ILITS Remain a Popular Estate Planning Tool and Technique

The federal estate tax may or may not be repealed or reformed anytime soon. But such discussions in Washington should not dampen the use of irrevocable life insurance trusts as a still very viable and valuable planning tool and technique which has applications beyond the tax efficient payment of estate taxes.

Indeed, financial planners say irrevocable life insurance trusts, or ILITs, can fulfill many estate-planning goals, not the least of which is avoiding federal estate taxes on the death benefit amount of the life insurance policy. By way of background, there are two major types of trusts: revocable—which can be changed as often as you want—or irrevocable—which generally cannot be amended or changed without the permission of a court, and then only for limited purposes. These trusts can either be funded (assets that will produce premium dollars are put in the trust) or non-funded (premiums are contributed annually). Typically, a person would either transfer an existing insurance policy on their life into a trust (or have a trust purchase a new insurance policy) if they were interested in controlling the distribution of the death benefit in a manner beyond the ability of the contract provisions to do so, if they wished to remove the proceeds from their taxable estate, or, in some cases, beyond the reach of the creditors of beneficiaries.

As the name suggests, an ILIT is a trust that cannot be changed or revoked by the creator or "trustor" once it is executed. Generally the trustee cannot be changed, the beneficiaries or the terms of the trust cannot be changed, and assets in the trust cannot be removed by the person who created the trust. By way contrast, a revocable trust can be changed by the trust's originator, beneficiaries can be added or removed, assets can be withdrawn, and the trust can be terminated.

In general, here's how it works: The life insurance trust is created first, and then the trust buys a life insurance policy in its own name on the trustor. The trustor, in an unfunded trust, annually adds funds to the trust, which in turn, buys (and continues to pay for) the policy in its own name, and pays the policy's premium against its own account. An independent trustee is generally required in this case if "incidents of ownership" of the life insurance policy are to be avoided on the part of the person creating the trust.

It is possible to transfer an existing life insurance policy to such a trust however; in this case, the policy death benefit will remain part of the trustors' estate for three years after the transfer. It's important that the trustor irrevocably relinquishes to the trust absolutely all control over the policy. It's best to work with an estate planning attorney when creating an ILIT.

In essence, the trust takes over ownership of the policy. The trustor then makes contributions to the trust, which, in turn, uses the contributions to pay the policy's premium against its own account.

As mentioned, a major reason for an ILIT is that the assets in the trust -- the proceeds of the life insurance policy or the face value after the insured dies -- will not be included in insured's taxable estate at their death. As long as they do not retain any incidents of ownership in the life insurance policy, the proceeds should not be taxed in their estate. Most people will use an irrevocable life

insurance trust if they anticipate that their assets will be above the applicable exclusion amount (and, thus, subject to tax).

But having assets pass outside on a taxable estate is just one reason for using an ILIT. The combination of life insurance and a trust assures the management, investment, and timing of that wealth. And it does so with a great deal more flexibility than the name might suggest.

The combination of life insurance and trusts have amazing creditor protection potential – far more than either alone. Once an individual has parted with (or never owned) life insurance and it's safely in an irrevocable trust containing the proper "spendthrift" provisions, it's almost impossible for the creditors of the beneficiaries to reach it. In other words, one of the most effective ways to assure the financial security and future of loved ones (or a charity) is life insurance in an irrevocable trust.

The combination of life insurance with a trust can avoid the costs, delays, and aggravation of probate – not just once – but over several generations. The life insurance/trust combo offers flexibility impossible to achieve through life insurance alone – while the life insurance in the trust makes a much larger and therefore more economical/practical/cost effective trust possible and in most cases is the only instrument capable of providing a benefit at precisely the time it is needed.

In addition, cash payments to an irrevocable life insurance trust may qualify for annual gift exclusion. In order to qualify, beneficiaries of the irrevocable life insurance trust are given what are called Crummey powers or "present interest rights" to the monies which when structured correctly will be declined by them so that the monies can be used to pay premiums.

As a reminder, it's best to work with an estate planning attorney when creating an ILIT.

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