

LEGALLY SPEAKING



IRREVOCABLE INSURANCE TRUSTS

Many individuals are surprised to learn that the proceeds from a life insurance policy they own will be included in their taxable estate for federal estate tax purposes, regardless of who is named as beneficiary under the policy. If a surviving spouse is named as beneficiary of a policy, the estate will receive a marital deduction for the amount of the proceeds, and there will not be any estate tax due on the insurance proceeds. However, if the beneficiary of a policy which is owned by a decedent is the decedent's estate, or a person or entity other than the decedent's surviving spouse or a charity, the insurance proceeds are included in the decedent's taxable estate and may result in significant tax liability if the decedent's taxable estate exceeds the current federal estate tax exemption amount of \$2,000,000. With the federal estate tax rate at 45% for taxable estates over \$2,000,000, the IRS may be the real beneficiary of a major portion of an insurance policy.

In order to avoid the inclusion of insurance proceeds in the insured's taxable estate, the insured must not

have any "incidents of ownership" in the policy. Incidents of ownership include any rights to the economic benefits of the policy, such as the power to change the beneficiary, borrow against the policy or cancel the policy. Therefore, a solution to this problem may involve the creation of an irrevocable insurance trust which is the owner and beneficiary of the life insurance policy. This type of trust cannot be amended, and the insured cannot be the trustee or co-trustee of the trust. When the insurance proceeds are collected, the independent trustee will administer the trust for the benefit of one or more named beneficiaries.

The proceeds of a life insurance policy will also be included in the taxable estate of a decedent if the beneficiary of the insurance proceeds is under a legal obligation to use the proceeds to pay the decedent's taxes or debts. Therefore, the trustee of an irrevocable insurance trust ordinarily is authorized (but is not required) to purchase assets from, or loan money to, the insured's estate. In this manner, the irrevocable insurance trust can provide liquidity to a decedent's estate without increasing the amount of the decedent's taxable estate and estate tax liability.

The insured normally provides the funds to the trustee to pay the insurance premiums through gifts to the irrevocable insurance trust. For gift tax purposes, there is an annual gift tax exclusion of \$12,000 per donee; however, in order for this annual exclusion to apply, the gift must be a present gift, i.e., a gift which the donee has a present unrestricted right to receive and enjoy. A gift to a trust for the benefit of a trust beneficiary to enjoy in the future

is not a present interest gift. Therefore, in order to qualify the gifts of funds to an irrevocable insurance trust for the annual gift tax exclusion, an irrevocable insurance trust normally provides that the beneficiaries of the trust have the immediate right to withdraw any gifts made to the trust for their benefit. These provisions in a trust which permit this type of withdrawal by the beneficiaries are referred to as "Crummey" provisions (named after a Tax Court decision, and not used as a descriptive term) and allow the beneficiaries the right to withdraw property of a specific value whenever a contribution is made to the trust. The withdrawal rights are not cumulative, and will lapse if the rights are not exercised within a time period which is specified in the trust agreement. Since the withdrawal rights give the beneficiaries an immediate unrestricted right to use and possess the property, the contributions to the trust qualify for the annual gift tax exclusion.

The recommended approach for utilizing an irrevocable insurance trust is to first establish the trust with an independent trustee by the transfer of funds sufficient in an amount to pay the initial premiums on an insurance policy on the trustor's life. The trustee then provides notice to the beneficiaries of the trust (normally the trustor's children) of their rights to withdraw their respective shares of the contribution to the trust. Assuming the beneficiaries do not elect to withdraw the contribution, the trustee may thereafter apply for a new insurance policy on the life of the trustor, and name the trust as the owner and beneficiary thereof. Thereafter, each year prior to the payment of the annual premium

on the policy, the trustor will again make a contribution to the trust, the trustee will then notify the beneficiaries of their rights to withdraw their respective shares of the contribution, and thereafter the trustee will use the contribution to pay the annual premiums.

An existing insurance policy may be transferred by the insured trustor to the trust; however, in the event of the death of the insured within three years of the transfer, the insurance proceeds will be included in the taxable estate of the insured and the irrevocable insurance trust will not accomplish its intended goal. Therefore, the purchase of a new policy by the trust itself is the recommended approach.

When an individual's estate has increased in size to the point that there will be an estate tax liability, life insurance is often an asset which can be removed from the taxable estate. As is often the case with trusts of this nature, the concept is relatively simple but the implementation is very complex.

CONTACT US FOR
ADDITIONAL
INFORMATION

The foregoing discussion gives you a brief overview of what an irrevocable insurance trust is, the advantages it offers, and how it works. It is a valuable estate planning tool for both individuals with taxable estates, and for others who wish to take advantage of the specific benefits an irrevocable insurance trust has to offer.

Santerre & Vande Krol, Ltd. devotes a substantial part of its legal practice to estate planning, and if you have questions concerning an irrevocable insurance trust or its application to your specific situation, please contact us to discuss your questions.

To contact Santerre & Vande Krol, Ltd. by phone, please call (480) 991-3990.

The offices of Santerre & Vande Krol, Ltd. are located at:

**7920 E. Thompson Peak
Parkway Suite 150
Scottsdale, Arizona 85255**