The Irrevocable Life Insurance Trust

In brief

An Irrevocable Life Insurance Trust (ILIT) is a flexible and well-established estate and tax planning tool for removing assets from the grantor's estate. ILITs are generally funded primarily with life insurance, but may hold other assets as well. This In brief summarizes how ILITs work, including trust design and income and transfer tax considerations.

NON-TAX ADVANTAGES

- Establishes family legacy planning
- Offers creditor protection for beneficiaries
- May help pay for college, weddings, homes or business for future generations
- Allows for centralized wealth management
- Provides liquidity by allowing the trustee to buy assets from (or lend assets to) the grantor's estate
- Allows a trustee to manage assets where the beneficiaries are unable to do so because of incompetence, age, or lack of expertise
- Avoids probate, which is a public, court supervised distribution of a decedent's estate that can be cumbersome and expensive

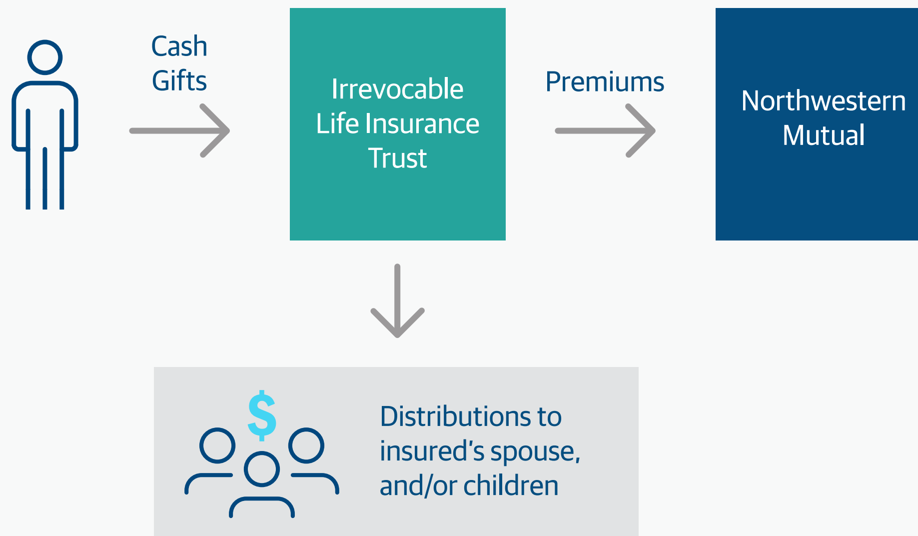
TAX ADVANTAGES

- Avoids federal estate taxation of the death benefit
- Premium payments may use the gift tax annual exclusion
- Minimizes or avoids the generation-skipping transfer tax (GST) through use of the GST tax lifetime exemption
- Can create income tax-free wealth at insured's death
- Provides liquidity for a surviving spouse to do a Roth conversion after death of the first spouse

(REV 0221)

22-4351

HOW IT WORKS — DURING LIFE OF INSURED



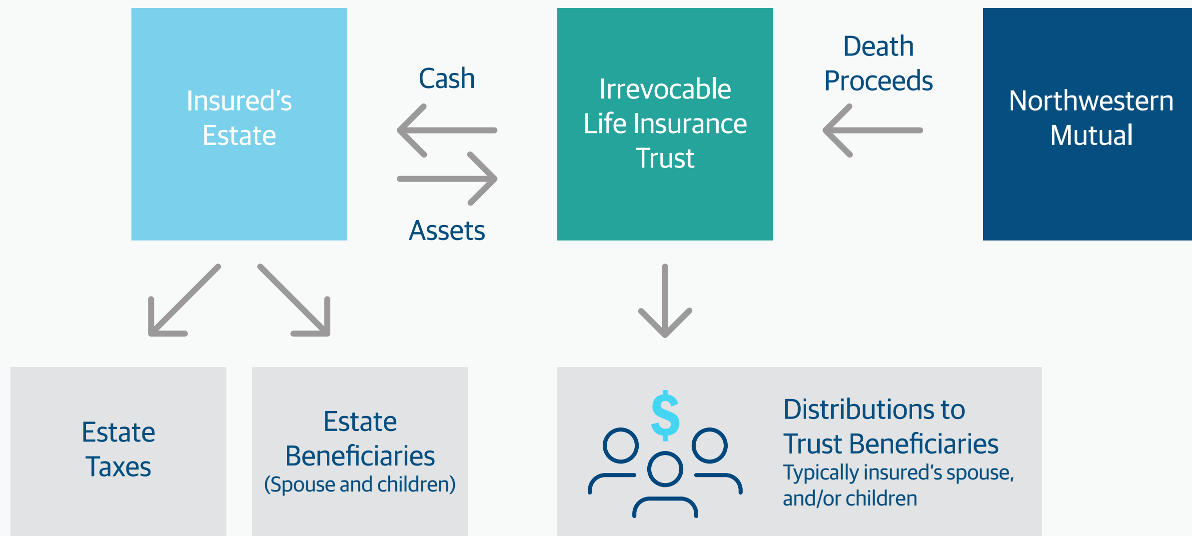
- During lifetime, the grantor-insured executes an irrevocable trust document that names as trustee the insured's spouse, adult child, or other third party such as a corporate trust company. The trust also names beneficiaries such as a spouse, children and/or grandchildren.

- The trust is the owner and beneficiary of a life insurance policy insuring the grantor or the grantor and spouse.

- The grantor can pay the premiums directly to the life insurance company or give the premiums to the trust, which would then pay the premiums to the life insurance company. Either way the premiums are considered gifts from the grantor to the trust beneficiaries.

- During the grantor's lifetime, the trustee can use the policy's accumulated value to make distributions to the trust beneficiaries (such as the spouse and children) according to the terms of the trust.

HOW IT WORKS — AFTER DEATH OF INSURED



- After the insured's death, the trustee receives the death proceeds on behalf of the trust.
- The proceeds are free of income tax and estate tax.
- The trust can buy assets from (or lend cash to) the insured's estate to provide the estate with cash to pay estate taxes and satisfy other liquidity needs.
- The trustee manages and invests the trust assets (cash or other property) for the beneficiaries, making distributions to them according to the terms of the trust.

Use permanent life insurance

Permanent life insurance should be considered an essential part of trust planning. By purchasing permanent life insurance on the grantor of the ILIT (and perhaps even on the spouse, children and grandchildren who are beneficiaries of the trust), trust assets can be passed down from generation to generation without transfer taxes. The death benefit can provide survivor income, create liquidity for an estate, preserve a family business, or fund a charitable bequest.

Placing the life insurance policy into the trust

- **Trust exists before policy issued.** After the trust is established, the trust applies for the policy and pays the premium.
  - This method avoids the insured having any "incidents of ownership" in the policy, thereby keeping the death proceeds out of his or her estate. Internal Revenue Code (I.R.C.) § 2042.
  - If the insured recently applied for a policy, the trust could apply for a new separate policy and use the same underwriting information that supported the first policy (at Northwestern Mutual, underwriting is good for six months). The insured might then cancel the first policy.
- **Policy issued before trust exists — transfer ownership.** The insured can transfer ownership of an existing policy to the trust by gift or sale.
  - If the insured gives the policy to the trust:
    - The policy's value is considered a gift to trust beneficiaries, which may fall within the annual exclusion or the lifetime gift exemption. The value of a policy can be obtained by requesting a Form 712 from the insurer, but it is ultimately up to the client's tax advisor to determine the policy's gift tax value.
    - The death proceeds paid to the trust will be in the insured's gross estate if the insured dies within three years after the gift (the "three-year rule" of I.R.C. § 2035).
  - If the insured sells the policy to the trust for adequate consideration, the three-year rule does not apply. I.R.C. § 2035(d). Nonetheless, there could be income tax effects due to the sale:
    - Generally, the insured/seller is income taxed on any amount received above policy cost basis, and the death proceeds are income taxed to the trust due to the "transfer for value" rule of I.R.C. § 101(a)(2) unless an exception applies (such as sale to a grantor trust where the insured is the grantor).
    - Both problems — current tax to insured/seller and income tax on death benefit under the transfer for value rule — are avoided if the trust is a "grantor trust" under I.R.C. §§ 671-679 with respect to the insured/seller. See Rev. Ruls. 85-13 and 2007-13.
  - A transfer can be a "part gift / part sale" if the insured transfers a policy to the trust with a loan on it. The transfer is treated as a part sale (equal to the loan amount) and part gift (the net accumulated value amount).
    - If the loan exceeds the insured's basis, the grantor is income taxed currently on that excess and the death proceeds will be income taxed per the transfer for value rule (unless an exception applies).
    - Both income tax results are avoided if (i) the loan is less than basis or (ii) the trust is a grantor trust. Even so, the net accumulated value would be considered a gift and the three-year rule would apply.

Paying premiums

- Trustee pays premiums. There are generally two methods for the trustee to pay premiums:
  - *Funded trust.* The trust holds assets in addition to the life insurance policy. The premium can be paid either from trust principal or income (e.g., trust holds stock in the family business and pays premium with dividends).
  - *Unfunded trust.* The trust holds only the policy. Typically, the insured gives cash to the trust as a gift as each premium is due.
- Insured pays premiums directly to insurance company. Each premium the insured pays directly to the insurance company is an indirect gift to the trust. Paying premiums does not create an incident of ownership. See Perry v. Comm'r, 927 F.2d 209 (5th Cir. 1991).
- Gift tax. When the insured makes gifts to the trust to pay premiums, or the insured pays premiums directly to the insurance company, the gift tax rules apply.
  - The annual exclusion of $15,000 (2021 figure) per year per donee is available as long as the donee — the trust beneficiary — has the right to immediately withdraw the amount of the gift, qualifying it as a gift of a "present interest." I.R.C. § 2503(b)(1). Because of a court case on this issue, this withdrawal right is known as the "Crummey power." Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).
  - If the insured gift splits with a spouse, the annual exclusion doubles to $30,000 per donee per year.
    - Gift splitting is necessary only if the gift is coming from the grantor-insured's separately owned property (versus a couple's joint or community property).
    - Fortunately, the spouse's act of gift splitting does not make the spouse a grantor to the trust for estate tax purposes. See Rev. Rul. 82-198 and Priv. Ltr. Rul. 200130030.
  - Gifts that exceed the annual exclusion do not trigger gift tax as long as the amount is less than the lifetime gift exemption amount, which is $11.7 million in 2021.
    - In 2021, with gift splitting, a grantor can give a trust $23.4 million in excess of annual exclusions and still pay no gift tax. This assumes the non-grantor spouse consenting to gift splitting is either (i) not a trust beneficiary or (ii) is a trust beneficiary but the portion of the gift to other parties (e.g., children) is ascertainable and severable from the portion going to the non-grantor spouse. See Rev. Rul. 56-439; and Treas. Reg. § 25.2513-1(b)(4).

Trust design and administration

- The grantor-insured should not be a trustee or trust beneficiary. To do so would risk estate inclusion. I.R.C. §§ 2036, 2038, and 2042.

- The grantor's spouse, however, may be trust beneficiary and/or trustee in certain situations:

  – Trust beneficiary. As long as the spouse is not a grantor, the spouse can be trust beneficiary, even if the spouse is one of the insureds on a second-to-die policy. See Priv. Ltr. Ruls. 97-48-020 and 96-02-010.

  – Trustee. A non-grantor spouse can also be trustee, as long as the policy is not a second-to-die policy that insures both the grantor and the spouse (neither insured should be trustee if the trust holds a second-to-die policy). See I.R.C. § 2042. Also, if the non-grantor spouse has ability to make distributions to him- or herself, this ability must be limited by ascertainable standards such as health, education, maintenance, and support. See I.R.C. § 2041.

- The grantor-insured's children and grandchildren (and others) can also be beneficiaries.

- The trust can be drafted flexibly, so that even while the insured is alive the trustee can withdraw from the policy's accumulated value to make distributions to trust beneficiaries (spouse or children). No distributions should be made that discharge the legal obligations of either the insured or the insured's spouse.

- Choosing a corporate trustee (rather than an individual trustee) is often wise, as this generally:

  – provides greater expertise in trustee administration and asset management.

  – avoids strains on family relationships that might arise if the trustee is related to the trust beneficiaries and is not making distributions as readily as the beneficiaries would like.

  – more clearly avoids estate inclusion issues for trust beneficiaries (e.g., non-grantor spouse) who might otherwise act as trustee.

This publication is not intended as legal or tax advice. This information is intended solely for the information and education of Northwestern Mutual financial representatives, their customers, and the legal and tax advisors with whom they work. It must not be used as a basis for legal or tax advice, and is not intended to be used and cannot be used to avoid any penalties that may be imposed on a taxpayer. Northwestern Mutual and its Financial Representatives do not give legal or tax advice. Taxpayers should seek advice regarding their particular circumstances from an independent tax advisor. Tax and other planning developments after the original date of publication may affect these discussions.

Northwestern Mutual is the marketing name for The Northwestern Mutual Life Insurance Company (NM), Milwaukee, WI (life and disability insurance, annuities, and life insurance with long term care benefits) and its subsidiaries.

Advanced Planning, January 2021

(REV 0221)