Irrevocable Life Insurance Trust

An Irrevocable Life Insurance Trust (ILIT) is used to remove the death benefit from the insured's estate for estate tax purposes. The grantor completely gives up all rights in the property transferred to the trust and retains no rights to revoke, terminate or modify the trust in any material way.

ILITs Are Used In Estate Planning To Accomplish Objectives

- Help meet the liquidity needs of the grantor's estate.
- Avoid estate taxation of the death proceeds.
- Help provide for the income needs of survivors after liquidity requirements have been satisfied.
- Shelter property from creditors at death.

Funding Alternatives

An irrevocable life insurance trust may be either "funded" or "unfunded."

- In a **funded** life insurance trust, the grantor transfers property to the trust from which the premium payments may be made. The property may be in the form of cash, securities, or some other asset. The trust income is generally taxed to the grantor.
- In an **unfunded** life insurance trust, the trustee has no other property in the trust with which to pay premiums, and depends on annual cash gifts from the grantor. The "unfunded" trust is more commonly used, and we will focus on it in the remainder of this material.

How An Irrevocable Life Insurance Trust Works

1. The grantor transfers a life insurance policy to the trust or the trustee applies for a new policy.
    - The beneficiaries of the trust are often family members.
    - If the transfers of the policy occur less than three years before the grantor's death, the death benefit will be subject to estate tax.
2. The grantor transfers cash annually to the trust which can be sheltered from the gift tax by the gift tax annual exclusion, through the beneficiary's Crummey power. Any gift that does not qualify for the annual exclusion reduces the lifetime exemption available or is subject to gift tax.
3. The trustee makes premium payments.
4. At the grantor's death, the trust receives the death benefit from the policy.
5. The trust gives the trustee the power to make loans to the grantor's estate, or to purchase assets from the estate, to provide the estate with funds to help pay estate settlement costs. The trustee does not make the payments directly.

Considerations

- The gift tax associated with transferring a policy is (1) total premiums paid on a newly issued policy; (2) cost of a comparable policy with insured's attained age on a paid up or single premium policy; or (3) the "interpolated terminal reserve" plus unearned premium on a previously issued policy still in premium paying status.
- Transferring cash to an irrevocable trust is considered a "future interest" gift. Therefore the annual exclusion is not available because the trust's beneficiaries cannot currently access

www.theasagroup.com
P: 501.224.7739 | F: 501.223.3791
11807 Hinson Road, Little Rock, AR 72212

and use the gift. However, the gift can be made a "present interest" gift by giving some or all of the trust's beneficiaries a temporary right to withdraw some or the entire gift.

- To do so, the trustee notifies the beneficiary (using a "Crummey notice") of the temporary right to withdrawal funds from the trust. If the beneficiary does not exercise this right within the stated period (usually 30-45 days) then the right "lapses" and the gift is considered a "present interest" gift. Once the withdrawal right lapses, the trustee can use the gifted funds to pay premiums.
- At the insured's death, the trust should receive death benefit proceeds income tax-free and estate tax-free. These proceeds can be used to provide liquidity to pay estate taxes (by making loans to the decedent's estate or purchasing assets from the decedent's estate).
- If the insured has an "incident of ownership" in the life insurance policy at death (or within three years prior to death) the death benefit value is brought into the insured's gross estate (the trust beneficiaries will receive the actual proceeds but the amount of those proceeds will be included in the insured's gross estate value).
- Paying premiums is not an incident of ownership. However, there are gift taxes associated with paying premiums on a life insurance policy that is not owned by the premium payor.
- For existing policies, the client can gift enough money to the trust so the trustee can buy the policy from the grantor for its fair market value. This avoids the three-year rule. If the insured is treated as the owner of the trust for income tax purposes, it qualifies for an exception to the transfer for value rule. Care must be taken to ensure that the sale is for the policy's fair market value.

Essentially

The grantor/insured creates an Irrevocable trust to own any life insurance policies on his/her life so the death benefit is not subject to estate taxes. Gifts to the trust by the grantor are used to pay the premiums.

www.theasagroup.com
P: 501.224.7739 | F: 501.223.3791
11807 Hinson Road, Little Rock, AR 72212