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U.S. Estate Tax Planning Using Life Insurance

An Irrevocable Life Insurance Trust Can Avoid the Irony of Purchasing Life Insurance to Reduce U.S. Estate Taxes

Wealth Management Services

In the March 1996 edition of Forbes magazine, an executive of a U.S. bank was quoted as saying, "Buy enough life insurance to cover your estate taxes. No matter how stiff the premium might seem, it's a bargain". That's a pretty bold statement on owning insurance to cover U.S. Estate Taxes. Although life insurance can be a cost efficient method to pay for a future U.S. Estate Tax liability, oddly enough owning insurance can also create additional U.S. Estate Taxes if not structured properly.

Due to the many different issues involved with this topic, this article is fairly lengthy. However, for better readability, we have broken up the article into four sections as follows:

1. **Background**
2. **U.S. Estate Tax Planning Using Life Insurance for Canadian Residents who are Non-Resident Aliens of the U.S.**
3. **U.S. Estate Tax Planning Using Life Insurance for U.S. Citizens and U.S. Residents**
4. **Conclusion**

1. Background

You may be aware that the U.S. federal government can potentially levy a U.S. Estate Tax on the **fair market value** of certain assets held at your death. For 2006, the U.S. Estate Tax rate can be as high as 46%. Non-resident aliens (NRA) of the U.S. are subject to U.S. Estate Tax only on the fair market value of their **U.S. situs assets** owned at death. If you are an NRA of the U.S., then you are neither a U.S. citizen nor a U.S. resident. The most common U.S. situs assets are real estate located in the U.S. and shares of U.S. corporations owned personally.

People who are U.S. citizens or U.S. residents are considered to be "U.S. persons". They are subject to U.S. Estate Tax on their **worldwide assets** at their death. Green card holders are generally considered as U.S. residents for U.S. Estate Tax purposes if their domicile (country where they intend to permanently live) is the U.S.

Some Canadian resident individuals purchase life insurance to pay for Canadian taxes owing on their final Canadian tax return. Similarly, insurance can also be an inexpensive method to pay for an expected U.S. Estate Tax liability. **However, based on how U.S. Estate Tax is calculated, if the ownership of a life insurance policy is not structured properly then, ironically, the life insurance death benefit paid to your heirs, could actually trigger higher U.S. Estate Tax! Why? Read on.**

The calculation of U.S. Estate Tax is linked to a person's worldwide estate. The greater the worldwide estate, the greater the U.S. Estate Tax or the greater possibility that some U.S. Estate Tax will now become payable. The worldwide estate is simply the fair market value of all the deceased's property at death (i.e. principal residence,

cottage, non-registered investments, RSPs/RIFs, etc) less certain specifically defined liabilities. **A critical rule regarding the calculation of the worldwide estate that surprises many people applies to life insurance death benefits. If the deceased has "incidents of ownership" within the insurance policy, the rules include the amount of the death benefit in the deceased's worldwide estate even if the death benefit was <u>not</u> received by the deceased's estate.** Thus the planning strategy of owning life insurance intended to be applied toward the deceased's U.S. Estate Tax liability can result in more tax being due as the worldwide estate includes the value of the life insurance death benefit.

In general, incidents of ownership mean that, prior to death, the deceased,

- could name or change the beneficiary on the policy;
- could borrow against the policy;
- had access to its cash value; or
- could assign or cancel the policy.

Most people who own life insurance personally have incidents of ownership, so any life insurance proceeds paid after their deaths will be included in their worldwide estates. The irony here is that someone who dies in 2006 with a worldwide estate of $1,000,000 US without any life insurance will not pay a single cent of U.S. Estate Tax since the worldwide estate is less than the 2006 U.S. Estate Tax exemption of $2,000,000 US. However, if the estate (or a designated beneficiary other than the estate) receives life insurance proceeds of $1,500,000 US and the deceased had incidents of ownership, then for U.S. Estate Tax purposes the deceased's worldwide estate is really $2,500,000 US. Thus, the estate could now be subject to U.S. Estate Tax.

If you are an NRA, ask your advisor to use the U.S. Estate Tax calculator on his/her intranet to get an estimate of your potential U.S. Estate Tax liability, if any.

The U.S. Estate Tax rules differ for U.S. persons (U.S. citizens and U.S residents) and people who are not U.S. persons (i.e. NRAs). Therefore, this article will discuss both of these scenarios separately. In addition, this article will only discuss U.S. federal Estate Taxes and not U.S. state Estate Taxes. It's essential to note that some U.S. state's Estate Tax calculations and exemptions are not harmonized with the U.S. federal Estate Tax rules. This means that even though you are exempt from U.S. federal Estate Tax, you may not necessarily be exempt from U.S. state Estate Taxes and vice versa. People may be subject to a particular U.S. state's Estate Taxes if they are a resident of that U.S. state upon their death or they have property located in that state upon their death. You should consult with a qualified U.S. tax and estate advisor for specific U.S. state details.

2. U.S. Estate Tax Planning Using Life Insurance for Canadian Residents who are Non- Residents Aliens of the U.S.

As previously mentioned, if an NRA is subject to U.S. Estate Tax, U.S. Estate Tax will be payable only on their U.S. situs assets. However, if the NRA's **worldwide estate** at death is less than or equal to $2,000,000 US (for deaths occurring in 2006) no U.S. Estate Tax will be payable.

Life insurance paid after the death of an NRA is **not considered a U.S. situs asset**, even if paid by a U.S. insurer. However, for NRAs, direct ownership of life insurance will increase the worldwide estate and result in less of a "Unified Credit". This is explained in more detail as follows.

Unified Credit and Life Insurance

Under U.S. Estate Tax rules, people may shelter or exempt a specified amount from tax. The exemption is available on a lifetime basis, which reflects the fact that the U.S. levies gift tax on lifetime transfers and estate tax on death.

The exemption level is paired with a credit system, which is the mechanism by which the U.S. Estate Tax bill can be reduced. For Estate Tax Purposes in years 2004 and 2005 the Unified Credit is $555,800 and the lifetime exemption amount is $1,500,000.

For Estate Tax Purposes in years 2006, 2007 and 2008 the Unified Credit is $780,800 and the lifetime exemption amount is $2,000,000. For Estate Tax Purposes in year 2009 the Unified Credit is $1,455,800 and the lifetime exemption amount is $3,500,000.

However, for NRAs, the amount of the Unified Credit that can be used to reduce U.S. Estate Tax **must be prorated based on the ratio of U.S. situs assets to worldwide assets**. As a result, the greater the worldwide assets, the less of the Unified Credit that can be claimed. The following U.S. Estate Tax calculation illustrates how life insurance proceeds where the deceased had incidents of ownership increases the worldwide estate and results in a greater U.S. Estate Tax liability. We will assume the individual passes away in 2004 with no surviving spouse.

U.S. situs assets = $500,000 US

Worldwide assets = $2,000,000 US (excluding life insurance)

Worldwide assets = $3,000,000 US (includes $1,000,000 of life insurance where deceased had incidents of ownership)

	Worldwide assets excluding life insurance	**Worldwide assets including life insurance owned by the deceased**
Tentative U.S. Estate Tax on $500,000 US of U.S. situs assets (A)	$155,800 US	$155,800 US
Ratio of U.S. situs assets to worldwide assets (B)	25% = $500,000/$2,000,000	16.67% = $500,000/$3,000,000
Prorated Unified Credit (C) = $555,800 x (B)	$138,950 US	$92,652 US
U.S. Estate Tax payable (A) – (C)	$16,850 US	$63,148 US

Based on the above table, there is additional U.S. Estate Tax of **$46,298 US** [$63,148 - $16,850] due to having $1,000,000 US of life insurance with incidents of ownership.

So does this mean you should not have any life insurance payable to your heirs because it will result in additional U.S. Estate Taxes payable? Of course not! In many cases, life insurance is the least expensive means to pay for taxes at death, buy out surviving business partners, provide an equal distribution of the estate to heirs, support the lifestyle of survivors, provide monies to friends and charities, etc. However, is there is a method to allow the $1,000,000 US life insurance proceeds to be paid after death to your beneficiaries without increasing your U.S. Estate Tax liability? Yes, there is! It's the Irrevocable Life Insurance Trust (ILIT)!

What is an Irrevocable Life Insurance Trust (ILIT)?

An ILIT is a trust that owns an insurance policy in such a way that the person whose life is insured does not have incidents of ownership. Since you don't have incidents of ownership, the death benefit paid after your death will not be included in your worldwide estate, thereby minimizing your U.S. Estate Tax. Of course a cost/benefit analysis needs to be undertaken to ensure that the taxes saved by implementing the ILIT are more than the costs to set it up and any annual fees.

In any trust relationship, you have three parties - settlor, trustee and beneficiary. In the case of the ILIT, you are typically the settlor, someone else other than you should be the trustee (could potentially be a corporate trustee) and the beneficiaries of the trust are your heirs who will eventually benefit from the insurance proceeds. The ILIT would be structured with you as the life insured so that the life insurance proceeds will be paid into the trust upon your death. Note that if you want a second-to-die policy with your spouse held in the ILIT, then your spouse should not be a trustee while both of you are living.

In addition, if the trustee is expected to be a resident of Canada and beneficiaries of the ILIT are U.S. persons or expected to be U.S. persons, then you should consult with a qualified cross-border tax and estate advisor. The reason is because there could be punitive U.S. income tax issues to the U.S. person beneficiary on income paid out of the ILIT.

When the trust is set up, you can determine the terms of the trust, such as who the beneficiaries are, how much they will receive upon your death and when they will receive the funds. **However, the insurance trust should be irrevocable - meaning you cannot change the terms of the trust after you have created it.**

You should also not be able to access the Cash Surrender Value (CSV) or borrow against the CSV within the policy held in the trust. So, before using an ILIT to hold your life insurance, you should make sure you won't need the insurance for investment or retirement purposes and your beneficiaries will strictly use it after your death.

When the insurance trust is irrevocable and you are not one of the trustees, your estate can argue that you do not have incidents of ownership of the life insurance policy. As a result, the life insurance proceeds would not form part of your worldwide estate for U.S. Estate Tax purposes.

Transfer of existing policy into the ILIT

If you have an existing life insurance policy and you want to transfer the policy into the ILIT, then for Canadian tax purposes you will have a disposition at market value. This will trigger an income inclusion equal to the Cash Surrender Value less the Adjusted Cost Basis (ACB) of the policy. Note that this is not a capital gain, so the income inclusion is taxed at your marginal tax rates. **Furthermore, under U.S. rules, if you die within three years of the transfer of a policy into the ILIT, then the proceeds paid into the ILIT will still form part of your worldwide estate for U.S. Estate Tax calculations.**

Purchase of new policy in the ILIT

If a new policy is purchased within a properly structured ILIT, then the insurance proceeds paid into the ILIT will **not** form part of your worldwide estate, no matter when you die. That is, the three-year waiting period discussed above does not apply to new policies purchased within an ILIT.

Paying premiums into the ILIT

So long as premiums must be paid to keep the life insurance in effect, transferring cash into the ILIT to pay the premiums of the insurance policy is not a taxable event for NRAs. That is, there are no Canadian capital gains tax issues of transferring cash to an ILIT. However, whenever a U.S. person transfers an asset to another person or entity, U.S. gift taxes must always be considered. In contrast, there are generally no U.S. gift tax issues for an NRA who transfers cash to an ILIT since cash is considered "intangible" property for U.S. gift tax purposes. Stocks, bonds and mutual funds are also considered intangible property. For NRAs, U.S. gift tax only applies when the NRA gifts **tangible** property. Tangible property includes property actually physically located in the U.S. – U.S. real estate, jewelry located in the U.S., cars located in the U.S., even cash located in the U.S., etc.

So, back to our numerical example. If the $1,000,000 US of life insurance were paid into a properly structured ILIT, then your beneficiaries would still be able to benefit from the life insurance monies. However, your estate would now save $46,298 US of U.S. Estate Taxes - the best of both worlds!

ILIT vs. testamentary insurance trust

One downside of having your insurance policy owned by an ILIT during your lifetime is that the ILIT is now considered an inter-vivos trust. As a result, any investment income earned on the proceeds paid into the ILIT after your death will be subject to the highest provincial marginal tax rate in Canada unless the income is paid or payable to a beneficiary.

If you continued to own the policy but then had the life insurance proceeds paid into a properly structured insurance trust created after your death, then this new trust would be considered as a testamentary trust. The main Canadian income tax benefit of having the insurance paid into a Canadian testamentary trust, as opposed to an inter-vivos trust, is that the investment income earned in the testamentary trust can be taxed like a separate taxpayer at the graduated income tax rates. However, in this case, since you owned the policy upon your death, the insurance proceeds would form part of your worldwide estate and could increase your U.S. Estate Tax.

As a result, for Canadian residents with potential U.S. Estate Tax liabilities, a cost benefit analysis needs to be undertaken as to which structure is more beneficial.

For more information on Canadian income tax and probate issues of a testamentary insurance trust please refer to the article titled “A Testamentary Insurance Trust Can Help You Meet Your Estate Planning Needs”.

3. U.S. Estate Tax Planning Using Life Insurance for U.S. Citizens and U.S. Residents

A U.S. person is subject to U.S. Estate Tax on their worldwide estate, not just their U.S. situs assets. Therefore, keeping insurance proceeds out of the estate of a U.S. person is even more important than for an NRA. That is, if the deceased had incidents of ownership (as discussed above) of a life insurance policy at their death, then the full value of the insurance proceeds would be subject to U.S. Estate Tax, which can be as high as 46% in 2006!

For a U.S. person, there is no U.S. Estate Tax if their worldwide estate is less than or equal to $2,000,000 US (for deaths occurring in 2006). Unlike an NRA, a U.S. person does not have to prorate the Unified Credit (U.S. situs assets compared to worldwide assets) since they are subject to U.S. Estate Tax on their worldwide assets.

The following U.S. Estate Tax calculation illustrates how life insurance proceeds where the deceased had incidents of ownership increases a U.S. person's worldwide estate, resulting in a greater U.S. Estate Tax liability. We will assume the individual passes away in 2004 with no surviving spouse.

Worldwide assets = $1,500,000 US (excluding any life insurance)

Life insurance = $1,000,000 US

	Worldwide assets including life insurance owned by an ILIT	**Worldwide assets including life insurance owned by the deceased**
Tentative U.S. Estate Tax (A)	$555,800	$1,020,800 US
Unified Credit	$555,800	$555,800 US
U.S. Estate Tax payable (A) – (B)	NIL	$465,000 US

Based on the above table, there would be **$465,000 US of U.S. Estate Taxes** due if you personally own the $1,000,000 US of life insurance at your death. If the $1,000,000 US of life insurance were owned by a properly structured ILIT, then there would be **U.S. Estate Taxes of $0!** As you can see, you can save a significant amount of taxes and provide more monies for your heirs by doing some simple planning regarding the ownership of your insurance policy.

Transfer of existing policy into the ILIT

If you transfer an existing policy, where you had incidents of ownership, into an ILIT and **you die within three years of the transfer, then the proceeds paid into the ILIT will still form part of your worldwide estate for U.S. Estate Tax calculations.**

Furthermore, if you transfer an existing life insurance policy with cash value into the ILIT, then there could be U.S. gift taxes on the amount of the cash value transferred to the ILIT. The gift tax issues and planning techniques around them are discussed in more detail under the section titled "Paying premiums into the ILIT".

Purchase of new policy in the ILIT

If a new policy is purchased within a properly structured ILIT, then the insurance proceeds paid into the ILIT will not form part of your worldwide estate, no matter when you die. That is, the three-year waiting period discussed above does not apply to new policies purchased within an ILIT.

Paying premiums into the ILIT

Transferring cash into the ILIT to pay for the premiums of the insurance policy is subject to U.S. gift taxes for U.S. persons. U.S. gift tax rates are identical to U.S. Estate Tax rates, so they are punitive. However, there is an annual gift tax exclusion in 2006 of $12,000 US per beneficiary. This annual gift tax exclusion can be doubled per beneficiary if the gift is coming from a legally married spouse and the non-donor spouse agrees to be treated as a co-donor.

However, in order to avail yourself of the annual gift tax exclusion, the gift must be a gift of a "present interest". In the case of an ILIT, the gift of a cash value policy or the gift of cash to pay the life insurance premiums is generally considered as a gift of a "future interest". As a result, if the ILIT is not structured properly then the donor cannot use the annual gift tax exclusion to minimize their U.S. gift tax. Note that if U.S. gift tax is applicable, then U.S. persons can still use their lifetime gift tax exclusion of $1,000,000 US to reduce their gift taxes. However, use of this lifetime exemption results in a dollar for dollar reduction of the lifetime U.S. Estate Tax exemption.

Therefore, if you can use your annual gift tax exclusion to eliminate your U.S. gift taxes, your lifetime U.S. gift and Estate Tax exemption stays intact. So, how can the ILIT be structured so that the annual $12,000 US gift tax exclusion is available when transfers of cash or cash value policies are made to the ILIT? Well, the ILIT should have "Crummey withdrawal rights", of course…what?

What is a Crummey withdrawal right?[*]

A Crummey withdrawal right occurs when an ILIT is structured so that the beneficiaries of the ILIT have a right to withdraw the cash recently gifted to the ILIT. This right to withdraw is non-cumulative and should exist for a reasonable time from when the gift is made (i.e. at least 30 days). In the case of an ILIT, if the beneficiaries don't exercise their rights to withdraw the cash within the specified period, then the cash gifted to the ILIT can be used to pay the premiums on the policy. By having an ILIT with Crummey withdrawal rights, the gift of cash or a cash value policy is considered a gift of a present interest. Since the gift is now considered a present interest gift, the donor can use the annual $12,000 US gift tax exclusion - and avoid a reduction of the lifetime gift tax exclusion (or at least by not as much).

Note that that there could be adverse U.S. Estate Tax consequences for an ILIT beneficiary when they die and having not exercised their Crummey withdrawal rights (i.e. allowed them to lapse). However, there are various methods to structure a Crummey withdrawal right to avoid or minimize these consequences (i.e. a "five-and-five safe harbor" power and "hanging" powers). A detailed explanation of these specific powers is beyond the scope of this article, therefore, you should consult with a qualified U.S. tax and estate advisor on this matter.

Generation Skipping Transfer Tax

If the beneficiary of an ILIT is at least two generations younger than the person who transfers property into the trust (i.e. typically the transferor's grandchildren), then - believe it or not - the U.S. imposes a **second** tax on the transfer of cash to the ILIT in addition to the gift tax. This **additional tax** is called the Generation Skipping Transfer Tax (GSTT). The GSTT is a flat tax, which is scheduled for repeal in 2010 but is reinstated in its entirety in 2011. Until 2010, the exemption amount will be the same as the estate tax exemption amount in effect for that calendar year. Effective 2006, after utilization of the $2,000,000 exemption, the rate of tax is 41% and once the assets have reached the size of $2 million, the rate of tax is 46%.

Normally gifts that are eligible for the $12,000 US annual gift tax exclusion will also be exempt from the GSTT. However, gifts to an ILIT where a grandchild is **not** the sole beneficiary may not be eligible for the annual exclusion for GSTT purposes. As previously mentioned, there is a lifetime GSTT exemption of $2,000,000 US for 2006 that can be used to avoid the GSTT. The lifetime GSTT exemption is **in addition** to the lifetime U.S. gift and Estate Tax exemption.

Dynasty Trusts

If you want to take your ILIT to the next level and provide inheritances to not only your spouse and children, but also grandchildren and perhaps even your great-grandchildren with no U.S. gift tax, Estate tax, or GSTT, the Dynasty Trust may be the solution. The Dynasty Trust is simply a fancy term for an ILIT that takes advantage of or leverages your lifetime gift/Estate and GSTT exemptions and can result in tax-free inheritances to successive generations.

For example, assume you make a large one-time cash payment to a properly structured ILIT. The cash is used to make a single premium payment on a significant face value life insurance policy purchased by the ILIT. The beneficiaries of the ILIT include your spouse, your children and your grandchildren.

The cash transfer to the ILIT is considered a gift. However, as long as it is under your lifetime $2,000,000 US gift and Estate tax exemption, there will be no U.S. gift taxes and no GSTT on the transfer. The payment of the life

[*] This planning technique arose from the landmark U.S. case *Crummey vs. Commissioner* in 1968, hence the term "Crummey" withdrawal rights.

insurance proceeds into the ILIT upon your death (regardless of the amount of insurance paid into the ILIT) will avoid U.S. Estate Taxes to your estate. Furthermore, if structured properly, the fair market value of the ILIT upon the deaths of your spouse, your children and even your grandchildren will not form part of their estates. This will avoid U.S. Estate tax on their deaths as well.

That is, regardless if the assets within the ILIT, due to the sound investing of the initial insurance proceeds, are worth $1,000,000 US, $10,000,000 US or $100,000,000 US on the deaths of the spouse, children or grandchildren respectively, there will no U.S. Estate Tax payable by anyone. This is what is meant by leveraging your lifetime gift/Estate and GSTT exemptions! Note that if the Dynasty Trust is subject to a specific U.S. state's trust laws, then it is possible that the life of the Dynasty Trust may not be perpetual and could be limited to a finite number of years like 90 years or less, so this needs to be investigated.

For the Dynasty Trust to be effective - such that the assets within the trust do not form part of any family member's estate (i.e. both spouses, children, grandchildren, etc) - it is imperative that the Dynasty Trust be structured properly by a qualified estates lawyer with expertise in this area.

4. Conclusion

Structuring the ownership of insurance incorrectly can have draconian U.S. Estate Tax consequences to your estate and estates of successive generations. In fact, there have been numerous court cases where the IRS has challenged the validity of ILITs. In cases where the IRS has won, the ILIT was either not structured correctly by the taxpayer's advisors or certain family members exercised too much control over the ILIT when they should not have.

However, if structured properly pursuant to U.S. tax law, the ILIT has proven to be a vehicle that can provide a large sum of monies to your beneficiaries. The ILIT can help to reduce your U.S. Estate Tax liability and even the U.S. Estate Tax of successive generations.

If you own an insurance policy personally and you expect your worldwide estate including the life insurance proceeds to be in excess of U.S. Estate Tax exemptions, then you should consult with qualified U.S. tax and estate advisors regarding the costs and benefits of restructuring the ownership of that life insurance policy using an ILIT. In addition, if any person (settlor, trustee or beneficiary of the ILIT) is a Canadian resident then you should work with qualified cross-border tax and estate advisors to ensure that the ILIT complies with applicable Canadian rules.

Finally, if you require assistance in your cross-border estate planning matters, speak to your advisor.

Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and/or legal advisors before taking any action based upon the information contained in this article.