

Life insurance is purchased with certain goals in mind. One goal may be to provide a deceased person's estate with **liquidity** to pay off expenses and taxes. Liquidity is usually required when the deceased person's main asset is a business that is cash-poor. Another goal of life insurance is to serve as an **inheritance replacement**, i.e., as in the case where one child receives the family business and the other child receives the life insurance proceeds commensurate with the business's value.

These life insurance goals can be thwarted by the estate tax. Generally, life insurance is included in the deceased's estate for calculation of estate tax. This inclusion can create a bigger problem for the estate unless proper estate planning is undertaken. Example A illustrates the issue:

The problem with life insurance - Example A: An unmarried individual, D, owns a \$4 million business which makes up the bulk of his estate. He wants the business to go to his oldest son. Because the estate tax exemption is \$2 million dollars, D expects to have a *\$2 million taxable estate* for estate tax purposes. Since the estate tax rate is 46%, he estimates that his estate will need to pay \$920,000 in estate taxes. To pay the estate tax, D takes out a \$1 million life insurance policy on his life, payable to revocable trust. D's children understand that the policy is to be used to pay estate taxes on D's estate. *When D dies, the \$1 million life insurance proceeds is included in his estate.* Instead of a \$2 million taxable estate, D's estate has a \$3 million taxable estate with estate taxes due of \$1,380,000. The policy proceeds were only \$1 million. Now D's trustee/executor will have a liquidity problem and have to sell property or make other arrangements to pay the estate tax.

An Irrevocable Life Insurance Trust (ILIT) can solve this problem by keeping the life insurance policy proceeds *out of D's estate*. The mechanics of an ILIT can be outlined as follows:

1. An irrevocable trust funded by an individual, D, with cash.
2. The trustee of the ILIT uses the cash to purchase a life insurance policy on D's life.
3. D makes yearly gifts to the ILIT in advance of the policy's annual premium due date.
4. The trustee uses the gifts to pay the policy premiums.
5. Upon D's passing, the policy pays out the proceeds to the ILIT, and the trustee manages and distributes the funds according to the D's instructions in the ILIT.

Because the ILIT applies for the policy, pays the policy premiums and has the power to change policy beneficiaries, the IRS considers the ILIT as the owner of the policy. D does not own the policy. Therefore, when D passes away, the policy is not included as an asset that he owns in his estate.

Overall, the ILIT concept is fairly straightforward. If you are interested in setting up and ILIT, the following additional considerations should be made to structure the trust:

1. **Selection of Initial and Successor Trustees.** In selecting the initial and successor trustees of the ILIT, you need to select someone other than yourself or anyone related to you. “Related” for this purpose means:
 - Your spouse.
 - Your father, mother, children, grandchildren and siblings.
 - A subordinate employee of a company in which you are an executive.
 - A company in which you hold significant voting control.

The IRS requires a non-related party to serve as trustee to be sure that you do not exert any control or influence over the trustee. If you do have this control or influence, then you would have such power that the IRS will deem you to be the owner of the policy and the policy proceeds would be included in your estate.

2. **Annual Gift To ILIT For Use In Paying Premiums.** You will make yearly gifts to the ILIT of cash, and the ILIT will use the cash to pay the insurance policy premiums.

As you may be aware, an annual gift tax exclusion exists to exempt \$12,000 per donee from gift tax. To qualify the gifts for the annual gift tax exclusion, the gifts need to be “*present interest*” gifts. A present interest gift is a gift which is made *outright* to an individual donee so that immediately after the gift is made, the donee can use the gift as he or she wishes. Normally, gifts to individuals *in trust* are not present interest gifts because the donee does not receive the gift outright.

Nevertheless, it is still possible to qualify gifts in trust as present interest gifts by drafting *Crummey* withdrawal powers in the trust. The *Crummey* withdrawal power derives its name from case law, *Crummey v Commissioner* (9th Cir 1968). Basically, a *Crummey* power gives the trust beneficiary the authority to request the gift outright from the trustee immediately after the gift is made. Because the beneficiary has this immediate right to receive the gift outright, the gift is qualified as a present interest gift and the first \$12,000 of the gift is excluded from gift tax. A *Crummey* power would work as follows:

- The beneficiaries of your ILIT are your two children.
- You give \$24,000 to your ILIT with the intent that the ILIT use the funds to pay the policy premium for the year.
- You wish for the \$24,000 to be exempt from gift tax (\$12,000 to each beneficiary of the trust).
- Upon receipt of the \$24,000, the trustee of the ILIT mails a *Crummey* notice to your two children, notifying them that your gift was made to ILIT and advising them of their right to receive their share of the gift immediately (\$12,000 each).
- The *Crummey* notice provides that the power to elect immediate receipt of the gift outright must be made within 30 days of the date of the notice.
- Your two children let the power lapse, and the \$24,000 gift remains in trust.
- The ILIT uses the cash to pay the policy premiums.

The IRS will not consider the \$24,000 as a taxable gift in this scenario. To further ensure that no gift tax will be due, you should make the cash gifts to the ILIT far enough in advance of the premium due date so the withdrawal powers will expire before the premium must be paid. In this way, the exercise of the beneficiary's right to receive the gift is more meaningful to the IRS. When the *Crummey* notice is sent, the ILIT contains sufficient cash at that time to actually distribute the gift to the beneficiary if such power were exercised. (However, the beneficiary knows not to exercise the right.)

Please note that in maintaining the ILIT, the trustee must maintain trust records which include photocopies of the notices sent to the beneficiaries, as well as each beneficiary's election to not take the gift outright within the time frame allowed. These records should be readily available in case the IRS questions the trust.

3. **Partitioning Community Property.** California is a community property state. Community property is any property earned or accrued during marriage, with the exception of gifts and inheritances. This community property concept presents a problem if you are married and you intend for the ILIT to insure your life for the benefit of a spouse. In this event, and if the gifts to the ILIT consist of community property, half of the ILIT is likely to be included in your spouse's taxable estate when your spouse passes away.

To avoid this result, you should fund the ILIT with your separate property. If you do not have separate property, then you can sign an agreement with your spouse to partition the community property into equal shares of separate property. You should then place your partitioned cash into a separate bank account into your name as separate property. Your spouse should not commingle his or her separate property with community property funds, so should also establish a separate property account. You should then make gifts

from the ILIT using only the funds in your separate property account. In this way, the paper trail is established from your separate property account to the ILIT, if the IRS should ever question¹.

Because of this extra complication stemming from community property, most spouses establish an ILIT jointly, with the beneficiaries of the ILIT being their children in common. In this scenario, no segregation agreement is required, and the ILIT is not included in either spouse's estate.

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The ILIT is a wonderful estate planning tool to provide an estate with liquidity while shielding the policy proceeds from estate tax. The above issues are the main considerations regarding establishing an ILIT. Otherwise, the ILIT can be established with distribution provisions similar to those of your Family Trust, i.e., upon your passing the ILIT holds the cash for your children's benefit and makes distributions to your children per your specifications in the trust document.

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¹ You and your spouse cannot set up your own separate ILITs to benefit each other. The Reciprocal Trust Doctrine would apply to include one-half of your spouse's ILIT in your taxable estate.