

## **Irrevocable Life Insurance Trusts: Perhaps the Best Kept Secret in Tax Savings**

A. Jude Avelino\*

Life insurance is protection against the death of an individual in the form of payment to a beneficiary, usually children. In exchange for premium payments, in the event of the death of the insured person, the face value of the life insurance policy (minus any outstanding loans and interest), is paid to the beneficiary.

The traditional view of life insurance is a “hedge” against the death of a family’s primary breadwinner. For example a young family would purchase a life insurance policy so that should the primary breadwinner pass unexpectedly the surviving family members would not have to change their lifestyle—i.e. sell the house, sell investments to make ends meet, etc.

### **Life Insurance and Taxes**

Pursuant to the Internal Revenue Code life insurance proceeds are income tax free,<sup>1</sup> but not estate tax free.<sup>2</sup> Upon the death of an individual all assets are calculated and taxed. What

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\* A. Jude Avelino is the principal partner of Avelino & Nitkewicz LLP, and is an estate planning attorney and litigator. He can be contacted at [javelino@avelinolaw.com](mailto:javelino@avelinolaw.com).

<sup>1</sup> Section 101(a) provides the general rule that “gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.” Exceptions are provided to the general rule for a transfer of a life insurance contract for valuable consideration (Section 101(a)(2)), certain amounts paid at a date later than death (Section 101(d)), amounts paid by reason of the death of the insured under a flexible premium life insurance contract (Section 101(f)), and payments under certain employer-owned life insurance contracts (Section 101(j)).

<sup>2</sup> Under Section 2042(1) the value of the gross estate includes “the amount receivable by the executor as insurance under policies on the life of the decedent.” Section 2042(2) provides that the gross estate includes the value of amounts receivable by all other beneficiaries:

To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term “incident of ownership” includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in [Section 2042(2)], the term “reversionary interest” includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

There is an extensive case law on incidents of ownership. The liability of the beneficiaries for estate tax, where the will does not place this burden on someone else, is specified in Section 2206:

Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate. If there is more than one such beneficiary, the executor shall be entitled to recover from such beneficiaries in the same ratio. In the case of such proceeds receivable by the surviving spouse of the decedent for which a deduction is allowed under

counts? Everything counts! The house, retirement accounts, life insurance proceeds, business interests, checking and savings accounts, personal possessions, and anything else of value. The IRS is able to ascertain this information because, within nine months after someone's death, a Form 706, an estate tax return, calling for an itemization of the deceased person's assets, must be filed with the IRS.<sup>3</sup>

The current estate tax rate is 45% of any assets over \$2 million.<sup>4</sup> Therefore, the tax on an estate of \$2 million would be \$780,800. If the insured is the owner of a life insurance policy, which is most often the case,<sup>5</sup> those life insurance proceeds are considered part of that person's estate for estate tax purposes.

This tax consequence, should it apply, does not occur with the death of the first spouse due to a full spousal exemption for estate tax purposes. The effect will be felt upon the death of the surviving spouse. Without proper estate planning, the surviving spouse could be sitting on a combined estate (that of the surviving spouse + assets previously belonging to the deceased spouse, including the life insurance proceeds) with only his/her exemption. With the inclusion of life insurance it is not hard to exceed the federal exemption—although the current market crisis is making it harder for many to reach the exemption level much to the detriment of many retirement and investment accounts.

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section 2056 (relating to marital deduction), this section shall not apply to such proceeds except as to the amount thereof in excess of the aggregate amount of the marital deductions allowed under such section.

Where life insurance payments are made to a surviving spouse in installments, see Section 2056(b)(6). Note that the gross estate includes the value of an annuity—

“receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement ... (other than as life insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment....

<sup>3</sup> For decedents dying in 2008, Form 706 must be filed by the executor for the estate of every U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemption, is more than \$2 million. Form 706 and its instructions are posted on the IRS website (respectively in pdf format at [www.irs.gov/pub/irs-pdf/f706.pdf](http://www.irs.gov/pub/irs-pdf/f706.pdf) and [www.irs.gov/pub/irs-pdf/i706.pdf](http://www.irs.gov/pub/irs-pdf/i706.pdf)).

<sup>4</sup> The Economic Growth Tax Reconciliation and Relief Act of 2001, PL 107-16 (June 7, 2001) (“EGTRRA”) allowed the federal estate tax exemption to rise steadily from 2001 until 2010. The federal estate tax exemption rises to \$3.5 million in 2009, there is currently no estate tax for 2010. And, accordingly to EGTRRA, should Congress not be able to agree on a new exemption level prior to 2011, the federal exemption will revert to pre- EGTRRA status—\$1 million exemption with a 55% estate tax rate.

<sup>5</sup> Incidents of ownership are not limited to ownership in the technical legal sense, but can include the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the policy. Reg. 20.2042-1(c)(2). Careful drafting is required. In Rev. Rul. 84-179, 1984-2 CB 195, a decedent purchased an insurance policy on his life and transferred all incidents of ownership to his spouse, and the spouse designated their child as the beneficiary. Subsequently, the spouse died, leaving a will that established a residuary trust for the benefit of the child. The insurance policy was part of the residuary estate, of which the husband was the trustee. As trustee, he had broad discretionary powers for managing the trust property and the power to distribute or accumulate income. The trust could borrow on the policy, assign or pledge it, and had certain other powers, but the husband could not exercise these powers for his own benefit. The Ruling concluded that the husband did not have incidents of ownership for purposes of Section 2042(2) provided he did not furnish the consideration for maintaining the policy and could not exercise the powers for his person benefit. Thus, it is important to consider where the ownership of the policy might lie under various future events. If the wife's residuary trust in Rev. Rul. 84-179 had granted additional powers to the husband, a policy that had once been protected from estate tax might come back into the estate on the unanticipated death of a spouse.

## **Estate Tax**

A non-traditional view of life insurance is that it is not just for young families. Life insurance, if structured properly, is a good way to pay for estate taxes without the beneficiaries having to sell the deceased person's assets. An example would be a widow worth \$4 million dollars. If she died in the year 2008, her taxable estate would be \$2 million (remember, the first \$2 million is not taxable because of the current federal exemption of \$2 million). As such, her estate would have a tax liability of \$900,000 or 45% of the taxable estate. The math shows that the purchase of a \$1 million life insurance policy (assuming she could medically qualify) would pay the estate tax and her beneficiaries (presumably her children) would inherit her entire estate, minus life insurance premiums paid.

However, the above example does not work if the widow was the owner of the life insurance policy. The life insurance policy proceeds would be considered part of her estate and thus taxed. It would increase her estate from \$4 million to \$5 million. The taxable estate would now be increased from \$2 million to \$3 million and the tax liability would now be \$1,350,000. Applying the insurance proceeds to the state would reduce the tax liability to \$350,000. This is a considerable savings from the \$900,000 in the example without life insurance, but not good enough in the author's opinion.

If the owner and beneficiary of the widow's \$1 million life insurance policy was her irrevocable life insurance trust ("ILIT"), the proceeds from the \$1 million life insurance policy would *not* be included in her estate and could be used to completely wipe-out the estate tax liability.

## **Setting Up an ILIT**

An ILIT is a trust specifically set up to be the owner and beneficiary of the grantor's life insurance policy. The grantor sets up the trust and has to make some choices—that cannot be changed, hence the term irrevocable—who will be the trustee and beneficiaries. Typically, a beneficiary cannot be the trustee of his or her own share of the trust.

Instead of premium payments made to the insurance company from the grantor's personal checking account, the grantor gifts the premium payments into the trust account and the trustee makes the premium payments from the trust account to the insurance company. The gift is made by writing a check from the personal checking account in the amount of the premium and depositing it into a checking account owned by the ILIT.

Upon the death of the grantor, the proceeds are paid into the ILIT checking account and are not included in the estate of the deceased grantor. This is done so that the grantor does not own the life insurance policy, but rather the ILIT does. Therefore, the proceeds are estate tax free and can result in hundreds of thousands of dollars, if not millions, in estate tax savings. The life insurance proceeds are then distributed according to the terms of the trust.

**Choosing a Trustee.** The biggest question clients ask is "Who should I choose to be the trustee?" Typically it is a non-beneficiary family member or trusted friend. Although there is a large amount of responsibility placed upon the trustee, that person still has to follow the rules of the trust established by the grantor. If that duty is breached it could give rise to a lawsuit as appointment as trustee does not result in *carte blanche* authority.

Beneficiaries can be whomever the grantor desires—from children, to friends to charities. However, once this choice is made it cannot be changed.

The grantor or the grantor's accountant or attorney should consult an experienced estate planning attorney in order to ensure the ILIT is implemented properly. Remember, you get what you pay for so do not look for the least expensive attorney. Money spent on attorney's fees should be made up for in estate tax savings.

**Gift Tax Issues.** Higher net worth clients have an additional issue to be aware of—federal gifting laws. Because premium payments must be made through the trust, that trust must be funded. And as was discussed above, the way to fund an irrevocable trust is to make a gift into it. Therefore, the grantor will make a gift by way of writing a check into the ILIT bank account in the amount of the premium. The current federal laws state that a gift of under \$12,000 per year/ per person is not reportable to the IRS.<sup>6</sup>

So what if the premium for the widow is \$50,000 per year and there is only one beneficiary? *Estate of Cristofani* allowed gifts to contingent beneficiaries.<sup>7</sup> Therefore, the first \$12,000 of the yearly premium would be considered a non-reportable gift to the beneficiary under the ILIT. The remaining \$38,000 could be divided up between four contingent beneficiaries who would be entitled to shares of the ILIT should the beneficiary predecease the grantor.

### **ILITs and Professionals**

Certain professionals, **such as financial planners and investment advisers**, should make themselves familiar with ILITs for business reasons. Clearly, ILITs should be something every estate planning attorney should be familiar with, but along with the creation and implementation of the ILIT comes other responsibilities such as filing tax returns. This will not occur until the death of the grantor, but once the ILIT is funded with the life insurance proceeds, any income it makes will be taxed at the trust tax rate (approximately 35%). Thus a yearly tax return is due. While benefiting the client, ILITs create work for accountants and tax professionals.

Whenever I encounter doctors, their primary concern is asset protection. I am a big believer in protecting assets from creditors such as plaintiffs, divorce, and spendthrifts and I implement my estate plans with an asset protection edge. The creation of a properly structured ILIT provides asset protection for the life insurance proceeds. Why? Because the grantor does not own the policy, the trust does.

Furthermore, the beneficiaries do not own the life insurance proceeds, the trust does. Therefore, if a beneficiary is embroiled in a divorce, s/he can ask the trustee not to distribute their share until after the divorce is settled. This would leave the inheritance of life insurance money outside of the divorce settlements, and, thus, asset protected.

### **Downsides to Establishing an ILIT**

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<sup>6</sup> Section 2503(b) provides an annual exclusion of \$10,000, which has been indexed for inflation since 1999, under Section 2503(b)(2), using a cost of living adjustment that is rounded down to “the next lowest multiple of \$1,000.” A gift tax return, Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, must generally be filed when gifts are made to someone totaling more than \$12,000. See instructions for Form 709, p. 2, describing the annual exclusion (available at <http://www.irs.gov/pub/irs-pdf/i709.pdf>).

<sup>7</sup> 97 TC 74 (1991) (“Decedent’s grandchildren held contingent remainder interests in the children’s trust.... We do not believe ... that Crummey requires that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the section 2503(b) exclusion.”)

As discussed, a properly structured ILIT has very many positive qualities. However, there are some negative traits that everyone interested in an ILIT should know.

- *You cannot change the beneficiary* of an ILIT. The ILIT is not only the owner of the life insurance policy, but the beneficiary as well. However, the beneficiaries within the ILIT cannot be changed once the ILIT is established.
- *You cannot borrow from the policy.* It has become more and more common for individuals to build up a cash value in their life insurance policies or take loans from the policy to fund business dealings. But once an ILIT is established, the grantor can no longer do that because s/he no longer owns the life insurance policy.
- There is a *three year look-back* when an existing life insurance policy is transferred to the trust.<sup>8</sup> If the client has an existing policy and dies within three years of the transfer, the grantor will be considered owner of the policy and it will be included in his/her estate for estate tax purposes. However, newly created life insurance policies are not subject to the look-back if initially established with ILIT as owner and beneficiary.
- *You cannot take the policy back.* Once the ILIT is established as owner of the policy, you would have to get a new policy in order to have life insurance in your name.
- *You must be mindful of the Federal gifting laws/limitations.* Remember, as of the date of this publication, the nonreportable gifting limits are \$12,000 per person, per year. Any gift in excess of that amount would result in a reduction of your federal estate tax exemption in the amount of your overage. For example, let's say the widow took out a \$5 million life insurance policy with an annual premium of \$100,000 and created an ILIT with her only son as beneficiary. She would have to make a yearly gift of \$100,000 to the trust in order for the trust to pay the premium. As such, after the first year of premium payments, the first \$12,000 would be a non-reportable gift and the remaining \$88,000 would be a reportable gift for which a gift tax return would have to be filed. The effect of this gift is that after year one the widow's Federal Estate Tax Exemption was reduced from \$2 million to \$1,912,000.
- *You must choose a trustee* other than yourself or your children. The concept of someone other than yourself being in control of your assets can be disconcerting. However, it is this principal that has allowed many wealthy families in this country to stay wealthy. It is the Rockefeller concept of owning nothing while controlling everything. The wealthy families are used to having someone they trust control their money. And because they do not own the money, no one can take it from them. The way to control the trust held asset is the ability for the beneficiary to hire and/or fire the trustee.

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<sup>8</sup> Under Section 2035(a), if

(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and  
(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

These transfers are reported on Schedule G or Form 706 regardless of whether a gift tax return was required to be filed when the gifts were made.

**Conclusion**

Despite these drawbacks, the tax savings potential of the ILIT makes it worth the cost and any added work on the behalf of the Grantor. ILITs are a great way to save on estate taxes, pass more money onto heirs and make charitable contributions. For professionals, it is a great way to help your clients while creating more business for yourselves. If you are an accountant, tax attorney, or litigator make yourself familiar with ILITs.