

---

## THE IRREVOCABLE LIFE INSURANCE TRUST (“ILIT”)

Discussing 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. Life insurance proceeds can be used to pay off estate expenses, and as outlined below, a certain type of life insurance – held by an irrevocable trust – can also be used to avoid federal estate tax. (There is no state estate tax in California.) As of 2017, there is a federal estate tax exemption of \$5,490,000 per person. Although most estates fall below the exemption amount, for those near or above the exemption, the federal estate tax rate of up to 40% is a major consideration.

**Life Insurance is Subject to Tax.** Because life insurance is not a *probate* asset (i.e. proceeds typically pass to your named beneficiary without requiring probate), many people assume that it is not a *taxable* asset. Not true! Life insurance proceeds held by an individual are included in his or her estate for estate tax purposes. In addition, estate taxes are due just 9 months after the date of death, regardless of the status of any probate or trust administration that may be ongoing.

**Married Couples – Tax Delayed But Not Avoided.** Federal estate tax can be delayed if you are married. The “unlimited marital deduction” allows you to pass all your property, including life insurance proceeds, to your spouse free from federal estate tax. But when your surviving spouse dies, his or her estate (including the amount inherited from you) will be subject to federal estate tax. Surviving spouses rarely use the entire estate left to them and, very often, die with a larger estate than the first spouse. As a consequence, the federal estate tax on the death of the *surviving* spouse can be substantial.

**The Irrevocable Life Insurance Trust.** If owing federal estate tax is a concern, buying typical life insurance, which adds to your taxable estate, makes little sense. A better solution is to structure your life insurance so that it is 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 (“ILIT”), is an additional trust that you create as part of your estate plan. It is a separate trust that owns your life insurance, pays the premiums, and receives the insurance proceeds upon your death. Through the use of an ILIT, at least three major estate planning objectives can be achieved:

- a. Insurance proceeds will be federal **estate tax free** upon your death and the death of your spouse;
- b. Insurance proceeds received by an ILIT **can be used to pay the death expenses, including taxes**, of both you and your spouse; and
- c. The terms provided in the ILIT document allow you to **direct that the remaining proceeds are used for the care and support of your beneficiaries**.

---

**How an ILIT Works.** You create an ILIT, which owns a life insurance policy on your life. If an irrevocable trust purchases a life insurance policy, the insurance amount 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 the policy in any way (such as borrowing against it) or it will be included as part of your estate. This is also why the ILIT must be irrevocable.

An ILIT can help provide liquidity for your estate. Upon your death, there needs to be cash in your estate to pay expenses, including estate tax. Although your estate cannot be the direct beneficiary of the ILIT, the ILIT can purchase non-liquid assets (such as real property) from your estate immediately, with cash provided by the life insurance proceeds. The result is that the ILIT retains the non-liquid assets, and your estate has cash to pay expenses.

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 an existing policy into the ILIT, it 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, your ILIT should purchase new policies instead. You should consult with your attorney and your insurance agent before transferring existing policies into an ILIT.

**Paying Premiums on the ILIT.** Through “gifts” of cash from you or others, the ILIT receives funds to pay the annual premiums on life insurance policies it owns on your life. Gifts to an ILIT are normally subject to federal gift tax. However, gift tax can be avoided by giving your beneficiaries a *demand right*. Here is how a demand right works: When a gift (e.g.: funds to pay the premium) is made to the ILIT, your trustee is required to notify your beneficiaries. Upon notification, the beneficiaries are entitled to take the gift funds out of the ILIT for a limited period of time (e.g.: 30 days). When this time period has expired, if the beneficiaries have not chosen to withdraw the funds, your trustee may use the funds to pay the premiums. This demand right eliminates federal gift tax. It is easy to plan for this notification process, as it is done annually at the same time every year based on when the premiums are due.

Some people are uncomfortable giving their beneficiaries a demand right, since this means they could elect to take the funds which were intended to pay the insurance premiums. However, this is rarely a problem when the beneficiaries understand the purpose of the ILIT, which is to reduce or eliminate estate tax which would otherwise be deducted from their inheritance. Once the ILIT is properly explained to the beneficiaries, the likelihood of a beneficiary disturbing the plan is very remote.

**The Bottom Line.** If your estate is likely to be subject to federal estate tax, having a knowledgeable estate planning attorney create an ILIT can be an effective tool in making sure your life insurance is maximized for the benefit of your loved ones, avoiding a loss of up to 40% in estate taxes.

*All information herein is for general information only and should not be construed as legal advice or legal opinion. You are urged to consult with your own attorney on any specific legal questions you may have.*

Rev. 3/2017