Uses of Irrevocable Life Insurance Trusts

Ordinary life insurance is often used by those with smaller estates to provide a legacy, or to infuse capital into the estate to pay for necessary expenses. It can also be used as a vehicle to fund a business buy-sell agreement, which provides for the purchase of a decedent's interest in the business. The common misconception is that insurance of this type is a totally tax-free vehicle. Life insurance is includable in the gross estate of the insured if the decedent had any "incidents of ownership" in the contract, no matter who the beneficiary is. Even if the decedent did not own the policy, but he or she had received benefits from the policy or had the power to change, assign, revoke, pledge it for a loan or borrow from it, the decedent would be considered to have incidents of ownership. Also, if the policy is paid to the insured's estate, he or she would be deemed to have sufficient interest in it to include the proceeds in the estate valuation. Therefore, although not taxed when received, life insurance proceeds can create a taxable estate when the money is left to heirs.

The Problems of Alternative Ownership

Although the spouse may not own a policy, the children may own a policy to avoid "incidents of ownership" in the insured. However, there are disadvantages. For example, 1) children may misuse the policy and cash it in for themselves, 2) the spouse of a child may claim the cash value in a divorce proceeding, as part of his or her "equitable distribution", 3) if the child predeceases the parent, the issue of ownership becomes problematic, 4) the beneficiaries will immediately control the proceeds without guidance or restriction, and 5) the beneficiaries may have disabilities for which they receive government benefits. If that is the case, payments of the proceeds will disqualify them for a significant period of time, until they spend down the money.

The Practical Aspects of an Irrevocable Insurance Trust (ILIT)

The Trustee is considered the applicant for the insurance policy, the owner and beneficiary of the policy. If the policy is an existing one, the insured assigns the ownership to the Trustee by means of an assignment. Each year, the insured gives a gift to the Trustee of the funds sufficient to pay the annual premium.

Usually, the surviving spouse is the primary beneficiary of the Trust, providing income to her for the rest of her life. Upon the death of the surviving spouse, the moneys flow to the children with the proceeds maintained for them in trust until they are of age. (In some cases, Irrevocable Life Insurance Trusts may utilize a "second-to-die" policy which distributes the proceeds to the children only upon the surviving spouse's death.) Although not specifically stated in the Trust document, the Trustee is also permitted to utilize the proceeds to pay the anticipated estate taxes prior to the distribution to the children. In the event that the Grantor funds the Trust with cash in addition to an insurance policy, income or principal may be distributed for the beneficiaries' health, education or welfare, or support or maintenance.

If the Grantor utilizes an existing policy by transferring said policy into the Trust rather than creating a new policy, the value of the initial gift is the "interpolated terminal reserve value" according to Regs. Section 25.2512-6 (a). This value can be obtained by requesting the interpolation from the insurance company. If the decedent had transferred

all rights or interest in the policy to the Trust within three (3) years of death, the proceeds come back into the estate since it was deemed to be a gift within three (3) years of death. IRC § 2035(d)(2). If the Grantor purchases a new policy to fund the ILIT, the insurance is deemed part of the insured's estate if he or she dies within three (3) years of the issuance of the policy.

At its heart, the ILIT uses the annual tax-free gifting to beneficiaries as the device which serves to exclude the insurance proceeds from the Estate. According to Crummey v. Commissioner, 68-2 USTC Par. 12,541 (9th Cir. 1954), the Court held that the payment of the premium would qualify for the annual gift exclusion if the beneficiary "had the present right, whether exercised or not, to withdraw from the trust corpus amounts from the annual contributions." Therefore, the Trustee must send the beneficiaries annual notices in a timely manner indicating that the beneficiary has the right to withdraw the cash value of the gift within a certain amount of time. That is, they have the right to demand up to their pro rata share of the annual premium up to the amount of the then current annual gift exclusion (presently $12,000). The beneficiary must have actual notice and must have approximately thirty (30) days to respond. The notice may be given to a guardian if the beneficiary is a minor. Each beneficiary must be given separate notice. The case of Cristofani v. Commissioner, 97 TC No. 5 (1661) acq. 1992-1, C.B. 1, held that contingent beneficiaries also need to be notified. If the time lapses and the child does not exercise his or her right of withdrawal, the lapse itself is considered an exercise of the gift according to IRC §2514 (b). [1]

[1] "Tax Aspects of Elder Law", NJ ICLE
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