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Irrevocable Life Insurance Trusts

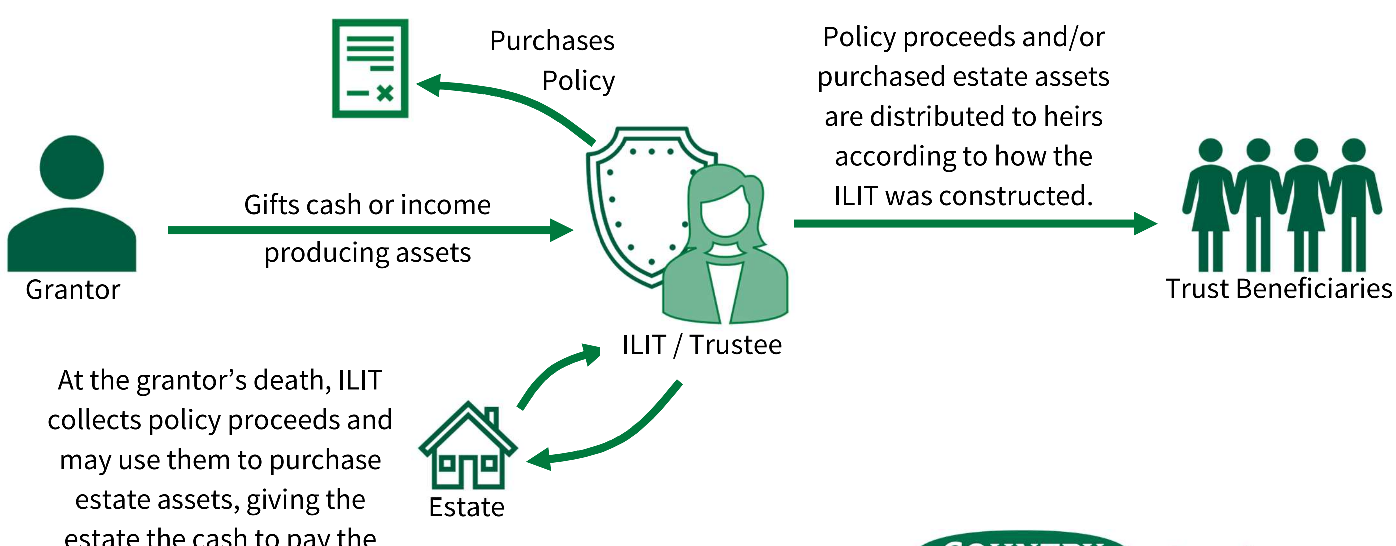
You are in good company if an Irrevocable Life Insurance Trust (ILIT) is an unfamiliar concept to you. In its most basic understanding, an ILIT is simply a separate legal entity that owns a life insurance policy instead of it being owned by a living person. The question then becomes, why would someone want or need their life insurance to be owned by this separate entity (a trust)? This edition of Financial Planning Insights will answer that question and help you understand if an ILIT might make sense in your situation after discussing this strategy with your attorney.

Many Americans may eventually reach the end of their lives with assets they want to leave to those they love. For many of them instruments like wills, living trusts, or basic beneficiary designations will be utilized to direct the distribution of those assets. However, individuals with larger estates may also have to plan for an additional "heir" when they die – the government. At the time of publication, the United States and 12 states plus the District of Columbia all impose an estate tax for decedents whose net worth exceeds certain thresholds. Additionally, another 5 states have a separate inheritance tax paid by some heirs, with Maryland having both an estate and an inheritance tax. For individuals who find themselves in these circumstances, an ILIT can be a helpful strategy for possibly reducing the size of their taxable estate and creating the liquidity necessary to pay the eventual tax bill that may arise.

How Does an ILIT Work?

The three main parties to an ILIT are the **grantor** (the person establishing the trust and transferring money or assets into it), the **trustee** (the representative charged with carrying out the terms of the trust in a fiduciary manner), and the **trust beneficiaries** (those persons who will one day benefit from the assets within the trust).

During their life, the **grantor** transfers cash or assets into the ILIT. The **trustee** then uses those resources to acquire a life insurance policy on the grantor, naming the ILIT as the owner, payor, and beneficiary. At the grantor's death, the ILIT trustee will collect the life insurance policy proceeds and then use them according to the terms of the trust for the benefit of the **trust beneficiaries**. Here's a diagram of how that works.



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How Does an ILIT Protect Your Estate?

One of the core benefits of an ILIT is the ability to have its assets excluded from the grantor's estate. When implemented properly, the assets of an ILIT are able to pass to heirs without being subject to federal or state estate taxes. That includes the income tax free proceeds from *most* life insurance policies owned by the ILIT. Additionally, ILIT assets can be sheltered from claims of future creditors.

Irrevocability

A crucial aspect of an ILIT is the ***irrevocability*** of the trust. When a trust is irrevocable, it means that its terms have been finalized and generally can't be changed once it's executed. An irrevocable trust is a completely separate legal entity from the grantor with its own tax ID number. This is different than the typical *revocable living trust* that is a common instrument in many estate plans. Because an ILIT is irrevocable, you should make sure you understand it clearly before executing this strategy and that the intended benefits outweigh the necessary inflexibility.

Life Insurance and ILITs

In most situations, individuals own the life insurance policies for which they may be the insured. When this is the case, the death benefit amount is included in the grantor's gross estate. That can make their gross estate larger than it was while they were alive, potentially intensifying the impact of an estate tax. When an ILIT is properly created the life insurance policies that it owns are not part of the grantor's estate. For this to be accomplished there are some important rules that generally must be followed.

- Neither the grantor nor their spouse should be an owner in any measure of the life insurance for the ILIT.
- Neither the grantor nor their spouse should have any direct control over the trust or be the trustee.
- Neither the grantor nor their spouse can receive any benefit from the assets inside the ILIT.

A grantor may transfer existing life insurance they own to an ILIT. However, in order for pre-existing life insurance to be completely considered as an asset of the ILIT and not the grantor, the grantor must survive at least three additional years after the date of the transfer. If this does not occur, the death benefits will be recaptured and considered part of the grantor's gross estate for estate tax purposes.

The three-year look-back rule under IRS regulations can sometimes be avoided if the grantor **sells** the life insurance policy to the ILIT for its full fair market value, rather than gifting it. However, these transactions must be handled carefully to avoid triggering the transfer-for-value rule, which could make part of the death benefit income taxable. These are complex planning strategies and should only be implemented with the guidance of an experienced estate planning attorney and tax advisor.

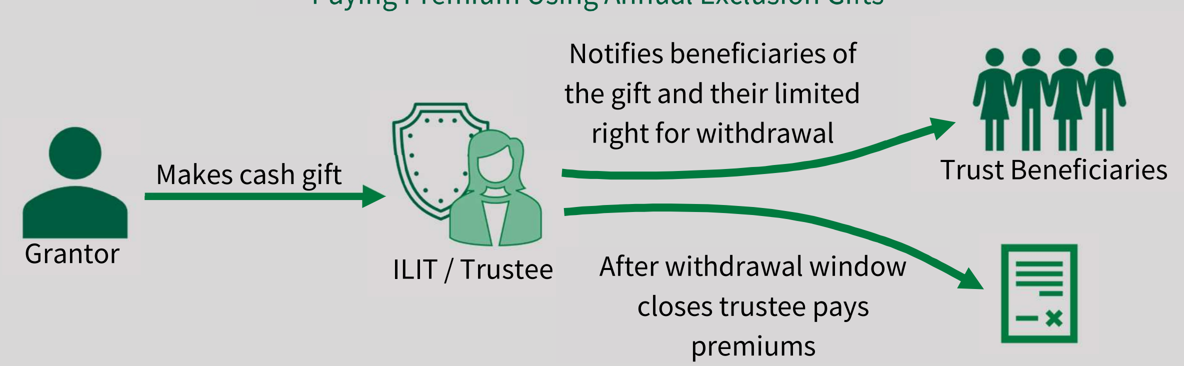
Where Does an ILIT Get the Money to Pay Premiums on the Life Insurance it Owns?

There are several ways in which the trustee of an ILIT can raise the cash needed to pay annual life insurance premiums. We'll briefly review three common options a grantor and trustee may use on the following pages.

Federal tax rules, which change annually, allow each person to give up to $19,000 in 2025 to any person without triggering gift tax reporting requirements. That exclusion amount is indexed for inflation annually. That includes gifts a grantor might make to an ILIT for the benefit of trust beneficiaries. As long as the total amount given to any one recipient from any one giver does not exceed that annual exclusion amount, the filing of a federal gift tax return is generally unnecessary. However, because most trust beneficiaries typically won't benefit from the trust for many years, in order for the IRS to consider the gift as applying to the current tax year and being considered complete, additional rules must be followed.

A key requirement is that trust beneficiaries must be given the right to withdraw, for a limited time, the amount contributed to the ILIT on their behalf each year. This is commonly known as a Crummey withdrawal right. It is called this, not because of it being a "bad deal", but because it arose from a court decision* involving a family with the unfortunate surname "Crummey." When gifts are made to the ILIT, the trustee notifies trust beneficiaries of the gift and grants them a limited time to request its withdrawal instead of it remaining in the ILIT. This can be risky if trust beneficiaries do not understand the long-term benefits they obtain by leaving the gift inside the ILIT so the trustee may use it to pay premiums on the life insurance it owns. In spite of this risk and the extra work of regularly notifying trust beneficiaries about gifts and their rights, annual exclusion gifting is the most common means for an ILIT trustee to obtain the money needed to pay premiums. The guidance of an experienced attorney is crucial in this approach.

Paying Premium Using Annual Exclusion Gifts



Income Producing Assets

Instead of (or in addition to) a grantor gifting cash to an ILIT, they may choose to transfer income producing property into the trust, such as investment real estate or securities like stocks, bonds, or mutual funds. If adequate, the income produced by these assets from rent, dividends, interest, or capital gains may be used by the trustee to pay the life insurance premiums each year.

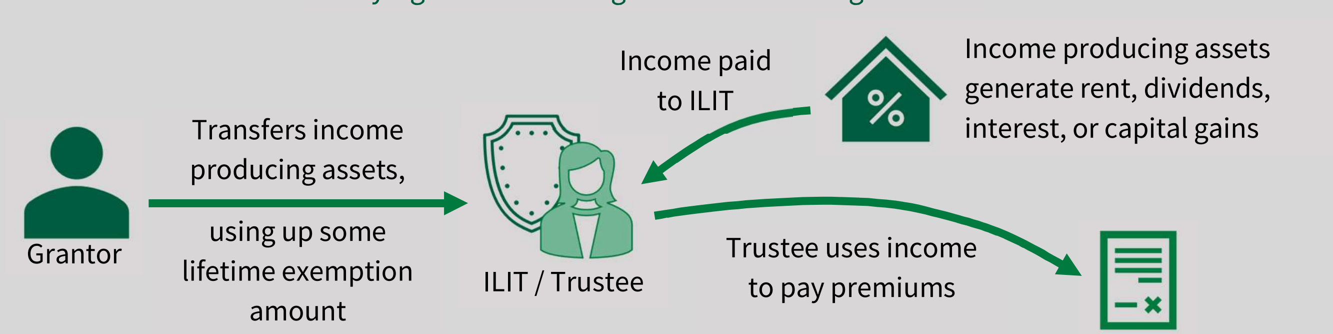
Because the money used to pay premiums does not come from a gift the grantor made that year, the trustee does not need to provide the trust beneficiaries with notice of a gift, and the beneficiaries don't have a right to instruct the trustee to pay them that income instead of it being used to pay the premiums; nor do the beneficiaries have Crummey

* D. Clifford Crummey et al., Petitioners, v. Commissioner of Internal Revenue (1968).

withdrawal powers. Crummey powers are only necessary when a gift is made under the protections of the annual exclusion amount.

Typically, the grantor's transfer of income producing property to an ILIT involves assets whose value far exceeds the limited annual exclusion amount discussed previously. When this is the case, the grantor will need to file a federal gift tax return when the transfer is made. This generally means that they will use up some of their lifetime exemption amount. IRS rules provide for a *unified credit* that effectively exempts a certain amount of one's assets from gift or estate taxation, whether those transfers occur during the grantor's life or from their estate after their death. In 2025 the exemption amount is $13.99 million per person. This is a complex strategy which requires the guidance of an experienced estate planning attorney to implement properly.

Paying Premium Using Income Producing Assets

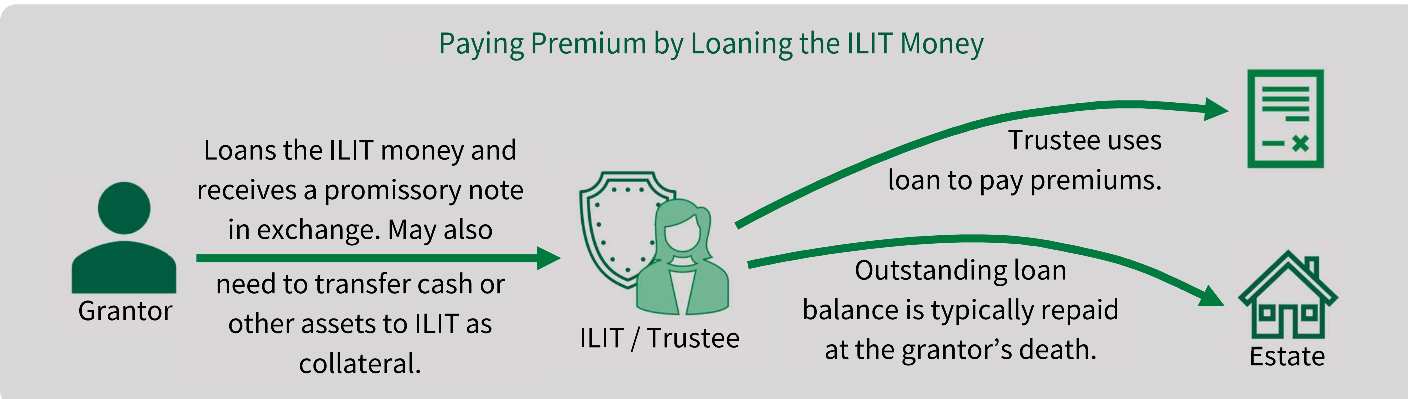


Lending the ILIT Money

One last way in which the trustee may obtain the cash needed to pay life insurance premiums is by having the grantor loan the ILIT the money. When doing so, the loan is formalized through a promissory note with a minimum interest rate directed by the IRS. Though this approach preserves the life insurance death benefit from being included in the grantor's estate, the balance of the outstanding loan associated with the promissory note would still be included in their estate.

The advantage of this strategy is that no Crummey withdrawal rights are required, and the grantor does not have to use any portion of their lifetime exemption amount. The loan (plus accrued interest) is typically repaid at death using some of the life insurance death benefit proceeds.

For the loan to generally be considered legitimate by the IRS, it may be advisable for the trust to demonstrate it has some means of repaying the loan other than relying on some future life insurance death benefit amount. This can be accomplished by the grantor gifting to the trust cash or other assets that could be used as collateral. When doing so, the rules associated with Crummey powers and/or potential depletion of one's lifetime exemption amount will apply to that "non-loan" transfer to the ILIT. The accounting for this strategy is complicated and the detailed IRS rules go far beyond the high-level explanation found here. Please consult with an experienced estate planning attorney and tax advisor when exploring how a loan might be used to provide an ILIT with the cash needed by the trustee to pay life insurance premiums.



Are There Income Tax Concerns with an ILIT?

Income tax consequences may arise for an ILIT if it owns assets other than life insurance. If those assets produce income, it must be accounted for and taxed. Depending on how the trust is constructed those taxes may be owed by the ILIT itself or reportable on the grantor's personal income tax return. An experienced attorney and tax advisor can explore which options may be best for your situation and how an ILIT should be written to achieve your goals.

What Should the Grantor, Trustee, and Trust Beneficiaries Understand?

An ILIT can't exist without the grantor. The grantor is the individual choosing to establish the trust for the benefit of someone else (the trust beneficiaries). The grantor **derives no personal economic benefit** from the ILIT, other than the satisfaction of knowing that they've set things in motion to have a more efficient and effective estate transfer when they eventually pass away.

For the ILIT to work as planned, the grantor can have no *incidents of ownership* – nothing that would suggest that they personally benefit from the trust or its assets. That means that even though life insurance inside of the trust may have cash value the grantor cannot benefit from it. The grantor cannot take a policy loan, request a withdrawal, or surrender dividends. Payments from riders that offer living benefits such as long-term care, chronic illness or terminal illness are also unavailable to the grantor. Everything in the trust is completely and ***irrevocably*** off limits to the grantor. If there is any type of current or reversionary interest, or benefit that the grantor will derive from the trust at a future point, the trust won't work for its purpose of transferring assets outside the grantor's estate.

The selection of a trustee is a crucial decision the grantor makes when establishing the ILIT. The trustee is often a family member or close friend of the grantor, an attorney, or a third-party trust company. The trustee is obliged to act in a **fiduciary capacity for the benefit of the trust beneficiaries**. They are placed in a position of great confidence and have many legal responsibilities to carry out. They must manage trust assets in a prudent manner, in alignment with the trust provisions and for the sole benefit of the trust beneficiaries.

The trustee's primary responsibilities include:

- **Paying life insurance premiums** when due.
- **Providing the legally required Crummey notifications** to trust beneficiaries in a timely manner. This responsibility cannot be overlooked without potentially adverse tax consequences.
- **Regularly reviewing the health of any life insurance** the trust owns to make sure it is performing as expected. This includes obtaining in-force illustrations and exploring options for underperforming policies.
- **Managing all trust assets**, including potential investments belonging to the trust in a prudent manner. Trustees lacking specific expertise in this area should delegate the responsibility of investment decisions to a skilled investment professional, but must still monitor what is going on with trust assets.
- **Ensuring that proper tax reporting takes place**. This may be minimal if only life insurance is inside the trust but can be more significant if other assets are owned by the trust as well. This can be complex and is best carried out with the assistance of a qualified tax professional.


Trust Beneficiaries

In most cases, ILIT beneficiaries are family members of the grantor, such as children, grandchildren, or even sometimes their spouses. When annual exclusion gifting is used to provide the trust with the money for life insurance premiums, it is important that trust beneficiaries understand how the ILIT works. It is essential that they understand the importance of funding the life insurance in the trust with the gifts made by the grantor, so **they don't exercise their Crummey withdrawal power** to divert those gifts, leaving the trust with insufficient funding to pay the premiums.

In Summary

ILITs are powerful tools for people to remove life insurance policies from their estates while helping provide crucial liquidity for estate expenses like federal and/or state estate tax bills. Careful construction and operation are required to achieve the full measure of the potential that an ILIT offers. While COUNTRY Financial does not provide tax or legal advice, we can work with your tax and legal advisors to help with the life insurance aspects of an ILIT. Together, we can work to implement strategies to help achieve your financial and legacy goals.