

Irrevocable Life Insurance Trust
Questions and Answers

Question 1: I have heard that life insurance proceeds are not taxable. I have also heard that they are taxable. Which is it?

Answer: Both. The beneficiary of your policy will not have to pay income tax on the death benefit, but your estate will have to pay estate tax on the death benefit if you are both the owner and insured. One way to remove the value of the proceeds from your taxable estate is by transferring the policy to another owner such as an Irrevocable Life Insurance Trust (ILIT) or by having the trust purchase a policy insuring your life. Since the trust is the owner, the proceeds will not be taxed in your estate.

Question 2: What is an irrevocable life insurance trust?

Answer: An ILIT is a legal relationship among persons that requires: (1) a person who creates and funds the trust (trustor), (2) a person who benefits from the income and principal in the trust (beneficiary), and (3) a person who manages the property in the trust and distributes income and principal according to the terms of the trust (trustee). Think of it as a contract. The trust document is the writing that contains the relevant provisions.

Question 3: What is the purpose of the trust?

Answer: The primary purpose is to remove the death proceeds of a life insurance policy from your taxable estate and your spouse's taxable estate. Trust provisions could also effectively remove the proceeds from your children's and grandchildren's taxable estates. An irrevocable life insurance trust may also be used to protect assets, limit the use of assets, avoid probate, benefit charities, provide for pets, and to address many other situations.

Question 4: Is it better for me to transfer an existing policy into the ILIT, or should I give the ILIT money to purchase a new policy?

Answer: If you assign an existing policy to the trust for free, the proceeds will not escape taxation unless you live for three years after the transfer. There is no such three-year rule if the trust purchases a new or existing policy.

Question 5: Are life insurance proceeds protected from the claims of my beneficiary's creditors?

Answer: Yes and no. If your beneficiary has claims at the time he receives the proceeds, the proceeds will be protected. If the debt arises after the beneficiary receives the proceeds, the proceeds will not be protected. An ILIT can extend the protection, that is,

the trust document may state that the proceeds held in trust shall not be available to satisfy the claims of your beneficiary's creditors even if the debt arises after your death.

Question 6: I read your Q&A about the New Jersey Inheritance Tax. In the answers to questions 13 and 14 you write that life insurance proceeds are not taxed; does this change if an ILIT owns the policy?

Answer: No. New Jersey law explicitly exempts from taxation the transfer of life insurance proceeds to a beneficiary of a trust that you created during your lifetime regardless of the nature of the beneficiary's interest in the trust. New Jersey law also explicitly exempts from taxation the transfer of life insurance proceeds to a trust that you create during your lifetime.

Question 7: How might an ILIT keep the proceeds out of my beneficiary's taxable estate?

Answer: Let's assume that you make your spouse the beneficiary of the policy. Upon your death, she receives the proceeds free of trust; the money belongs to her. If she invests it or buys a vacation home with it, the value of her taxable estate will include the value of her account or real estate. If she disclaims more than \$675,000.00 into a by-pass trust, your estate will have to pay tax. Now assume that your ILIT owns the policy and is the beneficiary. Regardless of the amount of proceeds, there will be no tax at your death. Your surviving spouse's access to the property held in trust will be limited to income, use and enjoyment for life, distributions of principal up to the value of the greater of \$5,000.00 or 5% of trust value per year and distributions of principal for health, education, maintenance and support. Upon your spouse's death, the balance of the trust would pass in trust or free of trust to the individuals you name. The value of the property held in the trust would not be included in your spouse's taxable estate. The same principals apply to beneficiaries other than your spouse.

Question 8: How can I use an ILIT to benefit my grandchildren?

Answer: Lifetime and testamentary gifts to grandchildren attract the generation skipping transfer tax (GSTT). This is a transfer tax that is payable in addition to any gift or estate tax that is payable. In other words, the gift is taxed twice at the confiscatory rate of 45% (2008-2009). The grandchild is left with 30% of the original gift amount. Each person is entitled to a lifetime GSST exclusion amount equal to the estate tax exclusion amount. If your ILIT owns the policy, the amount of your premiums, not the amount of the death proceeds, will count against your lifetime exclusion amount. This means that you can transfer to your grandchildren or a trust for your grandchildren as much proceeds as your premiums will buy free from estate, gift, and generation skipping transfer taxes. After the trustee receives the proceeds, he can make all investment and distribution decisions based on the terms that you have included in your trust document.

Question 9: What needs to be done?

Answer: The first thing to do is decide if an ILIT is right for you. This will depend on the value of everything you own and how you want your estate distributed after your death. Assuming that the ILIT fits into your plan, we would first identify the policy that you want the ILIT to own. Does it make sense to transfer an existing policy to the trust or should you have the trust purchase a new policy? Next, your attorney should draft the trust after conferring with you. After the trust is drafted and signed, your insurance agent can help you either transfer an existing policy into the trust or purchase a new policy.

Question 10: How do I select a trustee?

Answer: You may not serve as trustee. The trustee may be an individual or a company. Many people name a relative as a trustee; others name a trust company. Still others name an individual and a company to serve as co-trustees. Whom you select depends on a number of factors. Probably the most important factor is trustworthiness. You definitely do not want to appoint someone who is irresponsible, stubborn, self-absorbed or power hungry. You want a person who will consider the best interests of your beneficiary and who will not be tempted to steal or “borrow” from the trust. The trustee must be willing to seek help from professional advisors if necessary and accept his own limitations. The trustee should also be willing to make decisions based on a common-sense application of the law to the facts. If you intend for the trust to last for multiple generations, you may want to name a trust company with longevity. Regardless of whom you appoint, the trustee is entitled to a fee and has a fiduciary duty to put the beneficiary’s interests above his own.

Question 11: What are the trustee’s duties before my death?

Answer: Once the trust owns the policy, the trustee names the trust as beneficiary of the policy proceeds. He must also open a bank account in the name of the trust using either your social security number or the trust’s EIN. At least 50 days before premium payments are due, you give a check for the appropriate amount payable to the trust to the trustee. The trustee, in writing, notifies the beneficiaries that they have the right to withdraw their *pro rata* share of the money and that if they fail to exercise the right within 40 days they lose the right to withdraw. After the 40-day withdrawal period, the trustee sends a check to the insurance company.

Question 12: Is it absolutely necessary to notify the beneficiaries of their right to withdraw contributions that I make to the trust?

Answer: It is not absolutely necessary, but it may be advisable under all the circumstances. The right of withdrawal qualifies the premium contributions for the annual gift-tax exclusion. If you do not notify the beneficiaries of the right to withdraw their *pro rata* share of premium contributions, you will either have to pay gift tax or use

some part of your lifetime gift-tax exclusion. If the premiums are fairly low and there is a fair chance that the beneficiary or the beneficiary's guardian will exercise the right of withdrawal, you may opt to use a part of your lifetime exclusion. On the other hand, if the premiums are high and the likelihood is low that the beneficiary or someone acting in his behalf may exercise the right of withdrawal, then send the notice manage the gift tax.

Question 12: What happens if I want my policy back?

Answer: You may buy the policy for fair market from the trust either for cash or a trade of property of the same or similar value.

Question 13: What happens if I stop contributing to the trust?

Answer: Either the policy will lapse after cash value is exhausted or the beneficiaries will pay the premiums.

Question 14: May the trust pay my estate taxes and other estate debts?

Answer: The trust document may not require the trustee to pay your estate debts. The trust document may permit and even encourage your trustee to buy assets from your estate or loan your estate cash to pay such debts. This will give the estate liquidity without causing the trust assets to be brought back into your taxable estate.

Question 15: What happens if I change my mind about who should be beneficiary?

Answer: The trust document may permit the trustee to remove beneficiaries when events or conditions that you have included in the document occur.

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