Life Insurance Trust

Objectives

Life insurance policies are typically owned by individuals. If an individual owns a life insurance policy and is also the insured, the amount of the death benefit will be included in the owner/insured's estate at his or her death. If an individual owns a life insurance policy on another person's life and the owner dies before the insured, the cash value of the policy will be included in the owner's estate at his or her death.

It is possible to avoid the inclusion of the death benefit or the cash value of an insurance policy in a decedent's estate by transferring ownership of the policy to an irrevocable trust. The trust is then the owner of the policy, and at the death of the insured, the life insurance proceeds are distributed pursuant to the terms of the trust. Irrevocable life insurance trusts (often referred to as "ILITs") also offer the following benefits:

Wealth Replacement

A life insurance trust may be used to replace wealth lost to estate-related expenses such as estate taxes or costs of administration. Such wealth replacement is possible if the life insurance trust is properly implemented and maintained so that the trust assets will not be included in the insured's taxable estate.

Liquidity

If an estate consists primarily of real estate, closely held business interests, or retirement assets, then the estate may suffer substantial economic loss if these assets must be liquidated to pay estate taxes. Some assets (real estate or business interests) may not sell by the time taxes are due, and other assets (retirement benefits) may trigger income if they must be tapped to pay estate taxes. To avoid these problems, a life insurance trust can create a pool of liquidity, outside of the taxable estate, from which the personal representative could borrow to pay estate taxes.

Income Replacement and Asset Preservation

If a client has have a high-risk profession or business and wishes to ensure the economic well-being of his or her family in the event of an untimely death, a life insurance trust may be a good means of accomplishing this goal. Under the laws of some states, life insurance enjoys a special status in terms of protection from creditors, and a trust may also preserve funds for the benefit of the insured's beneficiaries.

Requirements to Avoid Estate Tax

A life insurance trust may avoid estate and other transfer taxes only if the insured individual: (1) parts with all ownership interests in the policy, (2) lives three years after the transfer, and (3) avoids having his or her estate be the beneficiary of the policy. If these criteria are satisfied, the policy proceeds will not be included in the insured's taxable estate, but will still be available to replace other assets liquidated to pay transfer taxes and administration expenses (wealth replacement), as a source of funds to pay transfer taxes and administration expenses generated by other estate assets (provide liquidity), or to provide income to a surviving spouse or dependent children (income replacement).

Absolute Assignment in Accordance with the Policy

The insured must make an absolute assignment of all interest in the policy, and the formalities governing assignments must be strictly followed. The insured should not assign a pledged policy. In assigning a group policy, the insured must assign the right to convert the policy to an individual policy.

Transfers Made Within Three Years of the Insured's Death

The policy proceeds will be taxed in the insured's estate if the insured transfers the policy within the three years before his or her death. Thus the insured must live three years after the transfer to achieve the estate tax savings. If the trustee purchases a new policy, even with funds provided by the insured, the three-year period does not apply unless the trustee is found to be acting as the insured's agent. The trust must be established before the policy is applied for, and the trustee, not the insured, must apply for the policy. The trust should authorize, but not require, the trustee to apply for insurance.

Group term policies present potential problems. If the employer changes insurance companies after the policy is transferred to the trust, the insured may transfer the new policy within the three-year period. To minimize this risk, the insured's original assignment should specifically include coverage increases, substitute policies, and conversion rights.

Requirements for the Trust

The trust must be irrevocable and unamendable to avoid estate tax. The insured cannot receive any benefits from the trust. The trust cannot require the trustee to distribute funds to support the insured's dependents while the insured is alive. If the insured's spouse is a beneficiary of the trust, the spouse should not transfer a policy owned by the spouse to the trust or make contributions to the trust. The insured cannot be the trustee of the trust.

Transferring Life Insurance Policy

Advantages and Disadvantages

A life insurance policy is well suited for gifting. The insured loses no source of income, and substantial value can be transferred with little or no gift tax cost because the value of the policy during life is much lower than the value of the proceeds upon the insured's death. However, the insured can no longer borrow from the cash value of the policy or change the beneficiary of the policy. These are important considerations if the insured's family situation or financial circumstances change. In addition, if a policy is transferred, the insured may have to make future gifts to pay the premiums to prevent the policy from being canceled.

Benefits of Assigning a Policy to a Trust and Not to an Individual

It is typically better to transfer ownership of a life insurance policy to an irrevocable trust rather than to an individual. If a policy is transferred to an individual, the individual may die before the insured and inadvertently bequeath the policy back to the insured. Transferring a policy to a trust avoids gift and estate taxes at the insured's death, even though proceeds may be paid to the insured's spouse and children. If the policy is transferred to the spouse, who then designates the children as beneficiaries, the spouse will be making a taxable gift when the children receive the proceeds. If the policy is transferred to the spouse and the spouse is the beneficiary of the policy, the proceeds will be included in the spouse's estate for estate tax purposes. However, if the policy is transferred to a trust for the spouse and children and the trust is the policy's beneficiary, after the spouse dies, the proceeds can be distributed to the children with no gift or estate taxes.

A trust can also give the insured some flexibility concerning distributions to the beneficiaries. The trust may be drafted to distribute funds to the spouse only if the marriage lasts until the insured's death. The trustee can be given discretion to distribute funds to the insured's children in accordance with their individual needs. The trustee can have the power (but not the obligation) to loan funds to the insured's estate or purchase assets from the insured's estate, to provide cash for the payment of estate taxes. Also, the trustee, unlike an individual, can be made subject to a fiduciary duty to keep the policy in force.

Gift Tax Considerations

Annual Gift Tax Exclusion

An irrevocable assignment of an insurance policy is a gift for federal gift tax purposes. The value of the gift of the policy is approximately the cash surrender value of the policy. Each subsequent payment of premiums by the insured's employer (on a group policy), or transfer of cash by the insured to the trust for premium payments, is also a gift from the insured. To minimize the gift taxes, the transfer of the policy or, later, the payments of the premiums, should be structured to qualify for the federal annual gift tax exclusion ($13,000 per recipient). This is done by qualifying the transfer as a gift of a "present interest." To qualify the transfer of the policy or, later, the premium payments, for treatment as a "present interest," the transfer to the trust must be subject to Crummey powers, as discussed below. Any transfer that qualifies for the annual gift tax exclusion will not incur any gift tax liability, nor will it reduce the donor's lifetime gift tax exclusion.

Lifetime Gift Tax Exclusion

The lifetime gift tax exclusion amount allows a transferor to make up to $1million of gifts (that are in excess of the $13,000 annual exclusion) during his or her lifetime without having to pay any gift tax. Although it may be appropriate tax planning to use some or all of the lifetime gift tax exclusion to establish or maintain a life insurance trust, doing so ultimately reduces the amount of the insured's estate that can pass free of estate tax (by up to $1 million). The insured must also file gift tax returns on the transfer of the policy to the trust and on subsequent payments of premiums.

Payment of Premiums

After the policy is transferred to the trust, the trustee should pay all premiums. The insured may transfer cash to the trust that the trustee can use for premium payments. As discussed above, these transfers will be considered gifts and may be subject to gift tax. If the insured pays the premiums directly, he or she is considered to be purchasing a portion of the policy each year and transferring it to the trust. When the insured dies, the portions he or she was considered to have transferred in the last three years are subject to estate tax. Premiums should not be paid by a beneficiary, because the beneficiary may then be considered the owner of the trust.

Crummey Powers

Transfers to a trust may qualify for the annual gift tax exclusion if the beneficiaries of the trust have the power to withdraw each contribution to the trust (i.e., a "Crummey power"). The key requirement of a Crummey power is that the trust beneficiaries must have a legal right to withdraw the policy or funds transferred to the trust. The right may expire after a specified time. The trust must require the trustee to inform beneficiaries of each transfer to the trust and of their withdrawal rights. The beneficiaries must have a meaningful opportunity to exercise their withdrawal rights, and there can be no implicit agreement that the beneficiaries will not exercise their withdrawal rights.

A Crummey power may be given to a specified group of beneficiaries. By increasing the number of Crummey power holders, the insured can make more annual exclusion gifts to the trust or transfer larger sums. The withdrawal rights of multiple Crummey power holders should be apportioned pro rata to prevent diminishing the right of any one beneficiary if another exercises his or her right.

Gift Tax Considerations for Beneficiaries

To the extent that a beneficiary does not exercise a Crummey power (i.e., the beneficiary does not elect to withdraw funds from the trust), the beneficiary has made a gift to the other trust beneficiaries. This gift, however, is not a present interest and does not qualify for the annual gift tax exclusion. To minimize this risk of potential gift tax consequences to the beneficiaries, the trust may limit the amount each beneficiary may withdraw each year to the greater of $5,000 or 5 percent of the value of the trust assets. This may have the disadvantage of reducing the amount each beneficiary may withdraw to less than the annual exclusion amount.

Generation-Skipping Transfer Tax Considerations

Depending on the terms of the trust and provisions for distributions of income and principal, it may be advisable to allocate some generation-skipping transfer tax exemption to transfers made to the trust.

Conclusion

Ownership of life insurance by a trust will provide significant tax savings if the policy is not taxed in the insured's estate. If drafted and administered properly, a life insurance trust may help achieve wealth replacement, liquidity, and income replacement for a decedent's estate. Please contact us to discuss whether a life insurance trust is appropriate for your estate plan.