CHAPTER 60

Irrevocable Life Insurance Trusts

BRUCE G. KAUFMANN (Clearwater, Florida)

HOW TO HAVE YOUR CAKE AND EAT IT TOO.

Iam Taxpayer and his wife, Ima Taxpayer, have a serious problem. They started a family business on a large parcel of inexpensive land many years ago. The children, who are looking forward to transitioning into positions of ownership and control, are involved in the business. The Taxpayers have acquired other valuable but non-liquid assets. What is the problem? The family business is very successful and very valuable. The land upon which the business sits has become very valuable due to the the discovery of mineral-rich deposits and the subsequent growth of a community to service the mines and related industries. The problem is that the Taxpayers are non-liquid asset "rich" and for estate tax-paying purposes, cash "poor."

The Taxpayers have not considered the estate tax consequences of such valuable assets. Iam, being the husband, the male, and the older of the two, is expected to die first. Iam can pass his share to his wife without significant estate tax consequences because of the unlimited marital deduction. However, upon Ima's death, the entire estate will be heavily taxed because it will all be in Ima's estate. However, the business and the land, while very valuable, will not be easily liquidated. Therefore it will be difficult for their beneficiaries, their children, to pay the impending federal estate tax. The business, or the land, or both, will have to be sold in order to pay the expected 45% estate tax.

What is the estate tax solution? The Taxpayers should consider an irrevocable life insurance trust (ILIT). The Taxpayers should consider their potential estate tax burden and then increase it based upon expected asset appreciation and their life expectancies. One or both should apply for life insurance in death benefit amounts sufficient to pay for the cost of the anticipated estate tax liability.

Assuming they are insurable, they should then create the ILIT. There is no need to create an ILIT if the Taxpayer(s) are not insurable. The ILIT must be irrevocable in order to avoid having the death benefit included in the value of the estate at the time of the Taxpayer's death, thereby increasing the taxable estate and the estate tax liability. Irrevocable means that once the trust is put in place and funded the trust cannot be changed. Therefore, it is wise to think through the selection of trustee and successor trustee(s), and also to consider including provisions for a trust protector, who, among other things, can remove and replace trustees. It is also important to think through the selection of beneficiaries and the terms of the ILIT.

The Taxpayers can then fund the ILIT by:

1. Transferring an existing life insurance policy into the ILIT;
2. Transferring enough money into the ILIT to fund a new single premium paid up endowment life insurance policy;
3. Transferring money into the ILIT bank account set up by the trustee with the new taxpayer identification number for the ILIT, which the trustee will use to pay the initial premium for the purchase of a new life insurance policy and making arrangements to fund the annual premium payment each year with further gifts; or
4. The trustee can arrange a premium financing plan to purchase a new life insurance policy.

However, if the Taxpayers want to put an existing life insurance policy into the ILIT the Taxpayers must transfer the ownership of the policy into the name of the trustee, and the beneficiary must be the ILIT. The transfer of ownership must be irrevocable. The Taxpayers must not be able to borrow on the existing life insurance policy or the life insurance policy will still be considered a part of the taxable estate upon the death of the Taxpayer. The Taxpayer must then live for a minimum of three more years for the life insurance policy, its cash value, and or its death benefit to be excluded from the Taxpayer's estate. It is important to note that the transfer of cash value to an ILIT may trigger a gift taxable event and/or cause the use of some or all of your lifetime gift tax exclusion. This gift tax complication and the three year "wait and see" rule is the reason why many ILITs purchase new life insurance policies.

The Taxpayers must give enough money to the trust bank account for the trustee to pay the policy premium(s). Using the ILIT concept as soon as possible is important for timing and funding purposes. Life insurance becomes more expensive the older an insured person becomes. The more money that has to be transferred into the trust bank account to fund the life insurance policy premium, the more likely that a taxable gift event will occur, or that the lifetime gift tax exclusion will be used.

The Taxpayers will need to put a plan in place to gift money to the trust bank account so that the trustee can pay the life insurance premiums on behalf of the trust. If the amount needed is substantial, it may be necessary to consider the use of a "Crummey" trust. The "Crummey" trust refers to a situation where the Taxpayers gift money to the trust for the benefit of the beneficiaries, their children, with the idea that the beneficiaries will benefit from the life insurance policy being in place and pay the proceeds to the beneficiaries on the death of the Taxpayers. However, the beneficiaries have to be given notice and a reasonable time in which to take the gift out of the trust before it is used to pay the life insurance policy premiums.

The Taxpayers need to be sure that the beneficiaries, their children, understand the purpose of the ILIT so that they will decide not to exercise their "Crummey" powers and take out the gift. After the beneficiaries have been notified of the gifts and their right to exercise their "Crummey" powers and take out the gifts, and the time (e.g., 30 days) has expired for those rights to be exercised and the beneficiaries have not exercised their rights, then the trustee has the necessary money to pay the annual premium.

The value of the death benefit is paid to the ILIT. The trustee then takes the policy proceeds and performs the trustee's duties according to the terms of the ILIT. One of the terms of the trust should be the power to pay estate taxes due on the deceased Taxpayer's estate. Paying estate taxes with the assets of the ILIT frees up the non-liquid assets (i.e., the land and the family business). Now the children of the deceased Taxpayers do not have to sell the land or the business to pay estate taxes.

The trustee could also utilize the idea of an over-funded premium financed life insurance policy. This concept requires the trustee to borrow a large enough amount of money to overpay the premium into a life insurance policy on the life of the Taxpayer. The excess cash value then increases with the underlying investment and pays the annual premiums. After several years, the increased cash value is used to pay off the loan and the remaining cash value continues to pay the premiums on the life insurance policy. If the Taxpayer dies before the loan is paid off, then the policy death benefit is used to pay off the loan and the remaining death benefit is paid to the ILIT. Once again, properly calculating the expected estate burden and policy loan so that the life insurance death benefit is sufficient to meet all the ILIT's purposes is very important.

Ultimately, utilizing an ILIT allows Iam Taxpayer and Ima Taxpayer to keep their land and family business intact for their children and still pay the estate tax burden to the government. This is like having your cake and eating it too.

Bruce G. Kaufmann, J.D., P.A. of Clearwater, Florida, has been assisting clients in handling their complicated estate planning and tax-paying issues with unique creative legal solutions for nearly 30 years.

Life Insurance Trusts Compared

	IRREVOCABLE	REVOCABLE
Grantor can select trustee to manage insurance proceeds.	X	X
Insurance proceeds are removed from the insured's estate.	X	
Grantor can determine under terms of the trust when beneficiaries receive proceeds.	X	X
Assets in the trust are not subject to probate.	X	X
The trust is ignored for income tax purposes.		X
Grantor loses the ability to control the trust's assets.	X	
Terms of the trust can be altered or amended to fit the grantor's changing circumstances.		X
The trust must have special provisions (Crummey) in order for gifts to the trust to qualify for the annual gift tax exclusion.	X	