IRREVOCABLE LIFE INSURANCE TRUSTS (ILITs)

DEFINITION

An Irrevocable Life Insurance Trust (ILIT) is an estate planning tool utilized by individuals and families for various estate planning reasons. As its name suggests, the ILIT is irrevocable, meaning it cannot be amended and as a result, it removes any incidents of ownership by the insured. By surrendering ownership of the policy to the trust, proceeds are removed from the insured's estate and escape taxation upon death.

HOW THEY WORK

SETUP

An Irrevocable Life Insurance Trust should be created with the help of an estate planning attorney. Once this has been set up, either a new life insurance policy is purchased and placed in the trust or an existing policy is transferred into the trust. The policy can either be on one insured or a survivorship policy (also known as second-to-die). The trust is both the owner and beneficiary of the policy, and the insured can name the trustee they would like to administer the trust. Once the insurance policy is placed inside the ILIT, the insured is not allowed to change the policy in his or her own name. They can, however, dictate who the beneficiaries will be, and the terms under which they will receive benefits.

TRUSTEE

Unlike a standard trust, neither an individual nor their spouse can serve as the trustee of an ILIT. If either were named as trustee, they would retain "incidents of ownership" over the trust and its life insurance policy, and the proceeds from this policy would be included in the decedent's estate for estate tax purposes. The trustee needs to be a U.S. citizen or a U.S. owned corporation. Due to the complexity of this estate planning tool, it is highly recommended to retain the services of a trusted individual or a financial institution such as a bank or trust company. This trustee will manage the ILIT for the grantor's behalf and is responsible for paying the annual insurance premiums, notifying beneficiaries of the annual transfers into the trust, filing the ILIT's tax return, and the ultimate distribution of the trust's assets in accordance with the decedent's wishes.

FUNDED VS. UNFUNDED

The insured is not allowed to pay insurance premiums directly, so as a result, an ILIT may be funded or unfunded. A funded ILIT is one in which an insurance contract and income producing assets are placed in the trust. The trustee, not the insured, then uses the income from these assets to pay the insurance premium. An unfunded ILIT is more common, and is one in which the insured makes transfers to the trust each year to pay the insurance premium. These transfers are usually kept within the annual gift tax limit ($14,000 for 2015) in order to incur any gift tax consequences. This gift tax limit is per person and per beneficiary, so if a married couple has two children, they can contribute up to $56,000 to be used to pay for the premium of a policy held within an ILIT.

CRUMMEY LETTER

A Crummey Letter is an important feature of an ILIT, as it ensures the annual premium payments are free of gift-taxes. Because gifts of "future interest" are not entitled to the gift tax exclusion, beneficiaries must be given the ability to receive the premium payments for it to be considered a "present interest." This is accomplished by giving beneficiaries a written notice, known as a "Crummey Letter," notifying them of the funds transferred into the ILIT. Beneficiaries must also be given a specific period, usually 30 days, to withdraw this money from the ILIT. If the beneficiaries have left the money in the trust at the end of this specified period, the trustee is then free to use the funds to pay the annual insurance premium.

ESTATE TAXATION

Normally, proceeds from life insurance policies are deemed to be owned by the decedent and will be included in their estate for estate tax purposes. This is because the policy owner will be deemed to have incidents of ownership over the proceeds if they can withdraw the cash value or change the beneficiaries prior to death. By using an ILIT, the trust is the owner and beneficiary of the insurance policy, and a third party is named as trustee. The insured has removed all incidents of ownership and, therefore, removed the proceeds from their estate. However, it should be noted that if an existing policy is transferred to the ILIT, the transferor must survive at least three years after the transfer. The beneficiary will still receive the proceeds, but the decedent will have to include the proceeds as being part of their estate for estate tax purposes.

ADVANTAGES

- Large amounts of life insurance can be purchased without potentially increasing the client's exposure to federal estate taxes.
- Transfers to an ILIT to pay an insurance premium avoid any current gift tax if kept within the annual gift tax limit of $14,000 per spouse, per beneficiary.
- A gross estate is reduced through gifts of life insurance premiums, lowering federal estate taxes.
- Proceeds from the life insurance can eventually provide a necessary source of liquidity to pay for the grantor's estate tax, final expenses, inheritances and charitable gift funding.

DISADVANTAGES

- The trust is irrevocable, meaning it cannot be changed or amended. Gifts made to the trust are final.
- The trustee must send beneficiaries a "Crummey Letter" advising them of their right to withdraw funds transferred into the trust. Failure to provide notice may ultimately cause the life insurance proceeds to be included in the decedent's estate.
- An ILIT must be properly drafted and specific steps must be followed by both the grantor and the trustee to avoid incurring gift and/or estate taxes so there will be legal fees to setup.

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