IRREVOCABLE LIFE INSURANCE TRUSTS

What Is an Irrevocable Life Insurance Trust?

An irrevocable life insurance trust allows the proceeds of life insurance to pass to the insured's intended beneficiaries without being subject to estate tax in the estate of the insured or the estate of the insured's spouse. The trust also protects insurance proceeds from claims against the insured's estate.

If the family will need cash after the death of one spouse, the trust can own a policy on that spouse's life only. If the family's estate plan is such that estate taxes will be due only on the death of the surviving spouse, the trust can hold a second-to-die policy on the life of both spouses. The availability of life insurance proceeds in a separate trust could allow specific assets (such as real estate or a closely held business) to pass to family members rather than being sold to pay debts, taxes, and other expenses. The assets in the trust would not be counted as part of the insured's estate, but could be a source of liquid funds for the estate.

How Is an Irrevocable Life Insurance Trust Created and Administered?

Generally, after the trust agreement is created, the grantor makes a cash gift to the trustee, who uses the cash to purchase a life insurance policy on the grantor's life. The trustee applies for the insurance policy. Alternatively, the grantor may assign an existing life insurance policy on his or her life to the trustee. A drawback of transferring an existing policy is that if the insured dies within three years after transferring the policy to the trust, the insurance proceeds will be included in the insured's taxable estate.

The trustee will be designated as both the beneficiary and the owner of the policy. The insured must not retain any incidents of ownership in the life insurance policies—that is, the insured must have no power to change the beneficiary, surrender or cancel the policy, assign the policy or pledge it for a loan, borrow against the policy, control the time or manner for payment of proceeds, or otherwise obtain any economic benefit from the policy. The insured should not be a trustee of the trust. If the trust owns a second-to-die insurance policy, neither spouse should be a trustee.

In addition to the insurance policy, the trust may be funded with other assets that will generate income to pay the insurance premiums. If the trust is funded with assets that earn income, however, trust income taxes will be a consideration. If the trust holds only the insurance policy, there will be no trust income taxes, but the trustee will need a source of funds to pay the annual premiums. The grantor will need to make additional cash gifts to the trust so that the trustee can pay the annual insurance premiums.

What Are the Gift Tax Consequences of Creating an Irrevocable Life Insurance Trust?
A gift to an irrevocable trust (i.e., the original transfer of the life insurance policy, as well as any additional transfers for payment of premiums) is a gift to the trust beneficiaries of a future interest that would ordinarily be subject to gift tax. In order for these transfers to qualify for the annual exclusion from gift tax ($15,000 per year per donee for 2018), the beneficiaries of the trust must be given a power (known as a "Crummey power," after the taxpayer whose court case upheld this technique) to withdraw their proportionate share of each gift to the trust. The trustee will give annual "Crummey notices" to the beneficiaries notifying them of their withdrawal rights after each gift to the trust. The withdrawal right can be available for a limited period of time (usually thirty to sixty days) and then lapse.

Since the Crummey power is considered a general power to appoint the ownership of property, its lapse can create additional gift tax issues for the beneficiaries. These issues will not arise if each beneficiary's annual right to withdraw is limited to the greater of $5000 or 5% of the trust principal. If the annual insurance premium will exceed $5000 multiplied by the number of beneficiaries, however, additional provisions should be included in the trust agreement to address the gift tax problem.

If any transfer to the trust exceeds the annual gift tax exclusion amount, then the donor must file a gift tax return and a portion of the donor's lifetime gift tax exclusion amount would be used. There are additional gift tax considerations if the trust is designed to be a generation-skipping trust to continue for the benefit of the insured's grandchildren.

What Happens to the Trust when the Insured Individual Dies?
On the death of the insured, the policy proceeds are paid to the trustee. If cash is needed for payment of estate taxes, the personal representative of the estate can borrow from the life insurance trust or sell estate assets to the life insurance trust for cash. The trust should not give the trustee the right to pay estate taxes directly, nor legally require the trustee to provide cash to the estate. This would cause the insurance proceeds to be included in the insured's taxable estate. The trustee may distribute funds remaining in the trust among the trust beneficiaries or continue to hold them in trust, depending on the terms of the trust agreement.

Are There Disadvantages to Creating an Irrevocable Life Insurance Trust?
One disadvantage of holding life insurance in an irrevocable trust is that the trust is irrevocable. The insured does not have the power to change the beneficiaries or to cash in or borrow against the life insurance. The insured can, however, stop making gifts to the trust for payment of the policy premiums and allow the insurance to lapse.

Another disadvantage of the life insurance trust is the administrative cost of maintaining the trust and providing annual Crummey notices as necessary. An alternative to the irrevocable life insurance trust is for the intended beneficiaries to own the life insurance policies directly. This could be a simpler arrangement if the intended beneficiaries are adults other than the surviving spouse. The insured can still make annual exclusion gifts to pay the premiums, without the need to use Crummey notices. If an individual beneficiary owns the policy, however, there can be complications if the owner/beneficiary dies before the insured. Another potential disadvantage to individual ownership is that there is less assurance that the insurance proceeds will be made available to pay taxes and debts of the insured's estate.

A trust is also preferable to an individual beneficiary/owner if the grantor wants to provide for ongoing professional management and investment of the insurance proceeds and to protect the proceeds from the claims of the beneficiaries' creditors.

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