IRREVOCABLE LIFE INSURANCE TRUSTS

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A. Irrevocable Trusts

a. In General.

i. Irrevocable trusts are not subject to revocation or amendment by the grantor. Irrevocable trusts used for tax reduction purposes should remove from the grantor all possibilities of control over the assets and all present or reversionary interest. This includes not allowing the grantor to serve as trustee of the irrevocable trust.

ii. Irrevocable trusts are used primarily to reduce or eliminate federal estate taxes imposed on larger estates. Irrevocable trusts can be very powerful tools when used to remove life insurance and other large assets from the estate of the grantor.

iii. Examples of irrevocable trusts include irrevocable life insurance trusts (ILITs), qualified personal residence trusts (QPRTs), and intentionally defective grantor trusts (IDGTs).

B. Irrevocable Life Insurance Trusts (ILIT).

a. **Overview**. An ILIT is an irrevocable trust established with the sole or primary function and intent to hold life insurance that is either currently held by or soon to be held by the donor.

i. Even though life insurance proceeds are not taxed as income to the insured, life insurance proceeds are generally included in the insured's "gross estate" for federal estate tax purposes (IRC § 2042) if they are receivable by the executor of the insured's estate or if the insured retains any "incidents of ownership" at death. Thus, life insurance proceeds are potentially subject to estate tax. By having the irrevocable trust purchase a policy on the life of the insured, or by transferring a life insurance policy to an irrevocable trust, the insured can keep policy proceeds out of his estate.

ii. There are two separate approaches, each with different benefits and risks.

(1) Transfer an existing policy to the ILIT

(2) Transfer cash to the ILIT, then have the trustee purchase a new policy; the ILIT will be the original policy owner.

iii. Transfer of the policy and/or all premium payments are treated as gifts to the trust.

iv. To qualify a portion of those premium payments for the $14,000 annual per donee gift tax exclusion ($28,000 if gifts are made by a married couple), the trust must be irrevocable and each beneficiary (usually children and grandchildren) must have a right to withdraw a portion of a gift in the year it is made.

v. As a practical matter, beneficiaries do not exercise the right to withdraw, because they understand that the benefit to them is greater if they do not exercise that right.

vi. Donors owning life insurance policies, particularly permanent insurance such as whole life and universal life, with high death benefits (or donors who plan to acquire such policies) are ideal candidates.

b. <u>Why create ILIT</u>: Compared to naming an individual beneficiary of a life insurance policy, an ILIT receiving the insurance policy death benefit can provide (i) flexibility, (ii) creditor protection, (iii) investment management, (iv) probate avoidance, and (v) potential estate and GST tax avoidance.

c. <u>Funded or Unfunded ILITs</u>. A funded ILIT will contain assets other than the life insurance policy. These assets often exist to produce enough income to cover insurance premiums. An unfunded ILIT contains only the life insurance policy and the insured will provide the funds to pay premiums on any policy held by the unfunded trust, making payments directly to the insurer or to the trustee in amounts sufficient for the trustee to pay premiums.

Funded ILITs may be administratively simpler; only the initial gift tax return to file and assets are always available to pay premium payments. However, they are harder to unwind and require a larger up-front gift.

d. Types of ILITs.

i. Single life insurance trust. A single life insurance trust owns a single life insurance policy on the life of the grantor. If each spouse has an individual life insurance policy, each spouse should execute a separate life insurance trust. In general, the grantor's spouse and/or issue will be beneficiaries during the grantor's lifetime. If so, joint or "second-to-die" life insurance policies should generally not be held in a single life insurance trust. The Trustee can generally make discretionary distributions of income and principal of any assets in excess of those required to make premium payments to beneficiaries. In addition, the spouse, children, and possibly grandchildren may be given withdrawal rights. Upon the grantor's death, the insurance proceeds are generally held for the benefit of the spouse and issue during the surviving spouse's lifetime. Upon the surviving spouse's death, the trust assets are divided into shares for the children, to either be distributed outright or further held in trust.

ii. Second-to-die life insurance trust. The use of two insureds reduces the insurer's risk and increases the insurer's use of premiums, resulting in a relatively low premium cost. The concept is for two lives to be insured with the death benefit payable upon the death of survivor.

Remember that the use of the unlimited marital deduction can completely eliminate federal estate tax upon the death of the first spouse to die. However, the federal estate tax is not necessarily reduced by the use of the marital deduction but rather the estate tax is merely deferred until the death of the surviving spouse. This "pre-portability election" situation created the environment for survivor joint life insurance as an attractive way to pay death taxes falling due at the second death.

In general, neither spouse will be the trustee or beneficiary of a second-to-die insurance trust. Rather, the spouse's issue are generally the beneficiaries. During the lifetimes of the insureds, the trustee will pay any required premiums to maintain the policy. On the death of the surviving spouse, the proceeds are collected and divided into shares for the remainder beneficiaries.

e. <u>Avoiding Inclusion in the Grantor's Estate – Three Year Rule</u>. This risk exists whenever an existing policy is transferred to an ILIT. Under § 2035 of the Internal Revenue Code, gifts made within three years of a decedent's death will be included in a decedent's taxable estate if the gift is a transfer of an interest in property which is included in the value of the decedent's gross estate under IRC §§ 2036, 2037, 2038, or 2042, or would have been included under any of these sections if the interest had been retained by the decedent. Under IRC § 2035(a), the proceeds of a life insurance policy will be included in a decedent's gross estate if he or she transfers a life insurance policy insuring his or her life to a trust and dies within 3 years of the initial transfer.

However, if the insured was never the owner of the policy and thus did not at any time have incidents of ownership over the policy, then the three year rule does not apply. That is, there is no three year concern if the insured dies within three years of the policy start date, even though the insured pays the premiums, so long as the policy was issued to the ILIT. <u>Estate of Leder</u> <u>v. Comm'r</u>, 89 T.C. 235 (1987), aff'd, 893 F.2d 237 (10th Cir. 1989); <u>Estate of Headrick v.Comm'r</u>, 93 T.C. 171 (1989), aff'd, 918 F.2d 1263 (6th Cir. 1990); acq AOD 1991-012. Thus, whenever possible, the grantor should create the life insurance trust first and have the trustee of the trust complete the application to purchase the life insurance policy. However, if the insured is no longer insurable, or premiums would be much higher, it may be necessary to transfer an existing policy.

f. Avoid Retained Interests. The trust should be drafted in a manner so that the grantor will not have any retained interests under IRC §§ 2036(a)(2) and 2038. The trust should be irrevocable, and the grantor should have no power to alter, amend, revoke or terminate the trust. The grantor should also relinquish any present or future interest in the trust. The trustee should not have the ability to use trust assets in a manner that would subject the assets to inclusion in the grantor's estate, including allowing the grantor to borrow any part or all of the trust assets, allowing any person to dispose of any part of the principal or income of the trust for less than adequate consideration, and allowing the trustee to revest title to any part of the trust in the settlor.

g. Avoid Incidents of Ownership. In order to avoid inclusion in the grantor's estate, the grantor must not have any "incidents of ownership" in the trust or the underlying insurance policy. *See* Tr. Reg. § 20.2042-1(c)(2). Incidents of ownership is defined very broadly and includes (i) the power to change the beneficiary of the policy, (ii) the power to surrender or cancel the policy; (iii) the power to assign the policy or revoke an assignment; and (iv) the power to pledge the policy for a loan or to obtain a loan against the surrender value of the policy. These incidents of ownership should be vested in the trustee.

Incidents of ownership also include a "reversionary interest" in the policy or its proceeds, whether arising by the express terms of the policy or by operation of law, if the value of the reversionary interest immediately before the decedent's death exceeded 5% of the value of the policy. Treas. Reg. § 20.2042-1(c)(3). A reversionary interest includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by the decedent. Id.

h. Payment of Premiums. Unless the life insurance policy has built up significant cash value used to pay premiums, gifts are made each year to enable the trustee to pay the annual premiums. In 2016, there is a gift tax annual exclusion of up to $14,000 per donee per year for gifts of present interests.

Although beyond the scope of this outline, in general, the use of a Crummey power may qualify transfers for the $14,000 annual gift tax exclusion. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

i. Drawbacks

In order to achieve the estate exclusion benefits described above, the ILIT must be irrevocable. However, the primary disadvantage of an ILIT is that it is irrevocable. In general, an ILIT cannot be revoked or modified after it is executed (absent cautious decanting, trust modification or court involvement which make irrevocable trust drafting much less perilous). This could make designing an ILIT for a young insured particularly difficult, as it could be around for a very long time.

In addition, the insured will have no control over the life insurance policy owned by the ILIT and will not have access to the policy's cash value during the insured's lifetime. While the insured does not have direct control over the policy, he does have indirect control as a result of the fact that it is typically the insured who makes gifts to the ILIT that enable the trustee to pay the premiums on the life insurance policy. If the insured is unhappy with the policy or an unfunded ILIT, he can stop making gifts to the ILIT. If, as a result, the trustee is unable to meet its premium obligation, the policy will lapse. If the insured becomes uninsurable or if the policy has accumulated significant cash value, this may not be a viable course of action. In such a situation, it may be best to encourage the trustee to consider exchanging the policy for a more suitable one.

j. Drafting Tips for Flexibility.

i. Funding.

(1) Planning Tip. Avoid the Three Year Trap for New Policies: If the insured settlor transfers a life insurance policy to an ILIT over which the insured held any incidents of ownership and dies within three years of the transfer, the total amount of the insurance proceeds will be included in the insured's taxable estate

under IRC Section 2035. Thus, if the insured purchases a policy, transfers it to the ILIT the next day and dies within three years, the insurance proceeds will be included in the insured's taxable estate. If, on the other hand, the settlor contributes the funds needed to purchase the policy to the trustee of the ILIT and the trustee acquires the policy, the insurance proceeds will not be included in the insured's taxable estate even if the insured dies the next day.

(2) Planning Tip. When funding an ILIT with an existing life insurance policy, it is critical that the insured settlor transfer ownership of the policy to the trustee, who in turn names the trust as beneficiary. Simply naming the ILIT as beneficiary of the insurance policy, without a change in ownership, is **insufficient** to divest the insured of incidents of ownership.

ii. Termination.

(1) Although an ILIT is irrevocable, there are a number of ways to draft flexibility into the trust.

(a) One way that flexibility can be added to the ILIT is by giving the trustee (or a special trustee or trust protector) the power to terminate the ILIT and distribute the assets to the beneficiaries.

(i) Important for client to understand that neither the policy nor its proceeds can be returned to the donor.

(b) Sample Language. "Any of the trusts administered under this article may be terminated, in whole or in part, at any time, if such action is deemed advisable and for the best interests of such trust or trusts, or the beneficiaries thereof, by the trustees whose judgment thereon shall be conclusive and free from question by anyone or in any court. In the event of such termination, the entire principal of each trust so terminated shall be paid over and distributed to the person with whose name such trust is designated, or in the case of the Family Trust, to the Donor's spouse."

(c) If the trustee is given this power, there is a risk that the beneficiaries could end up owning the policy or receiving the cash proceeds of the policy.

(d) If the donor is not comfortable with this, this power should not be included.

iii. Power of Appointment. In addition, a trust beneficiary could be given a limited power of appointment over the life insurance during the donor's lifetime.

(1) Such a power could, for example, be exercised in favor of anyone other than the power holder, the estate of the power holder, the creditors of the power holder, the creditors of the power holder's estate or the donor.

(2) It could also be drafted more narrowly (e.g., the donor's issue).

(3) The power, however, should not apply to any policy that insures the power holder.

(4) This would give the power holder the ability to withdraw the life insurance policy from the ILIT.

(a) Could be particularly useful if the power holder was the spouse.

(b) In the event of future problems between the power holder and the donor, this may become problematic.

iv. Divorce – Spouse. Another way to draft flexibility into an ILIT is to use a generic definition of the term "the Donor's spouse."

(1) In the event of a divorce or annulment, state law may revoke certain revocable dispositions in favor of the former spouse.

(a) Typically, such statutes have no application to an irrevocable disposition of property.

(2) Accordingly, rather than naming the donor's current spouse, you may want to consider a more flexible definition of the Donor's spouse.

(3) Sample Language. "Except as otherwise specifically provided herein, references to the Donor's "spouse" shall mean that person to whom the Donor is married from time to time during lifetime and after the Donor's death shall mean the person to whom the Donor was married at the time of the Donor's death."

(4) Some clients, however, may be uncomfortable with this approach.

(5) In addition, some commentators have expressed concern that such a definition could be argued to be a prohibited power causing inclusion of the ILIT assets in the donor's estate under IRC § 2038 because the donor retains the right to change her spouse.

(6) Similarly, although state law may revoke any revocable nomination of the former spouse or relative of the former spouse to serve as a fiduciary in the event of a divorce or annulment, it typically has no application to an irrevocable nomination of the spouse as a trustee of the ILIT.

(7) As such, consideration should be given to addressing what is to happen in the event of a divorce.

k. Divorce – Spouse's Family.

i. In the event that the marriage of the Donor and the Donor's spouse is dissolved other than by the death of either of them, then neither the Donor's spouse nor any relative of the Donor's spouse shall be a beneficiary or fiduciary hereunder.

ii. Consideration should also be given to including a provision in the ILIT that allows the trust beneficiaries to remove independent trustees and replace them with other independent trustees.

l. <u>Death Within Three Years of Transfer</u>

i. If a life insurance policy is owned by the insured and then transferred by the insured to the ILIT within three years of the insured's death, the death proceeds will be included in the insured's gross estate under IRC § 2035(a).

ii. In the case of a married insured, one way to mitigate the estate tax consequences of this inclusion is to draft the ILIT so that any proceeds includable in the insured's gross estate qualify for the marital deduction.

iii. <u>Sample Language</u>. "If all or any part of the money and property held by the trustees immediately prior to the death of the Donor (including all or any part of the proceeds from any insurance policies on the life of the Donor owned by the trust prior to the death of the Donor) shall be includable in the gross estate of the Donor for federal estate tax purposes, then such part of the assets of the trust fund so includable in the gross estate of the Donor shall be paid and distributed outright and free of trust to the Donor's spouse, if the Donor's spouse shall survive the Donor."

iv. In that case, estate taxes will be **deferred** until the death of the surviving spouse.

v. However, such deferral may over-fund the surviving spouse's estate.

m. Authorizing Retention of Life Insurance Policies.

i. The prudent investor act and the prudent investor rule require an ILIT trustee to diversify investments.

ii. The only exception is if the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversification.

iii. To mitigate this duty in the ILIT context, consideration should be given to including a provision in the ILIT that authorizes the trustee to retain undiversified assets.

iv. Sample Language. "The trustee shall have the power not to diversify the property which may be held, whether such property was originally received or subsequently acquired by exchange, investment or otherwise."

n. Qualifying for the Gift Tax Annual Exclusion.

i. Premium payments for life insurance policies owned by an ILIT are an obligation of the ILIT.

(1) These premium payments are typically funded by the donor via gifts to the ILIT.

(2) The trustee can then use the gifts to make premium payments.

ii. In order to qualify these ILIT gifts for the gift tax annual exclusion, the beneficiary must have a present interest in the gift.

iii. Inclusion of a Crummey withdrawal power in the ILIT should qualify any contribution subject to the power for the gift tax annual exclusion.

iv. The Crummey concept is based upon Crummey v. Comm'r of Internal Revenue.

(1) In that case, an irrevocable trust was created for the benefit of the taxpayer's four children, one of whom was an adult.

(2) Whenever a contribution was made to the trust, each of the children had the immediate right to withdraw $4,000 or the amount of the transfer to the trust, whichever was less.

(3) There was no evidence that any of the children knew of their withdrawal rights.

v. Sample Language. "If at any time or times prior to the death of the Donor, any gift is made to the trust created hereby or is deemed to have been made to the trust for United States Gift Tax purposes, each child of the Donor living at the time of such gift shall have the power to appoint to himself or to herself out of the assets of the trust an amount not exceeding the amount of such gift divided by the number of children of the Donor living at the time of such gift; provided, however, that the amount that can be appointed by any child of the Donor in any one calendar year, as the result of gifts by any one person, shall be limited to an amount equal to: (a) the maximum federal gift tax annual exclusion under Section 2503(b) of the Internal Revenue Code (currently $14,000.00) or twice that amount if such person making such gift is then married and if such gift qualifies for gift-splitting, less (b) all other prior gifts made by the donor thereof to such child which qualify for the federal gift tax annual exclusion during the same calendar year."

vi. Notice should be provided to the Crummey power holders of the power granted to them.

(1) These notices should be provided to the power holders upon creation of the ILIT and at least annually as contributions are made to the ILIT.

(2) Notices given after a contribution is made to the ILIT should be given immediately after the contribution and should include a description of:

(a) The property transferred to the ILIT.

(b) The power granted to the power holder.

(c) The period of time during which the power holder must exercise the power.

(3) Crummey notice should be provided in writing.

(4) If the power holder is a minor, notice should be given to the minor's legal guardian.

(5) Crummey notices should be provided even if the power holder has waived his right to future notices to bolster the argument that the power holder knew of her right to withdraw the contribution.

vii. Sample Language – vague example.

Dear Trust Beneficiary:

You are a beneficiary of the above-referenced trust. The trust agreement provides that when a contribution is made to the trust, you, as a beneficiary, have the right to withdraw a portion of the contribution based on the terms of the trust and the amount of the contribution. Those rights are described in greater detail in the trust agreement.

The purpose of this letter is to provide you with notice of these rights. We anticipate contributions will be made to the trust each year. If you would like to exercise your right to withdraw contributions made this year, or if you would like additional information concerning these rights or a copy of the trust agreement, please contact me within the next thirty days.

Very truly yours,

________________, Trustee

viii. IRS attacks on Crummey powers have focused on:

(1) Whether there were sufficient trust assets from which a withdrawal could be satisfied.

(a) The IRS could look to see whether the trustee used the cash to pay a premium before expiration of the beneficiary's withdrawal right.

(b) As such, with respect to the annual payment of premiums, best practice is for the donor to transfer cash to the trustee well before the insurance premium is due.

(i) The trustee should then promptly provide the beneficiaries with notice of the contribution and their withdrawal rights.

ix. The length of the period during which the power could be exercised.

(1) Was it a meaningful period of time.

(2) The withdrawal rights should exist for a reasonable period of time (e.g., 30 to 60 days from the date of the notice).

(3) Premium should not be paid by the trustee until the withdrawal period has expired.

x. Notice.

(1) Was notice provided.

(2) There is some authority to suggest that actual notice is all that is required, but best practice is to provide Crummey notice.

(3) Best practice is for the trustee of the ILIT to provide the Crummey power holders with an initial notice upon creation of the ILIT of their initial and continuing withdrawal rights.

(4) Additionally, whenever a subsequent contribution is made to the ILIT, the trustee should provide the Crummey power holders with written notice of their withdrawal rights.

(5) Ongoing notice may not be practical if trust contributions are expected to be made more frequently than annually.

(a) In that case, the trustee may elect to provide the Crummey power holders with actual (rather than written) notice of their ongoing withdrawal rights and to document the file accordingly – but provide written notice at least annually.

(b) Some commentators suggest that annual notice should suffice for recurring (quarterly or monthly) trust contributions.

(6) Each power holder should acknowledge receipt of the notice (both initial and ongoing) and the acknowledgements should be permanently retained by the trustee.

xi. Crummey powers should only be given to individuals with a continuing interest in the ILIT (e.g., income or remainder beneficiaries).

(1) Crummey powers given to persons with no continuing interest in the ILIT (other than the Crummey power) will be disregarded for annual gift tax exclusion purposes.

(2) Accordingly, at a minimum, the Crummey power holders should be given some direct beneficial interest in the ILIT.

o. Miscellaneous.

i. Some commentators argue that an ILIT:

(1) Should not include the words “life insurance” in the trust name; and

(2) Should not require the trustee to purchase insurance on the donor’s life.

(3) It is suggested that these actions will help avoid inclusion of the ILIT assets in the donor’s estate

(4) It is unlikely, however, that such features would result in inclusion.

(5) IRS will know that this is an ILIT even if "life insurance" is not included in the name and/or the trust does not require the trustee to purchase insurance on the donor's life

p. Common Pitfalls To Avoid.

i. Keep the Insured Out of the Application Process.

ii. To avoid the three-year rule, if the life insurance policy to be owned by the ILIT is a new policy, the ILIT should be created before the policy is applied for.

(1) The trustee of the ILIT can then apply for the policy.

(2) The trustee would be the initial owner of the policy.

iii. If the underwriting process begins before the ILIT is created, the insured should request an informal inquiry or a non–prepaid application.

(1) After the ILIT is created, the trustee can then submit the formal insurance application.

q. The Insured Should Not Be a Beneficiary of the ILIT.

i. The value of the ILIT will be included in the donor's gross estate under IRC § 2036 if he retains (directly or indirectly) a right to the income of the trust for life.

(1) As such, the donor should not be an income beneficiary of the trust during his lifetime.

(2) The use of trust income to pay premiums on the donor's life will not cause the trust assets to be included in the donor's gross estate.

ii. There is some authority to suggest that a donor will be treated as having directly retained a beneficial interest in the ILIT if the trust income could be used to discharge the donor's legal obligation to support someone.

(1) In at least one case, it was held that the mere existence of such a power would not cause inclusion of the trust principal in the donor's gross estate.

(2) So long as the donor did not have the right to force such distributions and such distributions were not actually made during the donor's lifetime.

iii. Nonetheless, inclusion of such a power is not recommended.

r. Do Not Require (or Even Permit) Payment of Estate Taxes and Debts Directly.

i. As mentioned earlier, ILITs were widely used when the estate tax exemption was $1 million or less. They were designed to soften the economic hit of estate taxes and in certain circumstances to provide liquidity for an estate holding illiquid legacy assets. If an ILIT is permitted or required to pay estate debts, the proceeds of the policy will be included in the donor's gross estate to the extent the proceeds are used for that purpose.

ii. Accordingly, an ILIT should never require (or even permit) the payment of estate taxes or other estate debts directly.

Instead, the trustee should be authorized (not required) to purchase estate assets (at fair market value) or lend money to the estate (on commercially reasonable terms). In that case, the proceeds should not be included in the donor's estate.