THE IRREVOCABLE LIFE INSURANCE TRUST

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To discuss life insurance in relation to estate planning should not come as a surprise to anyone. Life insurance and estate planning go hand in hand. Life insurance proceeds are very often the fuel that powers the estate planning vehicle, whether that vehicle be a will or a living trust. It represents a major building block in the estate planning process.

Many times the life insurance "fuel" is taxed at the pump before it finds its way into the estate planning vehicle. Because life insurance is not an asset in Probate because it passes by way of a beneficiary designation, many people assume that it is not a *taxable* asset. Not true! Life insurance proceeds are included in the deceased's estate for federal estate tax purposes. Current Federal estate tax is 40% of the estate over a value of $5,340,000 (in 2014). In addition, estate taxes are due only 9 months after the date of death, regardless of the status of any probate of the estate that may be pending.

Delayed But Not Avoided. The federal estate tax on life insurance proceeds can be delayed if you are married. The unlimited marital deduction allows you to pass your property to your U.S. citizen spouse free from federal estate tax. Federal estate taxes are not due until after the death of the surviving spouse. Non-citizen spouses can receive the proceeds in a special form of trust called a Qualified Domestic Trust and receive the same delay of taxation.

As a consequence, the federal estate tax due on the death of the surviving spouse can be very substantial. Surviving spouses rarely use the entire estate left to them and, very often, die with a larger estate than the first spouse. If life insurance is part of the estate, it will be taxed. It's just a matter of time.

The Irrevocable Life Insurance Trust. Buying life insurance to add to your taxable estate makes little sense. The solution is to structure your life insurance to be totally free from federal estate tax upon your death and, if you are married, upon the death of your spouse. This can be accomplished through a special type of trust called an *Irrevocable Life Insurance Trust.*

An Irrevocable Life Insurance Trust or "ILIT" is a additional trust that you create as part of your total estate plan <u>in addition to your revocable living trust</u>. It is a separate trust that owns your life insurance, pays the premiums, and is your beneficiary. Through the use of an ILIT, at least three major estate planning objectives can be achieved.

a. Insurance proceeds can be kept federal estate tax-free upon the deaths of both you and your spouse;

b. The terms provided in the trust document allow you to control the insurance proceeds received by the ILIT to care for your beneficiaries;

c. The life insurance proceeds received by an ILIT can be used to pay the death expenses, including taxes, of both you and your spouse.

How an ILIT Works. Generally, the ILIT is used to own a life insurance policy on your life. If an Irrevocable Trust purchases a life insurance policy, or an existing life insurance policy is given to the trust by the owner, the value of the insurance proceeds will not be included in your estate, so long as you do not retain any "incidents of ownership" in that policy. This means that you must not retain control over the use of that policy in any way or it will be included as part of your estate. This is why an ILIT is *irrevocable*.

You can transfer your existing life insurance policies into an ILIT in the form of a gift, but there is a risk involved. If you die within three years of gifting the existing policies into the ILIT, they will be included in your taxable estate, *no matter what planning you have done*. If this is a greater risk than you want to take, the trustee of your ILIT may apply for and purchase new policies. You should consult with your attorney before gifting existing policies into an ILIT.

An ILIT can also help provide liquidity for your estate. Upon your death, there needs to be cash (such as insurance proceeds) in your main trust in order to pay expenses. The ILIT can purchase the non-liquid assets from the main trust, using cash provided by the life insurance proceeds. This sale is income tax-free because assets receive a step-up in basis at the time of death. The result is that the ILIT then retains the non-liquid assets and the main trust has cash to pay expenses.

Paying the Premiums on the ILIT. Through gifts of cash from you or others, the ILIT receives funds to pay premiums on life insurance policies it owns on your life. Gifts to an ILIT are normally subject to the federal gift tax. However, this tax can be avoided by giving your beneficiaries a *demand right*. When a gift is made to the trust, your trustee is required to notify your beneficiaries of the gift. Upon notification, the beneficiaries are entitled to take their share of the gift out of the ILIT during a limited period of time after the gift is made. When this time period has expired, and the beneficiaries have not chosen to take the funds, your trustee may then use the funds to pay the life insurance premiums. This demand right eliminates any federal gift tax on the gift.

Some people are uncomfortable knowing that their beneficiaries have the right to take out the gifts made to the trust. However, this is rarely a problem when the beneficiaries understand the overall purpose of the estate plan. It also helps to make clear to them that a relatively small investment now in life insurance premiums will result in a much larger benefit to all the beneficiaries in the future. Once the ILIT is properly explained to the beneficiaries, the likelihood of a beneficiary disturbing the plan is very remote.

By having your estate planning attorney create an ILIT, you can ensure that all the life insurance you purchase goes to the beneficiaries you choose, instead of giving 40% of some or all of to the government in taxes.

A diagram of how an ILIT works is to the right.