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FAQ: IRREVOCABLE LIFE INSURANCE TRUSTS

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Q: Why use an Irrevocable Life Insurance Trust?
A: An Irrevocable Life Insurance Trust (ILIT) is commonly used to prevent the taxation of life insurance proceeds after the death of the insured person. Although life insurance proceeds are not subject to income tax, they are includable in the taxable estate of the insured. If the estate is large enough, up to 40% of the life insurance death benefit can be lost to federal estate tax. The solution is to purchase the policy using an ILIT or to gift an existing policy to an ILIT, so that the ILIT owns the life insurance policy, making the insurance proceeds estate tax free. When you gift an existing policy to an ILIT, the policy must be in the ILIT for three years before it is excluded from your estate and not subject to federal estate tax.

Q: I'm not worth millions of dollars, and the federal estate tax exemption is currently $5,430,000. Why should I consider an ILIT?
A: The Massachusetts estate tax exemption is only $1M. If an estate's value is over that amount, the entire estate is subject to tax. So, if you're a Massachusetts resident and your estate is worth exactly $1,000,000 (or less), you're in the clear – but if it's $1,000,001, you'll pay Massachusetts estate tax on the entire $1,000,001. It is surprisingly easy for an estate to exceed $1M when you consider the value of a home, pension, and other personal assets, including the life insurance proceeds at death. The Massachusetts estate tax rate is progressive, with a maximum rate of 16%.

Q: Why must the trust be irrevocable?
A: In order to prevent the life insurance death benefit from being taxed, the insured person must relinquish control of the insurance policy. If the insured person could revoke the trust and take back ownership of the policy, then it would be treated as a taxable asset when the insured dies.

Q: May the insured person serve as trustee?
A: No, the insured person must relinquish control of the insurance policy to a third party trustee.

Q: How are the premiums paid?
A: Since the insured person must give up control of the insurance policy, the trustee is responsible for payment of premiums. However, the insured may pay the premiums indirectly by gifting an equivalent amount into the trust when premiums are due. The trustee will then use that money to pay the premiums.

But this brings up another tax issue – the gift tax. When the insured gifts money to the ILIT, this is treated as a taxable gift to the beneficiaries of the trust (usually the children). Fortunately, there is an annual exclusion against the gift tax, which exempts the first $14,000 of taxable gifts each year to any beneficiary. But the annual exclusion is only available if the beneficiary actually has an unrestricted opportunity to take outright ownership of the gift, rather than let it be used for payment of premiums. This is called the "present interest rule."

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To memorialize the fact that the beneficiary has a current or present interest in the gift, Crummey notices, named after a tax court case, are issued to each named beneficiary, which describes the gift to the ILIT and grants the beneficiary a right to demand his or her share of the contribution. The demand right is usually limited to a number of days, often 30 or less. After the demand right expires, the beneficiary no longer has any present rights to the money. The trustee may proceed to pay the insurance premium and keep the policy in force.

Q: Is notice required each time a contribution to the trust is made?

A: Notice should be given to the beneficiaries at least once per year. This is sufficient even if gifts are made to the trust on a quarterly basis, for example. The notice should include a schedule of dates on which gifts will be made.

Q: What if the insured person wants access to the cash value?

A: One of the major benefits of permanent life insurance is the insured person's access to the cash value buildup within the policy. Since these policies are often purchased as supplemental retirement plans, the insured may not want to establish an ILIT when it restricts access to the cash value. However, the ILIT still permits the trustee to borrow cash from the policy and loan it to the insured person. Although a third party trustee is involved, the cash value remains accessible to the insured.

Q: Do you need to file an annual gift tax return (Form 709)?

A: A lot of factors come into play in making this determination, such as the amount of the annual insurance premium, how many beneficiaries there are in the ILIT, the amount of the cash surrender value the policy has when gifted to the ILIT and whether any tax elections are required to be filed with Form 709, to name a few. Each year a filing assessment must be made. Even if Form 709 is not required to be filed in a given year, a filing is usually recommended to memorialize the "Crummey" gifts and to trigger the 3 year statute of limitations that applies to the IRS review and audit rights.

For more information about Irrevocable Life Insurance Trusts, contact:

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