IRREVOCABLE LIFE INSURANCE TRUST:
HOW TO DOUBLE THE POST DEATH TAX VALUE OF LIFE INSURANCE

In the estate planning area, the classic credit shelter trust can be utilized to give over $3,000,000 of assets to the children free of federal death taxes after both spouses have passed away. For marital balance sheets in excess of this amount, other estate planning tools can be used to further minimize the federal death taxes. One of the more frequently used tools is the irrevocable life insurance trust.[1]

In concept, the life insurance trust is very simple. ownership of a life insurance policy is transferred to the trust and the trust is then designated as the beneficiary of the policy. If the insured lives for more than three years after transferring ownership of the policy to the trust, then the life insurance proceeds are not taxed in the insured's estate nor the insured's spouse's estate. Absent an irrevocable life insurance trust, the proceeds would be taxable in at least one estate. Although Pennsylvania exempts life insurance from inheritance taxes, the IRS does not. For IRS purposes, the taxable estate includes virtually anything and everything which is owned, as well as the death benefit value of any life insurance policies on the decedent's life for which the decedent was the owner.

The tax savings achieved by the irrevocable life insurance trust is in addition to the $3,000,000 or more of property which can be transferred on a federal tax-free basis using the standard credit shelter trust vehicle. The federal tax rates at the $3,000,000 mark are 41% and escalate to even higher marginal tax brackets for larger estates. Accordingly, the utilization of an irrevocable life insurance trust can result in as much as twice as much money passing to the ultimate beneficiaries as would otherwise have been the case had the benefits been subject to federal estate taxes.

In addition to transferring an existing policy to this type of trust, it is also possible to create the trust and then have the trust apply for a life insurance policy. In this situation, current case law provides that there is no three-year wait before the tax advantages are achieved. Accordingly, for significant marital estates, any new life insurance policies should be applied for directly by an irrevocable life insurance trust.

The tremendous tax savings capability of the trust is its major advantage. There are, however, some particular nuances which should be considered.

The trust is irrevocable. Once the policy is transferred to the trust, the trust cannot be changed or undone by the person setting up the trust (i.e., the insured). From a practical standpoint, however, allowing the policy to lapse will effectively terminate the trust. But, this presents the problem of obtaining replacement insurance in the event that the insured is then uninsurable or in a different risk category. It is also possible to include special provisions in the trust which allow someone other than the person setting up the trust (such as a child or a spouse) to withdraw assets (including a life insurance policy) from the trust. The special withdrawal powers must be very carefully drafted in order to avoid creating adverse estate tax problems.

Each time money is transferred to the trust for a premium payment, or a policy is assigned to the trust, certain paperwork procedures must be followed in order to avoid adverse gift and estate tax consequences. The $11,000 per year per donee gift tax exclusion only applies to present interest gifts. Present interest gifts are those which can be immediately spent. However, the gift to a trust is a future interest gift since the beneficiary cannot access and freely spend the gifted amount. In order to convert the future interest gift to a present interest gift, the trust provides that the trustee must give the beneficiaries written notice of the amount of the gift and allow each beneficiary to withdraw a pro rata portion of it. The trust document usually provides that this withdrawal right terminates after a relatively short period of time.

Thus, when a premium is to be paid, the proper procedure is for the dollar amount of the premium payment to be gifted to the trust. The trustee then sends out the requisite notice letters to the beneficiaries. After the period of time specified in the trust, the trustee will then issue a check to the insurance company in payment of the premium. To do this, the trust will need to establish its own bank account and apply for its own tax identification number.

Sending the notification letters to the beneficiaries is extremely important from a gift and estate tax standpoint. If the notification letters are not sent, the $11,000 per donee gift tax exclusion will not apply, and theinsured's $1,500,000 unified credit equivalent which can be given away tax-free either on a lifetime gift basis or through a will, will be reduced such that more death taxes will be payable on his other assets at the time the insured dies. It is imperative that the trustee keep a file containing all of the notification letters from the time of the trust's inception.

Using the proper insurance company forms to transfer the policy to the trust is extremely important. To transfer ownership of the policy to the trust, an "irrevocable assignment of policy." form is required. This form will be signed by the insured and will designate the trust as the new owner. One day later, the trustees of the trust will file a "change of beneficiary" form with the insurance company designating the trust as the beneficiary. A mere "change of beneficiary" form is not sufficient to obtain the tax advantages of the irrevocable insurance trust.

The transfer of the insurance policy to the trust and the premium payments made each year may require the filing of an annual gift tax return. To the extent that the total contribution to the trust in a year exceeds the $11,000 per year per

donee exclusion, then a gift tax return will be required. Even if the beneficiary notification letters are properly utilized and the total trust contributions are less than $11,000 per beneficiary such that a gift tax return is not required, the filing of a gift tax return may be desirable in order to make important generation skipping transfer tax elections. The generation skipping transfer tax is another tax which is in addition to the federal estate taxes. Generally, this tax is imposed on distributions made to grandchildren or later generations (i.e., skipping over the children). The generation skipping transfer tax can be quite substantial; often times exceeding the amount of the federal death taxes which would have been paid if the property had flowed through the skipped generation. Each person, though, can elect to allocate a one million dollar exemption to avoid this tax.

Generally, any generation skipping transfer tax exemption elections with respect to a pure term policy would be deferred until the insured dies when a return could be timely filed to cover the previous year's premium payment and thereby exempt the entire death benefit proceeds from the generation skipping transfer tax (recognizing that there are situations where this will not work depending on when in the year the premiums are paid and when death occurs); but with respect to a whole life policy or a policy for which there is a significant whole life component, it may be desirable to make the generation skipping transfer tax elections annually on a gift tax return. Since the trust may be designed to carry over from generation to generation, or since a distribution may in fact be made to a grandchild under the terms of the trust such that the generation skipping transfer tax would apply to that distribution, it would be desirable to have a trust which could be completely exempt from the generation skipping transfer taxes. Due to the nature of life insurance, a very significant trust corpus can be exempted through the utilization of a small dollar amount of a person's generation skipping transfer tax exemption.

As far as the actual dispositive provisions of the trust are concerned, there are very few limitations. For example, the trust could provide financial benefits to a surviving spouse and/or children in any manner which is desired. The primary beneficiary of the trust could be the surviving spouse with the children coming on as beneficiaries when that spouse has also passed away. Alternatively, the trust could be shared among the surviving spouse and the children right from the start. However, should a portion of the trust be taxable in the insured's estate (for failing, for example, to meet the three year test) then standby marital deduction provisions are advisable which would provide exclusive financial benefits for the surviving spouse during his or her lifetime.

Because of the very technical requirements of the income, gift, estate, and generation skipping transfer tax laws, it is advisable that anyone considering an irrevocable life insurance trust discuss it with a knowledgeable estate planning attorney.

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