# An ILIT Can Be A Wealth Preserver For Your Family

Life insurance is often an integral part of an estate plan. By acquiring life insurance coverage, you can provide liquidity when your family might need it the most, particularly if you're relatively young. The policy's proceeds can be used to help pay your mortgage, college tuition for your children or various other expenses.

Of course, you also must account for taxes. Generally, you can avoid dire federal estate tax consequences, based in part by using your gift and estate tax exemption. However, the exemption is scheduled to decrease after 2025, creating more complications. For many families, creating an irrevocable life insurance trust (ILIT) to hold your life insurance policy is a common solution.

## Avoid "Incidents Of Ownership"

Generally, the proceeds of a life insurance policy aren't included in your taxable estate if you don't own the policy and aren't subject to probate. For instance, if you're the insured person and someone else owns the policy and pays the premiums, the life insurance proceeds are exempt from estate tax.

However, life insurance proceeds will be included in your estate if you possess any "incidents of ownership." This goes beyond mere ownership of the policy. If you have the right to amend the policy — say, by changing the beneficiaries — or you can borrow against the cash value, it's treated as an incident of ownership.

The top estate tax rate is currently 40%. Fortunately, with your gift and estate tax exemption, you can shelter up to $11.7 million (for 2021) of the proceeds from federal gift and estate tax. Be aware that without congressional action, after 2025, the exemption is scheduled to revert to $5 million (indexed for inflation). Also keep in mind that the Biden administration supports a reduction of the estate tax exemption to $3.5 million.

Furthermore, you may have to contend with estate or inheritance taxes at the state level. In any event, the estate tax treatment of life insurance policies is a prime consideration in estate planning, especially for wealthier individuals.

## An ILIT To The Rescue

A common method for avoiding these estate tax complications is to use an ILIT. This may be accomplished by setting up the trust as the owner of the life insurance policy when the coverage is purchased or by transferring an existing policy to the trust.

For starters, the trust must be "irrevocable," as the name states. In other words, you must relinquish any control over the ILIT, such as the right to revise beneficiaries or revoke the trust. Similarly, if you act as the trustee of the ILIT, this will be treated as an incident of ownership that invalidates the trust. You can, however, name another family member or a knowledgeable professional as the trustee.

Typically, you'll designate the ILIT as the primary beneficiary of the life insurance policy. Upon your death, the proceeds are deposited into the ILIT and held for distributions to the trust's beneficiaries. In most cases, this will be your spouse, children, grandchildren or other family members.

Note that naming your surviving spouse as the sole beneficiary can be problematic. It may merely delay estate tax liability until the spouse dies (assuming he or she outlives you). But this can be addressed through estate tax planning measures designed for a surviving spouse.

The ILIT must be funded so the trust is able to pay the premiums on the policy. Choose a bank account to be used for this purpose.

## Other ILIT Considerations

There are several specific pitfalls to watch out for when transferring an insurance policy to an ILIT. Significantly, if you transfer an existing policy to the ILIT and die within three years of the transfer, the proceeds will be included in your taxable estate (see "Start the clock ticking" below). One way to avoid this is to have the ILIT purchase the policy on your life and then fund the trust with enough money over time to pay the premiums.

The transfer of an existing policy is subject to federal gift tax. The gift may be sheltered from tax by the annual gift tax exclusion ($15,000 for 2021) and the gift and estate tax exemption. Alternatively, you can arrange for a "Crummey letter" that gives beneficiaries the right to access funds for a limited time.

## Ensure Your Policy Works As Intended

A life insurance policy can protect your family's financial future. Using an ILIT can help ensure the policy works as you intend by shielding the proceeds from hefty estate taxes. Contact your estate planning advisor for more details.

## SIDEBAR: Start The Clock Ticking

No matter what your intentions, if you die within three years of transferring ownership of a life insurance policy to an irrevocable life insurance trust (ILIT), the proceeds are included in your taxable estate. Period.

Therefore, if the ILIT strategy makes sense for your specific circumstances, there's no sense in waiting around, even if you're currently in good health. Set up the trust and transfer the policy as soon as possible. This will start the clock ticking on the three-year period. Note, too, that the three-year rule applies to other assets gifted to a trust.

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