

# Proper timing for irrevocable life insurance trusts

By Jeffrey A. Baskies

I was recently confronted with an old problem: when does an Irrevocable Life Insurance Trust ("ILIT") have to be in place? If a client applied for life insurance before the trust was complete, does the policy's death benefit come into the client's estate if he or she dies within three years? Clearly, the issuance of an insurance policy and the existence of an ILIT can have important tax consequences of which advisors, agents and clients should be aware.

## Important dates

There are three key dates in the process of a life insurance application: the application date, the policy date and the issuance date.

- The application date

The "application date" is the date the client submits an application to the company. At this point, he or she is seeking an offer of insurance from the carrier. That offer may ultimately lead to entering into a binding agreement. Nevertheless, as of the application date, no agreement is in place.

This means that from an estate tax standpoint, the client possesses no "incidence of ownership" in the policy as of the application date. By definition, "incidence of ownership" includes, but is not limited to, the right to name a beneficiary or the right to utilize the cash value.

In an old tax advice memorandum (#93 23002), the Internal Revenue Service ruled that the filing of an application for an insurance policy will not cause the insured to have incidence of ownership in the policy when it is ultimately issued to an ILIT or another owner - even if that client dies within three years. If an incidence of ownership *had* existed at the application date, then the three-year rule of Section 2035 of the Code would apply and the proceeds would be included in the deceased client's estate if he or she died within three years of the policy's issuance.

- The policy date

The "policy date" is an underwriting provision which governs the premium rate set on a particular insurance policy. While the policy date may have significant underwriting ramifications and may impact the premiums, it is irrelevant for estate tax purposes. The date the company uses as a policy date for underwriting purposes will not impact whether the policy is included in the client's estate.

- The issuance date

The last (and perhaps most important) date in the insurance process for transfer-tax purposes is the "issuance date." The issuance date is the date upon which an actual contract is created; the date when the insurance company issues the policy and is bound by its terms. At that point, the offer for insurance has been accepted, and a binding contract is in place. At that moment, incidence of ownership would be established.

Obviously, this has significant gift and estate tax implications. If a client has applied for insurance and completed the application in her or his individual name, as she or he almost always would, and if the client has created an ILIT prior to the issuance date and if the policy is issued to the trustee of that ILIT, then the insured should have no incidence of ownership over that policy. As a result, the policy will not be includable in the insured's estate, even if he or she dies within three years of the issuance.

Unfortunately, some insurance companies (and perhaps agents) in their zeal to act will issue a policy naming an ILIT as the owner even though the ILIT itself has not yet been executed. Unless the trust is valid at the time, the designation of it as owner is not effective. Therefore, unless a state permits oral insurance trusts, this practice may have disastrous estate tax consequences.

#### **Trust needn't be created immediately**

Since there should not be a contract in existence until the issuance date, agents can have clients file applications for insurance without having already created irrevocable insurance trusts. Many times, applications will be denied or clients will be rated such that the insurance will never be purchased. Obviously, in those cases it would be imprudent to require the client see an attorney and create an irrevocable trust prior to applying, especially if no insurance will actually be issued.

However, in order to avoid the application of the three-year rule of Section 2035, and to ensure that your clients do not have incidence of ownership over a policy, there must be a valid ILIT in existence as of the issuance date. In fact, ensuring that the ILIT is in existence prior to the issuance date should be a fundamental part of planning.

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