# ILITs (Irrevocable Life Insurance Trusts)

Trusts play an essential role in estate planning for many individuals and families. The assets held in a trust can vary from real estate to stocks, bonds, insurance policies, family business interests, jewelry, and other collectibles. Reasons for utilizing trusts can vary from taxation, control, continuity, creditor protection, and more.

Did you know that death benefits paid to your chosen beneficiaries from your life insurance policies may be included in your taxable estate? Most people are surprised to find out about this. Life insurance death benefits are not subject to state or federal income tax (in most cases), but they are subject to state and federal estate tax, unless the insured did not have any "incidents of ownership" in the policy. These types of trusts were employed frequently in estate planning in the past when exclusion amounts were lower – people wanted to avoid having a large payout to their estate that might make it owe more in taxes. They are not used as commonly now in estate planning, but they do still have a place and ILITs are still in existence, funded either with active policies or with the proceeds from the life insurance payout.

Typically, an Irrevocable Life Insurance Trust (ILIT) owns a life insurance policy and will eventually hold the proceeds when you, the Grantor, die. Since the irrevocable trust owns these assets and there is an independent Trustee (not a member of your immediate family or anyone considered subordinate to you under tax law), the ILIT is considered a separate legal entity and the assets are not included in your estate when you die.

The ILIT has its own federal tax identification number and must file annual state and federal income tax returns, although it usually has no taxable income while you are alive. When you die, the entity which owns the policy and collects the death benefit "lives on," so to speak, so the death benefits are not taxed. The ILIT should have provisions for distribution of the death benefits (or holding them in a continued trust) which are coordinated with all other aspects of your estate plan. A single ILIT can own more than one life insurance policy.

Life insurance policies are complex financial instruments that require active management by policy owners. Many mistakenly believe that life insurance policies are static financial instruments with guaranteed benefits that can be filed away without further review or consideration. Thus, they are surprised to learn that policies can lapse due to insufficient policy values, premiums can increase, or the benefit at the time of claim will be significantly less than was projected at issue.

The Trustee's job is to purchase the policy (or transfer it from an existing owner), notify the Grantor of premiums before they are due, collect the required premium payments, deposit the payments to the trust and then submit the premium payments from the trust to the insurance carrier. In order to comply with the special rules of an ILIT, the Trustee must notify the trust beneficiaries, if required, of their rights with regard to each gift the grantor makes to the trust and maintain records of such "Crummey" notices. The Trustee must work with the beneficiaries to help them understand these notices, particularly if the beneficiaries elect to exercise any of their rights.

Additionally, the Trustee's job is to ensure that the policy continues to be good (e.g. review statements to verify policy values are being maintained and monitor insurance carriers for financial strength or changes to corporate structure). The Trustee should also evaluate the policy in terms of cost structure and performance relative to the rest of the insurance industry; review the relevance and continuation of supplementary benefits and riders; explore other opportunities presented by the life insurance policy and their benefits to the trust; and maintain an awareness of the insured's insurability.

If you transfer an existing policy to an ILIT, there is a three-year waiting period before the death benefits will be excluded from your estate. If you purchase a new policy, set up the ILIT first, have the Trustee sign the policy application and make sure the trust is designated as the original owner when the policy is issued. Even if you die within three years of issue, the death benefits should be excluded from your estate. The annual gift tax exclusion (currently $18,000 per person in 2024) to fund the trust and purchase the premium. The beneficiaries receive notice via a

Crummey letter upon this initial funding and have the right to withdraw the funds; if they elect not to, the funds are used to purchase the premium.  If an existing policy is being transferred to the trust, there are a few caveats: 1) you need to survive for more than three years from the date you transfer the policy into the trust or else, the life insurance amount will be included in your estate for estate tax purposes; and 2) the transfer of the life insurance policy into trust is a gift and could use up a portion of your gift tax exemptions (i.e. in excess of the $18,000 exemption per year).

In addition to the annual tax returns, your trustee will have to set up a bank account, into which you will make periodic deposits sufficient to cover the annual premiums for the insurance. These deposits to pay premiums will be considered taxable gifts to the beneficiaries of the trust (your spouse and children, for example). However, in a properly drafted ILIT, if certain “notice” procedures are strictly followed, deposits and premium payments up to $18,000 per year, per beneficiary, can be disregarded under the annual gift tax exclusion. For example, if your two children and four grandchildren were the beneficiaries of the ILIT, up to $108,000 of annual premium could be paid without gift tax consequences. (If the premiums added up to the full $108,000, you could make no other significant gifts to the children and grandchildren; all gifts each year are counted toward the $18,000 per person limit.)

Because of the setup costs and careful attention that must be paid to it every year, an ILIT is not appropriate for every person and every life insurance policy. In the right circumstances, however, it can be a simple way to prevent some of the proceeds from falling into the hands of the tax collector. That’s money in the bank for your loved ones.

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