

# Basics of Irrevocable Life Insurance Trusts (ILITS)

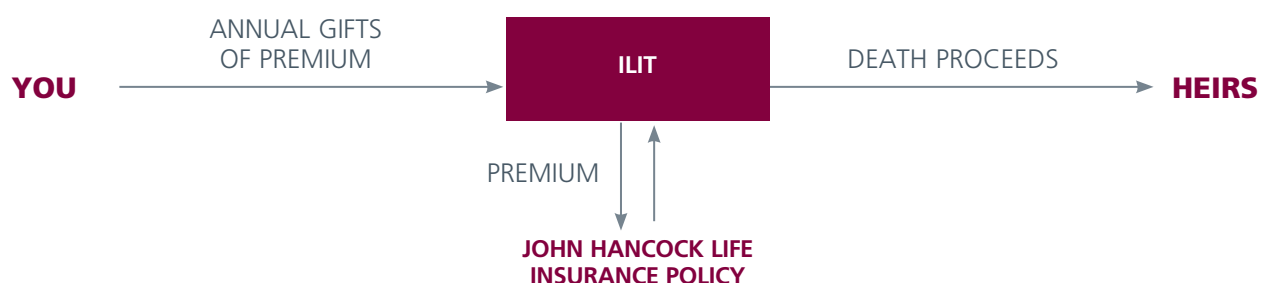
Life insurance plays a unique role in estate planning. It can help provide liquidity to pay estate taxes and expenses of administration, replace earnings in the event of death, equalize inheritances among heirs and fund the transfer of a family business. When life insurance is needed, an Irrevocable Life Insurance Trust (ILIT) offers both tax and non-tax advantages that are not available with outright policy ownership by an individual.

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## 1. What is an ILIT?

An ILIT is an irrevocable trust that contains provisions specifically designed to facilitate the ownership of one or more life insurance policies. The ILIT is both the owner and the beneficiary of the life insurance policies, typically insuring the life of the person or persons creating the ILIT, known as the grantor. If the trust is structured and managed properly, the life insurance death benefit received by the ILIT will not be subject to income tax or estate tax upon the death of the insured or the insured's spouse.<sup>1</sup> During the grantor's life, the trustee will often hold certain powers, often including the ability to make distributions to the trust beneficiaries. Upon the grantor's death, distributions from the trust to the beneficiaries will be made according to the trust terms.



## 2. Who can serve as an ILIT trustee?

The trustee of an ILIT can generally be anyone other than the insured, although naming an “independent trustee” may offer greater flexibility for estate planning. If a trust beneficiary is also a trustee, distributions should generally be subject to an “ascertainable standard” such as health, education, maintenance, and support.

## 3. How is an ILIT typically funded?

After an ILIT is drafted and executed, it must be funded to have the ability to purchase life insurance. ILIT funding is typically done through either 1. basic gifting; 2. financing techniques and/or loan arrangements; or 3. sophisticated estate planning techniques. Financing arrangements and sophisticated estate planning techniques are beyond the scope of this piece. Gifting cash or other assets to an ILIT is a common and simple funding method.

Each person subject to U.S. federal gift and estate taxation has the ability to give away a certain amount of property, during life or at death, without incurring any gift, estate taxes, or generation skipping transfer (GST) taxes. These amounts are commonly referred to as the exemption amounts — one for gift and estate taxes (the “lifetime” exemption) and another for GST taxes. Only gifts made in excess of these exemptions are taxable. Under current law, the lifetime exemption is \$10M, indexed for inflation each year (\$11.4M in 2019).<sup>2</sup>

In addition to lifetime exemption gifts, in 2019, each individual has the ability to give an annual gift of \$15,000 (indexed for inflation) to another individual each year without incurring any gift taxes. This gift is neither taxed nor subtracted from their lifetime exemption. The annual exclusion represents a very valuable opportunity to gift property to a trust, because the donor can make annual gifts of \$15,000 to each beneficiary of the trust.

## 4. What is a “present interest gift,” and how do Crummey withdrawal powers work?

For a gift to qualify as an annual exclusion gift, there must be a transfer of a “present interest” in the property. A transfer is of a “present interest” if there is an unrestricted right to the immediate use, possession, enjoyment of property, or the income from property.<sup>3</sup>

Contributions to an ILIT typically can qualify as a present interest gift (and thus avoid or partially avoid gift tax) if the beneficiaries possess a power to withdraw the contributions for a limited period of time. These withdrawal powers, called “Crummey Powers,” cause the contributions to be present interests and thus qualify for the annual exclusion from gift tax.<sup>4</sup> ILITs almost always include “Crummey Powers” for the primary beneficiaries of the trust, such as the grantor’s children, and may sometimes be referred to as “Crummey Trusts.”

## 5. Can a contingent beneficiary be a Crummey beneficiary?

Possibly. A “Cristofani Trust” is the name for an ILIT that gives “Crummey Powers” to the primary beneficiaries of the trust as well as the contingent or secondary beneficiaries of the trust (the grantor’s grandchildren or other relatives such as nephews/nieces or children’s spouses). A Cristofani Trust can be used in some cases when a trust is purchasing a large life insurance policy and the grantor needs additional annual exclusions to fund the trust.<sup>5</sup> However, trust beneficiaries who receive withdrawal powers should have at least a contingent interest in the ILIT, and all Crummey beneficiaries should receive actual notice of their withdrawal powers.<sup>6</sup>

## 6. What special provisions can be added to an ILIT?

There are several different types of drafting provisions and language that may be added to an ILIT depending on the planning needs and preferences of the grantor and his/her family. A given ILIT may contain special language also making it one or more of the following:

- **Spousal Lifetime Access Trust (SLAT)**

A SLAT is an irrevocable trust that gives the trustee the ability to make distributions to the grantor's spouse at any time during the lifetime of the spouse. A SLAT can provide the non-grantor spouse and children with access to the insurance proceeds without subjecting the insurance proceeds to estate taxation in the estate of either spouse. ILITs with SLAT provisions provide an enhanced level of control and flexibility over the assets because the trustee can make distributions to the spouse should the spouse need access to the trust funds.

- **Dynasty Trust**

A dynasty trust is a long-term trust created to maximize the transfer of wealth from generation to generation while minimizing (or eliminating) the impact of the GST tax and the estate tax. When an ILIT contains dynasty trust provisions, it may last for several generations, unlike a traditional ILIT which may be required to terminate after a period of years depending on state law.<sup>7</sup> Dynasty trust language can give each generation access to the trust assets (such as for health, education, maintenance, and support), while keeping the remaining trust assets outside of the beneficiaries' taxable estates and exempt from GST tax for as long as state law permits.

- **Grantor Trust**

Every trust has a "grantor," but not every trust is a grantor trust. A grantor trust – also commonly referred to as an "intentionally defective grantor trust" (IDGT) – is a type of irrevocable trust that contains certain provisions or powers that cause the grantor of the trust to be treated as the owner of the trust assets, but only for *income tax purposes*.<sup>8</sup> For estate tax purposes, assets held inside the trust remain outside of the grantor's taxable estate. Consequently, the trust is referred to as being "defective" because the grantor must pay all income taxes associated with trust assets despite the fact that the grantor does not actually own these assets or control them. A grantor trust can be an attractive vehicle to fund with income producing assets such as stock or real estate, in addition to a life insurance policy, because the income generated by the assets will be taxed at the grantor's income tax rate. Moreover, because the trust income is attributed to the grantor individually, rather than to the trust, no trust assets need to be spent to pay income taxes, which can allow them to grow more rapidly inside of the trust.

## 7. What is a credit shelter trust? Can a credit shelter trust own life insurance?

A credit shelter trust, also known as a bypass or family trust, receives a decedent's remaining applicable exclusion amount at death. The trust is outside of the taxable estate and will typically pass on to the children and grandchildren free from estate and gift taxes.

The assets inside the credit shelter trust can often be used to purchase life insurance on the surviving spouse (as an alternative to an ILIT) or the credit shelter trust assets can be leveraged by making a loan to an ILIT to fund life insurance premiums. If the credit shelter trust owns insurance on the surviving spouse, caution must be taken to ensure the insurance will not be includible in the spouse's estate. For example, the insured/spouse may not serve as trustee and must not hold a limited power of appointment.<sup>9</sup>

## 8. What are some of the key benefits of an ILIT?

- **Liquidity for Estate Taxes and Other Expenses**

ILITs provide liquidity, outside the insured’s taxable estate, for the payment of estate taxes, debts, and expenses of administration.

- **Equalization of Inheritances/Transfer of a Family Business**

ILITs create a pool of assets to enable an insured to equalize inheritances when the insured would like to pass a single asset (such as a family business or farm) to one child, yet leave equal value to other children.

- **Creditor Protection**

Life insurance proceeds received by an ILIT are typically protected from creditors of the ILIT beneficiaries until the ILIT beneficiaries actually receive the trust proceeds.

- **Asset Management Vehicle**

An ILIT can provide for the effective management of insurance proceeds after the insured’s death. By using a trusted advisor, bank, trust company, or appointed family member as trustee (or co-trustee) of the ILIT, the insured will know that the insurance proceeds will be properly managed.

- **Enhanced Control**

The trust structure allows the grantor to maintain some level of control “beyond the grave” by giving him/her the ability to determine how and when the death benefit and other trust assets will be distributed among beneficiaries.

1. Whether the proceeds of a life insurance contract are included in the gross estate of the insured depends upon whether, at the time of death (or within the three-year period prior to death) the insured held any incidents of ownership” with respect to the policy. IRC §§2042 and 2035(d)(2).
2. The maximum estate tax rate is 40%. Under the Tax Cuts and Jobs Act of 2017, the \$10,000,000 lifetime exemption (indexed for inflation) is scheduled to revert to a \$5,000,000 exemption (indexed for inflation) after 12/31/2025. The IRS clarified in 2018 that there will be no “clawback” of unified credit used before 2026. If an individual passes away with an unused amount of exemption remaining, that individual’s surviving spouse can use the unused amount to shelter a transfer from either gift or estate taxes.
3. §25.2503-3(b).
4. These powers are known as “Crummey Powers,” named after the taxpayer in the case of *Crummey v. Commissioner*. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968) and Internal Revenue Code Section 2503(b). For a Spousal Access Trust, the beneficiary spouse should not be given “Crummey” rights of withdrawal. In addition, in a community property state, the grantor spouse should create a separate property agreement and the premium gifts to the ILIT should be funded from separate property. See Treas. Reg. §20.2042-1(b)(2).
5. See *Cristofani v. Commissioner*, 97 T.C. 74 (1991) and *Kohlsaat v. Commissioner*, T.C. Memo 1997-212. In *Cristofani*, the 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.
6. It is customary for the Crummey withdrawal period to last 30 days. There should never be an explicit understanding among family members that a withdrawal power will not be exercised, otherwise the IRS may disallow the use of the annual exclusion.
7. Over 20 states have abolished the common law “rule against perpetuities,” which traditionally limited the duration of trusts. Consult your tax advisors to determine the law for your state.
8. The “grantor trust” takes advantage of the differences between the estate tax rules of IRC §§2036-2042 and the grantor trust income tax rules of IRC §§671-678.
9. Clients should work with legal counsel to determine if an existing credit shelter trust is suitable to own life insurance on a surviving spouse.

Taking policy loans and withdrawals from a life insurance policy during the insured’s lifetime can reduce the available death benefit and cash surrender value and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made, and a federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Cash value available for loans and withdrawals may be more or less than originally invested.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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