

# IRREVOCABLE LIFE INSURANCE TRUST

*A source of ready funds to pay estate taxes for the estate, not from the estate.*

## The problem

Life insurance proceeds are received income-tax free, but are includable in the insured's estate for estate tax purposes if the insured had any incidents of ownership in the policy, including being able to change the beneficiary or access policy values.

For individuals already facing a substantial estate tax liability, using personally owned insurance proceeds to pay estate settlement costs only makes the tax burden worse by inflating the insured's gross estate for federal estate tax purposes.

## A solution

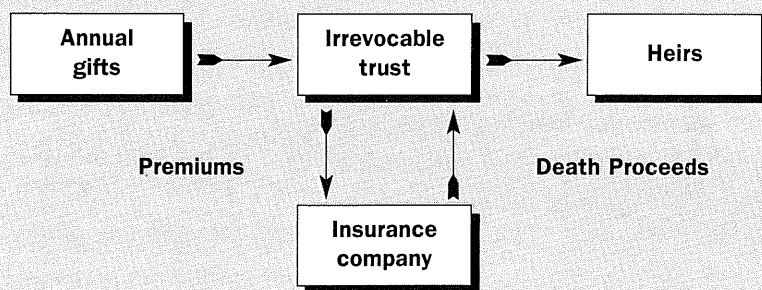
One way to get around this problem is with an *irrevocable life insurance trust*.

An irrevocable trust is one that the grantor can neither change nor amend. With a properly arranged irrevocable insurance trust, death proceeds pass into the trust – by-passing probate and avoiding estate taxes – where funds can be distributed income-tax free to the trust beneficiaries as directed in the trust document.

If properly structured, an irrevocable insurance trust could save more than 50% in estate taxes on any insurance proceeds. Thus, if a \$1 million life insurance policy is owned by an irrevocable insurance trust rather than by the insured, trust ownership could reduce the insured's estate taxes by over \$500,000.

**Funded or unfunded,  
irrevocable insurance trusts  
can provide tax-free death  
benefits that far exceed  
the sum of premiums paid.**

## Bypasses Probate Avoids Federal Estate Tax



## Here's how it works

### DURING THE GRANTOR'S LIFETIME . . .

The grantor establishes the trust and makes a gift of an existing life insurance policy. Or, the trustee can acquire a new policy owned by the trust. Either way, the trust should be the owner and premium payer. The grantor/insured should have no incidents of ownership in the policy.

### AT THE GRANTOR'S DEATH . . .

The insurance death benefit is paid to the trust. The proceeds can then be made available to the grantor's personal representative to pay settlement costs and meet other liquidity needs by *allowing* the trustee to either make loans to the estate or to purchase assets from the estate. The trust can also be structured to provide financial support to a surviving spouse and other beneficiaries.

### IF AN EXISTING POLICY IS USED . . .

If an existing policy is assigned to an irrevocable insurance trust, any cash value accumulations at the time of the assignment, plus later premiums, are treated as gifts, and may qualify under the \$10,000 annual gift-tax exclusion. Policy values or premiums in excess of the annual exclusion will be treated as taxable gifts and may consume all or a portion of the insured's unified credit equivalent amount.

**The three-year rule:** If the insured owns the policy, assigns it to a trust, and dies within three years of the assignment, the proceeds will be included in the insured's gross estate. However, provisions can be made in the trust document to distribute the proceeds to the surviving spouse if the three-year rule is triggered, thus qualifying them for the unlimited marital deduction and avoiding federal estate tax at the insured's death.

The only sure way to eliminate the three-year rule problem is by using a new policy.

#### **IF A NEW POLICY IS USED . . .**

If a new policy is used the trust should be in place before any premiums are paid, and the trustee – or someone other than the insured – should acquire the life insurance and be the policyowner.

Note that the trustee should be “allowed,” but not “directed” to make loans or purchase estate assets. To “direct” would imply that the proceeds were being held for the benefit of the estate, which would put them back into the grantor’s gross estate for estate tax purposes – and defeat the purpose of the trust.

#### **IRREVOCABLE INSURANCE TRUSTS CAN BE FUNDED OR UNFUNDED**

In a **funded insurance trust**, the trust owns income-producing assets, such as securities, in addition to the life insurance policies. Income generated by these underlying investment assets may be used to pay the insurance premiums. Where trust income can be used to buy insurance on the life of the grantor, any income tax liability must be paid by the grantor, not the trust. This offers special advantages. When the grantor pays income tax, he or she is, in effect, making an additional tax-free gift to the trust by allowing the assets inside the trust to grow income-tax free. This provides more assets to the beneficiaries.

In an **unfunded insurance trust**, the only asset owned by the trust is the life insurance policy. This results in the need to get dollars into the trust to be used to pay the premiums on the policy. Gifts of premium dollars to the trust may be sheltered from gift tax by use of the annual gift tax exclusion of \$10,000 per beneficiary (or \$20,000 if the gift is made by both spouses). In order to use the annual gift tax exclusion in an unfunded trust, the trust should include “Crummey” provisions (see inset on page 4).

**Insurance proceeds in an irrevocable insurance trust can be kept out of the insured’s gross estate by having the trust . . .**

**– Own the policy**

**– Pay the premiums**

**– Receive the death benefits**

## ADVANTAGES OF AN IRREVOCABLE LIFE INSURANCE TRUST

In general, an irrevocable trust is used by taxpayers who wish to remove not only substantial assets from their gross estates, but also any income from or future appreciation of those assets. This tax benefit is paid for by giving up complete control over the trust and trust assets.

By avoiding the insured's estate, however, insurance proceeds in an irrevocable trust do not increase the decedent's estate tax burden. Thus, they're able to provide a source of funds to pay estate taxes *for* the estate, but not *from* the estate.

## SURVIVOR LIFE INSURANCE

If the insured is married, survivorship life insurance could be a good choice. A survivorship policy covers both spouses and pays only at the death of the second spouse. If survivorship life insurance is used in an irrevocable insurance trust, the trustee can make proceeds available to the personal representative at the second death and the proceeds won't be included in either spouse's estate. Survivorship insurance is an excellent option when full use of the unlimited marital deduction is made.

## INDIVIDUAL OWNERSHIP VS. TRUST OWNERSHIP

There are advantages to transferring a policy to an irrevocable trust rather than giving it outright to either a spouse or children. For example...

- Proceeds are not taxed at the insured's death.
- Title and transfer problems associated with joint ownership are avoided.

### Gift-tax implications -

#### "Crummey" powers

Contributions made by the grantor to an irrevocable insurance trust to pay premiums can create a gift tax liability for the grantor. To avoid this, a "Crummey" clause can be written into the trust document giving the beneficiary the power to withdraw trust assets for a limited period, typically, 30 days. In this way, the grantor's contributions are considered a gift of a present interest, which qualifies them for the annual gift-tax exclusion.