Irrevocable Insurance Trusts

Married Taxpayers

Beyond the optimum use of the Marital Deduction and the Unified Credit exclusions available, we must look to actually reducing the taxable value of the estate in order to reduce estate taxes. The concept of removing assets from the estate is significantly more delicate than just rearranging the manner in which they pass to a beneficiary, because it involves one's actually giving up control or ownership of the assets. In the case of John and Martha Doe, however, their estate includes approximately $800,000 of life insurance insuring John's life which might be removed from the estate without their giving up anything of substantial value.

Life insurance is generally taxable as part of John's estate if he (the insured) possesses or controls any of the ownership rights associated with the policy. Therefore, if John has the right to name a beneficiary, borrow the cash value or surrender the policy for its cash value, for instance, the policy death proceeds would be taxed as part of his estate. On the other hand, if John doesn't possess any of those rights, the proceeds are generally not taxable as part of his estate. The issue, then, is whether we can divest John of the ownership rights in the policy, while still ensuring that the proceeds will pass as he and Martha wish for the benefit of their family. If so, we can preserve the economic benefits for the beneficiaries while avoiding any estate tax on the proceeds.

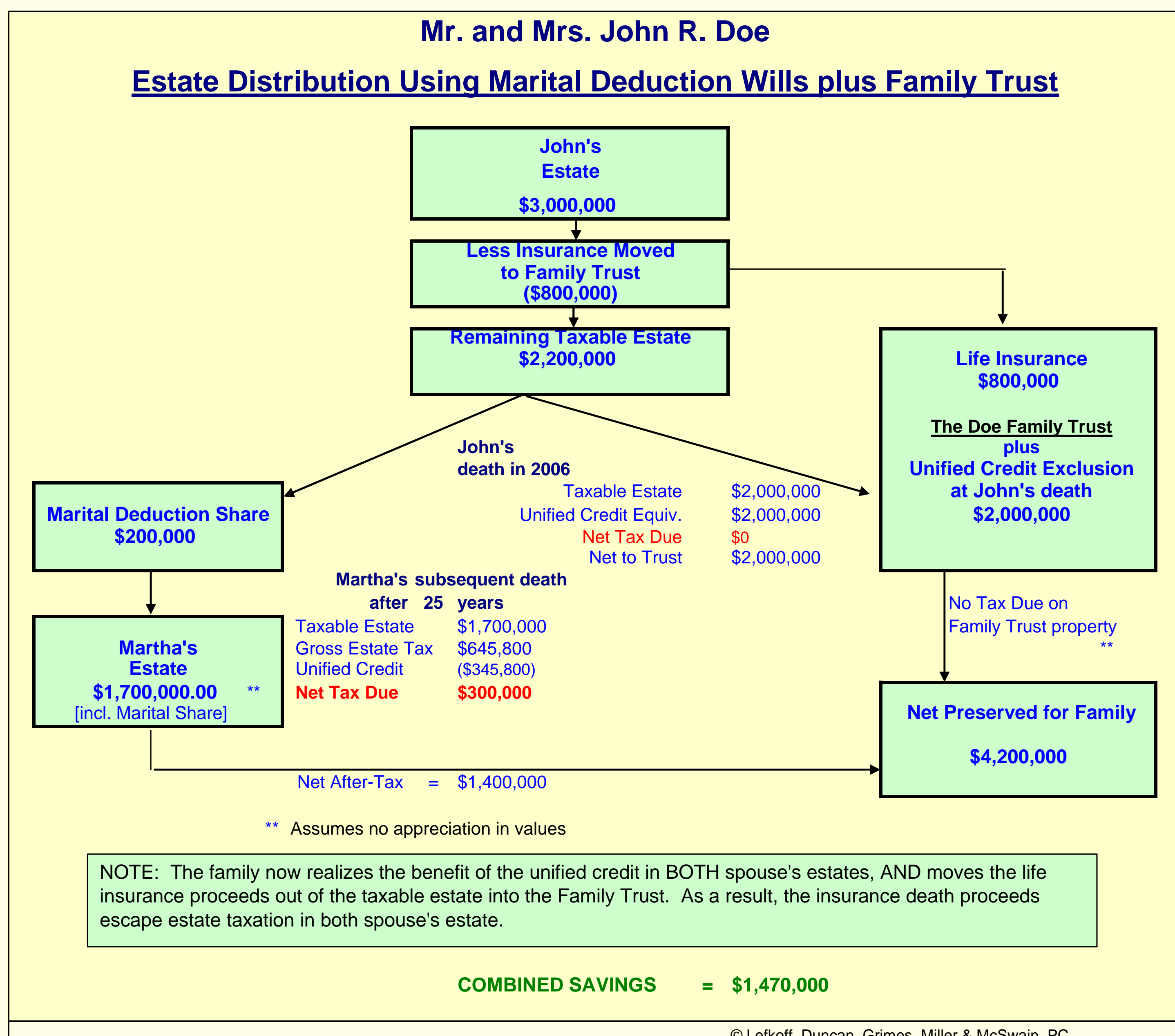
The irrevocable life insurance trust can accomplish that objective, and has been a popular estate planning tool for many years. The primary purposes of the trust are:

(1) to remove the insurance proceeds from John's taxable estate,

(2) to provide Martha and the family with the full economic benefit of those proceeds, and

(3) to prevent those funds from being taxed in Martha's subsequent taxable estate as well.

If these objectives can be accomplished, it can result in substantial tax savings. For example, if we can remove John's $800,000 of life insurance from their $4,500,000 taxable estate, we can effectively reduce the federal estate taxes ultimately payable to about $533,000. That is an additional tax savings of $412,000 beyond the savings from using optimum marital deduction Wills alone. In order to assist in visualizing this idea, consider the following schematic illustration of the Doe's using a trust to own John's life insurance, in conjunction with the disposition of their other assets under their optimum marital deduction wills:



Operation of Trust. The only property which would generally be held in the irrevocable insurance trust would be the insurance policy or policies themselves and periodic gifts of sufficient cash to enable the payment of premiums on the policies. The trust could own policies on John's life, and could also be created to own "second to die" policies for payment of the estate tax due after both John and Martha have died.

The trust itself would be both the owner and the beneficiary of the insurance policy or policies. If existing insurance is to be moved to the trust, then John would make a gift to the trust of all of his ownership rights in the policy. If the transferred policy has already accumulated a cash value, then that value will represent a current gift and the gift tax issues will need to be managed. If John is transferring an existing policy to the

trust, then the estate tax law requires that John must live for three years after the transfer in order to exclude the policy from the taxable estate. If John and Martha decide to acquire a new insurance policy to be owned by the trust, then it is advisable to give only cash to the trust and allow the Trustee to then purchase the new insurance directly. In that manner, John never owned any rights in the policy so the "three year rule" does not apply.

The trust is typically dormant during the insured's lifetime, except for activities related to the maintenance of the policies. The trust would become fully active upon John's death when the policy proceeds are received to be managed and administered by the Trustee for the Doe family.

In our hypothetical case, Martha would be the principal beneficiary of the trust, and could also be the primary Trustee. The trustee would be authorized to use trust income and principal for Martha's support and for the support and education of the children and grandchildren as may be needed. After both John and Martha have died, the trust could (1) terminate and make immediate distribution of the remaining trust assets to the children, or (2) continue to be managed for the benefit of children until they attain the age(s) for distribution which John and Martha specify in the trust instrument, or (3) continue in trust for the lifetimes of the children, providing financial support for family members and protection of the assets from the risks of financial difficulties and marital problems.

In order to effectively save taxes, an irrevocable insurance trust must be drafted to deny John (the insured) any right to revoke, alter or amend the trust in <u>any</u> way after the creation of the trust. Furthermore, John can retain <u>no</u> incident of ownership in the policies assigned to the trust. John cannot borrow against the policies, pledge them as collateral, change the beneficiary or exercise any other right in the policies.

It is possible, however, and advisable in many cases, to allow Martha to exercise such powers to the extent it may be advisable to change the terms of the trust for the children. For instance, Martha might be given limited powers to alter the time and manner in which the trust property will ultimately be distributed to the children. With such a power, any future changes in the needs of the family could be addressed by Martha's exercise of the power to change those terms of the trust.

Furthermore, it is permissible to allow the trust to use trust assets for the benefit of Martha and their children during John's lifetime. Therefore, if the policies accumulate substantial cash values in excess of that needed to maintain the policies, that cash can be used for the other family members even though John has no right to reach it directly.

So long as there are on-going premiums to be paid on the policies in the trust, it will generally be necessary for John to make periodic gifts of cash to the trust to fund those premium payments. Unless the family's annual exclusion gifts ($11,000 per year for each recipient) is already being fully used, it is generally advisable to establish a procedure to qualify the gifts to the trust for those exclusions. Most gifts to a trust will not qualify for the annual exclusion, because the trust beneficiaries do not have an "unrestricted right to enjoy" the cash given to the Trustee. In most cases, this problem is resolved by giving each of the trust beneficiaries (the Doe's children and grandchildren) a limited right to withdraw his or her share of any funds that are given to the trust before the trust actually uses them to make premium payments. This procedure has become well known as "Crummey" withdrawal powers, bearing the name of the taxpayer in the case of <u>*Crummey vs. Commissioner of Internal Revenue Service*</u> in which this principle was first established as law in 1968. By following the rules which have become well established for this procedure, John can treat the gifts to the trust as transfers to the beneficiaries which will qualify for the annual gift tax exclusions for those beneficiaries (up to $12,000 per year each.) This procedure involves a number of housekeeping tasks that the trustee must perform on an on-going basis so long as premium payments are being made, but they are easily manageable with a minimum of attention.