other estate taxes may be due on your assets.

### ***Cash gifts to trust to buy life insurance can be made without incurring gift tax***

If the ILIT is drafted properly (e.g., the beneficiaries have Crummey withdrawal rights), then any cash gifts made to the trust will qualify for the annual exclusion from gift tax. A husband and wife who are U.S. citizens and make the gift jointly could gift \$22,000 per beneficiary to the trust and not pay any federal gift tax on this amount. If there were four beneficiaries of the trust, then \$88,000 could be gifted to the trust tax free and used to buy an insurance policy.

### ***Gifts of existing life insurance may be given low value for gift tax purposes***

The gift of an existing life insurance policy will be valued for gift tax purposes at the interpolated terminal reserve value. This value is close to the cash surrender value of a whole life insurance policy for a healthy individual. The face value (what will be paid at death) is often many times greater than the cash surrender value. Thus, by utilizing the annual exclusion, applicable exclusion amount, and generation-skipping transfer tax exemption, you can often greatly leverage the value of the gift.

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**Example(s):** You own an existing whole life insurance policy. The face value on the policy is \$500,000. The cash surrender value (what you would receive from the insurance company if you surrendered the policy) is \$75,000. You set up an ILIT and gift this policy to the trust. For gift tax purposes, the value assigned to the policy will be the interpolated terminal reserve value, which is approximately the same as the cash surrender value. The value of the gift is therefore approximately \$75,000. You can either use the annual exclusion or the gift tax applicable exclusion amount to avoid paying the gift tax. When you die, the beneficiaries of the trust will then receive the \$500,000 free of estate and income tax. For a gift of \$75,000, you have transferred an asset that will eventually be worth \$500,000.

### ***ILIT may be excellent estate planning vehicle for minor or irresponsible children***

An ILIT may also be a good option if your children are too young or irresponsible to handle the insurance policies and the eventual proceeds from those policies. Because the trust will have either an institutional trustee (a bank trust department, for example) or an independent individual who understands the purpose of the trust, you have some assurance that the funds donated to the trust will be used to buy an insurance policy (assuming, of course, that the trust beneficiaries do not exercise their Crummey withdrawal rights). You should also be assured that the proceeds of that policy, upon your death, would be used in a responsible manner.

## Tradeoffs

### ***To be effective, life insurance trust must be irrevocable***

As the name implies, an ILIT must be irrevocable. Once the trust has been established, then you have lost the ability to revoke or to amend the trust. Furthermore, once you have transferred an insurance policy to the trust, then you cannot regain ownership of that policy. The transfer is final.

### ***Trustee must be completely independent of creator of trust***

In order to remove the proceeds of the life insurance policy from your taxable estate, you must appoint an independent trustee for the trust. The trustee may be either an institutional trustee (such as a bank trust department) or an individual. You can also appoint your spouse as the trustee or cotrustee of the trust. If your spouse is named as the sole trustee, then his or her ability to make distributions must be limited to ascertainable standards. Your spouse cannot use the trust assets for his or her own support. The trustee cannot be the creator of the trust or a beneficiary of the trust. The trustee should be given complete discretion in how to invest the money in the trust and in the day-to-day running of the trust. You cannot direct the trustee in any manner. Furthermore, you can have the trustee removed without cause only under very limited circumstances (if another independent trustee replaces that trustee).

**Example(s):** You decide to set up an ILIT. You name your subordinate at work to be the trustee of the trust. You plan to instruct the trustee what to do with the monies donated to the trust and to exercise other controls over the trust. This setup is

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playing with fire. The IRS will almost surely find you have retained sufficient control over the trust so that the proceeds from the insurance policy will be included in your taxable estate. You must be extremely careful about exercising any control over the trust. In fact, you should retain competent legal counsel to draft the terms of the trust.

### ***ILIT may be expensive to set up***

Another drawback to an ILIT is that the trust may be expensive to set up. You will certainly need to hire an experienced, competent estate planning attorney to draft the trust. The trust may have to file tax returns. These requirements will cost money and take time. You could avoid these expenses if you simply gifted the policies directly to your heirs.

## How to do it

### ***Competent, experienced attorney must be retained to draft trust***

There are many complex legal issues that can arise when you set up an irrevocable trust. An experienced estate planning attorney should be hired to draft the trust and to advise you on other legal and tax issues. An estate planning attorney should also be used to coordinate the life insurance trust with your overall estate plan.

### ***Trustee and beneficiaries must be selected for trust***

You will have to choose a trustee for the trust. As noted, the trustee should be independent of you. You could either choose an institutional trustee (a bank trust department), or you could choose an individual to be the trustee. You could also choose your spouse as the trustee (but only if certain restrictions are imposed on your spouse). The trustee should be someone who has experience administering a trust and who understands that the purpose of the trust is to hold a life insurance policy on your life. You also have to select the beneficiaries of the trust. Typically, these will be either your children and/or your grandchildren. If your children or grandchildren are minors, then guardians should be appointed for the minors.

### ***Existing life insurance policies must be transferred into trust***

Once the trust has been established and the trustee and the beneficiaries named, then you will have to transfer any existing life insurance policies into the trust. You may need to have your insurance agent assist you with changing the ownership of the policy.

### ***You must be committed to funding the trust for long period of time***

If the trust is going to purchase a new life insurance policy on you, then you must be committed to funding the trust with sufficient gifts to pay the premiums on the life insurance policy. Depending on your age, health, and the size of the policy, the premiums may be very expensive. If the policy is a whole life policy, the premiums will have to be paid over a long period of time before the policy will be self-funding. You should be committed to making the necessary gifts to fund the policy over the

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entire term that the premiums will be due.

### ***Gift tax returns may have to be filed***

If you gift an existing policy to the trust, or if your gifts exceed the annual exclusion limits, then you might have to file gift tax returns. For gift tax purposes, the value of a gift of an existing policy is valued approximately at the cash surrender value of the policy. If this amount is above the annual exclusion amount, and if you have completely exhausted the gift tax applicable exclusion amount, then a gift tax will have to be paid. You should consult either your tax accountant or your tax attorney prior to making the gift.

## **Tax considerations**

### **Income Tax**

#### ***Trust's income, deductions, and credits are attributed to the creator of trust***

An ILIT may be treated as a grantor trust under the Internal Revenue Code. If it does qualify as a grantor trust, then the trust's income, deductions, and credits will be attributed to you. This may seem complex, but as a practical reality, these life insurance trusts almost never have any taxable income. These trusts are usually unfunded, meaning that the only asset they hold are the insurance policies. Under the tax code, the cash buildup on these policies is tax free. Therefore, these trusts almost never generate any income, deductions, or credits to the grantor or to the beneficiaries.

### **Gift Tax**

#### ***Gift of life insurance policy may be subject to gift tax***

For gift tax purposes, the transfer of an existing life insurance policy will be valued at the interpolated terminal reserve value (which is approximately the same as the cash surrender value of the policy). Upon request, your insurance company can give you the exact terminal reserve value. Depending on the size of the policy, the health of the policyholder, and the length of time that the policy has been in place, this terminal reserve value may be very large. You may use both the annual exclusion and the gift tax applicable exclusion amount to shelter this transfer from gift taxes. One other strategy to reduce the size of the gift is to take out a loan against the cash value of the policy prior to the gift. This loan will reduce the interpolated terminal reserve value and thus reduce the gift tax. If, however, the gift tax applicable exclusion amount has been exhausted by previous gifts and no loan is taken out, then you may have to pay a gift tax on the transfer of the policy.

#### ***Cash transfers to trust may avoid gift tax through annual gift tax exclusion***

If the ILIT is drafted so that the beneficiaries have Crummey withdrawal rights, then gifts of cash to the trust will qualify for the annual gift tax exclusion.

#### ***Beneficiary may incur gift tax when withdrawal right lapses***

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When the beneficiary allows his or her right to withdraw money that has been gifted to the trust to lapse, he or she is considered to have made a taxable gift to the remainderperson of the trust. The Internal Revenue Code allows you to exempt from gift tax up to \$5,000, or 5 percent, of the total trust amount. Because the gifts may be greater than \$5,000 or more than 5 percent of the trust corpus, the beneficiaries may be considered to have made taxable gifts to the remainderpersons. However, there are ways to draft the trust to avoid this result. If the beneficiary is given a power to keep the lapse from being a completed gift, then no gift tax will be due.

**Caution:** This is an extremely technical area. Only an experienced, competent estate planning attorney should be used to draft the trust. Any missteps in the design of the trust could have disastrous tax results for both you and the beneficiaries.

## Estate Tax

### *Proceeds from life insurance policy not included in donor's taxable estate*

If the irrevocable trust is drafted and funded properly, then the proceeds from the insurance policy will not be included in the estate of the donor. This is one of the main benefits of setting up this type of trust.

**Caution:** If the donor gifts an existing insurance policy to the trust and then dies within three years of the transfer, the proceeds will be included in the taxable estate of the donor. However, if the donor gifts cash to the trust so that the trust can purchase an insurance policy, then the insurance proceeds are not included in the donor's taxable estate even if he or she dies within three years.

**Example(s):** You set up an ILIT and transfer a \$2 million face value life insurance policy to the trust. You die four years later. The \$2 million is not included in your taxable estate. If you had died two years after the transfer, then the \$2 million would be pulled back into your taxable estate. If you had gifted cash to the trust so that the trustee could purchase a life insurance policy on your life, then the proceeds from the policy would not be included in your taxable estate even if you died within three years of the purchase of the policy by the trust.

### *Beneficiaries may have to include lapsed gifts in taxable estate*

When the beneficiary allows the withdrawal rights in the trust to lapse, this is considered a gift to the remainderperson of the trust (see gift tax section). The trust may be structured so that the gift is an incomplete gift and not subject to gift tax, but this incomplete gift may have to be included in the beneficiary's estate. However, in most cases, the funds from the trust will be paid out before the beneficiary dies. Again, this is a very technical area. An estate planning attorney should be consulted about the estate tax ramifications to the beneficiaries of the trust.

## Generation-Skipping Transfer Tax

### *Gifts to trust with beneficiaries two or more generations below grantor may incur generation-skipping transfer tax*

When an ILIT has beneficiaries that are two or more generations below the grantor (your grandchild, for example), gifts to the trust may be subject to both gift and generation-skipping

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transfer taxes (GSTT). Unfortunately, a gift that qualifies for the annual insurance proceeds will be included in his or her estate. With careful drafting, though, a life estate can be provided to the surviving spouse in one-half of the proceeds from the other spouse's gift to buy the insurance. The community property may also be split to produce separate property. One spouse can then purchase life insurance with funds from that separate property, while the other can then have a life estate in the proceeds without any of the funds being included in his or her estate. This is a very complex area. An attorney well versed in these matters should be used to structure the transactions.

## Questions & Answers

### ***Should someone with a modest-size estate be concerned about setting up an irrevocable life insurance trust?***

In most cases, someone who expects to have a taxable estate (including life insurance policies) that will be below the estate tax applicable exclusion amount (\$1.5 million in 2004 and 2005) should not go to the expense and the trouble of setting up an irrevocable life insurance trust. The trust usually only makes sense for people who expect to have sizable estates and who would like to provide some liquidity to their beneficiaries to pay estate taxes. If the trust is drafted and funded properly, then the life insurance proceeds should not be included in the taxable estate of the decedent.

### ***Do gifts of cash to the trust qualify for the annual exclusion from the gift tax?***

Gifts of cash to the trust will qualify for the annual exclusion from the gift tax if the beneficiaries have Crummey withdrawal rights in the trust. The Crummey withdrawal right means that each time a gift is made to the trust, a beneficiary should be given written notice that he or she has the right to withdraw the money for a limited period of time—usually 30 to 60 days. If the beneficiary does not withdraw the money, then the trustee may use the money to pay the life insurance premium. It is this withdrawal right that gives the beneficiary a present interest in the gift and allows the gift to qualify for the annual exclusion.

### ***What value for gift tax purposes is assigned to the gift of an existing life insurance policy?***

An existing life insurance policy that is gifted to a trust is valued at the interpolated terminal reserve value. The insurance company that issued your policy can provide you with the interpolated terminal reserve value. This value is approximately the same as the cash surrender amount of your policy. In most cases, the face value of the policy (what will be paid at death) is many times greater than the cash surrender value of the policy. Thus, for a relatively small gift to the trust, your heirs may receive a much larger amount tax free when you die. Furthermore, you may be able to avoid paying any gift tax on the gift of the existing policy by utilizing the annual exclusion and applicable exclusion amount.

### ***Can you name yourself to be the trustee of the life insurance trust?***

No. Do not name yourself as the trustee of the ILIT. The trustee must be independent of you. The trustee generally should not be beholden to you or be a beneficiary of the trust (which usually

eliminates your children). The trustee may be an institutional trustee (a bank trust department, for example) or an independent person. Under limited circumstances, your spouse may be named as the sole or cotrustee of the trust as well. The trustee must run and manage the trust according to the terms of the trust agreement. You cannot direct the trustee in any manner. Furthermore, the trustee can be removed without cause only if another completely independent trustee is appointed.

***What happens if you donate an existing policy to an irrevocable trust and then you die within three years of the gift?***

The face value of the life insurance is pulled back into your taxable estate. In other words, you must live for more than three years after transferring the policy to the trust to avoid having it included in your taxable estate. If, however, you give cash to the trust and the trustee purchases a new life insurance policy on your life, then the three-year rule does not apply. Even if you die four weeks after the policy is bought, the proceeds will not be included in your taxable estate.

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