# Five Ways that an ILIT can Turbo-Charge your Estate Plan[1]

John C. Martin, Esq.[2]

What is an irrevocable life insurance trust ("ILIT") and why would it be useful to me? This article explores the upsides and downsides of the "ILIT." The author concludes that an ILIT is both a cost-effective and powerful tool for providing liquidity, paying estate tax, avoiding Generation Skipping Transfer Tax (GSTT), protecting beneficiaries from creditors, and for business owners, keeping a business in the family.

An ILIT is an irrevocable trust that holds life insurance. Its primary purpose is to keep life insurance proceeds out of the estate of the settlor. But it can also have a number of other purposes. Below are five reasons why one might consider an ILIT:

## First Reason: No Loss of Control over Income-Producing Assets

First, an ILIT is an attractive alternative to other estate planning strategies that involve transferring substantial amounts of assets out of one's estate. Grantor Retained Annuity Trusts (GRATs), Charitable Lead Trusts (CLTs), and other trust arrangements may involve the transfer of valuable income producing or business assets that most if not all would be hesitant to transfer out of their control (not to mention that the ILIT usually costs less). Yet, transferring a life insurance policy comes more easily: While premiums must be paid, the proceeds are only payable to beneficiaries upon death. Thus, there is not a great fear that transferring the policy would deprive the owner of its benefit.

## Second Reason: Liquidity Creation

Second, and most importantly, an ILIT that is structured properly provides liquidity. In an estate laden with illiquid real estate assets, an ILIT can be essential in order to pay a large estate tax bill without selling off assets. Consider the example of Robert and Sally Colmery. Over their lifetimes, Robert and Sally accumulated a small real estate empire throughout California, including a Palo Alto home ($3,000,000), a vacation home in Tahoe ($1,000,000) and three rentals in San Mateo (together worth $2,500,000). Robert's liquid assets were mostly spent by the end of his life, amounting to $150,000. At the end of his and Sally's life, $3,150,000 of the estate will be subject to the federal estate tax at a rate of 45%, and Robert's and Sally's children, Peter and Ruth, will not have sufficient cash to cover the bill unless they sell off some of the properties.

Now let's assume that Robert establishes a qualifying ILIT with a second-to-die insurance policy naming his children, Peter and Ruth, as remainder beneficiaries, and pays the premiums by using his $13,000 annual gift tax exclusion. Robert structures the payment of premiums with the help of an attorney so that they do not trigger any gift tax by using something called a "Crummy" power. At the time of the second spouse's death, the proceeds of the life insurance policy will pass estate tax-free. As a result, Peter and Ruth are not forced to sell off the real estate when

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[1] This article is intended to provide general information about estate planning strategies and should not be relied upon as a substitute for legal advice from a qualified attorney. Treasury regulations require a disclaimer that to the extent this article concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

[2] John C. Martin is a lawyer practicing in Menlo Park. For more ideas, visit his website: http://www.johncmartinlaw.com

they inherit.

Third Reason: Leveraging the Generation-Skipping Transfer Tax Exemption

Third, an ILIT can be used to leverage the insured's GSTT exemption. Whenever we would like to give to our grandchildren or to individuals removed by 2 or more generations, the IRS imposes a second layer of tax called the GST tax. However, a $1 million exemption exists to which transfers to a trust can be allocated at the time of such transfer. If the amounts transferred to a trust appreciate, the ratio of assets exempt from GSTT to non-exempt assets will remain constant. As a result, if the entire transfer to the ILIT is allocated to the GSTT exemption (an inclusion ratio of zero), all GST tax can be eliminated at the final distribution, even if the trust enjoys considerable income over the years.

For instance, let's say that Robert sets up a generation-skipping ILIT. The ILIT directs the proceeds from the life insurance to be invested in securities. All net income is payable to Peter and Ruth over their lifetime, with a remainder interest to Peter and Ruth's children. Normally, Peter and Ruth's children would be liable for GST tax at the maximum applicable federal rate when they take. However, if the ILIT is set up so that the inclusion ratio of assets subject to GSTT is zero, Peter and Ruth's grandchildren will pay no GST tax. If ILIT assets grow at a modest rate, the grandchildren would take potentially significant amounts without incurring any additional GST or estate tax liability.

Fourth Reason: Protecting Beneficiaries from Creditors

Fourth, Robert can also protect his children and grandchildren from future creditors by including a spendthrift provision in the trust document and granting discretion to the trustee in giving distributions to the beneficiaries. If the ILIT is set up with investments or cash that Robert doesn't need to access, the amounts can be shielded from Peter's and Ruth's creditors.

Fifth Reason: Encouraging Responsibility

Fifth, while the ILIT is non-amendable, it can be structured so that beneficiaries are incentivized to engage in positive behavior. The trustee may be given directions to not make distributions until the beneficiaries reach a certain age, or unless they have demonstrated positive behavior. For instance, they can be directed to withhold funds that would pay for a drug addiction, gambling, or otherwise. The trustee can be directed to pay for the education, business planning, or other positive expenditures that the beneficiaries may require.

The settlor should be cautious when establishing an ILIT. Take note of the following caveats: (1) there must not be incidents of ownership by the owner / insured within 3 years of purchase of the policy; (2) The reciprocal trust doctrine may bring the proceeds of the policy back into the estate (i.e., when two spouses who set up life insurance policies on each other at the same time); (3) gift tax consequences may result with funded ILITs. Consider the use of the annual gift tax exemption with an un-funded ILIT.

In conclusion, the ILIT is a powerful and cost-effective estate planning strategy. Often more attractive to individuals than strategies that require transfer of income-producing assets, the ILIT can ensure that estate taxes are paid; that beneficiaries are provided for according to the principal's wishes; and that the GST, estate, or gift tax are reduced or eliminated.