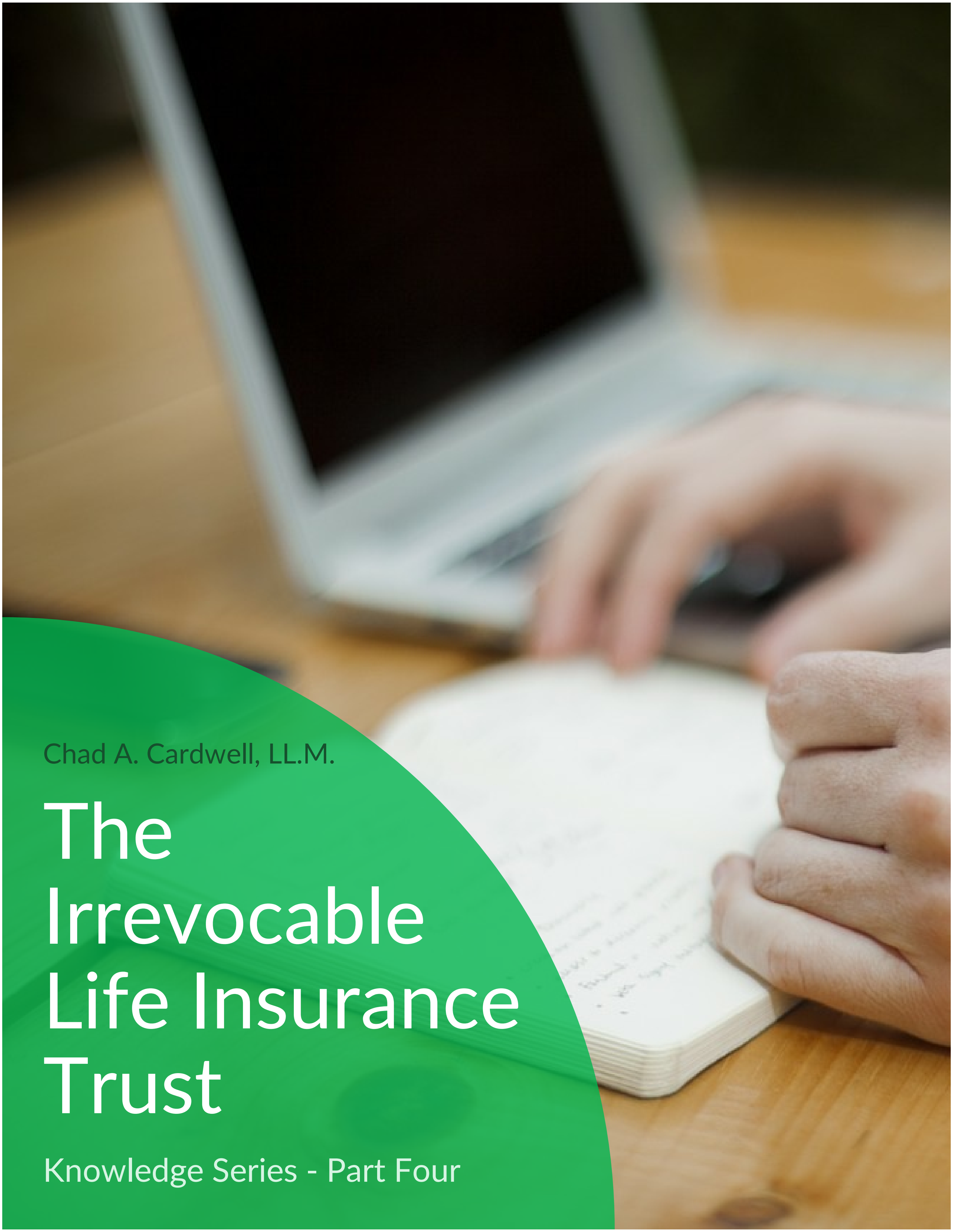

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The Irrevocable Life Insurance Trust

Knowledge Series - Part Four

The Irrevocable Life Insurance Trust

What is it? An irrevocable life insurance trust (ILIT) is a trust that is funded, at least in part, by life insurance policies or proceeds. If properly implemented, an ILIT can help minimize estate taxes and provide a source of liquid funds to your client's estate for the payment of taxes, debts, and expenses.

Generally, assets your client owns at death are subject to federal estate tax. This includes life insurance policies and proceeds. Estates in excess of the exemption equivalent amount (in 2017, $5,490,000 plus any deceased spousal unused exclusion amount) may have to pay estate tax at rates as high as 40 percent. If your client is an insured individual whose estate will have to pay estate tax, your client's family may receive less money from your life insurance than your client originally planned for.

An ILIT can solve this problem, and may be especially appropriate if your estate would not have to pay estate taxes were it not for the inclusion of the policy proceeds.

How does it work? Because an ILIT is an irrevocable trust, policies and proceeds (and any other assets) held by the trust are considered owned by the trust entity and not owned by your client. Since your client will not own the policy at your death, the proceeds will not be included in your estate. They will be received by the ILIT and ultimately pass to your client's family members undiminished by estate taxes. Your family members can use the proceeds to pay estate expenses. This may save your client's family members from having to sell assets at fire sale prices, and allow them to keep assets that may generate needed income or are valued family keepsakes. One key to this strategy is that your client must relinquish all power over and benefits from the property in the trust.

In a typical scenario, an insurable person (the grantor) first creates an ILIT, names an independent trustee (e.g., a bank trust department), and names the beneficiaries of the trust (usually his or her spouse and/or children). The trustee then applies for life insurance on the grantor's life and designates the ILIT as the sole beneficiary. The trustee also opens a checking account for the ILIT. The grantor gives the trustee funds for the initial premium, which the trustee deposits into the ILIT checking account. The trustee writes a check from the ILIT checking account, pays the premium to the insurance company, and coverage becomes effective. As premiums come due, the grantor and trustee repeat the same procedure. Whenever the ILIT receives funds from the grantor, the trustee provides a special notice (a Crummey notice) to each of the beneficiaries. This Crummey notice lets the beneficiaries know that they have a right to withdraw the recently deposited funds, but only within a certain limited time frame (e.g., 30 to 60 days). The trustee waits until this time frame passes before remitting the funds to the insurance company. This notice procedure serves to qualify the gift for the annual gift tax exclusion (see the section on Crummey withdrawal rights). At the grantor's death, the ILIT trustee collects the total proceeds and distributes them to the beneficiaries according to the terms of the trust.

Why use an ILIT? There are many reasons to use a trust rather than have an individual own your life insurance policy. An ILIT can accomplish some or all of the following:

- Avoid inclusion of the proceeds in your (and your spouse's) estate
- Make the cash liquidity provided by the total proceeds available to the estate of the insured
- Insulate the proceeds from estate taxes over multiple generations
- Provide professional management of the proceeds
- Protect the policy and proceeds from future creditors and potential ex-spouses
- Provide incentives to beneficiaries

Funding the ILIT. Your client can create an ILIT and leave it unfunded during your lifetime. An unfunded ILIT is one that holds a life insurance policy only, and does not hold any other assets. With an unfunded ILIT, your client will need to gift money to the trust so the trustee can pay policy premiums. If the trust holds a permanent life insurance policy and the policy allows it, premiums can be paid with accumulated cash values or dividends, and your client may not need to gift additional funds.

Alternatively, your client can fund an ILIT during your lifetime with assets in addition to your life insurance policy. Funding an ILIT with income-producing assets can provide the trustee with the money needed to pay the policy premiums. An additional benefit of funding your ILIT is that any future appreciation in the assets will be sheltered from estate taxes, again because the trust is irrevocable.

Funding your ILIT also allows your client to coordinate the asset's final disposition with the insurance proceeds.

After your client dies, the ILIT (unfunded or funded) will receive the policy proceeds and the trustee will administer them according to the terms of the trust. The trust can receive other assets at your client's death along with the insurance proceeds, such as assets poured over from your client's will, or death benefits paid by your client's employer or employer benefit plan. The trust terms can direct that the proceeds be distributed to the beneficiaries immediately, or the trust terms can direct that the proceeds remain in the trust and under the trustee's management for a period of time before being distributed. The latter option may be desirable if your client anticipates that his or her heirs might mismanage the funds or if his or her heirs are minor children.

The ownership problem. To keep the proceeds out of your client's estate and your client's spouse's estate, your client and your client's spouse must not retain any incidents of ownership in the policies held by the trust. Though the IRS doesn't specifically define incidents of ownership, the phrase generally refers to any rights your client retains that might benefit your client economically. Those rights include:

- The right to transfer, or to revoke the transfer, of ownership rights
- The right to change certain policy provisions
- The right to surrender or cancel the policy
- The right to pledge the policy for a loan or to borrow against its cash value
- The right to name and to change a beneficiary
- The right to determine how beneficiaries will receive the death proceeds

Your client must not retain any of these rights. Further, the trust document should expressly state that the trust is irrevocable and that the insured is retaining no rights to the policies held by the trust.

Crummey withdrawal rights. Transfers of cash (or any other property, including cash values accumulated in existing policies) to your client's ILIT may be subject to gift tax. However, your client can minimize or eliminate your client's actual gift tax liability by structuring the transfer so that it qualifies for the annual gift tax exclusion (currently $14,000 per beneficiary).

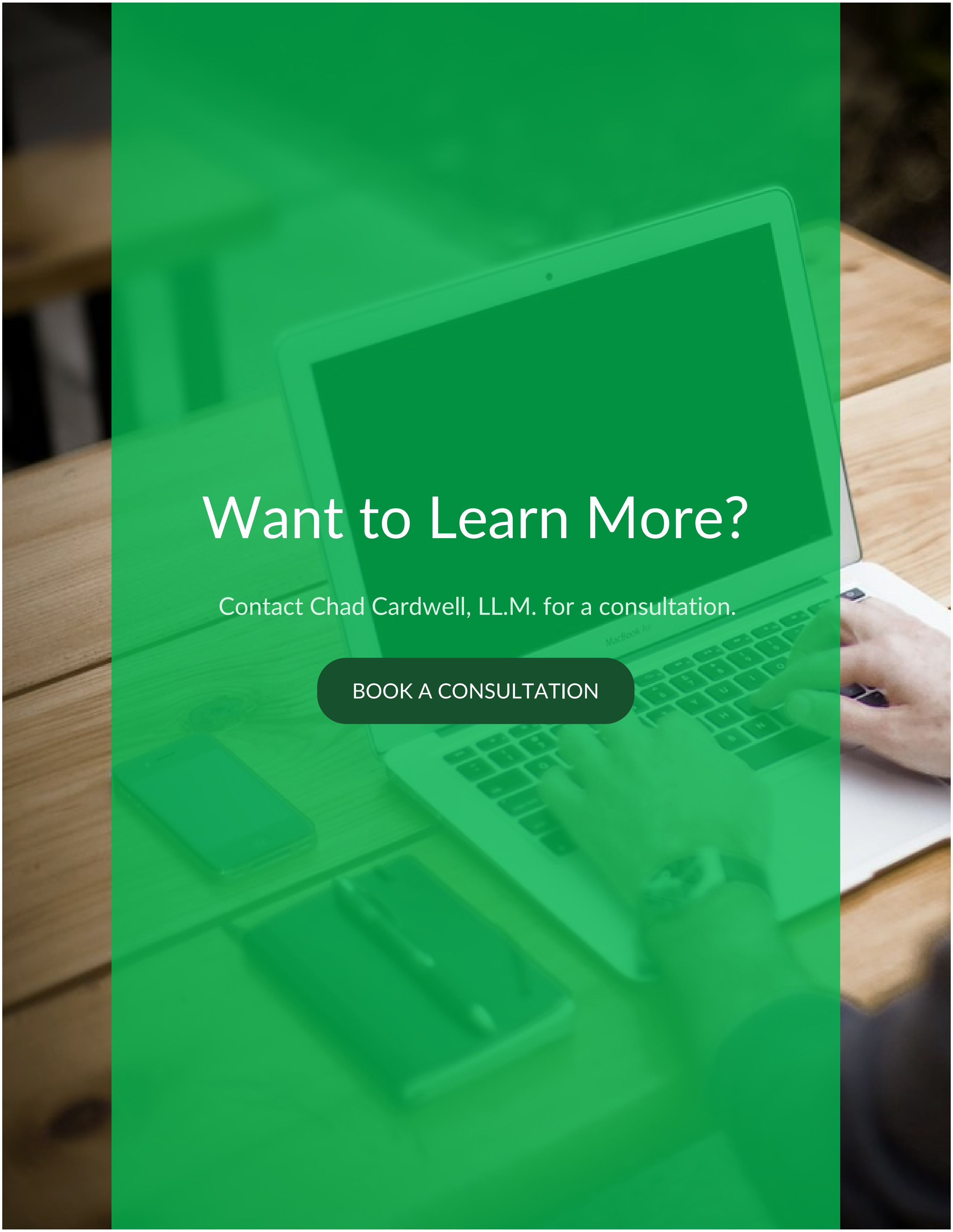
Generally, a gift must be a present interest gift to qualify for the exclusion, which allows your client to gift $14,000 (in 2017) per beneficiary gift-tax free. A present interest gift means that the recipient is able to immediately use, possess, or enjoy the gift. Gifts made to a trust are usually considered gifts of future interests and do not qualify for the exclusion unless they fall within an exception. One such exception is when the beneficiaries are given the right to demand, for a limited period of time, any amounts transferred to the trust. This is referred to as Crummey withdrawal rights or powers.

The beneficiaries (or their parents/guardians) must also be given notice of their rights to withdraw whenever your client transfers funds to the ILIT, and they must be given reasonable time to exercise their rights. The basic requirement is that actual written notice must be made in a timely manner. It is best to give written notice at least 30 to 60 days before the expiration of the withdrawal period. It is the duty of the trustee to provide notice to each beneficiary.

Trust's income generally attributed to the grantor. If your client funds his or her ILIT with income-producing assets and the trust is a grantor trust, income from the trust will be taxed to your client, and your client can use any gains, losses, deductions, and credits realized by the trust (most ILITs are grantor trusts). If the trust is not a grantor trust, the trustee must obtain a taxpayer identification number (TIN), which can be obtained online, over the phone, or by mail. If the trust is a grantor trust, a TIN is not required while your client is alive, but the trust will need one upon your client’s death. That being the case, it may make sense to obtain a TIN at the outset.

Transfers to an ILIT are taxable gifts. Transfers to an ILIT are taxable gifts. Crummey rights of withdrawal held by the beneficiaries, however, allow the transfers to qualify for the annual gift tax exclusion. Transfers that do not qualify for the annual gift tax exclusion are exempt from gift tax to the extent of your client’s lifetime gift and estate tax exemption ($5,490,000 in 2017) which is automatically applied.

Proceeds from life insurance policy not included in grantor's estate. If the ILIT is drafted, funded, and administered properly, the proceeds from insurance policies held by the trust will not be included in your client’s estate. This is one of the main benefits of setting up this type of trust.


Want to Learn More?
Contact Chad Cardwell, LL.M. for a consultation.
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Information

Chad Cardwell, LL.M. believes in helping clients through processes that can be challenging by giving each matter personal attention, providing sound legal information and having open communication with every client. Attorney Cardwell has dedicated his career to practicing exclusively in the area of estate planning since 2008. Attorney Cardwell was admitted to practice before the Supreme Court of Tennessee in 2007 and the United States Tax Court in 2008, and holds the distinction of being an Accredited Estate Planner® designee by the National Association of Estate Planners and Councils.