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Micah J. Nichols and Rodney S. Retzner: The uses and benefits of irrevocable life insurance trusts

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Most practitioners are familiar with the irrevocable life insurance trust, or ILIT.

If a client has a taxable estate and needs liquidity to pay expenses, taxes, and debts, one solution is to establish an ILIT that acquires a life insurance policy on the client's life. The client then makes cash gifts to the trustee of the ILIT, and the trustee, rather than the client, applies for the life insurance.

The trustee then pays the premiums with the cash gifts from the client. The ILIT becomes the ultimate owner and beneficiary of the life insurance policy, with the client only as the insured.

The client may choose to make a large cash gift to the trustee of the ILIT to cover the initial and ongoing premiums, but more commonly, on each subsequent year as premiums become due, the client will make cash gifts to the ILIT to qualify as present interest gifts (to qualify for the annual gift tax exclusion), giving an ILIT beneficiary a lapsing withdrawal right that lapses if not exercised (called a Crummey power).

The benefit of an ILIT, if structured properly, is that upon the death of the insured, the life insurance proceeds are paid to the trustee of the ILIT and those proceeds are not included in the client's taxable estate.

Those proceeds, then, are freed up to provide liquidity to the client's estate to pay expenses, taxes, and debts on other assets included in the client's taxable estate. The trustee has many options to pay such expenses, taxes, and debts, including buying assets from the estate for cash or lending cash to the personal representative of the estate or to a trustee of a revocable trust. Once those expenses, taxes, and debts are paid, any assets owned by the ILIT pass to the beneficiaries of the ILIT.

To accomplish the above objectives and avoid such life insurance proceeds inclusion in a client's taxable estate, the ILIT must be set up properly, and importantly, the insured must not possess any direct or indirect interest in the life insurance policy owned by the ILIT.

If the insured possesses any "incidents of ownership," either alone or in conjunction with any other person, over the life insurance policy, whether economic or by retaining control, the life insurance proceeds will be subject to federal estate tax in the insured's estate. See I.R.C. § 2042.

The regulations also define "incidents of ownership" as an insured having sole or co-power to obtain a loan, pledge the policy for a loan, surrender or cancel the policy, change the policy beneficiary, assign the policy, or revoke or veto an assignment made by the owner of the policy. See Treas. Reg. § 20.2042-1(c)(2).

Moreover, incidents of ownership include power over choice of settlement options, power to change beneficial ownership, or power to surrender the policy, and also a 5% or greater reversionary interest. See Treas. Reg. § 20.2042-1(c)(4) and 20.2042-1(c)(3); See I.R.C. § 2042(a).

Additionally, if a client anticipates transferring an existing policy (rather than the trustee of the ILIT applying for a new policy), the client must be mindful of the "three-year rule." The "three-year rule" provides that any transfer of a life insurance policy by the insured results in inclusion of the proceeds in the insured's estate if the transfer was made within three years of the insured's death and the transfer was not a bona fide sale for adequate and full consideration. See I.R.C. § 2035(d).

Because only a transfer by the insured is subject to application of the three-year rule, if an existing policy that was initially purchased by the insured-client is being used, one solution is to have the intended donee, i.e. the ILIT, purchase the life insurance policy from the insured-client rather than transferring the existing policy to the ILIT, so that there will be no transfer of the policy for less than adequate and full consideration. However, whenever one sells or transfers a life insurance policy, one must be mindful of the "transfer for value" rules, which in some circumstances, causes the death benefit to be income taxable to the purchaser of the life insurance policy. See I.R.C. § 101(a)(2).

An alternative to the ILIT is to have the beneficiaries of the client's estate own the policy directly. The child, then, rather than the ILIT, can loan policy proceeds, purchase estate assets, etc.

However, the very real possibility of an unnatural order of death should be considered. For example if a child of the decedent has a taxable estate of his or her own, then the policy would become an asset of the child's taxable estate.

The life insurance policy, now part of the child's taxable estate, will be subject to federal estate tax, even though the child never received the life insurance proceeds from the death of the insured.

The child will pay a forty percent (40%) tax on the life insurance policy as an asset due to the ownership of the policy at the value established by the interpolated terminal reserve

(ITR) value of the policy. This is obviously a bad tax result for the beneficiaries of the child's estate, a result which could have been avoided by using an irrevocable life insurance trust (ILIT).

An ILIT is an excellent estate planning tool when a client has a taxable estate that lacks liquidity. The ILIT assists in providing that liquidity while removing the policy proceeds from the taxable estate.

The ILIT can also be used to avoid the bad tax outcome in the ownership of a policy on another, as long as the transfer for value rules are addressed. Overall, with a taxable estate, and a client that is insurable, the ILIT should be considered as an option.•

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