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IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

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While most of us are aware that life insurance proceeds on the death of a loved one are free from income tax, the typical insured is not aware that it is subject to estate tax. This death tax has quite a bite: rates max out at 45% from 2007 to 2009, 35% from 2010 to 2012.

An IRREVOCABLE LIFE INSURANCE TRUST (ILIT) is a trust established by you, the grantor, to hold and own life insurance on your life for the benefit of your spouse, children, grandchildren and other heirs. Ownership of a life insurance policy is vested in that insurance trust. It can eliminate estate tax by keeping the insurance proceeds outside your estate. It becomes the owner of the policy. Since you no longer have control or ownership of the policy, the proceeds are out of your estate. More importantly, you protect your insurance from liens and seizures by your creditors, spouse's creditors, children's creditors and other adversaries such as the IRS, Franchise Tax Board, and plaintiffs of unwanted lawsuits.
Generally, life insurance proceeds are includable in your estate. This is particularly true of policies with INCIDENCE OF OWNERSHIP that includes the following powers: Power to change beneficiary, to surrender policy, to cancel policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan against its surrender value, to obtain a loan from the insurer. Any of these powers will put your policy back into your estate which then gets subjected to estate taxes. The goal of estate planning, therefore, is to remove "incidence of ownership" from your estate. This can be accomplished by establishing an Irrevocable Life Insurance Trust (ILIT).

An irrevocable life insurance trust is designed to help individuals with estates in excess of $1 million ($2 million for married couples) including life insurance. While such volumes may seem too large for your own estate, it is not hard to reach such threshold if you add your life insurance policies to the equity in your house, personal property, vehicles, unimproved land and other assets.

HOW DOES ONE SET UP an irrevocable life insurance trust? Establish a standard irrevocable trust that will both be the owner and beneficiary of the policy. You then contribute cash or an existing policy to fund the trust. Name the trustees and beneficiaries and you have an insurance trust. Here is a word of caution for those of you who may be thinking of contributing an EXISTING POLICY to the trust: If you die within three years of contributing an existing policy, the insurance proceeds will be included back in your gross estate and, therefore, taxed at estate rates. Thus, it is a better idea to acquire a NEW POLICY. Remember that the objective of setting up the trust in the first place is to give you peace of mind that when it is time for you to go (far, far away), the proceeds are free from estate taxation. Contributing an existing policy would seem to give you more stress from worrying about dying.

Let us now address the selection of a TRUSTEE. It is important to carefully select a qualified trustee to administer the trust and its funds. First, the trustee must be independent. You, the insured, should not serve as the trustee because you would be waving a red flag to the IRS that you retained the right to alter, amend, revoke or terminate the life insurance trust. Instead, the trustee should be independent such as a bank trust department or a finance-oriented person. Another very important criterion in selecting a trustee is the person's competence in managing investments, trustworthiness in handling vast sums of money, and time to administer the crummy powers of the trust.

COMMUNITY STATES like California can complicate the process when the trust is simply funded with community property. In this instance, the spouse could be treated as making a transfer of retained interests that will then drag half of the life insurance proceeds back into your estate. The trick here is to keep insurance proceeds out of both estates by funding the premiums from separate properties.

There are also some GIFT TAX ISSUES. The contribution of cash to pay for premiums as well as the contribution of an existing policy to a trust is a taxable gift. However, you can avail of the annual gift exclusion of $13,000 per year per donor. Remember though that this annual gift tax exclusion only applies to gifts of present interests. Gifts of future interests are not qualified for such exclusion. The trick, therefore, is to structure the gift so that it becomes a gift of present interest and qualifies for the exclusion. This can be accomplished by including a crummy provision that gives the beneficiaries an immediate right to withdraw their proportionate amount of the funds contributed to the trust for a limited period of time (usually 30 days).

For income taxation, the trust must file a Federal INCOME TAX return Form 1041 if it has gross income of $600 or more or any taxable income. Potentially, there are no returns required in the early years if its only asset is the insurance policy. You do need to get a taxpayer's ID number for the trust since it is an irrevocable trust.

IN CONCLUSION, the two goals of creating a life insurance trust is to avoid estate taxes on your death and your spouse's death while ensuring that your estate has enough funds for liquidity. If these goals are met, the tax savings could be enormous compared to the minimal cost of creating one. Besides financial savings, the trust can also be depended upon to provide income for your spouse and kids. It is also an excellent vehicle in scheduling payments to your beneficiaries. For example, my favorite payout schedule is to give one-third of the remaining proceeds when the kids graduate from college (talk about incentives), another one-third when they pass the board exams, and the remaining one-third when they are about 35 years old. Good luck.