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A PRIMER ON THE IRREVOCABLE LIFE INSURANCE TRUST

“Wealth is the product of man’s capacity to think.”

Ayn Rand

By George Chamberlin

The Irrevocable Life Insurance Trust (ILIT) is used by many of our clients as a technique to assist in the creation and transfer of wealth. Although the ILIT is commonly used for estate tax planning with high net worth clients, it has other uses as well and may be profitably employed by clients of more modest means. Given that some of our clients have already created an ILIT or are considering adding one to their financial strategies, what should we, as advisors and consumers, know about the ILIT and how it might be used in applying the Wealthcare process to our clients’ financial and tax planning strategies?

ILIT Defined

The ILIT is, as its name suggests, a trust designed to own life insurance and which, by its terms, is permanent and not subject to amendment or termination at the whim of the creator of the trust or its beneficiaries. In the usual case, the ILIT owns insurance on the life of its creator, generally the client, but often client and spouse. Upon the death of the insured person(s), the proceeds of the insurance owned by the trust are paid into the trust.

During the term of the trust, both prior to the death of the insured(s) and following receipt of the insurance proceeds, a trustee handles the operation of the trust in accordance with the provisions of the trust instrument. The trustee is normally an individual(s) or institution or both who has been selected by the insured but who acts independently of the insured. The selection of a trustee is critical to the success of the trust in the context of the insured’s goals since the trustee will oversee investments, distributions and other actions. The permanency of the irrevocable trust also underscores the importance of trustee selection by the insured client. The trustee should be independent of the insured since exercise of control by the insured would likely defeat the tax advantages associated with the trust and could open the trust to the reach of the insured’s creditors.

One common question about ILITs is whether the trust should own new or existing insurance on the life of the client who causes the trust to be created. The most efficacious approach is for the trust to apply for and obtain new insurance on the life of the insured client. The trust should be formed prior to the application for insurance and should make the application itself, through the trustee. This approach assumes, however, that the client is insurable, which is not always the case. Often times, the client already owns life insurance and may wish to transfer the existing policy(ies) to the trust. This approach raises two possible problems. The first is that, quite simply, the insured client must survive for at least three years after the transfer by gift of existing insurance to the trust. Death within the three-year period will mean that the insurance proceeds are pulled back into the estate of the insured

and taxed as a part of that estate. The second issue involves the proper valuation of the insurance policy at the time of the transfer to the trust and the assessment of the appropriate amount of transfer tax for the gift (or of the appropriate payment by the trust to the insured if the trust is to purchase the insurance). In order to provide the best advice to clients about the trust, these problems must be considered in the planning process and not after the fact.

Another typical question involves the means of payment of the insurance premiums by the trust. One alternative is to fund the trust with cash up front to pay the premiums, but the donor of those funds - the insured client - will incur gift tax liability for this transfer. Since one of the advantages of the ILIT is the ability to avoid transfer taxes on the insurance proceeds, using up exemption or paying gift tax seems to be contrary to that goal. A more common approach is to use the insured client's annual gifts of the premium amounts and apply the annual gift tax exclusion to these transfers. This approach takes advantage of a well-known tax case, the Crummey decision,¹ as its basis. The approach entails notice each year to the trust beneficiaries of the gift to them of the amount intended to fund annual premiums and allows the beneficiaries the right to demand from the trustee that portion of the total gift attributable to their interest in the trust. If the beneficiaries decline to take their share of the transferred funds from the trust, those funds are thereafter expended to pay the annual insurance premium on the trust-owned policy. The transfer qualifies for the annual tax exclusion as a current gift because of the demand power. The right to take the annual premium payment normally remains unexercised because the beneficiaries would prefer the much larger benefits in future when the proceeds of the insurance are paid into the trust on the death of the insured. The demand right should not remain unexercised because of an agreement among the parties; such an agreement would defeat the purpose of the transaction.

Is it that simple to make a gift that avoids any transfer taxes? Unfortunately, it is not quite that simple and the very act of a beneficiary declining to take advantage of the demand right to receive his or her share of the current gift of funds for the premiums may cause additional problems. The IRS position has been that the act of declining one's share of the annual gift is in fact a gift to all the other trust beneficiaries and that this gift may be taxable. As is the case with many other estate planning techniques, however, the ILIT may be drafted and operated in such a manner as to avoid this additional problem. One approach is to have separate sub-trusts within the ILIT for each beneficiary while another is to limit the amount of the gift. For the purposes of this article, the important thing is to remember that although the actual implementation of a particular technique may not be simple, as the taxing system is not itself simple, consulting with a tax professional and careful drafting should alleviate these potential problems and allow the client confidence that the technique will provide the desired result.

What happens to the insurance proceeds once they are paid into the trust following the death of the insured? First, assuming that all the legal requirements for the trust have been fulfilled, there is no tax due on the payment made to the trust - no estate tax and no income tax - and the entire proceeds are available to satisfy the trust purposes. Second, that portion of the proceeds which is not immediately distributed should be invested and future appreciation will be subject to the income tax under normal rules, albeit at the higher trust income tax rates for that portion of income which is not distributed. (Note that if the ILIT has significant income in the years before the trust proceeds are paid into the trust, there may be income tax due for those years as well). The assets in the trust are thereafter distributed to the named beneficiaries in accordance with the terms of the trust as to individual beneficiary, time, amount and/or other conditions.

Can a client have more than one ILIT? Yes, and sometimes it may be advisable for a family to have several distinct ILITs to address different purposes. For example, insurance on the individual lives of a client and spouse may best be held in separate trusts, since each person may have somewhat different

goals and objectives for a trust. Thus, an ILIT may provide for spousal support of the survivor after the death of the insured primary earner. If the client (or spouse) is the insured on a split-dollar policy, it may be advantageous to hold that insurance in a separate trust. Where separate trusts are employed, it is necessary to ensure that the trusts are sufficiently different in their terms to avoid the application of the reciprocal trust doctrine by the IRS to ignore the trust ownership and cause taxation to the insured's estate. A case for another separate trust exists where the ILIT owns second-to-die insurance on the lives of a client and spouse; such a trust is often used to provide liquidity in the estate at second death or to replace wealth for future generations. There are many possible combinations and permutations depending on the goals and objectives of the client and spouse.

Why Use the ILIT?

An important benefit of the ILIT is that, properly structured and operated, the insurance proceeds are not included in the insured's estate or subject to estate tax on the death of the insured. If the trust takes advantage of the annual gift tax exclusion, then transfer tax on the premiums will also be avoided. Further, it is possible that the ILIT can make distributions to grandchildren and other future generations without there being liability for the Generation Skipping Transfer Tax. Coupled with the traditional income-tax free nature of life insurance proceeds, these transfer tax features make the ILIT very attractive from a tax-planning standpoint. In fact, tax planning historically is a primary reason for the creation of the ILIT.

In addition, the ILIT is very useful as a means of creating and protecting wealth. The purchase of insurance later generates wealth in the form of the insurance death benefit and those proceeds, properly invested, may grow over time, adding to the wealth initially created through the insurance payout. When the ILIT is used in conjunction with other estate planning techniques, the insurance proceeds may be used to replace wealth that is transferred to non-family beneficiaries, such as a charitable beneficiary. The existence of life insurance protects wealth by providing an alternative to the liquidation of assets at the death of their owner. The ILIT, in the name of the beneficiaries selected by the creator of the trust, may purchase assets from the estate or loan funds to the estate, providing liquidity in the estate for taxes and other purposes, while preserving the underlying assets intact for the beneficiaries.

Another tremendous advantage of the ILIT is the ability of the insured, as creator of the trust, to provide in the trust instrument for the ultimate disposition of the insurance proceeds. Instead of the funds simply being paid to the named beneficiaries, the trust may provide for certain conditions to be met before distribution may be made. Such conditions may address various concerns as well as client goals and objectives and include, by way of example:

- Attainment of a specified age by a beneficiary (e.g., 1/3 of X's share to be distributed at age 35);
- Occurrence of specific need for a beneficiary (e.g., distribution may be made to fund graduate school, a business startup, first home or even a first wedding);
- Beneficiary's satisfaction of a prerequisite (e.g., distribution may occur only if the beneficiary graduates from college, obtains and holds employment or becomes clean of drugs, etc.).

The conditions which clients may impose on trust distributions are extremely broad and flexible and are limited only by the law and the imagination and desires of the insured trust creator and his or her advisors.

In addition to the above-named features, the trust instrument, through the imposition of conditions and

requirements on distributions, may provide a level of protection from creditors of the named beneficiaries ranging from business creditors to former spouses. The careful drafting of the terms for distribution permits a great deal of control and specificity on the part of the insured, helping to provide confidence that the funds provided are used in accordance with the insured's wishes.

Summary

The ILIT is a very powerful tool both for estate planning and addressing common issues in the broader context of family finances. Understanding the ILIT is important for advisors and their clients who may be considering this technique as a part of their financial strategies. The basic information on the ILIT provided in this article will answer some of the most common questions about the trust and help both you and your clients determine whether the ILIT is a good fit for their goals.

Assessing the implementation of the ILIT in your financial strategies. This is the future of financial advising.

¹ The full text of the opinion in the Crummey case is available here www.law.washington.edu/courses/PartTime/T510/Nov%2017/CrummeyVCommr.pdf

WEALTHCARE RESOURCES

Wealthcare Conference

Join us for our next Wealthcare Training Conference, March 25 & 26, 2004 in Las Vegas, Nevada. David B. Loeper, CEO of Financeware, is the featured speaker.

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New Prospecting Letters

[Click here](#) to access two new prospecting letters that introduce the Wealthcare process to your prospective clients.

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Advisor Call

On Monday, February 23rd, Phillip Knotts of Wealthcare Capital Management will present "Using Wealthcare to Unlock Concentrated Positions."

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Tax Time Resources

Now that it is tax season, it may be helpful to review developments in tax law that may apply to clients. [Click here](#) for the discussion of the new tax law changes made in 2003; [click here](#) for a discussion of the possible impact of AMT on your clients. The full archive of advisor e-mails on income taxes and other relevant topics is available by [clicking here](#).