Purchasing Life Insurance? Consider an ILIT

You may be thinking about purchasing a life insurance policy. Life insurance can be a powerful tool for estate planning while also providing support for our families when they need it. Unfortunately, in many situations, if a policy is not titled correctly, the result may be unnecessary and costly estate taxes, eliminating the very benefit we are hoping to achieve.

A common estate planning tool that allows you to both provide for your loved ones and avoid a costly taxation, if structured correctly, is the Irrevocable Life Insurance Trust ("ILIT"). This article will provide you a brief introduction to the benefits of an ILIT, as well as some commonly asked questions that will prepare you for a consultation with a professional.

- **What is an ILIT?** This is a separate legal entity, as are all irrevocable trusts, which acts as the owner of your life insurance policy. The benefit of having the ILIT as the owner of your policy is that it ensures that the proceeds will be separate from your estate and therefore not subject to estate taxes.
- **Who are the persons involved?** The basic structure of an ILIT starts with the person who creates a trust, the "*settlor*" *(or "grantor").* The settlor will determine who will manage the trust, the "*trustee*". The trustee acts on behalf of the ILIT and will manage the assets of the trust, which may involve paying annual premiums, receiving proceeds, and managing investments, for the "*beneficiaries*" of the trust. The ILIT will purchase insurance through the Trustee on the "*insured"*, but ownership rights are transferred to the ILIT and managed by the trustee.
- **Who will be the Trustee?** The trustee will manage the ILIT including all its assets and may invest the insurance proceeds after the policy pays out, either in order to generate income for the benefit of the beneficiaries or provide for the beneficiaries in accordance with the terms of the trust. As the insured, you cannot be the trustee of the ILIT, since as stated above, you must give up control and ownership rights to the policy. It is also important to note that if the ILIT is paying out to your children and you wish your children to be trustees as well, there should be an independent co-trustee appointed to oversee payments from the trust.
- **How do I pay the life insurance premiums?** You can either gift a lump sum to the ILIT and the premiums can be deducted from this amount or you can make periodic payments into the ILIT to cover the premium amount. Both payment methods have different tax impacts, so your estate-planning professional should address these options with you when you create your ILIT.
- **What if I already have an insurance policy?** An ILIT can either purchase a new insurance policy or you can transfer an existing policy into the new ILIT entity. One note of caution when you are transferring an existing policy into the ILIT: if you do not survive at least three (3) years after the date of the transfer, the policy may be considered part of your estate. This will result in estate taxes being withdrawn from the insurance policy proceeds. This is an important item to consider when choosing between your various options.
- **What type of policy can the ILIT hold?** The ILIT can own either a whole life policy, universal variable life or term-life policy. In addition, the policy can be either an individual life policy or a second-to-die policy (a life insurance policy on two lives that pays out after the second spouse to die passes away), however it is important to note that for tax purposes, there should only be one policy owned by an ILIT. If a couple has one individual life insurance policy each, they will need to create two ILITs – one per insurance policy.

- **After the ILIT is created, how do I make changes to the structure?** Unfortunately, the tax benefits that you will derive from the ILIT require you to give up control or ownership rights to your insurance policy. Furthermore, an ILIT is irrevocable, meaning that once it is established, it cannot be undone. This makes the initial planning stages vital and all contingencies should be discussed thoroughly with a professional at that time.
- **Who will receive the life insurance payouts?** The ILIT will also be the recipient of the proceeds of your policy. Once the ILIT receives the insurance proceeds, the terms of the trust will determine how the money can be distributed or invested. Some ILITs may pay income on a set interval to the spouse and leave the remainder to the children, or may leave the entire amount to the children.
- **What if something happens and my spouse needs more income?** As with all trusts, the ILIT you set up can allow some flexibility with the payments. Many people are concerned that if income is dispersed on a regular basis to the spouse, the income may be insufficient or an unexpected life event may leave the spouse with more of a need. To address this concern, careful drafting of the ILIT may allow for provisions which permit the Trustee to provide additional disbursement if it is necessary.
- **Why do I need a professional?** An ILIT can be a powerful tool that helps you to reduce estate taxes and provide for your family. There are many details, which if left neglected, may leave your successors with a more expensive solution than you originally planned. If you address the issues listed above and fully discuss how your situation affects any potential tax concerns, an estate planner can assist you with customizing your ILIT.

By creating an ILIT, it is possible to transfer insurance proceeds to your family while minimizing unnecessary estate taxes. As discussed above, ownership of a policy as well as how the proceeds are held at payout can have a significant impact on the post-tax estate left to one's family. You should discuss an ILIT with an estate planning professional to determine if it is right for you, and the best way to structure the trust to avoid negative estate tax consequences.