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IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

It is generally well known that life insurance proceeds, in most cases, pass to the named beneficiary free of any income tax. Less well known, however, but vitally important, is that the payout from a life insurance policy is generally included in the “gross estate” of the policy owner for estate tax purposes at the policy owner’s death and is potentially subject to federal and state estate taxes. At the current federal estate tax rate, (40%), a significant portion of the life insurance proceeds would be payable to the Internal Revenue Service for federal estate tax instead of passing to the policy owner’s beneficiaries.

An irrevocable life insurance trust (“ILIT”) takes advantage of a purposeful loophole created by Congress. If an ILIT is created to own the life insurance policy and the proceeds of the life insurance policy are payable to the trustee of the ILIT upon the insured’s death, then the proceeds are not included in the insured’s estate and, therefore, are not taxable for federal estate tax purposes. This is true even though the insured gives the money to the trustee of the ILIT to pay the annual premiums of the life insurance policy.

For example, if an ILIT is created and the trustee of the ILIT purchases a \$1 million life insurance policy on the life of the person creating the ILIT and the trustee of the ILIT is the beneficiary of the proceeds from the life insurance policy then, at the death of the insured, the trustee of the ILIT will receive the insurance proceeds free from estate tax. The trustee would then manage and dispose of the life insurance proceeds pursuant to the terms of the trust agreement. For example, the terms of the trust could provide that the trustee distribute the income to the surviving spouse for his or her lifetime and then distribute the remaining principal to their children upon the death of the surviving spouse. The result is that the \$1 million of life insurance proceeds is ultimately transferred to the children of the insured free of federal estate tax. The \$1 million is not taxed in the estate of the surviving spouse because the ILIT is set up not to qualify for the marital estate tax deduction.

Additionally, the provisions of the ILIT can provide liquidity for the estate of the insured. For example, the estate of the insured may consist of hard-to-sell assets, such as real estate, an interest in a business venture, closely-held stock or valuable artwork, and there is no ready cash or marketable securities to pay the federal estate tax within nine months after the death of the insured, which is the deadline for paying federal estate tax. Therefore, the terms of the ILIT can provide that the trustee be allowed to purchase assets from the estate of the insured at the fair market value for those assets. For example, if the estate of the insured owned a parcel of commercial real estate valued at \$800,000 for which a buyer could not be found before the nine month deadline, then the

trustee could use \$800,000 from the life insurance proceeds and purchase the parcel of commercial real estate. The estate of the insured now has \$800,000 to use towards the payment of federal estate tax and other administrative expenses. The ILIT now owns the commercial real estate which produces ample monthly rental income to be paid to the surviving spouse and the future appreciation of the commercial real estate will ultimately pass to the children of the insured, without estate taxes having to be paid.

What are the drawbacks of an ILIT? Irrevocable is irrevocable. The person who created the ILIT cannot get the life insurance policy or the money given to pay the premiums from the trust for a financial emergency or because the creator later changes his or her mind. The insurance premiums that have been paid into the trust will not be available to the creator of the ILIT by means of borrowing against the policy's cash value. The creator of the ILIT cannot retain control, dominion or any incident of ownership of the life insurance policy. Therefore, the creator of the ILIT cannot borrow against the cash value of the life insurance policy, cannot change the beneficiary designation of the policy, nor can the creator of the ILIT change the terms of the trust. The creator of the ILIT can stop providing the funds to pay the annual premiums, but the creator of the trust cannot receive back what has already been paid into the trust.

The ILIT must also be carefully drafted so that it avoids any gift tax liability. Because the trust is irrevocable and because the trustee of the ILIT owns the policy, any funds transferred to the trustee of the ILIT to purchase the policy or to pay annual premiums are gifts for federal gift tax purposes. The \$15,000 annual gift tax exclusion for an individual (or \$30,000 if consented to by the individual's spouse) does not apply to gifts in trust because such gifts are a gift of a future interest and not a present interest. However, if the trust is drafted so as to allow the trust beneficiaries to have the power to receive the cash, rather than allowing the trustee of the ILIT to use the cash to pay for the insurance, then such power, called a "Crummey" power, will allow the gifts to the ILIT to qualify for the annual gift tax exclusion. For example, if the creator of the ILIT gives the trustee of the ILIT \$41,000 to pay for the annual premium for the life insurance policy, and if the terms of the ILIT allow for the spouse to withdraw up to \$5,000 for a period of thirty days from the date the spouse received notice of the transfer to the ILIT, and for the three children of the creator of the ILIT the power to withdraw up to \$15,000 each for a period thirty days from the date they receive notice of the transfer to the ILIT, then, if each beneficiary does not exercise the withdrawal power, the money will stay in the trust to be used by the trustee to pay for the premiums and the initial \$41,000 gift will be covered by the \$15,000 annual exclusion for each beneficiary (\$5,000 as to the spouse). The full \$41,000 transfer will be covered by the individual's annual exclusion and no gift tax liability will be incurred.

If the creator of an ILIT transfers an existing life insurance policy into an ILIT, three years must pass before the transfer of the life insurance policy becomes excluded from the creator's gross estate for estate tax purposes. Therefore, if the creator of the trust (who is also the insured) dies within three years of the transfer of the policy to the ILIT, the policy proceeds will be subject to federal estate tax in the estate of the creator of the ILIT.

An important consideration when creating an ILIT is determining who will be the trustee. The creator of the ILIT cannot also serve as the trustee because this would result in the creator of the trust having an incident of ownership in the life insurance policy and the policy proceeds would be taxed in the estate of the creator of the trust upon his or her death. Also, a beneficiary of an ILIT

should generally not be a trustee. Therefore, you can choose a trusted professional advisor, friend or family member who is not a beneficiary or use a corporate fiduciary, such as a trust company or a bank's trust department. Charges for a corporate fiduciary vary according to the complexity of the trust but are typically an annual percentage of the trust assets.

ILITs are worth a careful examination for anyone with a taxable estate, but are particularly appropriate for people who want to potentially leverage their annual gifts or who have large amounts of illiquid assets, such as real estate or a business that the family wants to continue to run. For those individuals with large existing life insurance policies, transferring such policies to an ILIT, subject to the three year rule, is a viable means to pass the life insurance policies to your children or grandchildren free of estate tax.

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