

USE OF LIFE INSURANCE TRUSTS

**GREENE COUNTY ESTATE PLANNING COUNCIL
SPRINGFIELD, MISSOURI**

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I. Historical Background

The first legislation of significance dealing with life insurance in the United States appears to be the New York Life Insurance Statute of 1840. It provides as follows:

“Sec. 1. It shall be lawful for any married woman, by herself, and in her name, or in the name of any third person, with his assent, as her **trustee**, to cause to be insured, for her sole use, the life of her husband for any definite period, or for the term of his natural life; and in case of her surviving her husband, the sum or net amount of the insurance becoming due and payable, by the terms of the insurance, shall be payable to her, to and for her own use, free from the claims of the representatives of her husband, or of any of his creditors; but such exemption shall not apply where the amount of premium annually paid shall exceed three hundred dollars. (emphasis added)

“Sec. 2. In case of the death of the wife, before the decease of her husband, the amount of the insurance may be made payable after her death to her children for their use, and to their guardian, if under age.”

This statute is noteworthy for a number of reasons, first and foremost of which is that it is, according to professor Charles Kelley Knight, the first statute enacted in the United States dealing directly and exclusively with life insurance. From the very beginning of the legislative history of life insurance, reference was made to trusts funded with life insurance. Many of the legal concepts familiar to us today are reflected in the statute. Notice the following:

A. Gender equality. It provided that any married woman on her own initiative, and apparently without the consent of her husband, could insure his life. While this may seem sexist, it asserts the rights of a married woman, and in that way, may be viewed as progressive for its time.

B. Life Insurance Trusts. The insurance could be procured by the married woman individually, or by her trustee, suggesting that use of a life insurance trust was an accepted practice at that time.

C. Types of Insurance Products. The insurance could be used for “the life of her husband for any definite period, or for the term of his natural life;” -- Term or Whole Life.

D. Creditor Protection. The proceeds were to be free from the claims of her husband’s representatives or his creditors, unless the annual premiums exceeded three hundred dollars. Three hundred dollars was a fairly substantial amount of money in 1840, thus the wealthy were excluded from creditor protection.

E. Primary and Contingent Beneficiaries. If the wife (the primary beneficiary) were to predecease her husband, the proceeds could be used to support her minor children (the secondary beneficiaries).

F. Guardianship Trusts. The proceeds could be paid “to her children for their use, and to their guardian, if under age.”

See Charles Kelley Knight, *The History of Life Insurance in the United States*, University of Pennsylvania, Doctoral Thesis, 1920

II. Planning Analysis for Life Insurance Trusts

Zaritsky and Leimberg have stated:

“The major function of life insurance is to create capital and to solve problems through the use of that capital and the income it can produce.”

The task of the estate planner is to identify potential estate transfer problems the client may have, and then to select the appropriate strategy to solve those problems. Quite often, life insurance, especially when utilized through a trust, provides a multitude of flexible, cost effective, and sometimes “elegant” solutions. The appropriateness of life insurance and life insurance trusts involves consideration of three questions:

- A. What identified needs of the client could be met by life insurance?
- B. How much life insurance is needed and what type of policy would be the most effective?
- C. Which specific life insurance product would be the most effective?

III. Uses of Life Insurance Today - With or Without a Life Insurance Trust

- A. Provide basic necessities of life for the family.
- B. Create estate liquidity with which to pay federal and state death taxes, expenses of administration, and funeral expenses.
- C. Repay the home mortgage, investment debts, and other obligations.
- D. Secure funding for college education and vocational training.
- E. Generate funds for the purchase of a business interest.

- F. Satisfy a business obligation, such as payment of the employer's obligation in a nonqualified deferred compensation plan.
- G. Stabilize a business interest:
 - 1. Pay a business debt.
 - 2. Key employee insurance.
 - 3. Provide assurance to creditors of solvency after key person's death.
- H. Fulfill meaningful and substantial charitable gifts.
- I. Equalize an estate where one child is interested in the business and the other child is not.
- J. Simplify wealth management.
- K. Implement cost-effective wealth transfer to succeeding generations.
- L. Meet special needs to provide for physically handicapped, mentally challenged, autistic and other learning disabled children.
- M. Provide an inheritance for children from a prior marriage.

See Howard M. Zaritsky and Stephan R. Leimberg, *Tax Planning With Life Insurance*, WG&L RIA, 2002, Section 1.01[1]

IV. Structure of an Irrevocable Life Insurance Trust

One method of creating an irrevocable life insurance trust is for an irrevocable assignment of all incidents of ownership in one or more life insurance policies to be made to the trustee of an irrevocable life insurance trust. Such a gift is subject to the provisions of Section 2035 which requires inclusion in the insured's estate of any policy assigned to the irrevocable life insurance trust within three years of the insured's death. An irrevocable life insurance trust may also be created by the proposed trustee making application for the life insurance policy as owner and beneficiary from the inception of the policy. This approach avoids the three year waiting period.

Both revocable life insurance trusts and irrevocable life insurance trusts may be funded or unfunded. (See *Tonkovich v. Crown Life Ins. Co.*, 165 S.W.3d 210 (MoApp.E.D. 2005) for a case involving an unfunded trust.) A funded trust holds assets other than the life insurance policy and the assets are used to pay the premiums on the policy or produce income with which to pay the premiums. The insured typically pays the premiums on an unfunded life insurance trust, either by payment directly

to the insurance company (in the case of a revocable life insurance trust) or by payment to the trustee (in the case of an irrevocable life insurance trust).

Following is an example of a letter which describes the tax implications and procedural considerations in using an irrevocable life insurance trust. I believe this letter is adapted from one first developed by Lawrence Brody.

Date

Dear Valued Client:

The purpose of this letter is to review the intended tax results of creating an irrevocable life insurance trust to be the owner and beneficiary of your life insurance and to outline the procedures which need to be followed both in creating the trust and administering it to achieve those results.

Estate Tax Considerations. The major tax reason for using an irrevocable insurance trust as the owner and beneficiary of your life insurance policy is to remove the policy proceeds from your estate for estate tax purposes. This result will occur if you outlive any direct or indirect transfer of any policy to the trust by three years. This three year rule does not apply to any policies owned by the Trustee from the inception of the policy. We have received assurance from your insurance agent that the policy selected for your life insurance trust will be owned by the Trustee from its inception.

Because the main objective is to remove policy proceeds from your estate for estate tax purposes, the trust is IRREVOCABLE; in addition, you must give up all ownership rights of every kind (including the right to borrow against or withdraw from the cash value and the right to change the beneficiary) in any insurance policy which is to be owned by and payable to the Trustee of the trust.

Gift Tax Considerations. A second major tax consideration in creating your trust was to obtain the maximum annual gift tax exclusion (\$13,000 per donee) for transfers of policies or cash to the Trustee of the trust. Obtaining the full gift tax exclusion for any such transfers to the trust is important, because if the exclusion were not available, each time you transferred a policy or cash to the Trustee you would be using up some part of your lifetime gift tax credit and would be required to file a gift tax return each year.

If the contributions to the trust qualify for the annual gift tax exclusion, you will not need to use up any part of your unified credit, and you will not have to file gift tax returns for contributions to the trust.

Because the availability of the gift tax annual exclusion requires that the donee have a so-called "present interest" in the gift, in the absence of special provisions in your irrevocable trust, the gift tax annual exclusion would not be available, since the beneficiaries have a direct interest in the trust only after your death.

However, your trust agreement includes a so-called "Crummey" withdrawal provision, designed to obtain the gift tax annual exclusion for direct contributions to the trust (of policies or cash). The "Crummey" provision gives each trust beneficiary the right to withdraw an amount from the trust each year equal to any direct or indirect gift to the trust for that year; the fact that a beneficiary might exercise that withdrawal power is a risk you should consider in creating this type of trust and incorporating such withdrawal powers in it.

It is the responsibility of the Trustee of the irrevocable insurance trust to make each beneficiary aware of his or her withdrawal right on at least an annual basis. A copy of the required notice is attached to this letter.

Income Tax Considerations. Your trust is designed to be a Grantor trust for income tax purposes--meaning that you will include on your personal tax return any trust income or other deductions which the trust receives or pays in each year; during your lifetime, however, the trust is not likely to have much income. This provision has been included in your trust to protect the trust beneficiaries from potentially adverse income tax consequences both during your life and after your death.

Creation and Operation of Your Trust. We have made arrangements with your life insurance agent to have the Trustee as the sole and absolute owner of your life insurance policy; since only a Trustee, not a trust, can hold legal title to property, we have also made arrangements for the Trustee of your irrevocable life insurance trust to be the beneficiary of your policy.

Once the insurance policies have been acquired by the Trustee as both owner and beneficiary, any future transactions regarding those policies must be conducted by the Trustee; accordingly, any future change in policy dividend elections, modes of payment of premium, settlement options at death, policy conversions, etc., may be effected only by the Trustee.

All premium notices for policies owned by the Trustee should be sent directly from the insurance company or companies to the Trustee. In addition, all premiums on policies owned by the Trustee on which premiums are due to be paid by the owner of the policy must be paid to the insurance company or companies which issued the policies by the Trustee--not by you.

With regard to the payment of future premiums which you will be personally paying, you should plan to make future gifts to the Trustee to enable the Trustee to pay the premiums due on policies owned by and payable to the trust. As Trustee, I will deposit your gifts into a special account I have established to facilitate payment of life insurance trust premiums, and then write checks for the amount of premium payment to the insurance company.

I will then notify the beneficiaries of the Trust of their withdrawal rights regarding those gifts, and immediately prior to the end of the grace period, I will pay the premiums directly to the insurance company, using a trust check.

Of course, please feel free to contact me if you have any questions about the intended tax consequences of the trust or the procedures which will have to be followed in their creation and operation to achieve those goals.

Sincerely,

John Blackstone, Esq.

Copy to: Insurance Agent

V. Advantages of Irrevocable Life Insurance Trusts

- A. Provide for professional management through a carefully selected trustee.
- B. Remove proceeds from both the insured's and the surviving spouse's gross estates.
- C. Make proceeds available to the surviving spouse for his or her maintenance, support, medical care and education, or for buying assets from the insured's estate.
- D. More control over the ultimate use of the proceeds than with an outright gift.

VI. Disadvantages of Irrevocable Life Insurance Trusts

- A. Legal fees to establish the trust.
- B. Trustee fees for administration.
- C. Must jump through the Crummey "hoops".
- D. For gifts of existing policies, must survive three years or proceeds will be included.
- E. What happens if the insured and his or her spouse divorce?
- F. What happens if the trust is not adequately funded? See "Nursing the Sick ILIT - How a trustee can avoid liability when a trust lacks liquidity," Kimberly E. Civins, *Trusts & Estates*, December 2010. See also a summary of Kimberly E. Civins "Preventive Care for Sick ILITs" at Appendix A.

VII. Life Insurance Trusts as a Component of a Comprehensive Estate Plan

- A. Charitable Estate Planning
 - 1. Charitable Remainder Trust
 - 2. Wealth Replacement Trust

3. Revocable Life Insurance Trust

See Case Studies at Appendix B

- B. Estate Tax Protection
- C. Funding an Asset Protection Trust
- D. Special Needs Trust
- E. Combining Philanthropy And Special Needs Trusts

The IRS has approved charitable remainder trusts that pay income to a legally incompetent child for life, but with the payments going to a special needs trust established for the child (Rev. Rul. 2002-20).

The IRS has indicated that such arrangements are appropriate where the income beneficiary by reason of a medically determinable physical or mental impairment, is unable to manage his or her own financial affairs. The trustee of the special needs trust could have broad discretion as to how much income or principal would be paid to the beneficiary, and could take into account government benefits to which the beneficiary may be entitled.

Assets in the charitable remainder special needs trust could pass at the beneficiary's death to one or more qualified charitable beneficiaries.

- F. Dynasty Trust
- G. Business Succession Planning
- H. Educational Funding

APPENDIX A

SUMMARY OF

“PREVENTIVE CARE FOR SICK ILITs”

by Kimberly E. Civins, *Trust & Estates*, December 2010

- * Conduct Proper Screening - unfunded ILITs do not make sense for corporate trustees, considering relatively low fees compared to high potential for liability.
- * Get Liquidity - encourage the grantor to make extra gifts to provide a financial cushion for *Crummey* withdrawals and possible future unpaid premiums.
- * Consolidate Gifts - encourage annual gifts, even when premiums are paid more frequently, to minimize the number of *Crummey* letters.
- * Look to State Law (or Lobby For It) - a trend has developed in which states are enacting laws to relieve trustees of ILITs from liability. Delaware has such a statute. See 5.12 Del.C. Section 3302(d).
- * Include Special Provisions
 1. Looking to other sources for premium payments, including other ILIT assets and beneficiaries of the ILIT, and notifying any person or beneficiary of the non-payment of a premium;
 2. Selling, assigning, or pledging any policy;
 3. Relieving the Trustee of accountability for the failure to make a premium payment if there are insufficient funds to pay premium;
 4. Satisfying *Crummey* withdrawal rights with all or part of any insurance policy if liquid funds aren't available;
 5. Canceling or terminating an insurance policy;
 6. Exchanging a policy, even for an amount less than the original face amount and collecting cash surrender value remaining after an exchange;
 7. Accepting contributions to the ILIT from any person in an amount necessary to pay premiums in whole or in part;
 8. Entering into arrangements with any party other than Grantor with regard to payments of premiums, including agreement in which the party pays all or a portion of premiums and the Trustee repays the party by transferring all or a portion of the cash surrender value or death benefit of the policy to the party;
 9. Converting a policy into any other form of insurance or annuity; and
 10. Relieving the Trustee of a duty to investigate or monitor regarding the performance of policies, policies being sufficient for client needs, cost efficiency of policies, availability of other products and riders with better options and premium increases.
- * Get a Preemptive Blanket Release and Indemnification from the Grantor and/or Trust Beneficiaries

APPENDIX B

CASE STUDY #1

A Better Alternative to Rental Real Estate: Charitable Remainder Unitrust

A recently retired electrical engineer and his wife, Mr. and Mrs. K, have invested in residential real estate through the years. They are 68 and 60 years of age. Their adjusted gross income is \$100,000. There is no debt on the duplexes and the duplexes produce fairly good income, but Mr. and Mrs. K are getting tired of dealing with problem tenants. They would like to make a significant gift to their local community foundation. What advice do you have for Mr. and Mrs. K?

Wealth Replacement Trust

And/Or

The “Give It Twice” Plan: The Testamentary Charitable Remainder Trust

How would your advice be different if you knew Mr. and Mrs. K have two children and want to leave most of their estate to their children?

CASE STUDY #2

Gift of Remainder Interest in Personal Residence Gift of IRA

Mrs. B, a widow, age 65 and in excellent health, lives in Dexter, Missouri at her personal residence which she owns free of debt. Her home is valued at \$150,000. She has a comfortable retirement income and plans to leave her estate to her local hospital foundation and to her nieces and nephews, since she has no children of her own. Mrs. B is wondering if she should name her trust as the beneficiary of her \$150,000 IRA account. She understands there is no tax advantage to leaving part of her estate to charity after her lifetime since the value of her estate is well under the expected exemption equivalent amount of \$5 million. What could she do to obtain tax benefits from her charitable interests during her lifetime?

CASE STUDY #3

The Taxable Estate

Mr. H has operated a very successful construction business for many years. His net worth is \$17 million. Mr. and Mrs. H plan to leave their children \$10 million estate tax free by taking full advantage of the \$5 million exemption equivalent amount upon the death of each of them. Mr. and Mrs. H are concerned about the exposure of the remaining \$7 million of their estate to estate taxes. What strategies could they employ to minimize or eliminate estate taxes in the amount of \$2,450,000?

- A. Irrevocable Life Insurance Trust
- B. Outright gifts to charity
- C. Family Charitable Foundation
- D. Charitable Lead Trust