BAIRD
Private Wealth Management

Irrevocable Life Insurance Trust
(ILIT)

An Irrevocable Life Insurance Trust ("ILIT") is one of the staples of estate planning for higher net worth families. A properly designed ILIT and life insurance policy will allow the trust proceeds to pass to the named beneficiaries without being subject to estate tax or income tax upon the death of the insured.

Insurance Services

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Basics

An ILIT is an irrevocable trust created for the primary purpose of owning one or more life insurance policies. As an "irrevocable" trust, it cannot be rescinded, amended, or altered in any way after it is created. However, this "irrevocability" is the feature that will prevent the insurance proceeds from being included in the insured's estate.

Typically, the insured is the person who creates the ILIT. The insured names the trust beneficiaries (usually, the insured's children), and selects someone other than the insured to act as trustee. The insured retains no beneficial interest in the trust. The ILIT's trustee applies for and purchases all new insurance policies, and names the trust as owner and beneficiary of the policies.

Donor/Insured → Donor Establishes an Irrevocable Trust → Trustee Purchases Insurance Policy

During the insured's lifetime, the insured makes annual gifts to the ILIT to be used by the trustee to pay the premiums on the insurance policies owned by the ILIT. The insured can gift an amount equal to the annual gift tax exclusion (currently $15,000) for each beneficiary of the trust. If the insured is married, these amounts can be doubled. The insured can also make gifts above the annual gift tax exclusion amount by using some or all of his or her $11,400,000 lifetime gift tax exemption. This amount can also be doubled if the insured's spouse consents to using his or her lifetime exemption.

Donor/Insured → Annual or One-Time Gift to ILIT → Trustee Uses Gift to Pay Premiums

Upon the death of the insured, the trustee receives the insurance proceeds and distributes them according to the terms of the trust. Amounts payable to younger beneficiaries can be retained in trust until a specified age is reached. Insurance proceeds payable directly to the ILIT will bypass the insured's estate completely and pass to the beneficiaries tax-free.

Insurance Proceeds → ILIT → Beneficiaries

Benefits

- Annual gift tax exclusions can be used to pay premiums without incurring gift tax
- Insurance proceeds pass to family members free of estate and income taxes at the insured's death
- Insurance proceeds can provide liquidity to pay or offset estate taxes owed by the insured's estate
- Combined with a Charitable Remainder Trust, insurance proceeds can replace the value of charitable gifts

Other Considerations

- The ILIT can continue after the insured's death for the benefit of the surviving spouse, and then continue for the lives of the children. This will increase the likelihood that the insurance proceeds will not be lost due to frivolous spending, divorce or creditors.
- For wealthier couples who do not need insurance to provide economic support for the surviving spouse, the amount of insurance coverage can be leveraged by purchasing a survivorship policy. Timing the insurance proceeds to be paid at the second spouse's death will also coincide with payment of estate taxes in most cases.
- Pre-existing insurance policies can be transferred to an ILIT, but the insured must survive three years beyond the transfer date or the insurance proceeds will be includible in his or her estate. There may also be gift tax implications to the transferor of the pre-existing policy.
- Owners of a closely-held business can create an ILIT to purchase life insurance to pay the estate taxes due as a result of the inclusion of the business in the owner's estate. This will allow the business to pass to the next generation without having to be sold to pay estate taxes.
- When an ILIT is established with a Charitable Remainder Trust ("CRT"), the benefits of both techniques can be leveraged to an even greater degree in what is known as a Wealth Replacement Trust. Essentially, the ILIT and life insurance create a highly effective means of replacing assets that are donated to the CRT. When properly structured, this strategy can result in an increase in the inheritance to heirs, a decrease in taxes, and a benefit to one or more favored charitable organizations. For more information on this strategy, please see our flyer entitled "Charitable Remainder Trusts."