



Irrevocable Life Insurance Trusts (ILITs): A Key Tool for Estate Planning and Tax Efficiency

An Irrevocable Life Insurance Trust (ILIT) is a valuable estate planning tool designed to help individuals reduce estate taxes, provide liquidity for estate expenses, and protect life insurance proceeds from creditors. By placing a life insurance policy into an ILIT, the policy's death benefit is excluded from the insured's taxable estate, ensuring that beneficiaries receive the full benefit free from estate taxes.

ILITs are particularly useful for high-net-worth individuals looking to minimize estate taxes, provide for loved ones, and create a reliable source of liquidity that can cover estate settlement costs or provide an inheritance for heirs. This guide outlines the key components, benefits, and considerations of establishing an ILIT.

Key Benefits of an ILIT

- **Estate Tax Savings:** Life insurance proceeds are typically included in the taxable estate if the insured holds ownership of the policy at death. By transferring ownership of the policy to an ILIT, the death benefit is removed from the estate, potentially saving heirs a significant amount in estate taxes.
- **Liquidity for Estate Expenses:** ILITs can provide much-needed liquidity to pay estate taxes, debts, and other expenses. This is especially beneficial for estates with illiquid assets, such as real estate or closely held businesses, that could otherwise be forced to sell assets to cover tax obligations.
- **Asset Protection:** An ILIT provides creditor protection for life insurance proceeds. Once the policy is owned by the trust, the death benefit is shielded from creditors of both the grantor and beneficiaries, ensuring the funds are available to support the family or meet other estate planning goals.
- **Control Over Distribution:** An ILIT allows the grantor to set specific terms for how and when life insurance proceeds are distributed to beneficiaries. This control is especially useful when beneficiaries are young, have special needs, or may not be financially responsible. The trustee can manage the funds and ensure that distributions are made according to the grantor's wishes.
- **Generation-Skipping Transfer Tax Planning:** ILITs can be structured to benefit multiple generations, thereby reducing or avoiding generation-skipping transfer (GST) taxes. By carefully planning how the trust can benefit future generations, families can preserve wealth over the long term.





How an ILIT Works

- **Creation of the Trust:** The grantor (the person establishing the trust) works with an attorney to create an ILIT. The trust is irrevocable, meaning the grantor cannot modify or revoke the trust once it is established. The grantor also relinquishes control over the life insurance policy, transferring ownership to the trust.
- **Transfer of Life Insurance Policy:** The grantor transfers ownership of an existing life insurance policy to the trust or arranges for the ILIT to purchase a new policy. Once the policy is owned by the ILIT, the death benefit is excluded from the grantor's taxable estate, provided the grantor survives for at least three years after the transfer of an existing policy (to avoid the IRS's three-year look-back rule).
- **Annual Premium Payments:** The ILIT requires funding to pay the premiums on the life insurance policy. Typically, the grantor makes annual contributions to the trust, and the trustee uses those funds to pay the premiums. To qualify the contributions for the annual gift tax exclusion, the trustee typically issues **Crummey Notices** to the trust beneficiaries, informing them of their temporary right to withdraw the contributions. This right, which typically lasts 30 days, allows the contribution to qualify as a gift for tax purposes.
- **Payment of Death Benefit:** Upon the insured's death, the life insurance proceeds are paid directly to the ILIT. The trustee then manages and distributes the proceeds according to the terms set out in the trust document. The funds can be used to provide for beneficiaries, pay estate taxes, or fulfill other estate planning objectives.

Tax Treatment of an ILIT

- **Estate Taxes:** One of the primary advantages of an ILIT is the removal of the life insurance policy from the taxable estate. As long as the grantor no longer owns the policy and the transfer meets the IRS's requirements, the death benefit is excluded from the estate, reducing the overall estate tax liability.
- **Gift Taxes:** Contributions made to the ILIT to cover premium payments are considered gifts to the trust beneficiaries. These gifts are subject to gift tax rules, but the grantor can use the annual gift tax exclusion (currently \$17,000 per beneficiary in 2023) to minimize or eliminate gift taxes. By issuing Crummey Notices, the contributions qualify for the gift tax exclusion.





- **Generation-Skipping Transfer Taxes:** If the ILIT is designed to benefit grandchildren or later generations, GST tax considerations come into play. Proper planning and allocation of the GST tax exemption can help the trust avoid or reduce these taxes, preserving more wealth for future generations.

Considerations for Implementing an ILIT

- **Irrevocability of the Trust:** Once an ILIT is established, it cannot be modified or revoked. The grantor relinquishes all control over the life insurance policy and the trust assets. It is essential to carefully consider the terms of the trust and ensure that the trustee and beneficiaries are appropriately selected.
- **Trustee Selection:** The trustee manages the ILIT, including paying premiums, issuing Crummey Notices, and distributing the death benefit according to the trust's terms. It is important to select a responsible and trustworthy individual or professional institution to serve as trustee, as they will have significant control over the trust assets.
- **Crummey Notices:** To qualify contributions for the annual gift tax exclusion, the trustee must issue Crummey Notices to the beneficiaries, giving them a limited time to withdraw the contribution. Failure to issue these notices can result in the contributions being subject to gift taxes, so it is important to follow this process diligently.
- **Three-Year Rule for Existing Policies:** If the grantor transfers an existing life insurance policy to the ILIT, they must survive for at least three years after the transfer for the death benefit to be excluded from their estate. If the grantor passes away within three years of the transfer, the death benefit will be included in the taxable estate. For this reason, many grantors opt to have the ILIT purchase a new policy instead.
- **Funding the Trust:** The grantor must ensure there is sufficient liquidity to make regular premium payments on the life insurance policy. Failure to pay premiums can cause the policy to lapse, which would eliminate the primary benefit of the ILIT. It's important to establish a sustainable funding plan, either through regular contributions or other means.

Conclusion

An Irrevocable Life Insurance Trust (ILIT) is a powerful estate planning tool that can help individuals reduce estate taxes, protect life insurance proceeds from creditors, and provide liquidity for estate expenses. By carefully structuring the ILIT and selecting the right trustee, families can help ensure that their life insurance proceeds are protected, distributed according to their wishes, and used to preserve wealth for future generations. For those with substantial estates or significant life insurance policies, an ILIT is a crucial element of a comprehensive estate plan.





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