Irrevocable Life Insurance Trust (ILIT)

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Susan and Steve had been talking to their tax attorney, Elizabeth, about plans for their family. Susan is very concerned about their family.

Susan: "I wish that we had a perfect family, but we must admit we don't. We have three children. Our first child is out on his own, has a good job and is doing fine. But our second child has had substance abuse problems and recently was released from rehabilitation. He now seems fine but he has had relapses before. Our third child is a very sweet young woman who unfortunately has been married, divorced and is now remarried. But she is now going through some rough spots in her new marriage. How can we protect our three children with so many risks?"

Steve: "We've been very fortunate and our business has grown quite large. We have an offer for the business and have been told that we could sell it tax free through a special charitable trust. That sounds like a great idea, but we need to set up an inheritance for the children and it must be done in a way that protects them. How can we do this? What's the best way to sell our business tax free and replace the inheritance for the children?"

Elizabeth: "We have a great plan that achieves all of those goals. You will be able to sell your business tax free and set up a special trust that holds an insurance policy for the benefit of your children. After both of you pass away, the trust will receive the insurance proceeds income and estate tax free. The full amount can be invested to provide new taxable income for the lives of your children."

When to Use a Life Insurance Trust

A very beneficial estate planning strategy to protect your "less-than-perfect" family is to create a trust that owns life insurance. To gain the maximum benefit from this trust, it is irrevocable after it is created. Your advisor will usually call this an irrevocable life insurance trust (ILIT).

Benefits of an ILIT

Management. If you have a substantial estate and plan to pass a significant inheritance to children, a trust enables you to select the child or the financial institution that will be best qualified to manage

significant assets.

Income Rather Than Principal. Many parents are faced with Steve and Susan's problem. They have one or more children who will act in harmful ways with a substantial amount of principal. So the best solution is to provide income to everyone for a term of years or for life. A trust is an excellent method for this purpose. The trustee can also have discretion to distribute principal, or at an age you select the trust property can be given to your children.

Tax Savings. If your estate is more than the federal exemption, it may in future years be subject to taxes at a very high rate. For individuals who support charity, a great plan is to create a trust or make charitable gifts with the majority of the estate and replace the gifted property with an insurance trust. Steve and Susan can create a two-life charitable remainder trust and benefit from a tax-free sale and life income for themselves. After they pass away, their children will benefit from the insurance proceeds in the ILIT.

How Does the ILIT Work?

ILIT Goals. If you have a large estate, a very important goal is to make sure the ILIT is not subject to estate tax. In order to protect the ILIT from taxes, Steve and Susan cannot retain specific powers over the trust or the life insurance. Specifically, they cannot have the right to cash in the policy, to borrow against it, or even to designate the beneficiaries. The policy is purchased with the trust as the beneficiary and will not be changed after it is first acquired by the trust.

Gift of Premiums. Steve and Susan will need to make annual gifts to the ILIT to pay the insurance premiums. Because they can use their annual exclusion, they are able to fund a very substantial policy ($14,000 for each parent times three children equals as much as $84,000 per year in 2017—with indexing of the annual exclusion, it may be more in future years). When they transfer the premium amount to the trustee, their children each receive a special right known as a "Crummey" power, named after the first person to use this concept. Under their Crummey power, the children have 30 days to spend the money. With appropriate parental guidance, the children do not spend the money and it may then be used for payment of insurance premiums. Because the annual exclusion gift of $14,000 requires the child to be able to spend the money for a short period of time, the Crummey power is an essential part of the ILIT.

ILIT Insurance Policies. There are two ways for the insurance policy to be transferred to the ILIT. The first and preferred method is for the ILIT to actually purchase a new policy. However, if you or your spouse are not insurable, in some cases an existing policy is given to the ILIT. If you give an existing policy to the ILIT, in order for the ILIT to be estate tax free you must survive for at least three years.

Trustee

Child as Trustee. Many parents will select one of the children as trustee, preferably one with good financial skills. The child frequently serves for a reduced fee or no fee. The disadvantage for the child serving as trustee is that he or she may have conflicts with other siblings.

Financial Institution as Trustee. The second option is for a bank or trust company to serve as trustee. If the insurance trust is quite large, the objective nature of the bank or trust institution may make this a good option. In considering a bank or financial institution as trustee, Steve and Susan should understand the costs for the investment and administration services of the bank after the insurance proceeds have been received and the trust is funded.

ILIT Options

Income. After Steve and Susan pass away, the trustee will invest the insurance proceeds and pay income to the beneficiaries. Some trusts last until the beneficiary has reached a specific age, or the trust may last for their lifetimes. With the concern about protecting a child with a substance abuse problem and the marital relationship problems of their daughter, Steve and Susan decided to continue the income stream for the lives of their children. The primary goal of many parents is to provide an additional level of economic security for the children. This income stream will provide payouts for the rest of their lifetimes.

Ability to Distribute Principal. The trustee may be given permission to distribute principal. This could be based upon such standards as health, education, maintenance and support, or may be discretionary with the trustee. Steve and Susan permitted their trustee to make distributions for medical care but not for enhanced lifestyle. Steve asked, "What is likely to be the result if two of our children receive principal?" Based on the belief that principal distributions will be used for unneeded and perhaps unhealthy purposes, their trust will pay income and, if required, medical expenses.

Income Taxes on New Trust Income. While the insurance proceeds are tax free to the trust as long as there has been no violation of the insurance guidelines, the new income that is earned and distributed to the children will be taxable. If the income were retained in the trust, the trust would pay the tax. However, because most income would be distributed to the children, they will pay the ordinary income or capital gains tax on their trust distributions.