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THE IRREVOCABLE LIFE INSURANCE TRUST: AN IMPORTANT ESTATE PLANNING TOOL

A properly designed irrevocable life insurance trust can serve as the cornerstone of an effective and tax-efficient estate plan. Sometimes the focus is on "estate preservation" after the second death of a married couple using survivorship (or second-to-die) life insurance within the trust. Other times single life policies are used and can help meet a myriad of needs, including controlling growth in the estate, supplemental retirement income, and support for the surviving spouse and family, including those with special needs.

Why Use an Irrevocable Life Insurance Trust?

The principal advantage of an irrevocable life insurance trust is its ability to shelter death proceeds from estate taxes in one or more generations. The availability of this tax-free pool of liquidity offers many planning opportunities. One of the most common estate planning needs is liquidity to pay estate taxes. The death proceeds payable to the trust can be used to provide the funding for the paymentof estate taxes where the deceased's estate is made up primarily of illiquid assets, such as real estate or a closely held business. The trustee either makes loans to or purchases assets from the estate to provide the needed liquidity. Under current law most of the estate's assets, with a few exceptions such as IRAs, qualified plans and annuities, will experience a "step-up" in basis to their fair market value as the date of death. Therefore, no taxable gain will result from the purchase of assets.

Another advantage of an irrevocable life insurance trust is that it can be used to avoid "estate shrinkage." In large estates approximately half the value of the estate can be lost to federal and Massachusetts estate taxes. This is true even if the estate has sufficient liquid assets to pay those taxes. The irrevocable life insurance trust can be used, in part, to replace those assets and reduce the estate shrinkage caused by estate taxes.

Sometimes clients ask why they should use an irrevocable trust rather than simply have adult children own the life insurance policy. The use of a trust helps guarantee that the death proceeds will be available for their intended purpose. To the extent allowed by state law, the trust assets can be insulated from divorce proceedings and claims of creditors. Contingencies such as a beneficiary's death or incompetency can be provided for more effectively through the use of a trust than by ownership designations and settlement options offered by the policy. In short, non-tax reasons alone may favor utilizing an irrevocable life insurance trust.

Common Problems in Transferring Policies to the Trust

The trade-off for the benefits of the irrevocable life insurance trust is the added complexity required to gain the tax advantages afforded by the trust. One common issue related to transferring existing insurance policies to an irrevocable life insurance trust is the "three-year" rule contained in Internal Revenue Code section 2035(d). Death proceeds payable on a policy transferred by the insured within three years of the insured's death will be included in his or her estate for estate tax purposes.

One planning technique for single life policies is to insert language into the trust to qualify the death proceeds for the marital deduction should the insured die within three years of transferring the policy into the trust. The language might provide that the proceeds be paid to the spouse directly or perhaps to the insured's existing revocable trust. Alternatively, the irrevocable life insurance trust might contain a "stand-by" marital deduction trust.

The three-year rule problem may also extend to new policies placed in an irrevocable life insurance trust. In order for the rule to apply, the insured must have "incidents of ownership" in a policy and then transfer the policy rights within three years of death. A common problem with new policies is that the irrevocable trust is often not completed at the time the application for the insurance is made. It is acceptable to begin the underwriting process before the trust is drafted so long as no money has been accepted and the insurance application is not bound. If the insurance company makes an offer to underwrite the insured, there should be adequate time for the trust to be completed and for the trustee of the irrevocable life insurance trust to the original owner and beneficiary of the policy.

Controlling Growth, Supplemental Income, Support for Surviving Spouse and Family

An irrevocable life insurance trust funded with a single life policy can be used to control growth of a family's estate. Death proceeds can be used by the trustee to purchase assets from the estate that are expected to realize significant appreciation in the estate of the surviving spouse. This accomplishes a partial "estate freeze." The assets that have appreciation as a potential primary benefit are replaced by insurance proceeds that can be invested in assets that have income as their primary benefit. Future appreciation will accrue outside the surviving spouse's estate in the irrevocable life insurance trust, while income earned on the invested insurance proceeds is used to provide for the surviving spouse's well being.

In certain circumstances, a single life insurance policy in an irrevocable trust can be used to provide supplemental retirement income while the insured is still alive. To avoid having the trust assets included in the estate, the insured must not retain an interest in the income or principal of the trust. For this reason, the irrevocable trust funded with a single life policy is often overlooked as a potential source of retirement income. However, the trust can be designed to allow the trustee to pay out the trust principal to the insured's spouse during the life of the insured. It is possible for the trustee to take withdrawals or loans from the policy and distribute the proceeds to the spouse. In addition, the trust assets can be used for the benefit of the insured's children. During the lifetime of the insured, the trustee can distribute trust income and principal to the insured's children if it is necessary for their health and well-being. Caution, however, must be used because if the distributions may be made to discharge the insured's obligation of support to his or her children the trust principal will be included in the estate.

After the insured's death, the death benefit proceeds can be used to support the surviving spouse. The trustee may pay income or principal to the extent necessary for the health, maintenance and comfortable support of the spouse. The trust might also provide that the trustee may pay the trust income and principal to the insured's children and/or grandchildren. This allows the trustee to spread the trust income among several taxpayers who may be taxed at lower tax brackets than the insured's spouse. (It is important to note that distributions for the benefit of grandchildren may be subject to an additional tax, the generation-skipping tax, and must be appropriately planned for.) Upon the death of both the insured and the insured's spouse, the trust can be divided into shares for the children, and distributed according to the terms of the trust.

In summary, the irrevocable life insurance trust is an important estate planning tool. It can be used to meet estate planning needs, goals and objectives of the insured and his or her family during the insured's lifetime and after death.