

Abstract: The IRS has regulations that an irrevocable life insurance trust (ILIT) trustee must follow to exclude the ILIT's policy proceeds from federal estate and income tax. It is in the best interest of the insured to see that the trustee is following these regulations annually. Why? Because any significant mistake — even an honest one — may prompt the IRS to challenge the trust and tax the life insurance proceeds. This article discusses how to protect an ILIT's tax-advantaged status.

Is Your Trustee Annually Maintaining Your Insurance Trust? If Not, You Could Lose Tax Advantages

Just because you have no control over the assets in your irrevocable life insurance trust (ILIT) doesn't mean you shouldn't properly maintain it. The IRS has regulations that your trustee must follow to exclude your ILIT's policy proceeds from federal estate and income tax. It's in your best interest to ensure your trustee is following these regulations annually.

An ILIT holds one or more insurance policies on your life. Each year, you gift money to the ILIT that your trustee uses to pay the premiums. After your death, your trustee will distribute the insurance proceeds according to your instructions.

One advantage of an ILIT is that it holds the life insurance policies outside of your estate. Thus, the insurance proceeds won't be subject to estate tax after your death. The IRS isn't happy about this loophole and may scrutinize your ILIT for mistakes so it can collect the estate tax. Here's a closer look at how you can protect your ILIT's tax-advantaged status.

The Life Insurance Policy

After you establish an ILIT and deposit cash to cover the first insurance premium, the trustee will either purchase an insurance policy on your life or transfer an existing policy into the trust. In either case, the trustee must be the policy's owner and beneficiary.

Your gift to the ILIT -- whether cash or an existing insurance policy -- qualifies for the annual gift-tax exclusion of up to \$10,000 per beneficiary. If your gift is an insurance policy transfer, its value is the current year's premium (if it's a term policy) or the cash surrender value (if it's a whole life policy). If you transfer an existing policy to your ILIT and you die within three years of that transfer, the proceeds will be included in your estate for estate tax purposes. You can avoid the three-year rule by gifting cash to the trust and having the trustee purchase a new policy, if you are insurable. You can then surrender the old policy and use the cash value, if any, to pay the premiums on the new policy.

Premiums And Crummey Notices

Each year you will make a gift of cash to the ILIT, and the trustee will use it to pay the annual premiums. The gifts qualify for the annual gift-tax exclusion as long as the IRS considers the gifts "of present interest."

To confer present-interest status on the gifts, your trustee must give the beneficiaries a withdrawal right - - also called a demand right or a Crummey power. (For beneficiaries who are minors, your trustee should send Crummey notices to their parents or guardians.) This requirement applies to the first year's gift as

well as every subsequent year's. If your trustee forgets to send the Crummey notices, the IRS may include the gifts as part of your taxable estate.

Of course, you should explain to your beneficiaries that allowing the right to lapse each year without withdrawing the cash is in their long-term best interest. As soon as the withdrawal period lapses -- typically after 30 or 60 days and assuming the beneficiaries don't exercise their withdrawal rights -- the trustee can use the money to pay the premium.

Records and Tax Returns

Your trustee is responsible for filing annual tax returns for the trust if its gross income is more than \$600. The trustee should also maintain certain records in case the IRS chooses to examine the ILIT's operation. These records include:

- Copies of all Crummey notices sent to -- and related correspondence with -- the beneficiaries,
- Canceled checks from your individual or joint checking account showing the gifts you made to the ILIT, and
- The trust's checking account records, showing gift deposits and premium disbursements.

If the trust owns a second-to-die policy on your and your spouse's lives, your trustee should ensure gifts to the ILIT continue after you or your spouse die to pay the premiums.

Mistakes Can Be Costly

Any significant mistake -- even an honest one -- may prompt the IRS to challenge the trust and tax the insurance policy's proceeds. If you or your trustee have any questions about the proper way to handle your ILIT assets, please call before you act. And to learn why a partnership can also be an advantageous way to hold your life insurance, please fax back page 6 for a complimentary copy of our Estate Planning Insights report, "Which Should Hold Your Life Insurance -- A Trust or a Partnership?"

Avoid Incidents of Ownership

To maintain your ILIT's tax-advantaged status, avoid exercising any control over the trust. In IRS terms, the insured party must not have any "incidents of ownership" during the trust's life. If you violate this rule, the IRS will include the insurance policy in your estate and tax the proceeds. Incidents of ownership include the ability to:

- Change or add a beneficiary,
- Surrender or cancel the policy,
- Assign the policy or revoke a policy assignment,
- Borrow against the policy or pay premiums with policy loans, or
- Pledge the policy as collateral for a loan.