SAGE HILL
Advisory & Management

Irrevocable Insurance Trusts

Commonly Asked Questions and the Answers

Q. What is an Irrevocable Life Insurance Trust?

An Irrevocable Life Insurance Trust ("ILIT") is a living trust which cannot be altered, amended or revoked by the person setting up the Trust (the Grantor). This type of Trust owns life insurance policies, pays premiums when due, and designates the distribution of life insurance proceeds to the Trust Beneficiaries.

Q. What is a "BEST PRACTICES ILIT"?

BEST PRACTICES ILIT is an Irrevocable Trust which will maximize all the benefits of an Irrevocable Life Insurance Trust. The BEST PRACTICES ILIT has the following characteristics:

1. It is an Irrevocable Life Insurance Trust over which you retain no interest or power that would require the proceeds of your insurance to be included in your taxable estate upon your death.

2. Withdrawal powers are given to the Beneficiaries which allow you to take full advantage of the annual gift tax exclusion to add to the Trust or to pay future premiums.

3. The Trustee of the Best Practices ILIT has the power to purchase assets from or make loans to your estate for payment of any debts, costs or taxes in the settlement of your estate. This does not cause such payments to be included in your taxable estate, but still allows for estate liquidity.

Q. Why should an Insurance Trust be irrevocable?

If you retain the right to revoke the Trust or if you act as the Trustee, the assets owned by the Trust will still be included in your estate for tax purposes. To avoid the tax on the insurance, your Trust must be irrevocable and you must appoint someone other than yourself to be the Trustee of your Insurance Trust. By excluding the ILIT assets from your estate, you are eliminating the estate tax (currently 35%; in the past, it has been as high as 55%) upon your death. Additionally, Irrevocable Trusts oftentimes hold assets capable of appreciation; the appreciation following the gift (or sale) of assets to the trust is also removed from your estate.

Q. Why do I need an Irrevocable Insurance Trust?

With this Best Practices ILIT, your life insurance proceeds will not be subject to any federal estate taxes whatsoever.

When you die, everything in your name and all those things over which you had control are considered to be in your taxable estate. Your taxable estate also includes the amount of death benefits paid by your life insurance if you are the owner or if you paid the premiums. Federal Estate taxes are due on all assets valued at more than $5,000,000. In the case of a married couple, taxes are due only on assets valued at more than 10 Million Dollars (2011 Tax Figures).

You may establish an Irrevocable Life Insurance Trust to own your policies, to pay the premiums, and to be the Beneficiary of your life insurance. Since the Trust is irrevocable and since you are not the Trustee, the insurance proceeds are not considered a part of your taxable estate when you die. If your estate is above the estate tax exemption of $5,000,000, the placement of life insurance policies in an Irrevocable Life Insurance Trust will reduce your taxable estate.

Q. I have heard there are problems with Irrevocable Life Insurance Trusts — What are the problems?

Irrevocable Life Insurance Trusts can encounter 3 types of problems.

1. The first problem is that pre-existing policies transferred to the Trust will be brought back into the taxable estate if the Grantor dies within three years of the transfer.
2. The second problem is *irrevocability*. Once you establish your insurance trust you may not alter or amend the Trust and you lose control over your insurance policies.
3. The third problem is that contributions to the Trust may cause a gift tax.

Q. How does the BEST PRACTICES ILIT overcome the problems of an Irrevocable Life Insurance Trust?

1. A recommended way to overcome the problem of transferring already existing policies into the Trust is to consider the costs and advantages of simply replacing such policies. If this is not possible, the 3 year rule will apply, but betting that you will live for the 3 years is worth the estate tax saving gamble. With modern Life Insurance Company's new amortization schedules and administration techniques, it is sometimes cost effective and

simple to replace existing insurance with a new policy owned by the Best Practices ILIT, assuming you are still insurable. This allows the Best Practices ILIT to be the original owner of the insurance and so it will not be included in your estate for tax purposes.

2. The BEST PRACTICES ILIT contains an escape hatch to avoid the problem of irrevocability. The Trust assets can be restored to the Grantor through the Special Power of Appointment Clause. This special power would permit the Grantor's Spouse, (if any) to appoint the assets back to the Grantor without adverse tax consequences. The person holding this power cannot exercise it for their own benefit. The major problem with this provision is that the Grantor may not always be able to control the Spouse's decisions.

3. The Best Practices ILIT eliminates the gift tax problem by incorporating "Crummey" withdrawal rights for the Trust Beneficiaries. This allows you to make a gift to the Best Practices ILIT of up to $13,000 annually for each Trust Beneficiary without incurring any gift tax. (For example: 5 Beneficiaries x $13,000 each = $65,000 annual gift tax free).

Q. What are "Crummey" withdrawal rights?

Gifts of policies with cash value, property or cash to pay premiums, can be converted into *present* interests which qualify for the annual gift tax exclusion of $13,000 per Beneficiary per year, if the trust beneficiary is given an *immediate withdrawal right* with respect to contributions to the Trust. These withdrawal rights are temporary and, in this Trust, last for thirty days. This technique was established in the court case of Crummey v. Commissioner in 1968. The rights have become known as "Crummey Powers". The Beneficiaries must have notice of the existence of these rights.

Crummey withdrawal rights are not designed to be exercised. They are only designed to qualify the Trust for the annual gift tax exclusion. You should be surprised if a Beneficiary exercised his Crummey Power. Such an exercise might make it difficult to pay the premium due on the policy and the Grantor would think twice before making any future contributions to the BEST PRACTICES ILIT.

One issue for all Grantors to be aware of arises out of the 'Cristofani' case (1991). When your trust names beneficiaries whose interest is contingent upon a particular event (e.g. them surviving a beneficiary), the question addressed in this case is whether a Crummey Power extended to such a person qualifies them as a "Beneficiary of a present interest", and thus whether the annual gift tax exclusion applies to them. If the annual exclusion does not apply, then a portion of one's lifetime gift tax exemption ($5,000,000 – 2011) or estate tax exemption ($5,000,000 – 2011) must be utilized to shelter the tax. The law is not certain on this issue. Our advice is that one should assert the annual exclusion for such individuals, but be aware that you may have estate tax exposure or require use of your lifetime exemption. The impact is as follows, by example:

Jones creates an ILIT; Trustee buys a life insurance policy on Jones for $10mm death benefit; annual premium = $125,000 / year.

- Jones contributes $130,000 / year to the ILIT
- The Primary Beneficiaries of the ILIT include Jones' four children
- There are three grandchildren who are Contingent Beneficiaries (if their parent dies before Jones, the Grandchildren become Beneficiaries of the trust at Jones' death)

By so-called gift-splitting, Jones and his wife can exclude annually $26,000 ($13,000 x 2) per Donee from gift taxation. Based upon four children, $104,000 of the $130,000 is excluded from gift tax; if he includes the three Contingent Beneficiaries, the entire $130,000 is excluded (7 x $26,000 = $182,000…which of course is > the $130,000 gift). If the IRS would be successful in not allowing the three grandchildren as "Beneficiaries" for gift tax exclusion purposes, the $26,000 ($130,000 – 104,000) would be "debited" annually against Jones' lifetime gift tax exclusion of $5,000,000, or against his estate tax exemption of the same amount (2011).

Bottom line: Unless you inform us otherwise, we will assert that your Contingent Beneficiaries are made current gifts.

Q. Is it necessary that I set up my BEST PRACTICES ILIT more than 3 years before my death, so that the value of my insurance is not included in my taxable estate?

The BEST PRACTICES ILIT insulates any policy it holds from the federal estate tax if the policy has been transferred to the Trust more than 3 years preceding the insured's death. If you should die within 3 years of the time the BEST PRACTICES ILIT is transferred the policy, the IRS would argue that the insurance should be included in your taxable estate.

To avoid the possibility of having the insurance proceeds included in the taxable estate if the insured dies within the 3 years of transferring, you should consider having the Trust apply for and own a new policy from the beginning. This way there is no policy transfer made to bring the insurance back into your taxable estate under the provisions of this part of the tax code.

Q. Who should I choose as Trustee of my BEST PRACTICES ILIT?

You may not act as the Trustee of a BEST PRACTICES ILIT which holds insurance on your life. This would cause the insurance proceeds to be included in your taxable estate. Choices for Trustee include other trusted family members (as long as they are not minors, your spouse or members of your household), friends or relatives, professionals such as attorneys or accountants and corporations in the business of delivering trust services. You should have a great deal of faith and confidence and be able to work well with the person you appoint as Trustee of your Best Practices ILIT.

The main drawbacks of having a corporate Trustee are the annual administration fees and the occasional inability of the corporate Trustee to relate to the needs of the Trust Beneficiaries. Sometimes a professional or a family member is appointed Trustee when a Trust is created but is charged with transferring the assets to a corporate Trustee for investment purposes once policy proceeds are paid after the Grantor's death. This helps the Trust avoid paying unnecessary annual administration fees until a substantial Trust estate exists.

Q. Why should the Best Practices ILIT be the Beneficiary of the Insurance Policy?

If you name your Trust as Beneficiary, the insurance company will pay the proceeds to the Trust and your Trustee can then use the funds according to the instructions you put in your Trust. For example, your Trustee could purchase assets from your Living Trust, replacing hard assets with cash to pay income and estate taxes, preventing a distress sale of the assets.

Also, if one of your Beneficiaries is incompetent when you die, your Trustee can invest that Beneficiary's share and provide for that Beneficiary's care for as long as needed. If you had named this person as a Beneficiary of the life insurance policy, the insurance company probably would not pay the incompetent person directly, but would insist instead on court supervision through a conservatorship.

So, your Best Practices ILIT should be both the Owner AND the Beneficiary of the Insurance Policy.

Q. How are the insurance premiums paid when I have a Best Practices ILIT?

After the Grantor has made a gift to the Best Practices ILIT, the Trustee will pay the premiums to the insurance company. This will mean that the Best Practices ILIT will have its own bank account. Because a taxpayer I.D. number is required for a bank account, and "Application for Employer Identification Number" (form SS-4) must be filed with the I.R.S.

Premiums should NEVER be paid directly to the insurance company by the Grantor.
A special note for those in Community Property states who are transferring existing insurance policies to the Best Practices ILIT:

In the community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin) the Irrevocable Life Insurance Trust will not totally accomplish its intended purpose if any of the existing insurance policies can be classified as community property. The factors to determine whether a policy is community property are:

1. *If it is acquired by a married couple while the couple resides in a community property state;*
2. *If the couple uses community funds to pay premiums; and*
3. *If the couple does not take affirmative action to show that one spouse gave their community interest to the other, thereby converting the property to that spouse's sole and separate property.*

If the Grantor's Spouse dies before the Grantor and the policy is classified as community property, then the Grantor's Spouse's estate must include one-half of the value of the community interest in their taxable estate.

The disposition of property at death is governed by the laws of the state in which the person lived at the time he died; however, insurance policy proceeds are attributed to the decedent's estate according to the property rights already established in that policy, either as community property or as sole and separate property.

The key to avoiding the complications created by community property laws for the Irrevocable Life Insurance Trust is to make sure the life insurance policies are characterized as sole and separate property. When an existing policy is transferred to the Trust, the spouse should take affirmative action to convert each policy into the sole and separate property of the Grantor. Thus the Grantor who owns the policy as his sole and separate property may transfer it directly to the Irrevocable Life Insurance Trust without any community property strings attached.

A document entitled Release of Community Property Interest is used to convert the community interest of an existing insurance policy to the sole and separate interest of the Grantor for transfer to the Best Practices ILIT. Each policy transferred to the Trust should be accompanied by its own release. These releases constitute gifts which avoid federal gift taxes by virtue of the marital deduction. Care should also be taken to make sure the policy is identified on the insurance company's records as the Grantor's sole and separate property.

Note: If you are purchasing a new policy through your Best Practices ILIT then the "Release of Community Property Interest" is not necessary.