Funding an Irrevocable Life Insurance Trust

How Is an Irrevocable Life Insurance Trust Funded?

An irrevocable life insurance trust can be funded **either** by transferring ownership of an existing life insurance policy to the trust, **or** by purchasing a new life insurance policy:

- **Transfer of existing policy:** While an existing life insurance policy can be transferred to an irrevocable life insurance trust, there are "strings attached." If the gift of an existing life insurance policy is made within three years of the grantor/insured's death, the value of the life insurance proceeds are brought back into the estate for federal estate tax purposes.

- **Purchase of new policy:** Assuming the grantor is insurable, it may be preferable to make cash gifts to the trust, which then purchases a new insurance policy on the grantor's life. Since the grantor/insured never held any "incidents of ownership" in the new policy, the insurance proceeds should not be included in the taxable estate, even if death occurs within three years of the insurance purchase by the trust.

In situations where the trust will need to make premium payments, a typical irrevocable life insurance trust arrangement calls for the grantor/insured to make annual gifts to the trust, which are then used to pay the life insurance premiums. In order for those gifts to qualify for the annual gift tax exclusion ($15,000 in 2019), the gifts must qualify as a "present interest gift." This can be accomplished by including a "Crummey" withdrawal power in the trust.

A Crummey withdrawal power (the name derives from a court case, *Crummey v. Comm.*) gives the trust beneficiary a noncumulative, annual right to demand withdrawal from the trust. For the demand right to be legitimate, the trustee must provide the beneficiary with notice of annual trust contributions and provide an adequate amount of time, such as 30 days, for the demand right to be exercised. If the demand right is exercised, the trustee must deliver the funds to the beneficiary. If the demand right is not exercised, the annual gift is then available for the trustee to use for premium payment purposes. Since the beneficiary stands to ultimately benefit from the trust and since a demand withdrawal from the trust may affect the grantor's decision as to future gifts to the trust, beneficiaries generally understand that making a demand withdrawal is not in their best interest.