## **A Primer on the Irrevocable Life Insurance Trust**

*The Setting*. In the absence of corrective planning, life insurance proceeds are included in the insured person's estate. Many people employ the Irrevocable Life Insurance Trust (ILIT) to avoid or minimize the adverse consequences of this taxation.

The recently enacted Tax Relief, Unemployment Reauthorization and Job Creation Bill of 2010 (TRA) has reduced the burdenr of the Estate Tax on most Americans, but still imposes an estate tax that will cause some people to consider the ILIT as an estate planning tool. The following summary briefly notes the reasons for this planning tool.

*The ILIT Solution*. The Irrevocable Life Insurance Trust extends twin benefits to the beneficiaries of the insured: (1) the ILIT reduces the size of the insured's estate and thus the Estate Taxes, and (2) properly structured, it can provide beneficiaries the proceeds to pay for estate taxes on other assets of the insured individual.

*How it works*. The ILIT acquires and owns one or more life insurance polices. Those policies can take the form of second to die life insurance (under which the proceeds are paid when the second spouse of the married couple passes away), or a policy that insures an individual who has a large (and taxable) estate. The ILIT is structured to be a separate "person" for estate tax purposes, thereby keeping the insurance policy and policy proceeds separate from the insured's taxable estate. This structure is accomplished by preventing that insured from having "incidents of ownership" in the ILIT and ILIT policy proceeds.

The insured must take care to avoid any control over the policy ownership or proceeds. If such control is achieved even by indirect means, the ILIT will fail in its essential purpose.

*Funding the ILIT*. Ideally, an ILIT is originated by selecting a Trustee (more on that below) and instructing the Trustee to apply for and purchase a policy of life insurance on the person or persons to be insured. The Trustee handles all of the administrative tasks with respect to acquiring and owning the insurance policy. The parties must prepare an ILIT Agreement to evidence formation of the ILIT, identify the beneficiaries, and provide for ILIT governance.

The insured or insureds initiate and fund the ILIT by paying to the Trustee the initial premium and preferably an additional amount sufficient to cover the cost of the checking account and other Trust expenses. The insured can avoid gift tax by making a payment of less than $13,000 per beneficiary as a "gift" to the ILIT. The Trustee must then send a "Crummey Letter" to the primary beneficiaries informing them that they may withdraw their share of the gift from the ILIT in the next 30 days.

The goal is to have the beneficiary(s) not withdraw the money. In order to get the gift-tax break, however, the beneficiary must have the legal right to withdraw the money. If the beneficiaries do not withdraw the money, it then becomes property of the ILIT. In most cases, the Trustee will send at least some of the money to the life insurance company to pay the life insurance premium. The rest will remain in the trust and the balance above expenses will be paid to the beneficiaries when the insured dies.

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*Managing the ILIT*. The funding procedure described above is repeated annually prior to the policy premium date. The Trustee retains full control over any other management decisions and tasks, which will be minimal in the absence of any problems with beneficiaries.

If the beneficiaries seize any gift to the ILIT prior to a premium payment, that seizure will effectively terminate the ILIT policy, or convert it to a reduced payout per the policy terms. The insured can avoid that consequence by paying another sum to the ILIT Trustee, but that second payment may not be exempt from the gift tax.

*Transferring a Policy*. The less ideal procedure for forming an ILIT is to transfer an existing Life Insurance policy to the ILIT. If this is done, the life insurance proceeds will be taxable as part of the insured's estate for three years after the transfer.

During this three-year period, the ILIT must be formed and managed as noted in the two previous sections. The plan and intent is that the ILIT will remain in effect beyond the three-year transfer period. Once that period has expired, the ILIT will function as intended, with the policy proceeds excluded from the insured's estate, provide all other formalities are observed.

*Selecting a Trustee*. The ILIT Trustee must be an "independent trustee". This cannot be the insured, the insured's spouse, minor children of the insured, or certain of the insured's relatives. A sibling or adult child can usually serve as the ILIT Trustee. The insured may reserve the power to remove the Trustee, as long as the insured cannot replace the Trustee with the insured or other prohibited persons.

*Disadvantages of the ILIT*. The ILIT offers the advantages noted above, but those advantages are acquired at the cost of these disadvantages:

- The ILIT is irrevocable. The policy cannot be removed from the ILIT. The only practical recourse for an insured desiring to revoke an ILIT is to lapse or surrender the policy, and that can be an expensive or even damaging proposition.
- The policy beneficiaries cannot be changed. This could be particularly damaging if family relationships change during the life of the policy.
- The insured cannot borrow against the ILIT policy. That transaction would be tantamount to retaining "incidents of ownership." The Trustee can take out a loan, but if the loan benefits the insured in some way, the beneficiary could sue the trustee.
- If a beneficiary receives benefits under a government program (such as Medicaid), the proceeds from the ILIT policy could make that beneficiary ineligible for further benefits.

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