WELLS FARGO Wealth & Investment Management

Life Insurance Trusts

A wealth-transfer strategy designed to help reduce or potentially eliminate the impact of estate taxes

The irrevocable life insurance trust can be an effective strategy for transferring wealth to your beneficiaries without income tax or estate tax. It involves making gifts during your lifetime to acquire life insurance that will be paid at your death.

Life insurance death benefits are ordinarily income tax free but are includable in your taxable estate if you own the policy (or have rights over the policy, which tax law calls "incidents of ownership"). An irrevocable life insurance trust is designed with the intent being that death benefits will be both income tax free and estate tax free because they remain outside of your taxable estate. A series of relatively small gifts now can result in a much larger tax-free benefit at your death.

How does it work?

A typical irrevocable-life-insurance-trust strategy might look like this:

1. You make annual exclusion gifts (up to $17,000 per beneficiary in 2023) to a trust. The trust must be irrevocable and have an independent trustee.
2. Beneficiaries are notified that they have a right for a limited time to withdraw the gift. (This is required because only gifts of a "present interest" qualify for the gift-tax annual exclusion. Therefore, beneficiaries must have some real — even if limited — rights to access the gifted funds.)
3. The beneficiaries do not exercise their withdrawal rights.
4. The trustee, in turn, uses the gifted funds to acquire and support life insurance on you. The trust is the owner and beneficiary of the insurance policy. (For married couples, a second-to-die policy is often used.)
5. At your death, the policy proceeds are paid to the trust. Because you do not own the policy or control the trust, the death benefits are not included in your taxable estate.
6. The trustee applies the proceeds according to the directions you give in the trust. For example, you could design your trust to:
   - Pay everything out to beneficiaries
   - Keep the assets in trust and have the trustee pay income and principal to beneficiaries according to standards you set
   - Permit use of the proceeds to provide cash to your estate such as through a loan or purchase of assets, which can be used to pay estate taxes

There are other variations on this strategy, some of which are discussed in the frequently asked questions on page 3.

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Is this strategy right for you?

As you evaluate this or any other advanced planning strategy, ask yourself:

- Does it reflect my values?
- How does it affect my income and financial security?
- Is it consistent with my time horizon, risk tolerance, and financial situation?
- Will it help to accomplish my goals and dreams?
- Does it help me build the type of legacy I want?
- How does it affect the people I care about most?

When is this strategy a potential fit?

This strategy may fit if:

- Your estate is likely to be subject to federal (or state) estate taxes
- You would prefer to provide a tax-efficient death benefit later, rather than make gifts that beneficiaries could spend today
- You want to make gifts while being mindful of your own financial security
- You are willing to give up a significant measure of control over the funds you gift in order to gain tax advantages

The effectiveness of this strategy may vary depending on your particular situation. Either you or your spouse, or both of you, must qualify for life insurance. It's important to work with your attorney and tax advisor to evaluate whether a life insurance trust is a good fit for your particular situation.

What are some indications that this strategy may not fit?

This strategy may ***not*** fit if:

- Your total taxable estate (including insurance you own) is below the individual exclusion ($12,920,000 in 2023, or potentially as much as $25,840,000 for a married couple in 2023)
- You would prefer to let beneficiaries spend or invest gifted funds now
- You want to retain complete flexibility and are willing to give up tax advantages in order to maintain control over your assets
- Your health situation makes life insurance unattractive or unavailable

How is it implemented?

In general, the steps to implement this strategy are:

1. You determine a level of annual gifting that's consistent with your financial security and estate planning goals.
2. You work with your financial advisor to apply for life insurance.
3. You work with your attorney to design and implement the trust.
4. You make annual gifts to the trust.
5. Your trustee takes care of annual gift notices to beneficiaries and pays the life insurance premiums.

Frequently asked questions

What is a "Crummey letter"?

This is a written notice sent to a life insurance trust beneficiary. Usually the trustee sends this notice every time a gift is made to the trust. The letter advises the beneficiary that a gift has been made and that he or she has a right to withdraw funds for a limited time, typically 30 days. These notices get their name from a tax court case entitled *Crummey v. Commissioner*.

Why are Crummey letters required?

To qualify for the gift-tax annual exclusion, tax law requires that beneficiaries have a "present interest" in a gift. That means they must have some real — even if limited — right to enjoy the gift today. The Crummey letter is evidence that the trustee has notified beneficiaries of their temporary withdrawal right. It provides proof that the gift qualifies for the annual exclusion.

Do minor children have to receive a gift notice?

Yes. The notice may be sent to a parent or legal guardian on their behalf.

I'm concerned that my children might exercise their withdrawal rights and take the money. Is there any way to prevent that?

Beneficiaries often realize that it may be in their long-term best interest to forgo their withdrawal rights. At the same time, be sure to talk to your attorney about trust provisions that can give you flexibility to deal with short-term problems. For example, a trust could give the donor the ability to designate which beneficiaries will and which will not have withdrawal rights in any particular year. (Keep in mind that if you don't provide a withdrawal right, your gift will not qualify for the annual exclusion, so you would need to file a gift tax return. In most cases, this simply means that you would "use up" part of your lifetime gift exclusion. If you have already used your entire lifetime gift exclusion, you would have to pay gift tax.)

Do I really need a trust? Why not just let my children own the policy?

You don't have to establish a trust. But consider: What would happen to the policy if a child gets divorced or has problems with creditors? How will children coordinate responsibility for paying premiums and managing the policy? Are you comfortable letting children do whatever they please with the death benefit?

By having a trust own the policy, you can avoid many potential problems. The policy is insulated from possible financial problems that could affect the children; there is a centralized point for administration; and the trust document will help ensure that the death benefit is used according to your directions.

What is "second to die" life insurance and when is it used?

Traditional life insurance provides protection on the life of a single insured individual. "Second to die" or "survivorship" insurance covers two lives in one policy with the proceeds payable at the second death. Single-life insurance is commonly used to protect the financial security of a surviving spouse or minor children by providing capital to replace the income lost when a wage-earner dies. Second-to-die insurance, in comparison, is most commonly used as part of a plan to assist in efficiently transferring wealth between generations. Because two lives are insured under one policy, premiums are typically lower than for single-life policies on either spouse.

Can I transfer existing life insurance policies to an irrevocable trust to get them out of my taxable estate?

Yes, you can transfer existing policies; however, if you die within three years of making the gift, the death benefits will still be included in your taxable estate. In most cases, the gift's value will be somewhat greater than the policy's cash value. Ask your tax advisor to help you determine the gift's value.

Can an irrevocable life insurance trust hold assets in addition to a life insurance policy?

Yes. Income from trust assets can be used to pay policy premiums. This can reduce or eliminate the need to make annual gifts to the trust. This type of trust is often referred to as a "funded" life insurance trust.

Can an irrevocable life insurance trust be structured so that I am still responsible for the income taxes?

Yes. This type of trust is classified as a "grantor trust." This means that the grantor (the trust's creator) is taxed on all of the trust's income (even though he or she does not receive that income). While at first that may seem undesirable, it actually can be a smart planning strategy. By picking up the tax liability, you can reduce your taxable estate without making an additional gift. And your wealth-transfer strategy may be more effective because all of the trust income is available to fund premiums without being reduced by taxes.

What if I change my mind or want to disinherit one of the beneficiaries? Can I change the trust?

The trust is irrevocable, so you cannot change its terms. However, you could stop funding the trust. Any existing trust assets would still have to be used for beneficiaries according to the trust's terms.

Can my spouse or I be the trustee?

The trustee cannot be someone who is also a grantor of the trust. So, as a general rule, anyone who might provide funds to the trust should not be named as trustee. Your tax advisor can provide additional guidance.

What are the responsibilities of an Irrevocable Life Insurance Trust (ILIT) trustee?

The ILIT trustee is responsible for paying insurance premiums each year as gifts are received. He or she is responsible for providing "Crummey" notices to beneficiaries each year, and should keep records evidencing that notices were provided and received. It is a good practice for the trustee to regularly monitor the insurance policy to see if it is adequately funded and performing as expected; one should also periodically evaluate the financial strength of the issuing insurance company. In addition to these duties relating to the policy, the trustee has all the normal duties of recordkeeping and administration, and will administer the trust according to its terms after the policy pays its death benefit.

Talk to your Wells Fargo Professional

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Death benefits generally are not subject to income taxes but may be subject to income taxes in certain cases. Policy owners should consult with legal counsel prior to assigning the ownership rights in life insurance policies. Insurance policy values or death benefits are includable in the gross estate of the decedent if the decedent owned or was deemed to have owned certain "incidents of ownership" in the policy. Death benefit protection is based on the claims-paying ability of the issuing life insurance company.

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