Irrevocable Life Insurance Trust for a Married Couple

Since estate taxes are imposed upon all of the assets in the estate, many people prefer to pay the taxes by rearranging some of these assets instead of relying on their current income.

One method of achieving this goal is the irrevocable life insurance trust (ILIT). To prevent inclusion in the estate, an irrevocable trust cannot be revoked or amended by the grantor.

- **Funded irrevocable insurance trusts:** This trust has income-producing assets transferred into it which will pay the premiums on the insurance policy from the income earned. Irrevocable life insurance trusts are typically not funded with a single, lump-sum payment because the gift taxes on the assets transferred are the same as the federal estate taxes on assets remaining in the estate. Also, if the trust is a "grantor trust" for income tax purposes, the income earned on the assets would still be included on the income tax return of the insured grantor. See IRC Sec. 677(a)(3).
- **Unfunded irrevocable insurance trusts:** Although this trust is not totally unfunded, it usually just owns an insurance policy and the grantor makes annual gifts to the trust with which the trustee can pay the premiums.

Additional Considerations

- **Trust is irrevocable:** This means that the grantor cannot get anything out once it is put into the trust. Some suggest that a special power of appointment in the hands of the insured's child would permit that child to appoint the trust assets back out to the insured or others. In an uncertain estate planning environment, this flexibility may be very desirable. The trustee would need to be authorized to reappoint trust assets without liability to the trust beneficiaries.

- **Annual gift tax exclusion may be lost:** Contributions to the trust are generally "future" interests instead of "present" interests. Future interests typically do not qualify for the $18,000 (in 2024) annual gift tax exclusion. This concern can be overcome by granting to the beneficiaries a limited power to withdraw certain sums from the trust for

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a short time after the grantor makes the contribution. This is sometimes referred to as a Crummey provision after the case which decided the validity of this technique (Crummey vs. U.S., 397 F.2d 82 (CA-9, 1968)). The rules set forth in this case and subsequent rulings must be carefully followed. Crummey power holders should be actual trust beneficiaries; however, the tax court allowed annual gift tax exclusions for contingent beneficiaries (e.g., children, grandchildren, etc.) who were given withdrawal rights (Est. of Maria Cristofani vs. Comm., 97 T.C. 74 (1991)).

- **Non-exercise of withdrawal powers:** The failure of a beneficiary to withdraw the amounts permitted under the Crummey provision will cause a lapse of that power. Lapsed amounts in excess of specified limits (the greater of $5,000 or 5% of the assets subject to the power) are generally considered to be taxable gifts from the beneficiary. However, if the beneficiary is given a limited power to appoint the amount in excess of these limits (e.g., in his or her will), the power is deemed not to lapse and therefore no gift tax is due.

  Another strategy used to deal with this problem is referred to as a “hanging” power. It limits the amount which lapses each year to the larger of $5,000 or 5% of trust assets. Any amount in excess of this limit “hangs” or carries over to later years. The IRS has, in one situation stated its opposition to this method. See TAM 8901004.

- **Three-year rule:** If an existing life policy is gifted by the insured to an irrevocable life insurance trust and the insured dies within three years of the transfer, the policy proceeds will be included in the insured’s estate. IRC Sec. 2035. On the other hand, if the trustee uses cash in the trust to purchase a new policy on the insured’s life and the insured dies within the three-year period, the proceeds will generally be excluded from his or her estate. Care should be taken to make certain that the insured has no incidents of ownership in the policy or control over the trustee.

- **Second-to-die policies:** Second-to-die or survivor life policies do not pay the proceeds until both spouses are deceased, which is when the death taxes generally become due. Premiums on a single second-to-die policy are generally lower than the combined premiums on two individual policies, allowing a couple to obtain a larger face amount of insurance. If the surviving spouse will need policy proceeds to live on, however, this type of policy should generally not be used.

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Seek Professional Guidance

Because of the complexity involved, the guidance of appropriate tax, legal, and other financial professionals is highly recommended.

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