

Weatherby & Associates, PC

Counselors at Law

Henry C Weatherby*
Ronald A. Soccoli, Jr.

Of Counsel

Joseph D. Farrell**

*Also Admitted in Massachusetts, New Jersey and Idaho

**Also Admitted in California

34 Jerome Avenue, Suite 310
Bloomfield, Connecticut 06002-2463

Facsimile: (860) 769-6942

Telephone: (860) 769-6938

ESTATE PLANNING LIBRARY

Number Seven

Irrevocable Life Insurance Trusts

AN OVERVIEW

1. What client might need this technique?

The estate planner consults with the client to help them decide on the features and benefits of an ILIT that best serves the client's family's best interests. Actually, any client that owns a life insurance policy can benefit from an irrevocable life insurance trust (ILIT). Some specific types are:

- Clients who will have taxable estates due to the life insurance proceeds.
- Clients who want to provide asset protection for the insurance proceeds for their families and descendants.
- Clients who want to provide financial management for the insurance proceeds for their family and descendants.

2. How do ILITs work?

An ILIT is an irrevocable trust that is designed to be the owner and beneficiary of a life insurance policy on one parent or a second-to-die policy that pays at the death of the last parent to die. If a new policy is being purchased, the client will transfer funds into the ILIT and the ILIT will apply for a policy on the intended insured. If an existing policy is transferred to an ILIT, the insured must survive at least three years to have the policy proceeds protected from estate taxes. As premiums are due, the insured transfers funds to the trustee of the ILIT who holds the funds for a period of time and then pays the premiums.

3. Why does the trustee hold the funds for a period of time?

Each person may make an annual gift of \$10,000, indexed for inflation, to any other person and there are no gift or estate tax implications. However, to qualify for the annual exclusion, the gift must be a “present interest” gift. Present interest means that the person receiving the gift must have a current right to the property or the income from the property. For a gift to a trust to qualify, the beneficiary must be given the right to demand a portion of the gift. Because the beneficiary of the ILIT has a right to demand a portion of the gift, the gift qualifies for the annual exclusion. For the demand right to be respected, the ability of the beneficiary to demand some of the gift starts at the date of gift and for 30 days after the trustee notifies the beneficiary of the right to demand. That is why the trustee holds the funds for a period of time.

4. If the beneficiary demands the money, how are the premiums paid?

It is generally intended that the beneficiary not demand the funds, but there can be no such agreement. It is important that the beneficiaries understand that their right to demand is real, but that their economic interests are better served by having the insurance in force.

5. How does the client benefit from the ILIT?

Actually, the clients’ children are the ones who really benefit. Assume one client has a \$1,000,000 life insurance policy and no other assets. If that client names his or her spouse as the beneficiary and then dies, the surviving spouse receives the \$1,000,000 with no estate taxes paid because of the Unlimited Marital Deduction. However, the survivor will have a taxable estate and, in 2002, the spouses’ children will have to pay \$125,250 in estate taxes. However, if the \$1,000,000 had been held in an ILIT, there would be no estate taxes and the children would save \$125,250. As you can see, the benefits of an ILIT are significant.

6. What does the estate planner do in these engagements?

The estate planner designs the ILIT so as to accomplish the purposes of the clients. That means that the controls on the proceeds, the wording of the demand rights and other details are included in the ILIT document that accomplishes the clients’ goals and qualifies under the Internal Revenue Service’s rules to avoid estate and gift tax problems.

7. What does the client do in these engagements?

Initially, the client needs to decide that they want to use an ILIT to protect their children and grandchildren from needless estate taxes by purchasing, or transferring and existing policy, their insurance in a properly designed ILIT. Further, the clients must follow the formalities of the ILIT, such as sending the demand notices, to avoid having the IRS ignore the ILIT and tax the insurance

proceeds as high as 55%