

**IRREVOCABLE LIFE INSURANCE TRUSTS: AN EXAMPLE**

- A.** Husband signs a Trust Agreement naming someone other than himself as Trustee. Both Husband and Wife can sign one Trust Agreement as joint settlors (creators of the Trust) if the Trust will be purchasing or holding “survivorship” or “second-to-die” life insurance on both their lives. (If Husband’s Trust will not be purchasing or holding any insurance on Wife’s life, Wife can be the Trustee, and if Wife sets up a separate Trust to hold insurance on her life, Husband can be the Trustee of that Trust. If the Trust will be purchasing or holding “survivorship” or “second-to-die” life insurance on both Husband and Wife, neither of them should be a Trustee.) *The rest of this illustration assumes that Husband is the sole settlor of a Trust that will hold insurance on his life alone, but the same principles would apply to Trusts holding second-to-die insurance on the lives of Husband and Wife, or to a Trust created by Wife to hold insurance on her life alone.*
- B.** The settlor of the Trust cannot retain any right or power to amend or revoke the Trust or to replace the Trustee (except to replace a resigning, dead, or removed Trustee with a disinterested person not under the settlor’s influence, such as a bank or corporate fiduciary). It is generally advisable for the Trust Agreement to specify a procedure under which a resigning Trustee or the beneficiaries can name a successor.
- C.** The Trust Agreement authorizes the Trustee to purchase and hold life insurance and to pay premiums but does not require the Trustee to do so.
- D.** Ideally, no existing life insurance policies will be transferred by Husband to the Trust.
1. If existing policies *are* given to the Trust, the gift tax value of the policies must be reported on a gift tax return; Husband’s lifetime exclusion amount (\$1 million during the 2003-2010 period) will operate to absorb the gift tax on the resulting taxable gift up to the exclusion amount. Existing term life insurance policies can be gifted to the Trust at a relatively low gift tax cost, but it is better to let such term policies lapse after the Trust purchases new term policies (*See E* below).
  2. If Husband dies within three years of giving an existing life insurance policy on his life to the Trust, the policy proceeds will be included in his estate for estate tax purposes. *See* Code section 2035(a)(2) and its cross reference to Section 2042.
  3. Transferring an insured employee’s interest in a *group* life insurance policy to a life insurance trust will present several difficulties. *First*, the employee must be certain to transfer *all* his rights in the group policy to the Trust, including the right to convert the group coverage to an individual policy. *Second*, the insured employee is treated as making gifts to the Trust each year (equal to the premium cost paid by the employer). If a group term policy is the only policy held in the Trust, there will be no actual money flowing into the Trust, making it impossible to give Crummey withdrawal powers (explained at **G** below) to the beneficiaries in order to qualify the gifts as non-taxable gifts.
  4. If Husband does not want to surrender an existing life policy with significant cash value and pay the resulting income tax, if Husband cannot afford to maintain an existing policy and fund a new policy purchased by his trust, if Husband is no

longer insurable, *or* if the premium cost would be very high on an entirely new policy purchased by the Trustee (*see E* below), Husband may prefer to transfer the existing policy to the Trust and to run the risk that he may die within three years after the transfer of ownership. However, Husband's attorney should advise him in writing about this issue to confirm that Husband is knowingly incurring the risk of having the insurance proceeds included and taxed in Husband's estate.

5. Husband should *not* give to the Trust an existing life insurance policy on which there is an unpaid policy loan outstanding, or which has been pledged as security for any other debt. This could cause all the life insurance proceeds to be taxable income when collected after Husband's death.
- E.** The preferred, safer procedure is for the Trustee of the Trust to apply for *new* life insurance and to become the sole owner and beneficiary of the policy or policies. If Husband never owned or transferred an interest in an insurance policy on his life (as would be the case if the Trustee purchases an entirely new policy), the insurance proceeds cannot be taxed as an asset of Husband's estate under Code section 2035(a)(2). The Trust can purchase any type of life insurance (term, whole life, variable, universal) with any type of payment feature (single life, first-to-die, second-to-die).
- F.** Husband, as the insured, should not make any of the premium payments himself, although Husband's direct payment of premiums may not be a "fatal" mistake. Ideally, Husband makes annual cash gifts to the Trustee, the Trustee deposits the money into the Trust's checking account, and the Trustee writes a check or checks each year to pay the premiums as they become due.
- G.** In order to avoid paying gift tax on the annual cash gifts to the Trust, and to avoid using up any of Husband's lifetime exclusion amount:
1. A sibling, parent, or in-law of Husband or Wife, or some other responsible adult, is named as representative of any beneficiary of the Trust who is a minor (*e.g.*, Husband and Wife's children under 18, if they are beneficiaries).
  2. Promptly after Husband makes each cash contribution to the Trustee, the Trustee sends a notice to the minor beneficiaries' representative, and sends a notice to any other competent adult beneficiary who is given a "withdrawal right" in the Trust Agreement. This withdrawal right is called a "Crummey power," named after the court case that first permitted an annual gift exclusion to be claimed by means of this technique. Each written notice is called a "Crummey notice."
  3. The Crummey notice informs each beneficiary that he or she has the right to immediately withdraw and keep his or her pro-rata share of the amount that Husband contributed to the Trust. Each beneficiary generally is not allowed to withdraw more than the "five-and-five" limit each year (the greater of \$5,000 or 5 percent of the total value of all the Trust assets, including any cash value of the life insurance policies). If the beneficiary does not make his or her withdrawal within 30 days after the notice is sent (the exercise period), the withdrawal right disappears for that contribution and that year. Ideally, the Crummey notices must be sent every year, every time Husband adds gives money to the Trust in order to fund premium payments.

4. The existence of the withdrawal right makes Husband's cash contribution a "gift of a present interest," and it therefore qualifies for the annual gift tax exclusion (\$11,000 per child or other recipient) under Code section 2503(b).
  5. When the withdrawal rights are not exercised and therefore lapse, the "five-and-five" limit per beneficiary prevents the lapse from being treated as a taxable gift by any beneficiary to the other beneficiaries.
  6. If each beneficiary's pro-rata share of the total annual premium cost exceeds the "five-and-five" limit, the disappearance or lapsing of each beneficiary's withdrawal right would be considered a taxable gift by that beneficiary to the extent the amount withdrawable by the beneficiary exceeds the "five-and-five" amount (the greater of \$5,000 or 5 percent, etc). If this is a real possibility, Husband must decide whether the withdrawal rights should be explicitly "capped" at the "five and five" amount (which would make part of Husband's annual gifts to the Trust taxable), *or* whether the beneficiary's unexercised withdrawal rights should be allowed to lapse each year only to the extent of the "five and five" amount, with the excess to continue to be exercisable in future years until they lapse under the same limitation. If the latter strategy is used, the withdrawal rights are called "hanging" Crummey powers and tend to make the Trust's recordkeeping and administration significantly more complicated.
  7. The "Crummey notices" (described in Paragraph 2 above) are sent to the beneficiaries with the unstated expectation that the beneficiaries (*e.g.*, beneficiaries who are minor children, acting through their named representative(s)) *will not exercise* their withdrawal rights. ***There cannot be any informal agreement in advance between the settlor (Husband) and the persons holding withdrawal rights that they will not exercise them.*** If the IRS could prove the existence of such an agreement or scheme, it would disallow the \$11,000 annual exclusions for the cash gifts to the Trust, making those gifts fully taxable as a result.
- H.** Any person who has real rights as a beneficiary under the Trust Agreement (even a remainder interest postponed many years into the future) can be given withdrawal rights. Depending on the amount of money that must be given annually to the Trust to fund premium payments, children, grandchildren, siblings, spouses, etc. can be given withdrawal rights in order to shelter the contributed money from the gift tax. The IRS may challenge the validity of withdrawal rights given to persons whose interest in the Trust is too remote, or for whom there was no real possibility of exercising the withdrawal right because the Trust did not contain sufficient funds during the exercise period.
- I.** It is possible that some future Congress may pass legislation to prohibit the use of Crummey withdrawal powers in order to prevent such transfers to life insurance trusts from escaping potential taxation as taxable gifts.
- J.** The Trust Agreement can contain the same sort of gift provisions that are usually found in a Will (outright gifts, marital trust, children's trusts, disclaimer trusts, etc.), or it may simply provide that all funds left over in the Trust after Husband's death will be poured over into a separately created Trust. Most of the drafting cost for a life insurance trust is

attributable to these specific provisions that are tailored to the client's unique needs, and which have little or nothing to do with the insurance purchased and held by the Trust.

- K.** Because the Trustee of the life insurance trust is the owner of all life insurance policies held in the Trust, the Trustee would have the power to change the beneficiary on each policy, even if the Trust Agreement is silent on this point. Normally, the Trust itself (*i.e.*, the Trustee of the life insurance trust, in his or her fiduciary capacity) should be the named beneficiary on each policy. However, under some circumstances the Trustee might prefer to make a change of beneficiary, so that after the insured Husband's death, the proceeds will be payable to some other Trust (but never to Husband's estate).
- L.** It may be advisable to include in the Trust Agreement a provision explaining or limiting the Trustee's power to change beneficiaries. For example, the Trustee should never make a beneficiary change on a policy that is held in the Trust and which is subject to policy loans or is collateral for some other debt. The IRS would regard the beneficiary change as being a "transfer for value," and although the life insurance proceeds would not be taxable as an asset of the insured Husband's estate, the proceeds would likely be subject to federal income tax under Code section 101.
- M.** The Trust Agreement usually provides that after the insured's (Husband's) death, the Trustee is permitted and authorized (but not required) to use the life insurance proceeds and other Trust assets to purchase assets from Husband's estate or to loan money to his estate in order to pay death taxes, expenses, etc.
- N.** If the Trust Agreement *required* the Trustee to use the insurance proceeds to pay taxes and debts owed by Husband's estate, the insurance proceeds would be taxed as part of Husband's estate on the grounds that they are payable "for the benefit of" Husband's estate (*See* Reg. §20.2042-1(b)(1)). If the Trust Agreement merely *permits* the Trustee to use insurance proceeds to pay debts and taxes owed by Husband's estate, the proceeds actually used by the Trustee to pay such debts and taxes may well be taxable as an asset of Husband's estate (under cases decided in 1939 and 1942).
- O.** If the Trust holds no income-producing assets, it may file income tax returns but will report no taxable income until after Husband's death, when the life insurance proceeds flow into the Trust (The death benefit amount paid on each policy is not taxable, but interest income earned by the proceeds will be taxed).

The above explanation is provided as general information only and is no substitute for legal advice from your own attorney, tailored to your own needs and situation.

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