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The Irrevocable Life Insurance Trust

Most clients are shocked to learn that the death proceeds of their life insurance are subject to federal estate taxation. They believe that life insurance escapes estate taxes and passes to their loved ones intact.

This confusion probably began when the client was told that life insurance is **income tax-free**. For married clients, the confusion is compounded by the belief that the unlimited marital deduction somehow magically insulates the client's death proceeds from ever being taxed. Often the marital deduction merely postpones the heavy tax burden on such death proceeds.

Regardless of the source of this confusion, a great many clients will have far less life insurance proceeds than they expect as a result of lack of planning for this estate tax liability.

For clients who have taxable estates (meaning, at the time of death, over \$2,000,000 for single persons and over \$4,000,000 for married persons who have implemented proper estate tax planning), estate taxes can consume 46% of their life insurance proceeds.

These clients have far less insurance than they think they have; or alternatively, they are paying far more for their coverage than they should be paying. The Irrevocable Life Insurance Trust (or "ILIT" as it is frequently called) has proven to be a highly effective method of avoiding estate taxes without the many problems of transferring ownership of the policy to the client's children or other heirs. The ILIT has been tested extensively in court and an experienced estate planning attorney should have no trouble in properly drafting this highly technical document.

The ILIT allows the taxpayer to control how the life insurance proceeds will be used to provide for his or her loved ones. The taxpayer can take full advantage of all of the available \$12,000 annual exclusions to potential beneficiaries. The ILIT allows the death proceeds to pass to the taxpayer's loved ones free of estate taxes.

An ILIT is a highly technical trust document that is controlled not only by trust law, but also by the Internal Revenue Code and various regulations, rulings and court cases.

Nevertheless, if all of these technical requirements are followed, the client with a \$1,000,000 life insurance policy may save up to \$460,000 in estate taxes with this important planning tool.

It is important that you understand these requirements before the ILIT is established. A qualified and experienced estate planning attorney can explain the nature and reason for these technical requirements.

PURPOSE: The purpose of this article is to provide you with an overview of the nature of the ILIT and what it can accomplish.

Highlights of the ILIT that you should know:

BENEFIT: The proceeds from your life insurance are generally includable in your taxable estate if you owned the policy or had any "incidents of ownership." This is true for term insurance, cash value insurance, and even insurance provided by your employer. Estate taxes start at 46% once the estate exceeds \$2,000,000. The ILIT can keep life insurance proceeds from being taxed in your (or your spouse's) estate.

"Incidents of Ownership" which will cause life insurance death proceeds to be taxed as part of in the insured's taxable estate include not just policy ownership, but also the right to borrow the cash value, the right to change beneficiaries, and the right to change how the proceeds are ultimately distributed to the beneficiaries.

THE ILIT: An ILIT is created to own one or more policies insuring your life. The ILIT is irrevocable, meaning you cannot change the terms once it has been signed, although some flexibility can be written into the document.

For instance, you can allow others, such as your spouse, to exercise control over the timing of when the proceeds upon her death will be distributed to your children.

You (and sometimes your spouse) cannot serve as trustee of the ILIT. The trustee can be almost anyone else, such as a parent, a sibling, a friend, your attorney, certain law firms, or even a bank.

You cannot be a beneficiary of the trust, but your spouse and children can be (and usually are) beneficiaries. Quite often the ILIT parallels the dispositive provisions of your revocable living trust or other estate planning documents, although there is no legal requirement for the ILIT to do so.

Moreover, the ILIT cannot be payable to your estate or to your revocable living trust, as your ability during lifetime to change your will or trust would result in your ability to change the beneficial enjoyment of the policy proceeds, thus bringing the policy back into your taxable estate.

IT'S A GIFT: Your contribution to the ILIT represent gifts which you cannot get back. The gifts are usually used to pay the premiums on one or more policies insuring your life and which are owned by the trust. Because, you cannot reclaim the policies, or receive any benefit from the trust, it would be inappropriate to have the trust own policies whose cash values you had planned to use for retirement income.

THE \$12,000 ANNUAL EXCLUSION: You can gift up to \$12,000 per year per donee (recipient) without any gift tax implications. This exclusion is only available to gifts of a present interest, which is something you can enjoy or use today, and gifts in trust generally do not qualify, as they are gifts of a future interest, or one that will be enjoyed or used later.

To avoid this limitation, your ILIT should provide that each lifetime beneficiary (who must also be a beneficiary or contingent beneficiary at your death) has the right to withdraw his or her proportionate share of the contribution for a limited period of time after each contribution is made.

Usually the trust agreement provides that, after a contribution is made, each beneficiary will be notified of their right of withdrawal. After the expiration of the withdrawal period (usually not less than 30 days), the trustee can use the contribution to pay the premium of a life insurance policy.

IT WORKS IF: The IRS has approved the ILIT concept when all the technical requirements are met, but the IRS is notorious for challenging ILITs when these requirements are not met. Even the order in which the documents are signed on the same day can be critical. With almost half of your life insurance proceeds at stake, it is not worth taking shortcuts or having a novice prepare your documents.

EXISTING INSURANCE POLICIES: Existing policies can be contributed to your ILIT, but the death proceeds will be drawn back into your taxable estate if you die within three (3) years of completing this gift. If you are insurable, it is sometimes advisable to obtain a new policy.

Also, the transfer of an existing policy can trigger a taxable event should policy loans exceed total premiums paid.

UPON DEATH: The trustee receives the death benefit upon your death. These proceeds can be distributed to your family, held in trust, or used to purchase assets from your estate or from your revocable living trust. This last option would be important if your estate had insufficient liquid assets to pay estate taxes.

LIQUIDITY: The tax on your estate is due nine months after the date of death. For instance, on a \$5 million estate, the estate taxes will be over \$2 million.

Those with large estates often do not have that much cash or other assets which could be easily converted to cash in that time frame. The need to pay estate taxes has caused many a farm, family business, or major real estate holding to be sold at discounted prices to pay the estate tax.

Life insurance can provide the money needed to pay the estate tax, and by having the policy purchased and held in an ILIT, the proceeds can be used to provide the needed liquidity for your estate and yet not be subject to estate tax on your death.

Married couples may wish to consider using a "second to die" policy which pays the death benefit only after both spouses are deceased. That is usually the exact time that the proceeds are needed to pay the

estate taxes. Because no death benefit is paid on the first death, the premium is usually much lower than purchasing a policy which insures just one life. A special type of ILIT can be drafted to hold such a policy.

DIRECT OWNERSHIP: Often clients try to accomplish similar results to the ILIT by having, say, their two children own the policy equally.

Many problems can arise under such an arrangement. A child can die; the policy can be attached and liquidated by a child's creditors; the policy could be considered as the child's property in the event of a divorce; one child may refuse to pay the premiums, or may wish to borrow the cash value.

The outright gift of a policy makes no provisions for young children or grandchildren. These and other issues can be addressed in a properly drafted ILIT.

ARE YOU INSURABLE: Before paying legal fees to have your ILIT drafted by an attorney, you may wish to submit a trial application to the insurance company to ascertain that you are insurable at acceptable rates. Be sure to list yourself only as the insured. The owner and applicant should not be you, but could be your wife, your proposed trustee, or anyone else. **DO NOT** submit a check with such a trial application.

Once insurability is established and the ILIT is signed, the trustee can submit a new application with the trust as the owner, applicant and beneficiary. You will only be the insured. An experienced life insurance agent can help you prepare the proper type of application.

SUMMARY: The ILIT is an IRS-approved means of removing life insurance proceeds from your taxable estate, and yet still have the proceeds available to provide for your spouse and children according to your desires. Gifts made each year to the ILIT can be exempt from gift tax. For those with taxable estates, the savings in estate taxes can be 46% of the death proceeds.

The ILIT can also protect your family after you are gone. Many types of trusts are available to protect children from lawsuits, divorce, or their own indiscretion.

If you have a taxable estate and own a large insurance policy, or are contemplating purchasing one, see your estate planning attorney today to discuss how the ILIT might benefit your family.

This article was prepared by Midgett & Preti PC and is intended to provide general advice only. For answers relating to a specific situation, you should consult a competent estate-planning lawyer.

TOP TEN ILIT TIPS

The following top ten tips regarding Irrevocable Life Insurance Trusts (ILITs) are so important that the failure to comply with any one of them could cause an estate tax to be assessed against the value of the life insurance, even if owned by the ILIT, ruining the value of the overall estate plan.

1. **DO NOT** make the insured the Trustee or the beneficiary of the ILIT.
2. **DO** make sure the ILIT is both the owner and the beneficiary of the life insurance policy.
3. **DO** make sure that the trust provides the beneficiaries the right to withdraw contributions to the ILIT (“Crummey” powers) so that no adverse gift tax consequences occur.
4. **DO** keep the insured's contact with the insurance company to a minimum.
5. **DO** make sure that the Trustee has the right to loan, sell to, borrow from or purchase from the insured's estate, or any other trust created by the insured.
6. **DO** make sure that the ILIT allows contributions to be made to the trust by persons other than the grantor.
7. **DO NOT** have the insured pay the insurance premiums. Only the ILIT Trustee should pay these premiums.
8. **DO** make sure that the ILIT distribution provisions "mirror" the distribution provisions in the insured's Will or Living Trust.
9. **DO** obtain a separate taxpayer identification number for the ILIT.
10. **DO** discuss with your tax advisor or estate planning attorney the benefits of allocating your Generation Skipping Transfer (GST) Tax exemption to the ILIT.

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