

Irrevocable Life Insurance Trusts: An Important Yet Underutilized Estate Planning Tool



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Some of you may have read an article I published some months ago entitled, "What Is a Living Trust and What Are Its Advantages?" While revocable ("living") trusts are useful and often essential estate planning devices, these types of trusts do not offer any protection from federal and state death taxes. However, substantial death tax savings can be achieved when a client has an irrevocable trust own his or her life insurance policies rather than owning them outright.

The Basics

This strategy works by having the insured (the grantor) create an irrevocable trust during his or her lifetime. This trust will then either (1) purchase one or more insurance policies on the life of the grantor, or (2) the grantor will transfer already existing life insurance policies to the trust. An irrevocable life insurance trust may be either funded or unfunded. A funded trust contains assets other than life insurance policies, and these assets are often held to produce sufficient income to pay the premiums on the policies. An unfunded trust contains only life insurance policies. The grantor typically pays premiums on policies held by an unfunded life insurance trust either by direct payments to the insurer or by annual gifts to the trustee in amounts sufficient for the trustee to pay the premiums. Usually, an irrevocable life insurance trust is unfunded and transfers to the trust used to make premium payments are subject to a special withdrawal provision (often

referred to as a "Crummey Power") so that those transfers can qualify for an annual gift tax exclusion.

Any life insurance policies owned by and payable to the trust should be acquired by or assigned to the trust using the required insurance company forms which will vest all incidents of ownership in the policies to the trustee. To the extent possible, the insurance policies should be applied for by the trustee as applicant and owner, rather than being transferred to the trust by the grantor, to reduce the risk of inclusion of any insurance proceeds in the grantor's gross estate should the grantor die within three years of the transfer — although this risk is usually quite remote. Also, physical custody of the policies should be delivered to the trustee, and, after purchase or assignment of the ownership rights in the policies to the trustee, the trustee should be named as the revocable beneficiary of the policies. (If the trustee were named the irrevocable beneficiary of the policies, subsequent problems might arise if the trust were terminated prior to the grantor's death.)

Estate Tax Savings

When the grantor dies, the policies then pay the death benefits to the trust rather than to another individual or the estate of the grantor, and that is where the tax savings and other advantages of this technique become manifested. Because the life insurance proceeds are paid to the trust, those proceeds are not subject to probate fees, creditors of the estate, rights of the insured's spouse, and, in many instances, state inheritance taxes. Furthermore, proceeds paid to a life insurance trust avoid the publicity, delay, and costs of probate; are not, generally speaking, vulnerable to attack from a disinherited heir based on incompetency or undue influence; and can be collected and distributed before the probate process has even begun! Perhaps most important, the proceeds are free from inclusion in the federal gross estates of both

the grantor and the surviving spouse, and therefore are not subject to federal estate taxation. This exclusion may be particularly advantageous given the current uncertainty surrounding the federal estate tax. And, without jeopardizing any of the exclusions mentioned above, those same proceeds may be fully available to meet the needs of the surviving spouse and the needs of the insured's estate. Furthermore, by using a trust, the insured can provide professional management of the proceeds through the use of a corporate trustee. If one or more of the beneficiaries is developmentally disabled, is immature, is chemically dependent on some sort of substance that affects his or her cognitive abilities, is psychologically disturbed, or is simply not used to managing large amounts of money, creditor protection and professional management, rather than estate tax exclusion, may be the most important advantages of an irrevocable life insurance trust.

Special Circumstances and Caveats

You should be aware that special planning is needed for trusts owning group term or split dollar insurance policies because the premiums are paid on those policies by the employer directly to the insurer and nothing is contributed to the trust against which a holder of a *Crummey Power* can exercise that power. Similarly, special drafting is needed when joint life (second-to-die) policies are owned by a trust. In such situations, it is best that neither the husband nor the wife have any interests in or powers over the trust so as to avoid the risk that the insurance proceeds will be included in the surviving spouse's gross estate due to retained incidents of ownership.

As with any estate planning technique, there are a few disadvantages to using irrevocable life insurance trusts. Permanently transferring life insurance policies to an irrevocable trust will result in some loss

of flexibility and access to the policies' cash values. Use of an irrevocable life insurance trust increases the level of complexity of one's estate plan because a trust agreement, in addition to the insured's Will, is required. There may also be trustee fees during the insured's life, but such fees may be minimized if a family member is selected as the trustee during the insured's life because the family member may not charge any trust administration fees. In addition to the fees and added complexity, there are also some additional administrative matters that must be properly executed to obtain the tax benefits described above. The grantor and the trustee must fully understand their respective roles in the ongoing operation of the trust, including: who is to get premium notices, how and when contributions are to be made to the trust by the grantor to allow the trustee to pay the insurance premiums, who will prepare and file the fiduciary tax returns for the trust, and who will give the beneficiaries timely notice of their *Crummey Powers* when additional contributions to the trust have been made.

Conclusion

An irrevocable life insurance trust can add significant tax and nontax benefits to your overall estate plan, yet these planning devices are, in the author's humble opinion, underutilized. As with revocable trusts, however, it is important to carefully review your particular circumstances with an expert estate planning attorney before deciding whether an irrevocable life insurance trust is appropriate for your situation. The information contained in this article should be used for informational purposes only and is not intended to be legal advice and should not be relied upon by the reader as legal advice.

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