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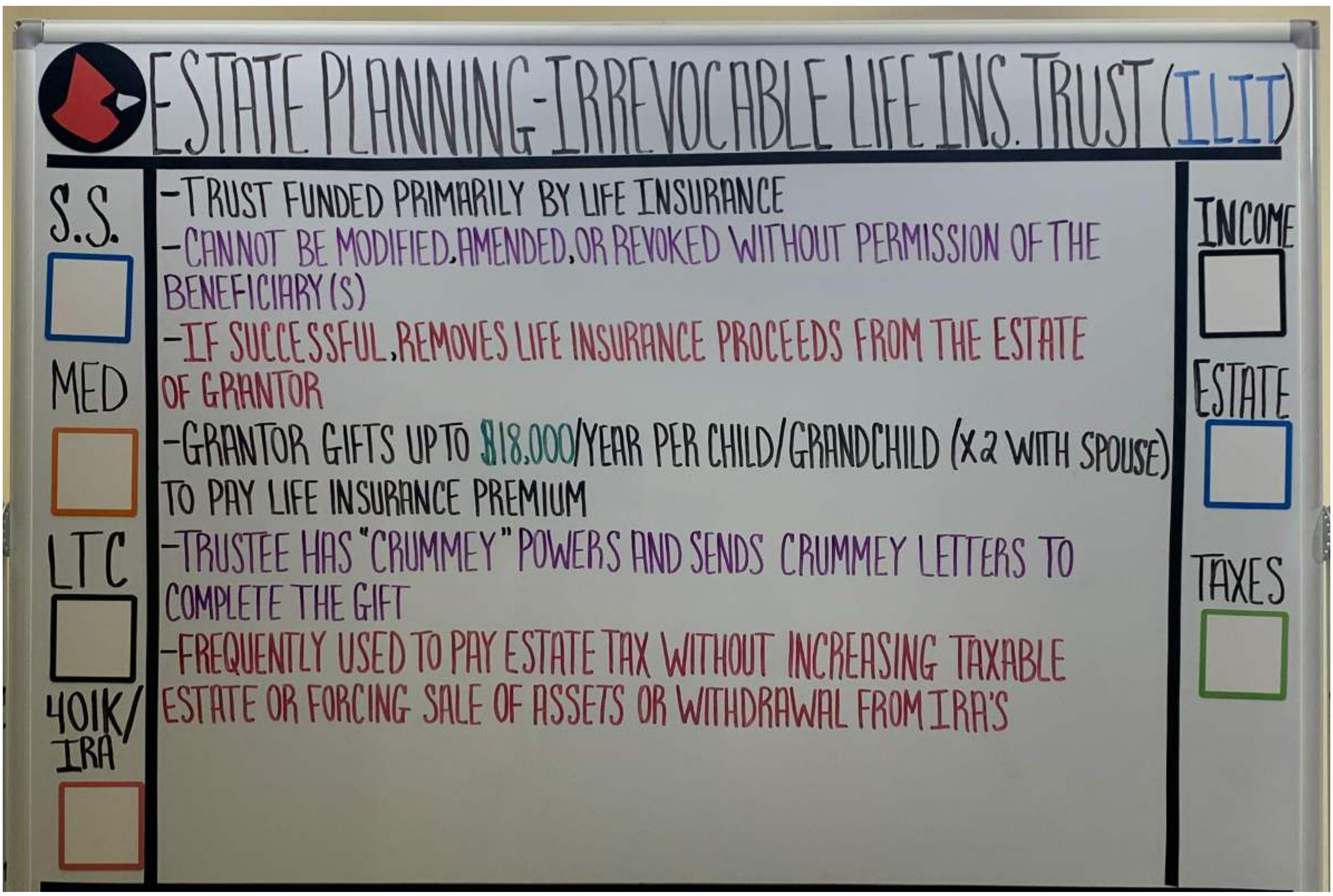
Estate Planning - Irrevocable Life Insurance Trust (ILIT)

Hans and Tom use the following document to discuss the video entitled "Estate Planning-Irrevocable Life Insurance Trust (ILIT)".



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Irrevocable Life Insurance Trust (ILIT) From Tax Facts

An irrevocable life insurance trust (ILIT) is a trust funded primarily by life insurance which cannot be modified, amended or revoked without the permission of the beneficiary. It is mechanism used in estate planning in which a grantor effectively removes all of his rights of ownership to the assets of the trust.1

1. https://www.irs.gov/tax-professionals/tax-code-regulations-and-official-guidance.

Typical parties to an irrevocable life insurance trust include a grantor, trustees and beneficiaries. The grantor typically creates and establishes the funding mechanism for the trust. In the case of an ILIT, the funding source would be a life insurance policy.
Gifts or transfers made to the ILIT are permanent, and the grantor relinquishes control over transferred assets to the trustee. The trustee manages the ILIT and is the individual holding the property in trust. Beneficiaries are those entitled to receive the benefits of the trust.1

1. Restatement (Second) of Trusts § 3 (1959).

The irrevocable life insurance trust is created during the grantor's life. The trustee purchases a policy on the life of the grantor. The trust should be the owner and premium payor of the policy and the grantor/ insured should have no ownership interests in the life insurance policy. The beneficiaries of the trust are often family members of the grantor—a spouse, children, grandchildren, and spouses of children and grandchildren. Because the trust is funded with a life insurance policy on the grantor's life, funding may be accomplished using an existing policy that the grantor gifts to the trust. Unless the insurance policy is paid up, the trustee will have to pay the annual premiums. The grantor usually makes annual transfers of cash to the trust so that the trustee can pay the premiums.1 These annual transfers are gifts, meaning that the gift tax annual exclusion may be available to shelter the annual cash transfers from the federal gift tax up to the annual exclusion amount ($18,000 for 2024).2

Planning Point: The grantor can also make a gift of an existing life insurance policy to the trust, but the insured must survive for at least three years in order to keep the policy out of his or her taxable estate. This provision is known as the "three year rule" or the "bringback rule," as it "brings back" assets transferred within three years of a decedent's death into his or her gross estate. *Desiree Day, J.D.*

1. IRC § 677.
2. https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes.

While life insurance proceeds are an income tax-free benefit,1 they are includable in the insured's estate for estate tax purposes if the proceeds are payable: (1) to the estate, either directly or indirectly; or (2) to named beneficiaries, if the insured possessed any incidents of ownership in the policy at the time of death.2
For individuals with a large estate tax liability, using insurance proceeds can worsen this tax burden by inflating the insured's gross estate for federal estate tax purposes.3 Using an ILIT can allow death proceeds from the life insurance to pass into the trust, where funds can be distributed income tax-free to the trust beneficiaries as directed by the trust documents. By avoiding the insured's estate, insurance proceeds in an ILIT do not increase the estate of the decedent, thus avoiding additional estate tax.

1. IRC § 101(a)(1).
2. IRC § 2042.
3. IRC § 2206.

An ILIT can present many advantages to individuals who possess significant amounts of life insurance. One of the primary benefits is that the ILIT strategy can help reduce estate tax liability as it removes life insurance from the decedent's gross estate. Further, the ILIT strategy may reduce the amount of insurance coverage needed by the insured, since his or her estate tax bill will be lowered due to funding through an ILIT.

Planning Point: As an example, assume that an individual dies and leaves a $13.06 million estate. $1 million of that amount is life insurance and there is an $12.06 million estate tax exemption. The estate would then be responsible for estate taxes on $1 million of the total gross estate. Assuming the estate tax is 40 percent, this estate tax liability translates to $400,000. Having an ILIT would remove the $1 million life insurance proceeds from the taxable estate. Therefore, the $400,000 tax liability that would otherwise be assumed is eliminated. *Desiree Day, J.D.*

Creating an ILIT also helps the insured protect the cash value of the life insurance policy from creditors. In an ILIT, the grantor no longer legally owns the assets or controls the trust. Due to this loss of ownership and control, a future creditor cannot satisfy a judgement against assets held in an ILIT.

Planning Point: It is critical to understand that the extent of creditor protection in an ILIT is largely based on state creditor regulations. Clients should be sure to consult their local laws. *Desiree Day, J.D.*

Another advantage of an ILIT is that it can allow the grantor to control when, how and why the beneficiaries receive the proceeds of the life insurance policy. This is set out in the trust documents. Upon the insured's death, the life insurance proceeds will pay to the trust. The trust documents will then detail the disbursement of the funds.

An ILIT will also help protect the benefits of a beneficiary who is receiving government aid, and prevents the court from controlling insurance proceeds if a beneficiary is incapacitated. This can be accomplished by naming the trust as the beneficiary of the insurance policy. Most insurance companies will not knowingly pay to an incompetent or disabled person, but if the trust is the beneficiary, the trustee can use the funds to provide for that individual without court interference.

Gifts made to an ILIT typically come in the form of the grantor paying premiums on the life insurance policy, and must be made correctly in order to avoid creating gift tax liability. If the amount of the premiums is directly transferred to the trustee in cash, gift tax liability can arise. A grantor can make annual tax-free gifts up to annual gift tax exclusion amount ($18,000 in 2024, or $36,000 for spouses that consent to gift splitting)1 to each beneficiary of the trust.

For the premium payments to qualify for the annual gift tax exclusion amount, rather than the grantor making a gift directly to each beneficiary to pay the premiums, the funds are given to the trustee for the benefit of each beneficiary.2 The trustee then notifies each beneficiary that a gift has been received on their behalf and the trustee pays the premium on the insurance policy. To avoid gift tax liability, it also is crucial that the trustee, using what is known as a "*Crummey*" letter,3 notify the beneficiaries of the trust of their right to withdraw a share of the contributions within a 30-day period. After 30 days have expired, the trustee can then use the contributions to pay the insurance policy premium. The *Crummey* letter qualifies the transfer for the annual gift tax exclusion by making the gift a present interest gift (rather than future interest gift) thus avoiding the need in most cases to file a gift tax return.4

1. See IRS FAQ, available at https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes.
2. Let. Rul. 9809032.
3. *Crummey v. Commissioner*, 397 F.2d 82, 68-2 U.S. Tax Cas. (CCH) ¶12541, 22 A.F.T.R.2d (P-H) ¶6023 (9th Cir. 1968).
4. Treas. Reg. § 25.2512-6(a).