Benefits of Establishing an Irrevocable Life Insurance Trust (ILIT) For Your Life Insurance

What is an Irrevocable Life Insurance Trust?

The use of an Irrevocable Life Insurance Trust (ILIT) should be considered any time that there is a potential for estate taxes or in situations where a major asset (farm, business, etc.) is to go to one child and you want something for the other children of equal value but do not have other assets that can be used to equate the distribution.

Irrevocable Life Insurance Trusts are used in four basic situations in estate planning; namely:

- Both husband and wife are living. Insurance is acquired on the single life of either spouse. Provisions are made in the ILIT so that the surviving spouse receives the income during his or her life with the remainder to named beneficiaries at the death of the surviving spouse. This provides an income source for the surviving spouse and allows control of final distribution of principal.
- Both husband and wife are living. Insurance is acquired on a last to die basis. The beneficiaries therefore do not receive anything until the surviving spouse passes away. Usually the insurance proceeds are designed to "pay for" estate taxes or to balance and equate distributions among heirs.
- Single person has insurance on his or her life. Beneficiaries receive proceeds at death of insured and proceeds used to "pay for" estate taxes or to balance and equate distribution among the heirs.
- Any of the above formats, but where the intent is to provide funds outside of the taxable estate to equalize the estate distribution among the beneficiaries or provide a tax-free cash legacy for beneficiaries.

One thing you should understand about ILITs and Revocable Living Trusts is that, while the insurance proceeds in an ILIT are generally thought of to be available to pay for estate taxes, it cannot be a requirement in the trust agreement. You must remember some basic accounting principles. These principles will cause no particular problem when the beneficiaries of the ILIT and the beneficiaries of the estate are all the same, that is to say if you have four children and you are dividing your estate into four equal shares and the ILIT is dividing the proceeds into the same four equal shares, the considerations mentioned really do not have any net effect on the planning. However, in situations where, for whatever reasons, you want to use ILIT money to pay for taxes and yet have an unequal distribution of the primary revocable living trust assets because it is a business or other asset and yet state that the ILIT is to be distributed equally among the children, you have the possibility for some distortions in your analysis and desires for the children.

What people often forget to do is to deduct from their revocable living trust assets the amount of the estate taxes and then look at the net remaining assets and how those are divided up among the beneficiaries. Remember, an ILIT itself has no estate tax to pay and merely sits there as a vehicle to loan money to the revocable living trust to pay estate taxes. Thus the ILIT has an asset consisting of a note receivable and the revocable living trust sits there with all of the assets, essentially with a mortgage or lien on those assets equal to the note payable.

As you can see, if the same exact beneficiaries are on both sides of the equation, it makes no difference. If you have a revocable living trust in which one child is receiving a certain asset or certain property and is therefore getting a disproportionate amount of the estate, yet the ILIT says you divide the property four equal ways, the division of the your total assets will not be equal. If you really want to have the total assets of the ILIT and the Revocable Living Trust be divided four equal ways, and give the one asset of higher value to the one child as part of said child's trust share, you need to have special language in the two trusts to coordinate that kind of distribution.

Often there is a need to explain how the special asset left to Child A is to be valued for division purposes in place of estate tax values. For example, a vacation home may have an estate tax value of $500,000, but because the child receiving this asset will receive less in liquid assets, the parent may provide a "discount" since the child getting the vacation home is receiving less cash. Any modification or adjustment a person desires may be incorporated in the planning.

The following examples somewhat illustrate this principle:

EXAMPLES

Example 1:

If estate consists of family farm with a value of $750,000 and you have two children, one who will farm the land but the other has no interest in the land. The estate plan might be to leave the farm to Child A and ILIT insurance proceeds to child B. Properly structured, this program can be done without estate taxes being paid.

Example 2:

Say you have 4 children and a gross estate of $6,000,000 consisting of some assets that have a value of $1,500,000 that you want Child A to have, but you want Children B, C and D to get an equal share of the estate. On the surface $6,000,000 ÷ 4 = $1,500,000. This appears to be okay, except for one thing - **estate taxes!** The federal estate tax payable in 2017 would be about $360,000. Assume you solve the problem with a $400,000 ILIT, but you do not coordinate the trusts. In both trusts you say 4 equal ways with special assets to Child A. The result is as follows:

	Total	RLT	ILIT
Total Gross assets	$6,400,000	$6,000,000	$ 400,000
Estate tax liability	(360,000)	(360,000)	
Total available to Family	6,040,000	5,640,000	400,000
Special Asset to Child A	(1,500,000)	(1,500,000)	
RLT balance 3 ways or $1,380,000 per child	(4,140,000)	(4,140,000)	
ILIT four ways or $100,000 per child	(400,000)		(400,000)
	$ - 0 -	$ - 0 -	$ - 0 -

Result:	Child A gets	$1,500,000 + $100,000 = $1,600,000
	Child B, C, D each get	$1,380,000 + $100,000 = $1,480,000

If instead coordinating language is placed in **both** the **RLT** and the **ILIT**, that would solve the problem so all children get equal dollar amounts. The result would be:

	Total	RLT	ILIT
Total Gross assets	$6,400,000	$6,000,000	$ 400,000
Estate tax liability	(360,000)	(360,000)	
Total available to Family	6,040,000	5,640,000	400,000
Special Asset to Child A	(1,500,000)	1,500,000	
ILIT and RLT balance allocated to equalize benefit so each child would end up with $1,510,000	(4,540,000)	(4,140,000)	(400,000)
	$ - 0 -	$ - 0 -	$ - 0 -

Result: Child A gets special asset plus $10,000 = $1,510,000
Child B, C, D each get $1,510,000

Proof: 1,510,000 x 4 = $6,040,000, the total amount available after estate taxes to the family.

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