THE IRREVOCABLE LIFE INSURANCE TRUST

Most people buy life insurance to protect their family, not to increase the amount of federal estate tax their estate may have to pay. Your estate may bear a greater tax burden, however, if you are the owner of an insurance policy or you have an "incident of ownership" in a policy, such as the right to name and change beneficiaries, the right to borrow on policy cash values, or the right to surrender the policy for cash. Your ownership of the policy or retention of an incident of ownership in the policy will cause the insurance proceeds to be includible in your taxable estate, even though the proceeds pass directly to the designated beneficiary, and not through your probate estate.

If your surviving spouse is the beneficiary, the proceeds generally will not be taxed at your death, even if they are includible in your estate, because they will qualify for the estate tax marital deduction. This option, however, merely defers the estate taxation of the proceeds until your spouse's death to the extent that your spouse does not use up the proceeds during his or her lifetime. The result is the same if your spouse owns a policy on your life. Another alternative is to have your children own the policy. This may not be satisfactory if your children are not fiscally mature or you want your spouse to have use of the proceeds.

The life insurance trust has become a popular estate planning tool because it can be structured to give your spouse use of the policy proceeds while preventing the proceeds from being subject to estate tax at either your or your spouse's death. In fact, the trust can be used to insulate the insurance proceeds from estate tax for multiple generations. In addition to reducing estate tax costs, the trust serves as a vehicle for managing the insurance proceeds for the beneficiaries.

It should be noted that there is one circumstance in which an irrevocable insurance trust will not reduce estate tax. If you transfer an existing policy to a trust and do not survive the transfer by at least three years, the policy will be included in your taxable estate. The trust will provide for such a contingency by causing the policy proceeds to qualify for the marital deduction, thereby deferring the estate tax until your spouse's death.

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Trust Features Relevant During Insured's Lifetime

A life insurance trust is funded by transferring existing policies to the trustee or transferring funds to allow the trustee to purchase a new policy. The latter alternative avoids the possibility that the proceeds could be drawn back into your taxable estate should you die within the following three years. You must also make periodic contributions to the trust in order for the trustee to make the premium payments.

The policies and funds transferred to the trust are taxable gifts by you to the trust's beneficiaries. The gift tax value of an existing policy generally approximates its cash value. Gift tax can be reduced or eliminated, however, by drafting the trust so that the beneficiaries have a right for a limited period of time--generally 30 days--to withdraw property transferred to the trust. It is not intended that the beneficiaries exercise this right, but it allows gifts to the trust to qualify for the annual $10,000-per-donee exclusion from gift tax ($20,000, if you are married and elect to "split" the gift with your spouse). The annual gift tax exclusion will be indexed for inflation in $1,000 increments for gifts made after 1998, but the inflation adjustments through 2000 were not enough to increase the annual exclusion above $10,000 for gifts made in 2000. Each beneficiary's right of withdrawal may be further limited to $5,000 in order to ensure that, under another provision of the gift tax law, *the beneficiary* is not treated as having made a gift by forfeiting his or her right of withdrawal. As a result, the amount of annual premium that can be paid to the trust free of gift tax may be limited to $5,000, multiplied by the number of trust beneficiaries (your spouse and children, for example). If the value of an existing policy transferred to the trust exceeds the annual gift tax exclusion, you can use a portion of your combined gift and estate tax credit to shelter taxable gifts from tax. In 2001, the cumulative total of all taxable transfers sheltered is $675,000, and this amount increases over the next five years to $1 million in 2006.

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Trust Features Relevant After Insured's Death

Following your death, the trustee collects the insurance proceeds and invests them in income-producing assets. The income and principle may be used to provide for the support of your spouse and children. Following your spouse's death, the trust may continue for the benefit of your children and grandchildren, or may be distributed to your descendants when they reach specified ages.

This memorandum only highlights the features of life insurance trusts. The costs of establishing and administering a trust must be weighed against the potential gain in estate tax savings and estate planning flexibility. We can help you decide whether a life insurance trust is appropriate for you.