

ILIT's Offer Exceptional Estate Tax Planning Benefits

by Shawn Christopher

An Irrevocable Life Insurance Trust (“ILIT”) is a trust which owns life insurance policies. Generally, life insurance proceeds are included on your estate for federal estate tax purposes. Depending on the size of an estate, there may be federal estate taxes due upon death. If the ILIT is established and operated correctly however, the insurance proceeds from the policy (ies) are not included in your estate for federal estate tax purposes.

As the name indicates, an ILIT is irrevocable and its terms cannot be amended after it is created. The ILIT will need a trustee, which must be someone other than the person creating the trust (“Grantor”) or a person “close” to the Grantor. The ILIT must also have beneficiaries designated in the trust, which usually are the children of the Grantor.

Once the ILIT is created it must obtain a tax identification number and open an account to receive “gifts” from the Grantor. Typically, these gifts are annual payments made to the ILIT that are equal to or less than the amount allowed for annual gifts to any person, so as not to trigger any federal gift tax issues. The “gifts” are then used by the trustee to pay the premiums due on the life insurance policy(ies).

The “gifts” made by the Grantor must also meet other requirements in order to ensure that the life insurance proceeds will not be subject to federal estate taxes. First, once the gift is made, the trustee must give written notice to the beneficiary (or guardian of a minor beneficiary) and give the beneficiary the right to take the gift in lieu of making the premium payment. The beneficiary will typically have 30 days to elect to withdraw the gift amount. It is important to explain to the beneficiary that by withdrawing these funds, they may ultimately do more damage to their inheritance. Also, if the beneficiary withdraws the monies, then the premium may not be paid and may cancel the insurance policy. At the end of the 30 day period, the trustee then uses the gifts to pay the insurance premiums.

Upon the death of the Grantor, the ILIT, which is the beneficiary on the policy(ies), will receive the death benefit. The insurance proceeds can be:

- used to increase the liquidity in the estate by purchasing estate assets for cash;
- loaned to the estate to pay off liabilities or tax obligations;
- held in trust for the beneficiaries; or
- distributed pursuant to the terms of the ILIT.

In summary, the key benefits of ILIT are:

- provide for liquidity without requiring the sale of other assets;
- increase the size of the estate without increasing estate taxes;
- allow for transfers out of the estate with minimal or no gift tax consequences; and
- can provide for ongoing management of assets under the terms of the trust.

There are a couple of other points to consider when implementing an ILIT. First, the ILIT is a taxable entity that must file its own separate tax returns each year. However, the returns are generally simple and can be handled easily by an accountant. Second, the transfer of an existing life insurance policy to an ILIT may result in the policy proceeds being included in the taxable estate if the death of the policyholder occurs within three (3) years of the transfer. The recommended approach is to have the ILIT acquire a new policy and then the three year restriction would not apply.

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