Warner Norcross + Judd LLP

IRREVOCABLE LIFE INSURANCE TRUST ("ILIT")

Description

The irrevocable life insurance trust ("ILIT") is a popular, but complex, estate planning technique used to minimize transfer taxes--estate, gift, and generation skipping tax--while providing liquidity, replenishing wealth lost to taxes, and permitting the management and control of policy proceeds. The technique utilizes an irrevocable trust as owner and beneficiary of life insurance policies to avoid subjecting the policy proceeds to tax in your estate. Because the ILIT can avoid transfer taxes while permitting use of the policy proceeds by your estate, it is a very useful estate planning tool.

Background

The beneficiary of a life insurance policy generally will not pay income tax on receipt of the policy proceeds. But if the insured possesses any "incidents of ownership" in the policy the value of the policy proceeds will be includable in the insured's estate for estate tax purposes. This can be a very expensive consequence. If the insured's net worth, including policy proceeds, exceeds $5,430,000[1], 40 cents from every dollar of policy proceeds could go to pay estate taxes[2]. If the beneficiary of the policy is someone other than the insured's estate, the proceeds may not be available as a source from which the taxes can be paid. Generally, "incidents of ownership" in a life insurance policy include (1) the power to change the beneficiary, (2) the power to borrow against the policy, and (3) the power to transfer the policy. If you possess any of these powers over life insurance policies, the policy proceeds will be includable in your estate.

On the other hand, if you do not possess any of these powers, no amount of the policy proceeds will be includable in your estate and the policy can pass free of both income and estate tax. You could transfer ownership of the policy to another individual to avoid inclusion of the policy proceeds in your estate, but this gives rise to at least two problems: (1) when the new "owner" dies, the policy proceeds will be includable in his or her estate (so if the new "owner" is your spouse, this accomplishes no tax savings), and (2) upon the transfer, you give up the ability to control the beneficiary of the policy proceeds. Alternatively, you could transfer ownership to

[1]The applicable exclusion amount is $5,430,000 in 2015 and indexed for inflation thereafter.

[2]The estate tax rate is at 40%.

an ILIT, which you create, and which is also the beneficiary of the policy. If properly structured, the policy proceeds should be excludable from your estate yet you can still control, through the dispositive provisions of the trust, the use of the policy proceeds.

Planning

An ILIT is an irrevocable trust created by you. You designate its trustee and determine all terms of the trust. After the ILIT is formed, you will either transfer your existing policy to the trustee, or the trustee will apply for a new policy on your life. The trustee, as owner of the policy, will name the trust as beneficiary. Upon your death, the trustee will collect the policy proceeds and dispose of them in accordance with the terms of the ILIT. Moreover, the proceeds can be used to ease any liquidity problem in your estate, because the ILIT can purchase assets from or lend money to your estate. The terms of the trust can be very flexible, and often provide for surviving spouse and/or your descendants.

- **Existing Policies**

By transferring an existing policy to an ILIT you should avoid inclusion in your estate of the policy proceeds if you survive the date of transfer by three years (the "three-year rule"), and the trust is operated correctly. If you do not survive the date of transfer by three years, the policy proceeds will be included in your estate under the current Internal Revenue Code.

- **New Policies**

If you purchase a new life insurance policy in an ILIT, the "three-year rule" does not apply and the proceeds should escape taxation in your estate of the ILIT is properly operated.

- **Gift Taxes**

Policies which are not "paid up" will require premiums to be paid. Because the ILIT will be the owner of the policies, the trust will pay the premiums. When you contribute cash to the ILIT for the ILIT to pay the premiums, that is a gift. Properly structured, you can contribute up to $14,000 per person (or as much as $28,000 per person if you are married), per year free of gift taxes. Special steps must be followed to avoid gift taxes on these transfers.

If you contribute existing policies to an ILIT that have cash value, that is also a gift to the ILIT at the time of contribution. A gift tax return may be necessary to report the gift.

- **Income Taxes**

During your lifetime, any income earned on assets held in the trust will be taxable to you. Life insurance policies are generally not income-producing assets so the ILIT is unlikely to incur income tax during your life. After your death, the ILIT will become a separate taxpayer and report income earned on the insurance proceeds.

Advantages of an ILIT

An ILIT provides an excellent means of achieving (1) favorable transfer tax treatment of life insurance, (2) continued management of the insurance proceeds for beneficiaries, (3) a means of disposing of the life insurance proceeds consistent with your personal wishes, and (4) access to the life insurance proceeds by your estate. Again, while common, an ILIT is a complex trust that must be properly structured and operated to achieve the desired tax consequences.