LIFE INSURANCE TRUST

The Irrevocable Life Insurance Trust is one of the most beneficial estate planning tools available. The purchase of life insurance in an irrevocable life insurance trust is a key element in most of the highly advertised books and seminars on how to eliminate estate taxes.

Life insurance can provide the resource needed to support the surviving spouse, raise and educate minor children, provide liquidity to pay estate taxes and replace part or all of the estate lost to estate taxes. However, it can make a nontaxable estate taxable and can generate additional taxes when its purpose is to pay the taxes on the current estate -- unless the life insurance ownership and beneficiary designation are structured to avoid having the proceeds included in the insured's estate.

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For example, on a $2 million all community estate, the addition of $500,000 in life insurance can cause the imposition of a tax of $225,000 if the individual dies in 2002 or 2003. Likewise, in an estate in the 50% tax bracket, $500,000 of a $1 million policy purchased to pay the taxes could be lost to tax.

The Irrevocable Life Insurance Trust (ILIT) is intended to provide the structure to avoid having the insurance included in the individual's estate while still retaining its availability for the purpose for which it was purchased. The ILIT is very successful at meeting this objective. However, the Irrevocable Life Insurance Trust has two disadvantages. First, it is irrevocable. The terms of the trust cannot be changed. In addition, its benefits are gained from a little legal maneuvering through a technical and obscure set of IRS rules, not just in the initial structure but in funding the trust each year. Meeting the IRS rules requires certain procedures to be followed and paperwork to be maintained. These technical "hoops" will be explained in this chapter.

Let's look at what we want to accomplish. Our objective is to provide all the benefits for which we purchased the policy (e.g. support for our spouse and children and/or to pay estate taxes) and do so without incurring any transfer (estate, gift and generation skipping) taxes. To keep the insurance out of our estate we must not have any "incidents of ownership" over the policy, and our estate must not be named as beneficiary on the policy. The latter is not difficult. However, being named as the owner, having the power to change the beneficiary and/or having the power to use the cash value are all incidents of ownership. Therefore, we need to transfer all ownership rights to another person. If we transfer all ownership rights to our spouse, we have avoided having the life insurance policy

taxed in our estate, but it will still be taxed in our spouse's estate.

Enter the Irrevocable Life Insurance Trust.

We want the trust 1) to provide for our spouse and our children 2) not be included in our estate, 3) not be included in our spouse's estate and 4) not be subject to gift taxes when we transfer money to the trust to pay the premiums. Can we accomplish these objectives? Yes, but we must jump through several hoops to get there.

Hoop #1 - The policy must be owned by a trust in which the insured is not a beneficiary and over which the insured has no control.

Jump #1 - We transfer all of our ownership rights to the trust, or the trust purchases the insurance policy. We relinquish any control over the insurance policy by appointing someone other than ourself as the Trustee of the trust. Since the trust won't have much money in it until we die, not being the Trustee is generally not a problem.

> Hoop #1 - The policy must be owned by a trust in which the insured is not a beneficiary and over which the insured has no control.

If we transfer an insurance policy to the trust, the insurance will be included in our estate for a period of three years following the transfer. If the trust is the original purchaser of the policy, the policy is excluded from the insured's estate from the date of purchase. If the policy is purchased by the trust, the trust should be the original applicant on the policy.

Let's assume one of our purposes in creating the trust is to provide for our spouse. Therefore, we want our spouse to have the benefit and control over the proceeds from the insurance. Can our spouse be the Trustee and keep the insurance proceeds out of his or her estate?

> We want the trust ... to provide for our spouse and our children ... [and] not be included in our estate...

Hoop #2 - Only the insured's separate property can be placed in the trust if the spouse is a beneficiary of the trust.

Enter one of the technicalities that affects the transfer to the trust of the policy and/or the funds to pay the premiums on the policy. Normally, we would use part of our earnings to pay the premiums on the life insurance. Our earnings are community property. That seems irrelevant, but it isn't. Community property is deemed to be owned one-half by each spouse. If we transfer property to another person (or a trust) and retain the right to receive the income from that property, the property is included in our estate. So, when we create a trust of which our spouse is a beneficiary and transfer community property to the trust,

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our spouse has retained an interest in his or her one-half of the community which was transferred to the trust. We thought we had avoided tax on all of the property by the creation of the trust, but now we have brought one-half of it back in to our spouse's estate.

Can we avoid this result? Yes, simply transfer our separate property to the trust. And what if we don't have any separate property? Create some.

Jump #2 - You can partition community property into two parts, one part is our separate property and one part is our spouse's separate property. The partition must be evidenced by an instrument in writing. Every contribution to the trust must be of the insured's separate property.

We want the trust...not to be included in our spouse's estate...

Our next objective is to avoid all gift taxes on the transfer to the trust. We can avoid gift tax on the transfer, if we jump through another hoop.

Hoop #3 - Give one or more of the beneficiaries the right to withdraw each and every contribution for a period of at least thirty days.

A gift tax applies to any transfer we make to a person or a trust. In order to exclude relatively small transfers from the transfer tax system, each of us can give up to $11,000 each year to as many people as we want. However, if we give someone $11,000 per year for five years with the restriction that they cannot have the gift until the end of five years, the IRS says we have not given that person $11,000 a year, we have given them $55,000 plus interest at the end of five years. The individual must have the ability to use the money at the time of the gift. This requirement is called the "present interest" requirement. The individual must have a "present interest" in the money we have given them. In a trust, our intent is to provide funds for use at a later time, so it seems we can't meet this present-interest requirement.

We want the trust ...not be subject to gift taxes when we transfer money to the trust to pay the premiums.

Jump #3 - We create the "present interest" by giving the beneficiaries the right to withdraw the property contributed to the trust for a specific period of time. If they do not exercise their right to withdraw the money, their right lapses, and they may not withdraw the funds at a later time. The Trustee must send written notices of each and every contribution to the beneficiaries.

About twenty years ago, a taxpayer created one of these "withdrawal right" trusts and gave his minor children the right to withdraw the contributions. The IRS argued that the children were too young to be aware of the withdrawal right and thus the right was illusory. The IRS lost and these trusts have come to be known by the name of the taxpayer, Mr. Crummey. Hence, a Crummey trust is a trust which gives the beneficiaries the right to withdraw each contribution for a period of time, not a trust which was poorly drafted.

These are the hoops for a trust created to own life insurance on our lives to provide for the support of our spouse and our children.

What about a trust which is solely for the benefit of our children or intended solely to provide cash to pay the estate taxes on the death of the survivor of me and my spouse? Yes, this can be an Irrevocable Life Insurance Trust, but some hoops remain.

> Hoop #3 - Give one or more of the beneficiaries the right to withdraw each contribution for a period of at least thirty days.

Frequently this type of trust is a generation skipping trust, sometimes called a Dynasty Trust. The generation skipping trust is a trust which provides for our children and continues for their lifetime, thereby avoiding estate tax in their estates as well as providing protection of these assets from the claims of creditors and, to some extent, from estranged spouses. See the discussion concerning generation skipping taxes in the chapter titled "Transfer Taxes - An Overview" and see the discussion later in this chapter titled "Generation Skipping Trusts".

First, since our spouse is not a beneficiary, the trust does not need to be funded with separate property. We can eliminate that hoop.

Purchasing life insurance in a generation skipping trust may enable us to "leverage" the use of our $1 million generation skipping exemption from generation skipping tax. The ability of the purchase of insurance to leverage the use of our generation skipping exemption depends on several factors. One factor is the proper and timely allocation of a portion of our generation skipping exemption to the trust as discussed below. The leveraging ability also depends on the untimeliness of our death and on a comparison of the investment of the premium were life insurance not purchased.

Of course, we would like to maximize the use of our generation skipping exemption. Indeed, in estates which are larger than $1 million ($2 million for a couple), we have property which cannot be left in this type of trust without subjecting it to the generation skipping tax. With a life insurance trust, we may contribute $200,000 in premium payments over a 10-year period and purchase $2 million in life insurance. However, we must take the steps necessary to ensure that our generation skipping exemption is allocated to the contributions made to the trust each year during our lifetime. If our exemption is not allocated during our lifetime, the exemption will be allocated to the trust upon our death - whoops, we don't have enough exemption to allocate to the $2 million in proceeds. The result will be that the trust will be partially subject to the generation skipping tax. Not a result that we want.

> Purchasing life insurance in a generation skipping trust enables us to "leverage" the use of our $1 million generation skipping exemption from generation skipping tax.

Prior to 2001 exemption was only allocated to a transfer to a trust if there were no beneficiaries who were not "skip" persons. In other words, the trust must be solely for the benefit of grandchildren and more remote generations. If the trust was structured like most generation skipping trusts, ones children were beneficiaries during their lifetime. Prior to 2001 a gift tax return was required to be filed to allocate generation skipping exemption to any contribution to the trust. Many people were not aware of this requirement or failed to allocate exemption each year. The 2001 Tax Act changed the automatic allocation rules to address this problem. The automatic allocation rules are far too complex to discuss in this booklet, but for our purposes it is important to note a couple of aspects of the law. First, the intent was to automatically allocate generation skipping exemption to trusts which continued for our children's lifetime; however, some of the exceptions can catch us so it is unsafe to rely on automatic allocation. Second, the new law allows us to file a gift tax return when the trust is created and elect "in" or elect "out" of automatic allocation of the generation skipping tax exemption.

Enter a new hoop - file a gift tax return when the trust is created and elect for the automatic allocation rules to apply to the trust.

Jump through hoop - When a generation skipping trust is created, a gift tax return should be filed allocating part of our generation skipping exemption to the trust and electing that the automatic allocation rules apply to the trust in the future.

In our above example, if our exemption were allocated to the premium payments, we would have created a $2 million generation skipping transfer using only $200,000 of our exemption. Very nice leveraging --

Wait a minute, isn't all that money going to be used to pay the estate taxes on the death of the survivor of me and my spouse? Well, the trust does not actually *pay* the estate taxes. The trust purchases assets from the estate of the survivor. The estate has the cash to pay the estate taxes and our generation skipping trust owns $2 million of the assets we owned at the time of our deaths.

Very beneficial, very slick -- that's why they are so highly touted - the secret you see in the advertisements on TV are now revealed. Now you don't need to order the book -