A Trust to Help Fund the Payment of Estate Taxes

Consider this dilemma faced by a high-net worth individual: He doesn't want his heirs to be burdened with estate taxes so he takes out a life insurance policy to cover the tax bill. But then the proceeds of the insurance policy wind up as part of his estate -- only to be included for estate tax purposes.

In this case, the individual might solve the problem by setting up an irrevocable life insurance trust ("ILIT").

What Are ILITs and How Are They Used?

There are many estates that are subject to estate taxes, either the federal estate tax, or an estate or inheritance tax levied by the state. Consult with your attorney or tax adviser to determine your potential tax liability. If estate taxes are expected, you should consider the use of an irrevocable life insurance trust.

The reason: The proceeds of a life insurance policy that a trust holds are exempt from estate tax. (The trust is subject to its own income tax, which is a factor to consider.)

Generally, life insurance proceeds are included in the gross estate for estate tax purposes. The estate must pay the tax on the life insurance proceeds if they are subject to estate taxes. However, if the life insurance is held in an ILIT, then the proceeds escape estate taxation.

Many people want life insurance so their estates can use the proceeds to pay for estate taxes. It doesn't make sense to subject the proceeds to estate taxes, and then have less money to pay the total estate tax bill.

An ILIT might makes sense but there are many rules to follow and you should not attempt to create an ILIT without legal counsel. A comprehensive review of your estate and assets is necessary to determine whether an ILIT is the correct estate planning tool in your situation.

How to Create an ILIT

There are a couple ways to create an ILIT. Either an individual already has life insurance and wants to transfer the life insurance into an ILIT, or the ILIT trustee purchases the life insurance. The proper type of life insurance for the use in an ILIT can be determined with the help of an insurance professional.

Be aware that with a transfer of a current life insurance policy to an ILIT, there is a 3-year "look back" period. That means if death occurs within the look back period, the proceeds are subject to estate tax.

The grantor (also known as the settlor, donor, trustor or creator) must select the trustee of the ILIT. The trustee has important tasks to consider when managing the trust, most importantly, not to let a lapse occur in the life insurance policy. The grantor must make a "present interest" gift to the trustee to pay premiums on the life insurance. The trustee must then notify the beneficiaries of their present right to withdraw the trust proceeds. This is known as "Crummey Powers."

More specifically, the grantor can make an annual gift of $15,000 or less per beneficiary to the trustee for the premiums of the life insurance (up from $14,000 in 2017). Any annual gift above $15,000 per beneficiary would be included in the grantor's lifetime gift amount exemption. The trustee then writes a "Crummey Letter" to the beneficiaries informing them of their right to withdraw the gift amount. If the beneficiaries opt not to withdraw the money, the trustee can use it to pay the premium on the life insurance.

Possible Concerns

1. A grantor must consider the cost of creating the ILIT as well as the administrative expenses of maintaining the trust.

2. Be aware that an irrevocable trust is just that -- irrevocable. The grantor cannot alter the terms of the ILIT after its execution. The life insurance policy must stay in the trust. The policy may lapse or there may be a surrender value, but the grantor cannot change the terms. So, if at a later date, the grantor wants to have different beneficiaries, this will be impossible with an ILIT.

3. The grantor cannot borrow against the policy.

To sum up, the primary role of an ILIT is to help fund the payment of estate taxes with the use of life insurance proceeds that are not considered part of the creator's estate.

The trust receives the life insurance proceeds free of estate taxes. To receive this favorable tax treatment, the trust must be irrevocable -- meaning that its terms can't be changed once it is set up. If you want more information about how an irrevocable life insurance trust could work in your situation, consult with your estate planning adviser.

A Case in Which an Estate Needs Life Insurance But Not an ILIT

Let's say an estate is not subject to estate tax but the estate is made up of only real property and no cash. (In other words, it's illiquid.) The estate might still have a need for life insurance to pay income or real estate taxes, any outstanding mortgages and administrative expenses.

In this case, there is no need for an irrevocable life insurance trust because there are no estate taxes, but the proceeds can help pay expenses, eliminated the need for a "fire sale" of real property or the risk of foreclosure

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