Estate Tax Concepts

IRREVOCABLE LIFE INSURANCE TRUST

Presented for

Valued Client

Presented by

John M. Webster

HMS Insurance Associates, Inc.

johnwebster@financialguide.com

443-632-3436

IRREVOCABLE LIFE INSURANCE TRUST

The Concept…

- With an irrevocable trust, the grantor gives up all rights to transferred property with no ability to revoke, terminate or modify the trust in any material way.
- When an irrevocable trust simply holds a life insurance policy—usually on the grantor's life—it's called an irrevocable life insurance trust.
- If the trust beneficiaries are granted limited withdrawal powers, it may also be called a "Crummey trust," named after the taxpayer in a famous court case approving certain powers.

Uses…

Irrevocable life insurance trusts (ILITs) are recommended by estate advisors to:

- Meet estate liquidity needs.
- Provide income to survivors after estate liquidity costs have been met.
- Avoid federal estate tax on the life insurance proceeds.
- Shelter trust property from creditors when the grantor dies.

Funding…

- An ILIT may be funded or unfunded. An unfunded trust is the most common.
- With an unfunded life insurance trust, there is no other property in the trust. The trust pays premiums with annual gifts from the grantor.
- In a funded ILIT, the grantor initially transfers cash or other property to the trust that the trustee uses to pay the life insurance premiums. The drawback is that income earned on the property inside the trust will be taxed to the grantor if it can be used to pay premiums on a policy insuring the grantor or the grantor's spouse.

The Process…

- The grantor creates an ILIT during life and names the trust beneficiaries—usually family members (spouse, children or grandchildren and their spouses).

IRREVOCABLE LIFE INSURANCE TRUST

- The trust holds a life insurance policy insuring the grantor and/or a spouse. The grantor may transfer an existing policy to the trust, or cash or other property that the trust will use to acquire a new policy.
- In an unfunded ILIT, the grantor makes annual transfers to the trust so the trustee can pay the premiums. The annual transfers are considered gifts to the trust beneficiaries.
- Since the beneficiaries can't "enjoy" the gifts immediately, they are considered gifts of a "future interest" for gift tax purposes. This would mean that there is no gift tax annual exclusion ($14,000 per donee in 2017) available to shelter the annual transfers from tax.
- To make them into gifts of a "present interest" and make use of the gift tax annual exclusion, trust beneficiaries can be granted special withdrawal powers—called Crummey powers—that give them the ability to withdraw the gift within a limited amount of time.
- Gifts in excess of the annual exclusion can be sheltered by the applicable lifetime exclusion for estate and gift taxes equal to $5.49 million in 2017.

Creating Estate Liquidity…

- Suppose the grantor-insured dies and the policy proceeds are paid to the trust. The trust can make the proceeds available to the grantor's estate by authorizing the trustee to purchase illiquid assets from the estate or make loans to the estate.
- Either way, cash ends up in the executor's hands when it's needed to pay funeral costs, last illness expenses, estate taxes, probate expenses, and the claims of creditors.

The Tax Picture…

- It's critical that the trust document authorizes, but does not require, the trustee to purchase estate assets or make loans to the executor. If it's a requirement, the policy proceeds will likely be included in the grantor-insured's gross estate and subject to tax.
- If the trustee purchases an asset from the estate, it should be for a fair price. If the trustee "overpays" to provide additional cash to the estate, it could be included in the gross estate as a taxable distribution of trust income. The result is the same when the trustee makes a loan to the estate on much more favorable terms than prevailing market conditions.

- Other factors required to keep the trust assets—including the insurance proceeds—out of the grantor-insured's gross estate include:
  - The trust must be irrevocable.
  - The grantor cannot be the trustee.
  - The grantor cannot have a right to any incidents of ownership in the life insurance policy.
  - The insurance proceeds can only be used to purchase estate assets or make loans to the estate in reasonable arm's-length transactions—not to pay estate costs directly.
  - The insured must live for at least three years after transferring a policy to the trust.

The Bottom Line…

An irrevocable life insurance trust is an estate planning tool that can create funds for estate liquidity and beneficiary needs, with the added advantage of keeping life insurance proceeds out of the taxable estate.

IRREVOCABLE LIFE INSURANCE TRUST

SUMMARY

What Is an Irrevocable Life Insurance Trust?

In creating an irrevocable trust, the grantor must give up all rights in the transferred property, retaining no ability to revoke, terminate or modify the trust in any material way.

When the trust holds a life insurance policy—usually insuring the life of the grantor or the grantor's spouse—it's an irrevocable life insurance trust, or ILIT. If the trust beneficiaries are given withdrawal powers, it may also be called a "Crummey trust."

ILITs are used to accomplish certain objectives: to meet the liquidity needs of the grantor's estate, provide income for survivors, avoid estate tax on life insurance proceeds, and shelter property in the trust from creditors at the grantor's death.

Funded or Unfunded?

In an unfunded life insurance trust, the trustee relies on annual gifts from the grantor to pay premiums. These annual transfers are considered gifts to the trust beneficiaries. Since the trust beneficiaries cannot "enjoy" these gifts immediately, these gifts would ordinarily be considered gifts of a "future interest." That means no annual gift tax exclusion ($14,000 per donee in 2017) would be available to shelter the transfers from the federal gift tax. However, the grantor can convert those gifts of a future interest into gifts of a present interest by giving trust beneficiaries special limited withdrawal powers called Crummey powers. This allows the grantor to make use of the annual gift tax exclusion. Gifts in excess of the annual exclusion can be sheltered by the applicable lifetime exclusion for estate and gift tax equal to $5.49 million in 2017.

In a funded life insurance trust, the grantor initially transfers cash or other property to the trust, which the trustee uses to pay premiums. The major drawback of a funded life insurance trust is that income earned on property in the trust will be taxed to the grantor if it can be used to pay premiums on a policy insuring the life of the grantor or the grantor's spouse.

Avoiding the Estate Tax

The trust principal—including the life insurance—generally avoids the federal estate tax if:

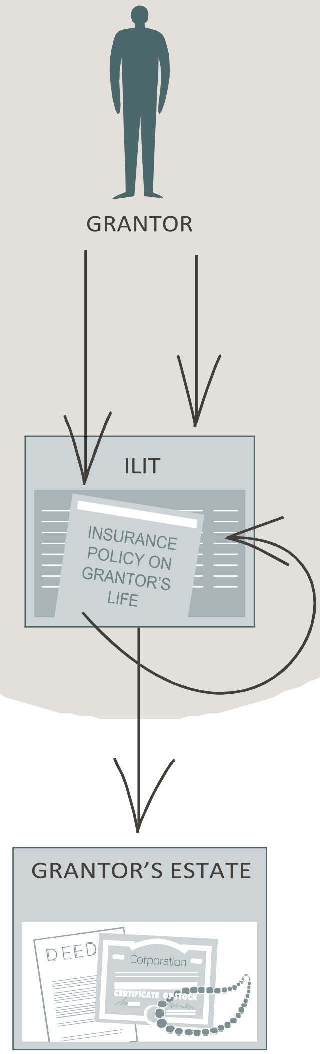
- the trust is irrevocable
- the grantor is not the trustee
- the grantor-insured has no incidents of ownership in the insurance
- the insurance proceeds are only used to purchase estate assets or to make loans to the estate, not to pay estate costs directly
- the insured lives for at least three years after transferring the policy to the trust

The irrevocable life insurance trust is clearly an effective estate planning tool. It can create funds for estate liquidity and other uses precisely when they're needed, and it keeps life insurance proceeds out of the gross estate.

IRREVOCABLE LIFE INSURANCE TRUST

1

The grantor creates an irrevocable life insurance trust (ILIT) and funds it with an Existing life insurance policy or a new policy purchased by the trustee. The grantor may not have any incidents of ownership in the policy.



2

If the grantor also funds the trust with cash to cover insurance premiums, the trust income is taxed to the grantor.

3

More often, the grantor makes annual gifts to the trust to cover the premiums. These gifts are only sheltered by the gift tax exclusion if the trust beneficiaries have Crummey powers—the power to withdraw the annual gift within a specified window of time.

4

At the grantor's death, the trust receives the insurance proceeds. Because the proceeds are outside the estate, they avoid the estate tax.

5

To ensure estate liquidity, the trustee is authorized (not required) to use the proceeds to purchase illiquid assets from the estate or make loans to the estate. Whatever remains goes to the trust beneficiaries.

This service is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that neither the publisher nor any of its licensees or their distributees intend to, or are engaged in, rendering legal, accounting, or tax advice. If legal or tax advice or other expert assistance is required, the services of a competent professional should be sought.

While the publisher has been diligent in attempting to provide accurate information, the accuracy of the information cannot be guaranteed. Laws and regulations change frequently, and are subject to differing legal interpretations. Accordingly, neither the publisher nor any of its licensees or their distributees shall be liable for any loss or damage caused, or alleged to have been caused, by the use of or reliance upon this service.