Flexible ILIT

- An Irrevocable Life Insurance Trust (ILIT) is used to remove the death benefit from the insured's estate for estate tax purposes. If the insured has an "incident of ownership" in the life insurance policy at death (or within 3 years prior to death) the death benefit value is brought into the insured's gross estate (the designated beneficiaries will receive the actual proceeds but the amount of those proceeds will be included in the insured's gross estate value).
- An "incident of ownership" includes, but is not limited to:
  - the right to change the beneficiary; the right to surrender the policy; the right to take policy loans; the right to assign the policy; the right to revoke a previous assignment; the right to pledge the policy as collateral; the right to receive disability income that reduces the policy death benefit.
  - paying premiums is not an incident of ownership. However, there are potential gift taxes associated with paying premiums on a life insurance policy that is not owned by the premium payor.
- The client (grantor/insured) creates an irrevocable trust then transfers any life insurance policies owned to the trust and/or gifts funds to the trust sufficient to pay premiums. There are gift tax issues associated with gifting life insurance policies and/or cash to an irrevocable trust.
  - The gift tax associated with transferring a policy is (1) total premiums paid – newly issued policy; (2) cost of a comparable policy with insured's attained age – paid up or single premium policy; or (3) the "interpolated terminal reserve" plus unearned premium – previously issued policy still in premium paying status.
  - Transferring cash to an irrevocable trust is considered a "future interest" gift and therefore the annual exclusion ($12,000 for 2008) is not available. It is a "future interest" gift because the trust's beneficiaries cannot currently access and use the gift. However, the gift can be made a "present interest" gift by giving some or all of the trust's beneficiaries a temporary right to withdrawal some of the entire gift.
  - The trustee sends information (Crummey notice) to the beneficiary notifying him/her of the temporary right to withdrawal funds from the trust. If the beneficiary does not exercise his/her right to withdrawal those funds within the stated period (usually 30 – 45 days) then the right "lapses". Once the withdrawal right lapses, the trustee can then use the gifted funds to pay premiums and the gift is considered a "present interest" gift.
- At the insured's death, the trust should receive income-tax-free and estate-tax-free death benefit proceeds. These proceeds can be used for estate liquidity to pay estate taxes (i.e. make loans to decedent's estate or purchase assets from decedent's estate).
- ILITs can be designed with certain provisions or funded in certain ways that allow flexibility. These provisions include:
  - Giving the client's (grantor's/insured's) spouse a withdrawal power limited to $5,000 or 5% of the trust's principal
  - Giving the client's spouse rights to annual distributions of trust income
  - Giving the client's spouse rights to discretionary distributions (if spouse is not trustee); or for distributions for health, education, maintenance and support (if spouse is trustee)
  - Funding through private demand loan

The preceding summary is intended to be a general discussion of the topic presented, and is based on our current understanding of applicable tax laws, regulations and rulings. In actual practice, the transaction discussed may be more complex and will require the attention and expertise of professional advisors. In no way should this summary be construed to constitute tax or legal advice. **For agent use only.**

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