What is an Irrevocable Life Insurance Trust?

Friday, October 25, 2013

Life insurance is an important estate planning tool; however, life insurance proceeds can be quickly diminished by taxation. This is due to the fact that a policy's face value is often included in a decedent's taxable estate. For instance, if you own a life insurance policy with a face value of $2 million dollars and you have other assets valued at $4 million dollars, then at the time of your death your estate would be valued at $6 million dollars. Your heirs would be exposed to estate tax liability on the amount exceeding $5.25 million dollars, the current estate tax exemption, (which is always subject to change). Notwithstanding these facts, proper planning can protect life insurance proceeds; one way to minimize the threat is to create an irrevocable life insurance trust ("ILIT").

Upon creation of an ILIT, the named trust becomes the owner of the life insurance policy. Because the trust - and not the decedent - is the owner, the life insurance proceeds will not be subject to estate tax upon the decedent's death. The insurance premiums are paid by the grantor (the person who established the trust) through "gifts" to the trust. Upon death of the grantor, the trust beneficiaries can use the proceeds to offset taxes that may be owed on the estate. This is advantageous because beneficiaries are often left without the cash liquidity needed to meet tax obligations (especially if the estate includes a large amount of real property). The trust arrangement will also allow proceeds to escape probate administration.

Of course, there are some drawbacks that should be considered before creating an ILIT. As the name implies, such a trust is irrevocable and cannot be changed after its creation. A grantor must be willing to relinquish control of the assets to the trust and cannot retain rights to revoke, alter, amend, etc. The grantor is also not permitted to retain any economic benefit in the life insurance policy, such as the right to cash in or borrow against it.

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