Life Insurance Trusts

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What is an Irrevocable Life Insurance Trust (ILIT)?

Trusts in General—A Trust is created when one person (the Trustee) holds title to money or property for the benefit of one or more people (the Beneficiaries). The terms of the relationship are decided by the person providing money to the trust (the Grantor) and are usually in writing.

Design of a Life Insurance Trust—There are many ways to design an ILIT. Typically, an ILIT is irrevocable so that it minimizes estate and inheritance taxes and so that it can better protect the assets in the trust. The Grantor should not be the Trustee or a beneficiary of an ILIT. Most ILITs are created as "Crummey" Trusts which creates a narrow window in which every time you fund the trust, the beneficiaries can take out the money that you put in. This is for tax efficiency. If there is a particular family concern though, this feature can be removed.

Who Should Consider a Life Insurance Trust?

Parents of a Special Needs Child—Relatives should not give money outright to a special needs child if the child cannot handle the money or if the child might lose goverment benefits like Medicaid. An ILIT can be customized as a Special Needs Trust to ensure the child does not lose govement benefits. A second-to-die ILIT is particularly advantageous in these circumstances.

Individuals with Significant Assets or Large Insurance Policies—Individuals with substantial wealth or a large insurance policy may benefit from a life insurance trust as a way to reduce taxes or to create liquidity for an estate that may have significant tax liabilities and cash flow issues.

Individuals Married to Non-Citizen Spouses—Non citizen spouses do not recieve the unlimited marital deduction for estate and gift tax purposes. Accordingly, a good way to minimize estate taxes upon your death is to create an ILIT.

Unmarried Couples—Often one person will want to benefit a significant other, yet control where the money goes after the surviving partner passes away. An ILIT is a very tax efficient way to make sure this happens particularly in states like NJ and PA which have an inheritance tax.

Recent Divorcees—Many divorce agreements require that a trust be established for children in the event one of the parents dies. An ILIT can benefit both the custodial and non-custodial parent by ensuring the existance of a life insurance policy, giving then a voice in when their children recieve the money, and guranteeing that the money benefits the children. It is particularly useful when you have a de-escalating life insurance obligation to cover alimony.

People Who Have Liquidity Concerns—If a significant portion of your assets consist of real estate, business intrestes, or other illiquid assets, then paying for expenses upon your death can be a real problem. Life insurance can provide liquidity, and the ILIT can provide for that liquidity in a tax efficient way.

What are the Benefits of a Life Insurance Trust?

Reduces Estate and Inheritance Taxes—Although money recieved from life insurance proceeds are not subject to income tax, it can be subject to both federal and estate estate taxes if you own your own policy. By properly establishing an ILIT, life insurance proceeds will NOT taxed at all.

Allows for Control of Assets After You Die—You can set the terms of an ILIT so that your heirs receive money over time, rather than in a lump sum. Moreover, a trust can protect your assets from creditors and make it less likely your heirs will squander their inheritance.

What is Involved In Creating a Life Insurance Trust?

Hiring an Attorney—When choosing an attorney to prepare your ILIT, you should choose an attorney who specializes in estate planning and is knowledgeable in tax and asset protection law.

Choosing a Trustee—You can hire either a corporate trustee or an individual trustee. Many people simply have their spouse or a relative act as trustee. You may also have two or more people acting as co-trustees. Honesty is the most important charactaristic to consider when deciding who should be trustee.

Cost—The cost of an insurance trust varies from practitioner to practitioner as well as each client's needs. How complicated you wish to make the trust and how many beneficiaries you wish to name may also be a factor in the cost. Nevertheless, the fees involved will often be far less than the anticipated tax savings.

Timing—Generally, the trust should be created before purchasing an insurance policy to avoid a three year lookback for tax purposes. If you have an existing policy, you should consult with an attoney to discuss whether it is best to transfer the existing policy to the trust or consider other options.

Funding—You are not obligated to fund an ILIT with cash or life insurance. You can put any asset into this type of trust. We generally recommend funding it no more than once per year to minimize the maintenance costs.

Maintenance—An ILIT created as a Crummey Trust generally requires annual maintenance as certain notices must be sent out every time a contribution is made to the trust. The fee for this is usually nominal.

Purchasing Insurance—Whether you pruchase whole life, universal, or term insurance depends upon what you can afford and how long you need the insurance. Many people do not like the expense of whole life, but they do like the idea of having a guaranteed death benefit. Because a trust can own more than one insurance policy, a mix and match approach may be the most effective for some prople. If you know that you wnat a guaranteed death benefit for your children, rather than for your spouse, you may want to consider a second to die insurance policy. A special ILIT would be required for this as neither spouse could be trustee.

Tax Returns—Unless the trust generates income, income tax returns do not have to be filed for an ILIT. However, funding an ILIT may generate the need to file a gift tax return.

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