Protecting Life Insurance Proceeds: An Irrevocable Life Insurance Trust Review

Are you aware that an irrevocable life insurance trust can be used to remove life insurance proceeds from your taxable estate, so that your beneficiaries receive the entire amount undiminished by estate taxes?

Table of Contents	Page

Ask Yourself…

- Do you want to protect the value of your estate from shrinkage due to the payment of estate settlement costs at your death?
- Do you want your family to have funds available to replace your earning power at your death?
- Do you want to make plans to provide for your children from a prior marriage at your death?
- Will your heirs need cash to continue operating a family business at your death?
- Do you want to make a substantial gift to charity, without depleting the size of your estate that passes to your heirs?
- Would you like the value of insurance proceeds on your life to pass to your heirs transfer tax free and outside of probate?

If the answer to one or more of these questions is "yes," then an irrevocable life insurance trust may be the solution.

What Is a Trust?

The word "trust" is applied to all types of relationships, both personal and business, to indicate that one person has confidence in another person.

For our purposes, a trust is a legal device for the management of property. Through a trust, one person (the **"grantor"**) transfers the legal title to property to another person (the **"trustee"**), who then manages the property in a specified manner for the benefit of a third person (the **"trust beneficiary"**). A separation of the legal and beneficial interests in the property is a common denominator of all trusts.

In other words, the legal rights of property ownership and control rest with the **trustee**, who then has the responsibility of managing the property as directed by the **grantor** in the trust document for the ultimate benefit of the **trust beneficiary**.

A trust can be a **living trust**, which takes effect during the lifetime of the grantor, or it can be a **testamentary trust**, which is created by the will and does not become operative until death.

In addition, a trust can be a **revocable trust**, meaning that the grantor retains the right to terminate the trust during lifetime and recover the trust assets, or it can be an **irrevocable trust**, meaning that the grantor cannot change or terminate the trust or recover assets transferred to the trust.

What Is an Irrevocable Life Insurance Trust?

While there are many different types of trusts, our focus is on an irrevocable life insurance trust…a trust with the primary purpose of owning a life insurance policy in order to remove life insurance proceeds from the taxable estate and, as a result, avoid paying estate taxes on those proceeds.

While life insurance proceeds usually pass to the beneficiary free of federal income tax, they are subject to federal estate tax if included in the insured's estate at death. If the estate exceeds a certain value, this means that a portion of the life insurance proceeds, if included in the taxable estate, could go to pay federal estate taxes instead of being available to the beneficiaries:

If you die in:	And the value of your estate, as indexed for inflation, exceeds:	Your taxable estate is subject to tax rates from/to:
2020	$11,580,000	18%/40%
2021	$11,700,000	18%/40%

The objective of an irrevocable life insurance trust is to remove life insurance proceeds from the taxable estate so that the beneficiaries receive the entire amount, undiminished by estate taxes.

How Is an Irrevocable Life Insurance Trust Funded?

An irrevocable life insurance trust can be funded **either** by transferring ownership of an existing life insurance policy to the trust, **or** by purchasing a new life insurance policy:

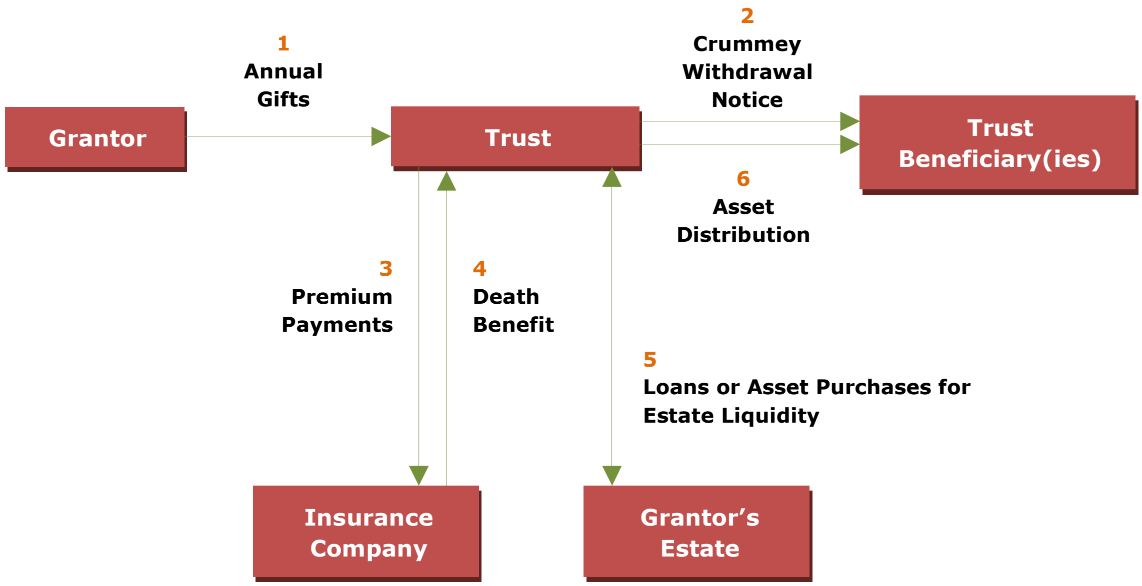
- **Transfer of existing policy:** While an existing life insurance policy can be transferred to an irrevocable life insurance trust, there are "strings attached." If the gift of an existing life insurance policy is made within three years of the grantor/insured's death, the value of the life insurance proceeds are brought back into the estate for federal estate tax purposes.

- **Purchase of new policy:** Assuming the grantor is insurable, it may be preferable to make cash gifts to the trust, which then purchases a new insurance policy on the grantor's life. Since the grantor/insured never held any "incidents of ownership" in the new policy, the insurance proceeds should not be included in the taxable estate, even if death occurs within three years of the insurance purchase by the trust.

In situations where the trust will need to make premium payments, a typical irrevocable life insurance trust arrangement calls for the grantor/insured to make annual gifts to the trust, which are then used to pay the life insurance premiums. In order for those gifts to qualify for the annual gift tax exclusion ($15,000 in 2021), the gifts must qualify as a "present interest gift." This can be accomplished by including a "Crummey" withdrawal power in the trust.

A Crummey withdrawal power (the name derives from a court case, *Crummey v. Comm.*) gives the trust beneficiary a noncumulative, annual right to demand withdrawal from the trust. For the demand right to be legitimate, the trustee must provide the beneficiary with notice of annual trust contributions and provide an adequate amount of time, such as 30 days, for the demand right to be exercised. If the demand right is exercised, the trustee must deliver the funds to the beneficiary. If the demand right is not exercised, the annual gift is then available for the trustee to use for premium payment purposes. Since the beneficiary stands to ultimately benefit from the trust and since a demand withdrawal from the trust may affect the grantor's decision as to future gifts to the trust, beneficiaries generally understand that making a demand withdrawal is not in their best interest.

An Irrevocable Life Insurance Trust in Action



1. The grantor makes an annual gift to the irrevocable life insurance trust sufficient to pay the premiums on the life insurance policy owned by the trust.

2. The trustee provides a notice to the trust beneficiary(ies) of the annual trust contributions subject to withdrawal, qualifying the gift for the annual gift tax exclusion.

3. Assuming the trust beneficiary(ies) do not exercise their withdrawal right, the trustee then uses the gift to pay the life insurance premiums.

4. When the grantor/insured dies, the life insurance death benefit passes income and estate tax free to the trust.

5. If needed for estate liquidity purposes, the trustee can loan money to the estate or purchase assets from the estate.

6. Finally, the trust assets are distributed to the trust beneficiary(ies) according to the terms of the trust document.

Irrevocable Life Insurance Trust Tax Considerations

- If an existing life insurance policy is given to the trust, the value of the policy is subject to gift tax, but only if it exceeds the annual gift tax exclusion. The value of the policy is generally based on the policy's interpolated terminal reserve value, a value that is usually close to the cash surrender value.

- If death occurs within three years of giving an existing life insurance policy to the trust, the value of the death proceeds will be brought back into the estate for federal estate tax purposes.

- Annual gifts made to the trust for premium payment purposes must be subject to the Crummey withdrawal powers in order to qualify for the annual gift tax exclusion ($15,000 in 2021). Alternatively, gifts will be subject to the unified federal gift and estate tax, but qualify for the lifetime exemption equivalent ($11,700,000 in 2021).

- The death benefit payable to the trust will not be included in the insured's taxable estate, assuming the insured held no incidents of ownership in the policy at death.

- Death benefits are generally received free of federal income tax.

Uses of an Irrevocable Life Insurance Trust

An irrevocable life insurance trust can be put to a variety of uses:

- If your estate is likely to face a federal estate tax liability, an irrevocable life insurance trust can replace funds used to pay the estate tax, without the death proceeds also being subject to the estate tax.

- If your heirs are likely to need additional estate liquidity after your death, such as to continue a family business, an irrevocable life insurance trust can provide that liquidity, again without the insurance proceeds being subject to the federal estate tax.

- If you want to control how death proceeds are distributed, you can do so through the provisions included in an irrevocable life insurance trust.

- If you have children from a prior marriage, but want your current spouse to be the primary beneficiary of your estate, naming your children the beneficiaries of an irrevocable life insurance trust can provide them with a distribution at your death, rather than at your surviving spouse's later death.

- If you want to leave your loved ones a substantial life insurance estate, an irrevocable life insurance trust can be used to pass the full value of life insurance proceeds to your heirs estate tax free.

- If you want to make a substantial bequest to a charity, either during your lifetime or at your death, an irrevocable life insurance trust can play a wealth replacement role, with the proceeds from the trust replacing for your heirs the value of assets given to charity.

If you are considering use of an irrevocable life insurance trust, however, it is important that you also evaluate the potential drawbacks of this arrangement:

- Since the trust is irrevocable, you relinquish control of the life insurance policy and annual gifts made to the trust. In addition, once the trust document is executed, you cannot change the terms or terminate the trust.

- If the trust contains the Crummey withdrawal provision in order to qualify the gifts to the trust for the annual gift tax exclusion, a beneficiary may exercise his or her right to demand a withdrawal.

- There is some expense involved. In addition to possible trustee fees, you should consult with an attorney experienced in estate planning in order to avoid unforeseen tax and distribution consequences.

Irrevocable Life Insurance Trust Action Checklist

- ☐ **Grantor and Attorney:** Draft and execute a trust agreement; name a trustee.
- ☐ **Grantor, Trustee and Financial Professional:** Transfer existing life insurance policy to the trust or apply for a new life insurance policy, naming the trustee as policy owner and beneficiary.
- ☐ **Grantor:** Make cash gifts to the trust.
- ☐ **Trustee:** If applicable, send Crummey withdrawal notices to beneficiary(ies).
- ☐ **Trustee:** Pay the life insurance premiums.
- ☐ **Trustee:** Upon the grantor's death, manage the insurance proceeds and make distributions according to the terms of the trust.

A Note About Naming a Trustee

While an individual or a corporation, such as a bank or trust company, can be named to serve as trustee of an irrevocable life insurance trust, **the insured must not be the trustee.** Naming the insured as trustee will cause the life insurance proceeds to be included in the insured's taxable estate!

The spouse can be named as trustee, but the attorney may have to include special provisions in the trust agreement in order to avoid adverse tax consequences. If, however, second-to-die life insurance is used in the trust, the spouse should **not** be named as trustee.

Finally, it is generally recommended that the trustee of an irrevocable life insurance trust not be the same as the estate's personal representative (executor). Reason: Conflicts between the trust and the estate may arise after the grantor's death.

Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

Life insurance contracts contain exclusions, limitations, reductions of benefits and terms for keeping them in force. All contract guarantees are based on the claims-paying ability of the issuing insurance company. Consult with your licensed financial representative on how specific life insurance contracts may work for you in your particular situation. Your licensed financial representative will also provide you with costs and complete details about specific life insurance contracts recommended to meet your specific needs and financial objectives.

NOTE ABOUT THE FEDERAL ESTATE TAX: Whether your estate is actually subject to the federal estate tax will depend on the size of your estate, the year you die and whether future Congressional action modifies the estate tax rules.

U.S. Treasury Circular 230 may require us to advise you that "any tax information provided in this document is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. The tax information was written to support the promotion or marketing of the transaction(s) or matter(s) addressed and you should seek advice based on your particular circumstances from an independent tax advisor."

© VSA, LP All rights reserved (VSA 1c1-03 ed. 01-21)