Introduction

Life insurance plays a unique role in estate planning in that it can help: (1) provide liquidity to pay estate taxes and expenses of administration, (2) replace earnings in the event of death, (3) equalize inheritances among heirs and (4) fund the transfer of a family business. When life insurance is needed, an Irrevocable Life Insurance Trust (ILIT) offers both tax and non-tax advantages that are not available with outright policy ownership by an individual.

What is an ILIT?

An ILIT is an irrevocable trust created to own life insurance. The ILIT is both the owner and the beneficiary of one or more life insurance policies, typically insuring the life of the person or persons creating the ILIT, known as the grantor. If the trust is structured properly, life insurance proceeds received by an ILIT will not be subject to income tax or estate tax upon the death of the insured or the insured’s spouse. The trustee can generally be anyone other than the insured, although naming an “independent trustee” can offer greater flexibility for estate planning. If a trust beneficiary is trustee, distributions should generally be subject to an “ascertainable standard” such as health, education, maintenance, and support.

How Does it Work?

The grantor will set up a trust for the benefit of his/her family and fund the trust. This is typically accomplished with annual contributions of cash and, in some cases, non-cash assets as well. Gifting is typically how many trusts are funded. Gifts can be made up to certain limits without transfer tax consequences (the annual exclusion, which is $14,000 in 2013, and the lifetime applicable exclusion amount, $5,250,000 in 2013, both of which are indexed for inflation). Such gifts can allow clients to leverage their gifts during lifetime with life insurance and gain significant tax benefits.1

The trustee of the trust will purchase a single life or survivorship life insurance policy on the life or lives of the grantor(s).

The trustee will often have the discretion to make distributions to some or all of the trust beneficiaries during the grantor’s life.

The trust should receive the life insurance proceeds free of estate and income tax.2

The trustee can distribute assets to the beneficiaries following the grantor’s death. The trust may terminate at that point, or the trust may stay in existence for several generations, depending on the terms of the trust document.

Making “Present Interest Gifts” to an ILIT – the Use of Crummey Withdrawal Powers

Contributions to an ILIT typically can avoid (or partially avoid) gift tax if the beneficiaries possess a power to withdraw the contributions for a limited period of time. For the gift to qualify for the annual exclusion, it must be a “present interest” gift. These withdrawal powers, called “Crummey Powers,” are not frequently exercised, they cause the contributions to be present interests and thus qualify for the annual exclusion from gift tax.3
ILITs almost always include “Crummey Powers” for the primary beneficiaries of the trust, such as the grantor’s children, and may sometimes be referred to as “Crummey Trusts.”

A “Cristofani Trust” is a name for an ILIT that gives “Crummey Powers” to the primary beneficiaries of the trust as well as the contingent or secondary beneficiaries of the trust (the grantor’s grandchildren or other relatives such as nephews/nieces or children’s spouses). A Cristofani Trust is named after a Tax Court case and can be used in some cases when a trust is purchasing a large life insurance policy and the grantor needs additional annual exclusions to fund the trust. However, trust beneficiaries who receive withdrawal powers should have at least a contingent interest in the ILIT, and all Crummey beneficiaries should receive actual notice of their withdrawal powers.

**What are the Different Types of ILITs?**

There are several different types of ILITs that are available depending on the planning needs and preferences of the grantor and his/her family. A given trust may be one or more of the following:

**Spousal Access Trust:** ILITs that allow distributions to the grantor’s spouse during life and at death are known as Spousal Access Trusts. A Spousal Access Trust can provide the non-grantor spouse and children with access to the insurance proceeds without subjecting the insurance proceeds to estate taxation in the estate of either spouse.

**Dynasty Trust:** ILITs known as Dynasty Trusts can be used for Generation-Skipping transfer (GST) tax planning and may last for several generations, unlike a traditional ILIT. The Dynasty Trust can give each generation access to the trust assets (such as for health, education, maintenance and support), while keeping the remaining trust assets outside of the beneficiaries’ taxable estates and exempt from GST tax for as long as state law permits.

**Credit Shelter Trust:** A Credit Shelter Trust, also known as a bypass or family trust, receives a decedent’s remaining applicable exclusion amount at death. The trust is outside of the taxable estate and will typically pass on to the children and grandchildren free from estate and gift taxes. The assets inside the Credit Shelter Trust can be used to purchase life insurance on the surviving spouse (as an alternative to an ILIT) or the Credit Shelter Trust assets can be leveraged by making a loan to an ILIT to fund life insurance premiums.

**Grantor Trust.** Another type of ILIT is known as a “Grantor Trust” or a “Defective Grantor Trust.” This type of trust is one in which the trust assets are outside of the taxable estate but the grantor is treated as the owner of the asset of the trust during his/her lifetime, for income tax purposes only. With a Grantor Trust, the trust income is attributed to the grantor individually, rather than to the trust, which typically has higher income tax rates so no trust assets need to be spent to pay income taxes. A Grantor Trust can be an attractive vehicle to fund with income-producing assets such as stock or real estate, in addition to a life insurance policy.

**Benefits of ILITs**

**Liquidity for Estate Taxes and Other Expenses.** ILITs provide liquidity, outside the insured’s taxable estate, for the payment of estate taxes, debts and expenses of administration.

**Equalization of Inheritances/Transfer of a Family Business.** ILITs create a pool of assets to enable an insured to equalize inheritances when the insured would like to pass a single asset (such as a family business or farm) to one child, yet leave equal value to other children.

**Creditor Protection.** Life insurance proceeds received by an ILIT are typically protected from creditors of the ILIT beneficiaries until the ILIT beneficiaries actually receive the trust proceeds.

**Asset Management Vehicle.** An ILIT can provide for the effective management of insurance proceeds after the insured’s death. By using a trusted advisor, bank, trust company or appointed family member as trustee (or co-trustee) of the ILIT, the insured will know that the insurance proceeds will be properly managed.

**Considerations**

**Irrevocable Transfers.** Transfers of assets to an ILIT are irrevocable, and may only be used for the benefit of the trust beneficiaries.

**Potential Reduction of Policy Value.** Taking policy loans and withdrawals from a life insurance policy during the insured’s lifetime can reduce the available death benefit and cash surrender value and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made, and a federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested.
1. The annual exclusion will be indexed for inflation in $1,000 increments based on increases in the Consumer Price Index (CPI). Under the current law, which is based on the “American Taxpayer Relief Act of 2012,” the maximum estate tax rate is 40% with a $5,000,000 exemption (indexed for inflation) for each individual. For 2013, the $5,250,000 exemption amount can be used either during lifetime, as a gift tax exemption amount, or at death as an estate tax exemption. In addition, each individual has a $5,000,000, indexed for inflation, exemption to the generation-skipping transfer (GST) tax; this $5,000,000, indexed for inflation, can be used during life or at death. If an individual passes away with an unused amount of exemption remaining, that individual’s surviving spouse can use the unused amount to shelter a transfer from either gift or estate taxes.

2. Whether the proceeds of a life insurance contract are included in the gross estate of the insured depends upon whether, at the time of death (or within the three-year period prior to death) the insured held any incidents of ownership with respect to the policy. IRC §§2042 and 2035(d)(2).

3. These powers are known as “Crummey Powers,” named after the taxpayer in the case of Crummey v. Commissioner. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968) and Internal Revenue Code Section 2503(b). For a Spousal Access Trust, the beneficiary spouse should not be given “Crummey” rights of withdrawal. In addition, in a community property state, the grantor spouse should create a separate property agreement and the premium gifts to the ILIT should be funded from separate property. See Treas. Reg. §20.2042-1(b)(2).

4. See Cristofani v. Commissioner, 97 T.C. 74 (1991) and Kohlsaat v. Commissioner, T.C. Memo 1997-212. In Cristofani, the court stated that the Crummey beneficiaries did not have to have a vested present interest or vested remainder interest in the trust, in order to qualify for the annual exclusion.

5. It is customary for the Crummey withdrawal period to last 30 days. There should never be an explicit understanding among family members that a withdrawal power will not be exercised, otherwise the IRS may disallow the use of the annual exclusion.

6. Over 20 are known as “Crummey Powers,” named after the taxpayer in the case of Crummey v. Commissioner. States have abolished the common law “rule against perpetuities,” which traditionally limited the duration of trusts. Consult your tax advisors to determine the law for your state.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It was not intended or written for use and cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock’s understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance products are issued by John Hancock Life Insurance Company (U.S.A.), 197 Clarendon Street, Boston, MA 02116 (not licensed in New York), and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2013 John Hancock. All rights reserved.

IM1454 MLNY040313022 04/13