KAREN S. GERSTNER & ASSOCIATES, P.C.
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
Telephone (713) 520-5205
Fax (713) 520-5235
www.gerstnerlaw.com

FREQUENTLY ASKED QUESTIONS
About

Irrevocable Life Insurance Trusts

Is Life Insurance Subject to Estate Tax?

Life insurance death benefits are generally exempt from income tax. However, they are not generally exempt from estate tax. Instead, life insurance proceeds are fully includable in the insured's gross estate, subject to estate tax rates as high as 50%. If life insurance proceeds are paid to the surviving spouse, the marital deduction will shield them from estate tax in the estate of the first spouse to die; however, on the death of the surviving spouse, the remaining proceeds will be taxable along with the rest of his or her property.

How Can Estate Tax Be Avoided?

Life insurance is subject to estate tax if the insured person owns or controls the life insurance contract. Therefore, estate taxation of life insurance often can be avoided if the insured is willing to part with all "incidents of ownership" in the policy. "Incidents of ownership" include all rights to benefit from or control the insurance policy. Thus, for example, they include the right to change the beneficiary; the right to borrow against the policy; the right to surrender the policy for its cash value; and the right to pledge the policy as collateral for a loan.

How Does a Life Insurance Trust Avoid Estate Tax?

If someone other than you buys insurance on your life, and holds all incidents of ownership over the policy, the death benefits will be completely excluded from your gross estate for federal tax purposes. In other words, third-party ownership of life insurance makes the death benefits estate tax free. Some people select their adult children to serve as owners. Frequently, however, the third party selected to own the insurance is an "irrevocable life insurance trust" ("ILIT").

What are the Benefits of Using a Life Insurance Trust?

Using an ILIT to own the insurance offers some significant advantages over ownership of the policy by the insured's children. For example:

- If you intend for your spouse to benefit from the life insurance, an ILIT can be used to provide for the surviving spouse, with any balance remaining at the spouse's death passing to the children.

- An ILIT can be structured to continue after your death as a vehicle to manage and preserve wealth for your children (and/or grandchildren). For example, optional management assistance can be provided by naming a trusted family member to serve as trustee, or by naming a professional trustee or co-trustee. And holding the proceeds in trust can preserve their exemption from creditors' claims and keep them beyond the reach of a divorce court's property settlement powers.

- If properly structured, an ILIT can avoid estate tax not only at your death, but also--substantially if not entirely--at your children's deaths. Insurance on your life owned directly by your children--to the extent not consumed by them during their lifetimes--will be included in their taxable estates when they die.

- With an ILIT, you can control the future beneficial ownership of the insurance (for example, you might provide for trusts that last for your children's respective lives and then continue for their children); however, if your children own the insurance

directly, they can sell and/or Will their interest in the policy to whomever they please.

- With an ILIT, you can provide a source of cash to the executor of your estate for the payment of estate taxes. (Generally, an ILIT will be coordinated with your Will to facilitate this.) However, if your children own the insurance directly, it may not be possible to force them all to apply their share of the benefits towards the payment of your estate taxes.

What if I Transfer Existing Insurance to the Trust?

If you transfer a life insurance policy on your life to a third party, you must survive for at least three years after the transfer date in order for the insurance to be estate-tax free; otherwise, the insurance will be treated as if you had never parted with it. On the other hand, if someone other than you is the initial purchaser of the insurance, the three-year rule does not apply. Therefore, if you are planning to purchase a new insurance policy on your life and you want that policy to be owned by another person, that person should acquire the policy from its inception. For example, if you use an ILIT to own insurance on your life, you can avoid the three-year rule if you establish the ILIT before you acquire the policy, and then let the ILIT actually purchase the insurance as the original owner.

How Does the Trust Get the Money to Pay the Insurance Premiums?

If you transfer an existing policy into the ILIT and that policy is paid up, you will not have to worry about future premiums. If the existing policy is not paid up, and in virtually all cases involving new policies, you will have to provide the money for future premium payments. You have two options. First, you can transfer a lump sum to the ILIT up front, and then the trust can use that sum (and the income it earns) to pay the premiums. The second and more commonly used option is to make regular (usually annual) cash gifts to the ILIT that are large enough to cover the premiums as they become due.

Are Transfers to the Trust Treated as Gifts?

Every transfer that you (or anyone else) makes to the ILIT will be treated as a gift, which is potentially subject to gift tax. For example, if you transfer an existing policy to the ILIT, you have made a gift roughly equal to the current cash value of the policy. Likewise, when you make additional cash transfers to the ILIT to provide for the payment of premiums, those transfers are treated as gifts, too. If a "taxable" gift is made, a gift tax return must be filed. No gift tax is paid until the total of all taxable gifts made exceeds the lifetime gift tax exclusion amount (currently $1,000,000).

Are Transfers to the Trust Subject to Gift Tax?

Fortunately, not all gifts are subject to gift tax. A properly drafted ILIT will avoid gift tax by taking advantage of the $12,000 per year (2006 amount) "present-interest exclusion." Outright gifts of cash to your children clearly qualify for the $12,000 per year present-interest exclusion. If an ILIT is used, however, the rules are more complex. The $12,000 per year exclusion is available only for gifts that qualify as "present interests." Gifts to trusts are usually treated as gifts of a future interest, which do not qualify for the exclusion. To avoid this problem, most ILITs contain "withdrawal rights." By giving each beneficiary the present right to withdraw the amount of any gifts made to the ILIT (up to $12,000 per year), those gifts qualify as present-interest gifts, which are not subject to gift tax. (Note that if you intend for the funds in the ILIT to be excluded from estate taxation in your children's estates, a gift

tax return should nevertheless be filed to enable you to allocate a portion of your "generation-skipping transfer tax" exemption to transfers made to the ILIT.)

How Do Withdrawal Rights Work?

Most ILITs contain withdrawal rights which give each beneficiary a limited window of time to withdraw his or her pro rata share of the gift(s) made to the ILIT for that year (not to exceed $12,000 per year). If the beneficiary is a minor, then his or her parent or guardian exercises (or elects not to exercise) the right for the beneficiary. Beneficiaries with withdrawal rights may either exercise the right (i.e., take the money) or choose not to--in their own, absolute discretion. This is one aspect of the ILIT that can be troubling to clients. However, in the vast majority of cases, the children will understand your estate planning goals (that is, that you are trying to minimize taxes and maximize the children's inheritance). As a result, they will usually choose not to make a withdrawal.

Can Husbands and Wives Both Make Gifts?

If neither the husband nor the wife is a beneficiary of the ILIT, both spouses can make gifts to the trust. More commonly, the spouses contribute insurance policies or cash which is "community property" under Texas law; in that case, both spouses are treated as having made a gift to the ILIT. If one spouse is a beneficiary of the trust (for example, if the husband creates a trust to benefit his wife and children) it is very important that the beneficiary spouse *not* make any contributions to the ILIT (and that no community property is contributed). This often means that the couple must execute a "partition agreement" each time a gift is made, to create separate property for the insured spouse to contribute to the trust.