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Memorandum

TO: LeBlanc & Young Clients

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SUBJECT: Irrevocable Life Insurance Trusts

Irrevocable life insurance trusts are established to accomplish a variety of objectives, some tax related and some not. The purpose of this memorandum is to summarize some of the considerations which have a bearing on whether and how to establish an irrevocable life insurance trust.

I. Estate Taxes

A life insurance policy is normally owned by the person who is insured under the policy. When the insured dies, the life insurance company issues a check for the insurance proceeds to the designated beneficiary. This payment of insurance proceeds is usually not taxable income to the beneficiary. The policy proceeds are, however, includable in the estate of the owner/insured for federal and state estate tax purposes. If the estate of the insured is large enough (currently the federal estate tax exemption is $12.06 million and the Maine state estate tax exemption is $6.01 million, indexed annually for inflation), and if the estate does not have the benefit of a marital deduction or charitable deduction, there could be an estate tax on part or all of the policy proceeds. If the estate is large enough to be subject to an estate tax, such tax could take a substantial bite out of the value of the policy.

The value of the policy will not be subject to estate tax, however, if the insured has no "incidents of ownership" in the policy. That is, if the insured does not own the policy and has no power to change the beneficiary, to convert term insurance to whole life insurance, to convert whole life insurance to a paid up policy, to assign or transfer the policy, or to exercise any other form of control over the policy, then the value of the policy is not counted as part of the estate of the insured for estate tax purposes. For example, if a son acquires a life insurance policy on his father, with son as beneficiary, on father's death the proceeds will be paid to son free of income tax and free of estate tax. Because father did not own the policy, and had no "incidents of ownership," the policy does not count as part of his estate.

It is sometimes a useful strategy to establish an irrevocable trust which can own such an insurance policy. As long as the insured has no control over the trust, he or she is not treated as having any control over the policy and the value of the policy proceeds can be excluded from the estate of the insured. The trust must be irrevocable, because if the insured could revoke or amend the trust, he or she would have too much control of the trust's assets and the insurance would be subject to estate tax. Also, to further insulate the policy from the insured, there should be an independent trustee.

If an existing insurance policy is transferred into an irrevocable insurance trust, the policy proceeds will still be subject to estate tax if the insured dies within three years after the transfer of the policy. Because the three-year "gift-in-contemplation-of-death" rule still applies to a gift of an existing insurance policy, but does not apply to a gift of cash, it is preferable to transfer cash to the trust and let the trustee buy a new insurance policy. Starting with a new policy avoids the risk that, if death occurs within three years, the policy will be includable in the insured's estate.

II. Gift Taxes

Lifetime transfers to others are subject to the federal gift tax rules. An individual can make gifts to others of up to $16,000 per year per recipient. This is known as the gift tax "annual exclusion." If a gift is made in one year to one recipient of an amount greater than $16,000, a gift tax return must be filed and the excess gift uses up some of the donor's federal estate tax exemption (currently $12.06 million), so there is less exemption available for future gifts or for the donor's estate at death.

For example, if a donor makes a gift of $116,000 to one individual in one year, the first $16,000 of the gift is sheltered by the annual exclusion, and the gift tax return will report a $100,000 taxable gift. If there have been no prior taxable gifts, this gift will use up $100,000 of the $12.06 million federal exemption, leaving $11.96 million to shelter future gifts or to shelter estate transfers by that donor. Taxable gifts are cumulative during one's lifetime.

If the donor is married and his or her spouse "joins in the gift" by signing the appropriate space on the gift tax return, the couple can make a "split gift," and will have $32,000 per year per donee worth of annual exclusion shelter.

The annual exclusion is available only to shelter gifts of "present interests." A current transfer of cash, stocks, real estate or other assets to another person is a gift of a present interest. A transfer of assets to a trust, however, where the beneficiary may not receive any benefit until a future date, is not a gift of a present interest. It is a gift of a future interest, and the $16,000 per year annual exclusion is not available. If any amount is contributed to such a trust, the annual exclusion is unavailable and the entire gift must be reported on a gift tax return as a taxable gift.

III. The Use of an Irrevocable Insurance Trust.

If an irrevocable trust buys an insurance policy on the donor of the trust, but the donor has no control of the trust or its assets, the value of the policy will not be counted as part of the donor's taxable estate. It accomplishes the same result to have a child or children of the donor own the policy. If there are minor children, however, or if there are a number of children, not all of whom would function well as a co-owners of the policy, a trust is preferable. The trustee of the trust could be a responsible adult child or other relative of the donor, or an independent trustee such as a bank or an unrelated individual, or a combination of both (which is generally best).

The use of an irrevocable insurance trust requires a special strategy to deal with the gift tax issues arising from the payment of the annual premium. Usually, the donor must contribute funds to the trust each year sufficient to cover the premiums on the policy held by the trust. When the donor contributes cash to the trust, he is making a gift of a future interest, because the ultimate beneficiaries of the trust will not receive anything until after the donor has died. As noted above, a gift of a future interest is not sheltered by the $16,000 annual exclusion, and uses up some of the donor's lifetime exemption from gift and estate taxes.

An approach commonly used to get the benefit of the annual exclusion is to give the beneficiaries of the trust a right to withdraw the cash contribution immediately. Upon receiving the contribution to the trust, the trustee sends a notice to each of the beneficiaries, or to the parent of a minor beneficiary, advising them that a contribution to the trust has been made, and that they have the right to withdraw their portion of that contribution. If the beneficiary does not send a written notice to the trustee within a time period

set by the trust document (often thirty (30) days) that the beneficiary wishes to withdraw his or her share of the contribution, then the right of withdrawal lapses. If none of the beneficiaries exercises a withdrawal right the trustee can then use the cash to pay the annual premium on the insurance policy. The trust is then dormant until the following year. The withdrawal right makes the contribution to the trust a "present interest" gift, sheltered by the annual exclusion. This kind of withdrawal right is sometimes referred to as a "Crummey Power," named after a federal tax case.

Because of the tax advantages of an irrevocable life insurance trust, the IRS may scrutinize these arrangements with particular care. In the audit of an estate tax return, the IRS agent will look closely at an irrevocable life insurance trust. If the examining agent can find some defect in the trust language or in the annual issuance of notices of the right to withdraw contributions, the IRS may take the position that part or all of the trust is subject to estate tax, or that the gifts of cash to the trust to cover premiums were not sheltered by the annual $16,000 gift tax exclusions. Consequently, it is important that the trustee exercise care in issuing the withdrawal notices. These notices should be sent to the beneficiaries by registered mail, return receipt requested, so that the trustee can keep in the files the green return receipt cards to confirm that the beneficiaries received notices of the withdrawal rights. Alternatively, the trustee can send a form of notice that the beneficiary can sign and send back to confirm receipt of the notice. (The beneficiary should simply acknowledge receipt of the notice and should **not** waive the right of withdrawal. Believe it or not, this makes a tax difference. It is preferable for tax reasons to let the right lapse by the passage of time.) The form of the trust document is important to ensure advantageous tax treatment, and scrupulous record keeping by the trustee is equally important.

IV. Paying Estate Taxes

When the donor of an irrevocable insurance trust dies, the trustees(s) can collect the death benefits on trust-owned policies. Sometimes a policy is purchased by an irrevocable insurance trust that pays out the proceeds on the death of the survivor of a husband and wife (known as a "second-to-die" or "survivorship" life insurance policy). This is often desirable because the premiums are lower on a survivorship policy than the premiums on two separate policies. Also, if an estate tax is going to be due, it is typically due from the second of the two estates, so the cash proceeds will be received at the time when estate taxes are due.

The donor's estate should never be entitled to funds from the insurance trust. This would make the insurance trust subject to estate tax. The strategy typically used to shift cash from the insurance trust to the estate so the estate can use the cash to pay the estate taxes is for the insurance trust to **purchase assets** from the donor's estate. If the donor's estate includes real estate, closely held business interests, or other illiquid assets, especially if the family hopes to keep such assets in the family, the insurance trust can purchase these assets from the estate. The insurance trust would then own those illiquid assets for ultimate distribution to the Donor's beneficiaries. The estate will have received the cash necessary to pay taxes and other obligations. As long as the estate has a stepped up basis in the assets that pass through the estate, there will be no taxable gain on such transactions, except to the extent the purchased assets appreciate in value after the death of the donor. If the insurance trust is expected to participate in this kind of transaction, the trust should be drafted with a view that the trust will ultimately hold real estate or closely held business interests for eventual distribution to members of the family. Special care is necessary if, for example, the trust will hold stock in an S Corporation.