BASICS OF AN ILIT

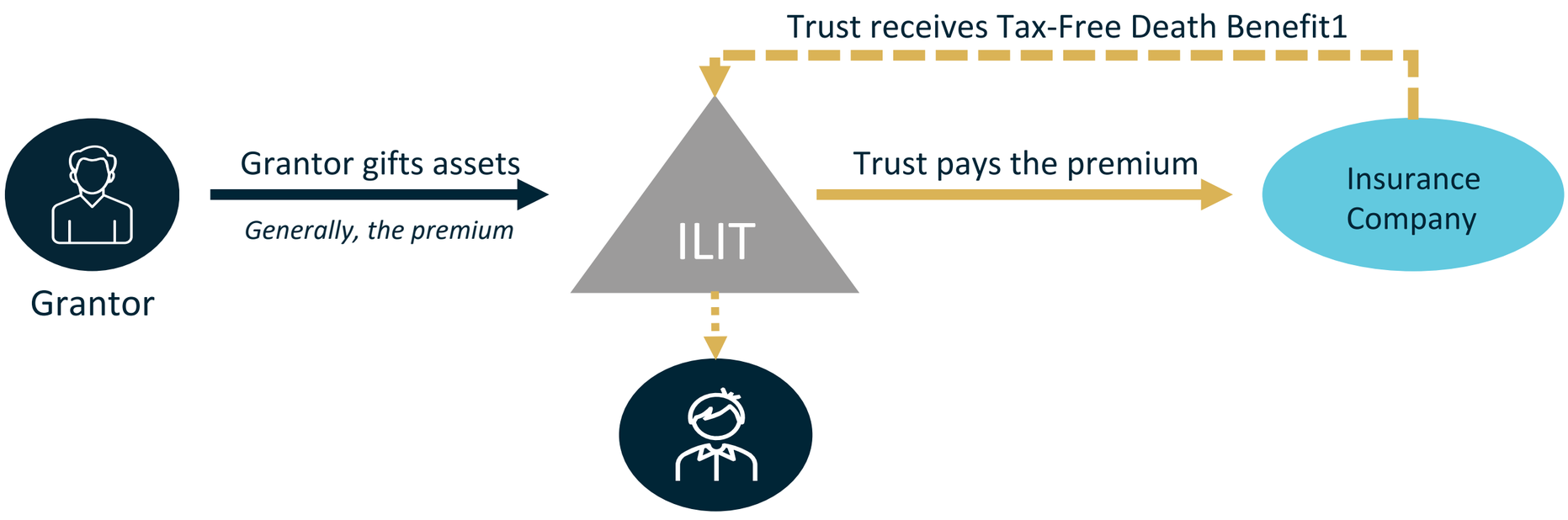
WHAT IS AN IRREVOCABLE LIFE INSURANCE TRUST (ILIT)?

An ILIT is an irrevocable trust created specifically for the purpose of being the owner, beneficiary, and payor of a life insurance policy. The ILIT is then in a position to receive the tax-free death benefit1 outside of the taxable estate. Generally structured as a Grantor Trust and often intentionally-defective to defer tax liabilities to the Grantor rather than the Trust itself. The Trustee maintains the assets according to the provisions of the Trust, including the ability to make distributions to the Beneficiaries of the Trust.

BENEFITS OF AN ILIT:

Removes the death benefit from the taxable estate2
Provides liquidity for taxes & expenses
Enhanced creditor protections3
Improved asset management over life insurance policy
Enhanced control over assets after death

HOW DOES IT WORK?



Mechanics of an ILIT. The trust will have at a minimum of three parties involved: 1) the Grantor(s), 2) the Beneficiary(ies), and 3) the Trustee(s). The Grantor establishes the trust, funds the trust, and is generally the insured on the life insurance policy. However, the Grantor relinquishes control over assets in the trust to avoid "incidents of ownership", which would cause all assets of the trust to be included in the taxable estate.2 Therefore, the Trustee is charged with managing the assets of the trust in the best interest of the beneficiary (not the Grantor). The Trustee is also responsible for distributing assets to the Beneficiary when and how it has been prescribed in the trust document.

Funded vs Unfunded. An ILIT can be funded or unfunded. The funded Trust contains both the life insurance policy and other non-life insurance assets qualified to be held in trust. Often this is used to provide additional estate planning strategies and these assets, or the income they provide, can be used to pay the premiums on the life insurance policy. The unfunded Trust is the opposite, life insurance is the only asset held by the trust. Being the only asset, the Trust will need regular cash contributions from the Grantor in order to maintain the premiums. Generally, annual cash gifts are scheduled to fall under the Annual Exclusion for that year to avoid any additional taxation.

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BASICS OF AN ILIT

THE BASICS OF GIFTING

Gift Tax Exclusion. An individual subject to U.S. federal taxation is subject also to gift and estate taxation. However, each individual has the ability to give away a certain amount of property without incurring any gift, estate, or generation-skipping transfer (GST) tax. The exempted amount is provided for lifetime and death transfer for gift & estate tax, and an additional exemption provided for GST tax. For 2022, the exempted amount is $12,060,000, indexed for inflation.4 Married couples may be able to combine their exemption to $24,120,000. Only the amounts exceeding the limit are taxable.

In addition to the 'Lifetime Exemption' taxpayers are given the opportunity to make annual gifts, as long as they don't exceed the annual exclusion limit. In 2022, the annual exclusion limit is $16,000 per donor, per donee. Again, married couples may be able to combine their annual gift to $32,000.5 An ILIT can help to maximize the annual exclusion by allowing gifts to each beneficiary as a separate donee. For example, a married couple gifting cash to an ILIT with 3 beneficiaries can make a total annual gift of $96,000 without incurring any gift tax or using any lifetime exemption. A meaningful premium for purchasing life insurance.

Crummey Notices. Annual gifting sounds pretty simple, however there is a requirement that the gift be a ~~"present interest"~~ or completed gift. In order to qualify as a completed gift, it is required that the donee have an unrestricted right to the immediate use, possession, or enjoyment of the property. Often an ILIT will include "Crummey Powers"6 that will give the beneficiary the right to withdrawal the annual gift for a set period of time, generally 30 days. After expiration, the gift is considered complete for purposes of qualifying under the annual exclusion. The power to withdrawal is communicated at the time of the gift by sending "Crummey Notices" to the beneficiaries.

The Three-Year Lookback. A life Insurance policy is property. The gift of property in the three years preceding death will be includable in the taxable estate.7 Gifting an existing life insurance policy would result in the death benefit being included in the taxable estate and not considered held in the ILIT for three years.

KEY CONSIDERATIONS

Property gifted to a trust is no longer accessible by the Grantor and therefore may not be appropriate in certain situations. Crummey Notices are more than just a formality, but a right given to each beneficiary that can affect the planning set in place. Annual gifting to pay premiums can be an efficient and simple mechanism. However, it does not substantially remove assets from the taxable estate when compared to a gift of appreciating property. There are many special provisions that may be added to an ILIT. You should consult with your legal and tax advisors when deciding if an ILIT is right for you.

1. Per IRC §101(a)
2. Determined by 'incidents of ownership', §2042 & §2035(d)(2)
3. Creditor protection varies by state and may not be available in all situations.
4. The Tax Act of 2017 set lifetime exemption at $10,000,000 indexed for inflation. Pre-2017 regulation of $5,000,000 indexed for inflation reinstates after 12/31/2025.
5. Gift splitting is available to married couples and applies one-half gifting to all gifts made in the tax year. Spouses must provide consent on the gift tax return and may not file a joint gift tax return.
6. §25.2503-3(b) Known as "Crummey Powers" after the case of Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), Cristofani v. Commissioner, 97 T.C. 74 (1991) court stated that the Crummey beneficiaries did not have to have a vested present interest or vested remainder interest in the trust in order to qualify for the annual exclusion.
7. Per IRC §2035. §2035(d) provides that this section shall not apply to a bona fide sale for an adequate and full consideration.

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