

Swan Songs: Simplifying Irrevocable Life Insurance Trusts

Swan Songs is a series designed to explain important estate planning concepts to advisors and their clients in an easily digestible way.

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Simplifying Irrevocable Life Insurance Trusts

An irrevocable life insurance trust (ILITs) is a specialized trust designed to hold life insurance policies outside of an individual's taxable estate. Once established, an ILIT can't be changed or revoked by the grantor. This permanence ensures that policies purchased directly by the trust—including the death benefits eventually paid out—aren't included in the grantor's estate. This approach can significantly reduce estate taxes upon death.

Policies owned by the grantor that are subsequently transferred into the ILIT are subject to a three-year lookback period for estate inclusion purposes. The lookback period is intended to prevent individuals from circumventing estate taxes by transferring their life insurance policies to an ILIT shortly before death. If the policyholder survives the three-year period after the transfer, the death benefits paid out from the transferred policies are generally not included in the grantor's taxable estate, allowing potential tax savings.

Premium payments for policies held within an ILIT can be funded through gifts. In order to use the grantor's annual gift-tax exclusion and avoid gift taxes, the gifts to the trust must be considered gifts of a present interest. ILITs can be drafted to meet this requirement by granting a limited withdrawal power to the beneficiaries, known as a *Crummey power*. Crummey powers and their associated notice requirements are complex—and if the requirements are overlooked, there could be unintended tax consequences.

Like most types of trusts, an ILIT allows the grantor to specify who will receive death benefits and under what conditions. These conditions can include designating beneficiaries other than the grantor's spouse or children and/or setting up specific terms for distributions. The trust can include various distribution strategies, allowing flexibility in how and when beneficiaries receive life insurance proceeds.

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