

# Benefits Of An Irrevocable Life Insurance Trust

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## CHAPTER OVERVIEW

Life insurance is the only asset that Congress has bestowed with “most favored tax” status.<sup>1</sup> No other investment provides the potential benefit that life insurance provides. Life insurance is unique<sup>2</sup> and enjoys favorable tax status because of the important role it plays in protecting families. As a matter of policy, Congress has decided that life insurance is critical to protecting America’s families and businesses, and it is hoped that status will not change.<sup>3</sup> For a “few dollars” of premium an insured can obtain thousands of dollars of life insurance coverage. No other investment provides a “payoff”

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<sup>1</sup> Life insurance is the only tax-free investment under the Internal Revenue Code. All other investments are potentially subject to income (or capital gains) tax. For example, municipal bonds are essentially “pre-taxed” because their lower rates of return reflect their income tax free feature, and qualified retirement plans and annuities are tax deferred—not tax free. Only with a life insurance policy does the event of death eliminate the income tax. If estate taxes are permanently repealed, the loss of a complete step-up in basis will make life insurance even more attractive.

<sup>2</sup> “Life insurance is a unique form of property. There is no other investment vehicle that can as effectively guarantee the delivery of a specific amount of cash at the precise, but unpredictable, moment cash is needed, namely, at death.” Brody, Richey, and Baier, 828 T.M., *Compensating Employees with Insurance*, section II, B, 2, a (Bureau of National Affairs, Washington, DC).

<sup>3</sup> See, Jeffrey A. Baskies, “Could Abuses in the Life Insurance Industry Lead to Penalties?,” 33 *Estate Planning* 22 (February 2006).

like life insurance. Pay the first year's premium, die several months later, and the insured's beneficiaries receive thousands (possibly millions) of dollars of death benefits—income tax free. Not only does life insurance enjoy special income tax treatment, but when life insurance is owned by an irrevocable life insurance trust (“ILIT”), the death benefits can also be received free of death taxes and generation-skipping transfer taxes, and be used to benefit the insured's love ones for generations to come. This chapter highlights 22 reasons/benefits<sup>4</sup> of using an ILIT.<sup>5</sup> ILITs can play an important role if the grantor is the owner of a closely held business, particularly one that is family owned. As will be seen, an ILIT can be structured to accomplish a multitude of objectives, limited only by the grantor's imagination and cash flow, and the Internal Revenue Code.

### §1.1 AVOID INCLUSION OF LIFE INSURANCE PROCEEDS IN INSURED'S GROSS ESTATE

The principal goal of an ILIT is to remove the life insurance proceeds from the insured-grantor's gross estate for federal estate tax purposes.<sup>6</sup> For a grantor to successfully remove transferred property

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<sup>4</sup> Some of the disadvantages of using an ILIT might be (i) the cost of establishing the ILIT, (ii) the complexity of making gifts to an ILIT because of the need for *Crummey* withdrawal rights or the use of the grantor's gift tax applicable exclusion amount (currently \$1 million), (iii) the ongoing expense of trust administration, including annual *Crummey* withdrawal right notices, (iv) the possible income tax disadvantages if the ILIT is taxed as a separate taxpayer (and is not taxed as a grantor trust in its entirety), (v) the “irrevocability” of the ILIT and inability to change beneficiaries, (vi) the insured's lack of control over the life insurance policy, its cash value, and lack of control over the other ILIT assets, and (vii) the potential of IRC section 2035 applying to a policy transferred within 3 years of the insured's death and the loss of the federal estate tax marital deduction if the ILIT is not drafted carefully. However, by drafting a flexible ILIT, the grantor can maintain some indirect control over the policy. See, Chapter 11, below.

<sup>5</sup> See, Giarmarco & Mitra, *Estate Planning with Insurance*, Mitra & Associates, Rochester Hills, MI (which can be purchased at Amazon.com) for an overview of the many different ways life insurance can be used in planning a client's estate.

<sup>6</sup> “After bypass trusts, life insurance trusts are probably the most frequently used estate planning device. The reason for their popularity is simple: enormous transfer tax savings.” Bradley E.S. Fogel, “Life Insurance and Life Insurance Trusts: Basics and Beyond,” 16 *Probate & Property* 8 (January/February 2002).

(such as an existing life insurance policy or cash to fund an ILIT) from his or her gross estate, the grantor must:

- (1) Make a completed gift of the property transferred to the ILIT. Treas. Reg. §§25.2511-2(b) and (c).<sup>7</sup> See, section 3.5, below.
- (2) Survive three years after making a gratuitous transfer of the property if the transferred property would otherwise be in-

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Life insurance owned by a nonresident alien is not subject to federal estate taxes, even if the life insurance proceeds are payable to the nonresident alien's estate. IRC section 2105(a). Life insurance owned by a resident alien is, however, subject to federal estate tax, and an ILIT is an appropriate estate planning tool for keeping the proceeds out of his or her gross estate. IRC sections 2001 and 2031.

<sup>7</sup> Treas. Reg. §25.2511-2(b) provides that a gift is complete as to any property with respect to which the donor has so parted with dominion and control as to leave the donor with no power to change the disposition of the property, whether for the donor's own benefit, or for the benefit of another. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. An example of a reserved power that causes an incomplete gift is where the donor transfers property in trust to pay the income to the donor, or accumulate income in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor's descendants. However, if the donor does not retain a testamentary power of appointment, but instead provides that the remainder should go to a third party or to the donor's heirs, the entire transfer would be a completed gift.

Special rules apply concerning the donor's parting of dominion and control regarding negotiable securities. Treas. Reg. §25.2511-2(h).

Treas. Reg. §25.2511-2(c) states that a gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title in himself or herself. The power to revest can be direct or indirect, such as through distributions to the donor subject to a fixed or an enforceable ascertainable standard. See, Treas. Reg. §25.2511-1(g)(2) concerning fixed or ascertainable standards. Under Treas. Reg. §25.2511-2(e), a donor is considered as possessing a reserved power if it is exercisable by the donor in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property. See, Rev. Rul. 79-63, 1979-1 C.B. 302 where the IRS ruled that a joint powerholder did not have a substantial adverse interest in the exercise of an inter-vivos general power of appointment (even though the joint powerholder was a permissible appointee under the inter-vivos general power of appointment) since the joint powerholder was not a taker in default upon the non-exercise of the inter-vivos general power of appointment.

Also, Treas. Reg. §25.2511-2(f) provides that the relinquishment or termination of a reserved power to change the beneficiaries of transferred property, occurring otherwise than by death of the donor, is regarded as the event that completes the gift

cludable in the grantor's gross estate under IRC sections 2036, 2037, 2038, and 2042 or if the grantor relinquishes a power over the transferred property. IRC section 2035. *See*, sections 1.4 and 4.1, below.

- (3) Not retain any interest beneficial interest in the transferred property or in the ILIT. IRC section 2036. *See*, section 4.2, below.
- (4) Not provide that the possession or enjoyment of the transferred property can be obtained only by surviving the grantor, and not retain a reversionary interest in the transferred property or in the ILIT that is greater than 5% at the time of the grantor's death. IRC section 2037.

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and causes the gift tax to apply. A gift is also incomplete to the extent that the donor has the power to add or remove beneficiaries or to change the interests of the beneficiaries as between themselves (such as a sprinkling power or power to accumulate) unless the power is a fiduciary power limited by a fixed or ascertainable standard, such as health, education, support and maintenance, or the donor possess the fiduciary power in conjunction with another person who has a substantial adverse interest in the transferred property. Treas. Reg. §§25.2511-2(c) and (e). If the donor possesses a fiduciary power not limited by an ascertainable standard, the property may be includable in the donor's gross estate pursuant to IRC sections 2038 and 2041.

If a donor retains a purely discretionary interest in a trust and is not the trustee, but the donor's creditors can reach the transferred property, the gift is incomplete. Rev. Rul. 76-103, 1976-1 C.B. 293. In such instances, the gift becomes complete when the donor dies or when the trust moves to a jurisdiction where the donor's creditors cannot reach the transferred property.

If the grantor retains an interest under IRC section 2036 in the transferred property, the transfer of the property will not be a completed gift. Rev. Rul. 76-103, 1976-1 C.B. 293. A typical situation would be where the grantor has retained a discretionary interest in the trust, and the retention of the discretionary interest is subject to the claims of the grantor's creditors. IRC section 2036 will apply in such instance even if the trustee is an independent trustee with the sole, absolute, and uncontrolled power to make distributions. The reason being is that the focus is on the grantor's transfer (not the trustee's discretionary power) that typically gives rise to a creditor's ability to reach the trust assets. *See*, section 4.2(d), below.

In TAM 9533001, the IRS ruled that a provision in an ILIT that required life insurance proceeds includable in the insured's gross estate to be paid to the insured's revocable living trust did not cause the gift of the policies to the ILIT to be incomplete. In this instance, both the ILIT and the revocable living trust were established by the insured's conservator pursuant to a court order, after the insured became incompetent.

- (5) Not retain the power to alter, amend, revoke, or control the beneficial enjoyment of the transferred property, or the power to alter, amend, or revoke the ILIT. IRC section 2038. *See*, section 4.3, below.
- (6) Not hold a power of appointment over the transferred property or the ILIT. IRC sections 2514 and 2041. *See*, section 10.15, below.
- (7) Not possess any incidents of ownership in any life insurance policies transferred to the ILIT or owned by the ILIT. IRC section 2042. *See*, section 4.8, below.
- (8) Not possess or exercise any powers over the ILIT. *See*, section 10.15, below.
- (9) Not serve as a trustee of the ILIT. *See*, section 10.16, below.
- (10) Not use community property funds to pay for a single life policy. *See*, section 12.4, below.

*See*, Paragraphs 1.1 and 2.1 of Sample ILIT.<sup>8</sup>

**Caution:** To avoid the three year rule of IRC section 2035, a life insurance policy should not be purchased by the ILIT trustee until the ILIT has been executed and funded. *See*, section 4.12, below, concerning an insured's "test application" for a life insurance policy. *See also*, section 12.10, below.

### **§1.2 INCUR LITTLE OR NO GIFT TAX UPON CREATION OF THE ILIT AND PAYMENT OF SUBSEQUENT PREMIUMS**

A *Crummey* withdrawal right granted to each beneficiary, when used in conjunction with the gift tax annual exclusion amount under IRC section 2503(b) and gift splitting under IRC section 2513 (for married persons), allows the grantor's payment of premiums to be gift tax free. *See*, sections 3.5 and 3.10, below.

Although a *Crummey* withdrawal provision may turn a gift of a future interest into a gift of a present interest qualifying for the gift tax annual exclusion under IRC section 2503, a transfer to a trust that qualifies for the gift tax annual exclusion does not automatically qualify for the GST tax exemption purposes. Under the GST rules, a transfer that qualifies for the gift tax annual exclusion constitutes a

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<sup>8</sup>The Sample ILIT referenced throughout this book is set forth in Appendix 1.