

# Common Mistakes And Practical Solutions When Considering An ILIT

The irrevocable life insurance trust is a tried and true technique

BY ROBERT A. FISHBEIN

IN A TIME WHEN MORE SCRUTINY than ever is being cast on aggressive advanced marketing concepts, life insurance professionals are increasingly left with the more traditional planning techniques as a primary source of business. One of the tried and true estate planning techniques is establishing an irrevocable life insurance trust (or ILIT) to hold life insurance.

When done properly, the life insurance proceeds provide a source of income-tax-free and estate-tax-free funds for the trust beneficiaries at little or no gift tax cost for the grantor/insured. The proceeds may provide a legacy for the trust beneficiaries and may also serve as a source of liquidity for an illiquid estate.

Of course, the devil is in the details and there are many traps for the unwary along the way to the desired tax and estate planning results.

For example, what if the client doesn't want to incur the cost of setting up the trust but does want one or more family members to own the life insurance? What are the risks of not using an ILIT and what are the tax and non-tax benefits if an ILIT is established?

Once the client decides to use an ILIT, what if the life insurance policy is ready to be issued but the attorney has not drafted the trust? Under what circumstances should a purchaser other than the trust be used pending the preparation and signing of the ILIT?

Is an oral trust a viable temporary solution? What about temporary third-party ownership? When will the transfer of an existing policy to an ILIT cause income tax

consequences for the owner?

This article will analyze some common mistakes when considering whether to establish an ILIT and, where possible, provide practical solutions to those problems.

► *Why can't the client name a spouse, child or some other family member as the policy owner?*

Many clients do not want to incur the cost of retaining an attorney to prepare an ILIT and would rather have a spouse or child named as owner. But there may be adverse tax consequences if the life insurance professional and the client's tax and legal advisors do not know how to set up the life insurance contract properly.

Assume a parent wants to leave his or her two children from a first marriage a specific dollar amount and purchases a life insurance policy to provide the legacy. Assume further the life insurance professional understands that someone other than the insured should own the policy to avoid estate tax inclusion upon the death of insured.

Therefore, the parent chooses his/her daughter, the more responsible of the two children, to own the policy and names his/her daughter and son as beneficiaries. Unfortunately, based on the analysis of the *Goodman* case, upon the parent's death the daughter will be deemed to have made a gift to the son equal to one-half of the death benefit proceeds.

The reason for the gift tax result is that the daughter, as owner of the policy, has the right to change the policy beneficiary until the death of the parent. The death of the parent ends the right to change the beneficiary and completes the previously incomplete gift.

Unfortunately for the daughter, the policy also has matured and the value of the gift is the portion of the death benefit passing to the brother. Assuming the gift exceeds the per donee annual exclusion, then

the daughter will need to use some of her lifetime \$1 million gift tax applicable exclusion amount.

If this exclusion is still available, then gift tax can be avoided, but less of the amount will be available for that daughter's heirs at her death. And if no lifetime exclusion is available, then the daughter will have to pay gift tax. This would be quite a surprise to the daughter, who could incur a gift tax liability of approximately one-half of her share of the death benefit proceeds.

In addition to these adverse gift tax consequences, this contract structure also entails estate tax consequences. Since the daughter owns the policy, if she predeceases the parent, then the value of the policy will be included in her estate. Again, the daughter's heirs may be surprised to learn the amount of estate tax the policy value triggers will reduce her estate.

If a married client resides in a community property state, then each spouse is considered to own 50% of all community property assets, including life insurance policies. This is true even if only one spouse is the applicant and owner of the policy.

If one spouse is the applicant and owner of the policy and the couple's two children are the beneficiaries, the surviving spouse will make a gift equal to one-half of the death benefit proceeds upon the death of the insured spouse.

One solution to these contract structure problems is for the owner and beneficiary to be the same person or persons. In the case of the spouse, this means that the death proceeds will be included in the estate of the surviving spouses due to the "incidents of ownership" held at death.

Another approach would have the children named as both owners and beneficiaries and have the insured pay all premiums from his/her separate assets. If this ap-

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proach is taken, then death benefit proceeds payable to the couple's children will not create an estate tax issue for the surviving spouse, who would have no incidents of ownership.

Assuming a proper contract structure and the *Goodman* problem is avoided, why shouldn't the client use family members as owners and beneficiaries? Assuming that it is undesirable to name the spouse of the insured as owner and increase his or her estate, then it is likely the client will need to name multiple owners and beneficiaries.

One non-tax challenge of this approach is that the owners must agree on all policy actions. While this may not ordinarily be a problem, obtaining the consent of all owners may be cumbersome or an invitation for disrupting the insured's intended purpose for the policy value.

Imagine the displeasure of the insured if the owners agree to surrender the policy to enjoy the policy value. An ILIT, of course, ensures that all policy decisions will be centralized in the trustee(s) and that the policy value only will be distributed in accordance with the wishes of the grantor/insured.

A possible tax problem with using a family member as owner and beneficiary is that the client will be unable to use the per donee annual exclusion for premium payments on the policy. The exclusion is available for the gift of a "present interest" in property.

But when multiple parties own the policy, there can be no present interest in a premium payment. That's because no owner has an individual right to enjoy the premium payment. This is a classic "future interest" in property and, accordingly, must be shielded from gift tax using the lifetime gift tax applicable exclusion amount (if any).

In contrast, a transfer to an ILIT can qualify as a present interest gift where the trust includes Crummey withdrawal rights. This technique gives the trust beneficiary the right to demand the withdrawal of his/her pro rata share of the gift (the policy cash value) during a specified period. The beneficiary thereby gets an immediate right to enjoy the trust contributions, thus qualifying the transfer for the gift tax annual exclusion.

Another tax benefit of using an ILIT is the opportunity to skip a generation of estate tax by using the grantor's generation-skipping transfer tax exclusion amount. If properly structured, the exclusion can be leveraged to avoid estate tax in the estates of the insured's children and leave a significant legacy for the insured's grandchildren.

Besides the tax benefits described above, there are other non-tax reasons for setting up an ILIT, including: (a) greater protection from creditors of the insured and creditors of the beneficiaries; (b) a reduction in probate costs (for those states where probate costs are material); (c) the privacy benefits afforded non-probate assets; (d) better financial management through the selection of a knowledgeable trustee; and (e) greater flexibility to tailor payouts based on the age, maturity and needs of each beneficiary.

If these non-tax benefits are valued, and if the insured also seeks to minimize transfer taxes, an irrevocable life insurance trust is often a better solution to direct ownership by multiple individuals.

▶ *What can the insurance professional do when the life insurance policy is ready but the ILIT is not?* This is a fairly common problem, since the attorney and the insurance professional are not always on the same page as to the time sensitivity of obtaining the life insurance.

The best approach, of course, is to develop relationships with attorneys who are reliable and understand the importance of the timely purchase of the life insurance by the ILIT. Try to give the attorney as much lead time as possible.

If the client has an attorney, offer to contact the attorney to explain the proposed plan, including when the executed trust will be needed. Throughout the planning process remain in communication with the attorney so that you (and the client) can ensure the plan proceeds on the intended timeline.

#### **INQUIRY APPLICATION APPROACH**

When the insurability of the client is unknown, the client may hesitate to pay an attorney to draft a trust that may not be needed. In this situation many companies have an inquiry application to initiate the medical underwriting process.

As the process proceeds (usually for 30 to 90 days), the insurance professional and

the client can evaluate when it would make sense to ask the attorney to prepare the ILIT. Ideally, the ILIT will be signed prior to the formal application being submitted.

▶ *What if insurability is not an issue but best efforts to manage the preparation of the ILIT have been ineffective? Is an inquiry application a viable alternative?* While it is always preferable to manage the ILIT preparation upfront, the inquiry application may be considered under these circumstances. Again, the goal is to sign the ILIT prior to submitting the formal application.

When using this approach, the client's insurance professional, tax and legal advisors should explain to the client that the insured's use of the inquiry application may cause—however unlikely—the insured to be considered the policy applicant. If so, the death benefit proceeds will be included in the insured's estate if he or she dies within three years of transferring the policy to the ILIT.

But there should be no estate inclusion given these facts because no premiums have been paid, the contract has not been issued, and the inquiry application is a medical inquiry, not a formal application by the insured. Still, given the lack of legal authority on this point, the life insurance professional should understand the legal risk whenever using an inquiry application.

In the case where insurability is not an issue, of course, good communication with the client's attorney can avoid entirely exposing the client to this legal risk.

#### **ORAL TRUST APPROACH**

Another approach when the life insurance policy is ready but the ILIT is not is to establish an oral trust pending the signing of the ILIT. An oral trust is an unwritten trust agreement evidenced by a memorandum of understanding confirming the existence of the trust and that its terms will be reduced to writing at a later date.

While some states recognize the legality of oral trusts, this approach presents practical problems and risks for all involved parties (including the life insurance company). Suppose the parties try to reduce the terms of the trust to writing later but the grantor and trustee disagree as to what was intended?

What if the insured dies before the trust terms can be memorialized? What if the parties never reduce the terms of the trust to writing? One easily can understand that

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an oral trust, even if legal, creates significant potential risk with respect to the administration of the life insurance policy and is a recipe for dispute and disagreement.

The lack of written provisions also could allow the IRS to challenge the irrevocability of the trust with the unwanted result of inclusion of the death benefit proceeds in the insured's estate.

#### **HEALTHY APPLICANT (OR TAKE A CHANCE) GIFT APPROACH**

If the insured is healthy, should he or she apply for and own the policy and later transfer it to the ILIT? The obvious risk is the insured will die within three years of the transfer and the death benefit proceeds will be included in the insured's estate.

However, the purchase of a term policy by a family member in the event the insured dies during the three years can address this risk. In the case of a survivorship policy, many insurers offer a term rider to gross up the death benefit to cover the estate tax if both insureds die within three or four years of policy issue.

#### **HEALTHY APPLICANT (OR TAKE A CHANCE) SALE APPROACH**

As an alternative to the gift approach, should the healthy client apply for and own the policy and then sell it to the ILIT? Assuming the trust pays the insured fair market value for the policy, this approach greatly reduces the period during which the insured must live to avoid estate tax inclusion.

However, the transfer for value rules do not appear to provide an exception for the sale to an ILIT. Result: The portion of the death benefit proceeds in excess of the amount paid for the policy and subsequent premiums paid will be subject to income tax. So, this is not a practical solution.

#### **THIRD-PARTY APPROACH**

Another approach is for a trusted friend or family member to apply for and own the policy and then transfer it to the ILIT. Assuming the temporary owner is the insured's spouse, the unlimited marital deduction will shield gifts from the insured to the spouse from gift tax.

If a child or other third party is the temporary owner, then gifts from the insured must be less than the per donee annual exclusion; otherwise, they will reduce the insured's lifetime gift tax applicable exclusion amount.

Upon transfer of the life insurance policy from the temporary third-party owner to the

ILIT, there will be potential gift tax (presumably based on the gross premium paid to date if the transfer is made soon after the issuance of the policy). If the temporary third-party owner is also a beneficiary of the ILIT, then the retention of an interest in the policy would result in inclusion of the policy cash value in the third party's estate should he or she predecease the insured.

► *What if the client has an existing policy that he wants to transfer to the ILIT?* Before transferring the policy, the life insurance professional should determine whether there is an outstanding loan on the existing policy. If the loan exceeds the policy basis, then the difference will be taxable income to the insured grantor (who has been relieved of that part of the loan obligation).

In addition, the transfer violates the transfer for value rules and will result in the death benefit proceeds being subject to income tax (to the extent they exceed the sum of the consideration paid and subsequent premiums paid on the policy after the transfer). This is because the gift exception to the transfer for value rules requires that the transferee's basis be determined in whole or in part by reference to the transferor's basis.

Where the loan exceeds the transferor's basis, the greater of the transferor's basis or the amount paid (or the loan amount) determines the new basis. To avoid this result, always ensure the client pays down the loan so it equals or is less than the policy basis before transferring the policy.

An ILIT is a reliable estate planning technique with significant tax and non-tax advantages that should be considered for many clients. Attention to detail is required when contemplating how to establish the trust.

While this article provides discussion of some issues for life insurance professionals, many more issues must be considered. For example, what provisions should and should not be included in the ILIT document? What actions must be taken once the ILIT is signed?

And how should one administer the ILIT (including the mechanics and tax implications of the Crummey withdrawal rights)? While these questions are beyond the scope of this article, suffice it to say that even a "simple" estate planning technique has complexity and requires careful attention to detail if the desired benefits are to be realized. ■

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