Irrevocable Life Insurance Trusts (ILIT)

ILITs are a much-underutilized tool in the estate planning arena. Only about two clients out of ten will have an ILIT, which means a good portion of the other eight will mostly be underinsured due to the fact that 50% of the life insurance proceeds will go to the government via estate taxes at death.

Life Insurance

Do you have enough? For the younger clients, overall we would say that the majority have too little life insurance in their estate plans. There is the need for life insurance when you are young to protect the family in case of an early death of the breadwinner. Many younger clients we get calls from have between $500,000-$1,000,000 in term life insurance. (We typically advise against whole, universal, and, most certainly, variable life for younger clients).

The question we pose to each younger client is: Do you have enough life insurance so that, if you die in the near future, your spouse does not have to go back to work (if the spouse is a homemaker) and will your children (if any) have enough money to pay for their living and educational expenses until they get through college? The answer 90% of the time is that the client does not have enough life insurance to pay for that noble goal.

While the clients will be dead and will not have to worry about what is left behind, most clients intend to take care of their families as if the clients had not died. That is usually not possible with $500,000-$1,000,000 worth of insurance.

How much is right for you? Without talking with you, we have no idea; but any decent insurance agent (one whom you can trust) should be able to tell you how much insurance you need taking into account all the debts of the family and the needs ongoing after a premature death of the breadwinner. At a minimum, most younger clients will need at least 2 million dollars of life insurance.

For those older clients, they too are usually underinsured due to the fact that almost all high net worth clients over the age of 50 have estate tax problems. You can either 1) gift assets away; 2) have your heirs pay 50% estate taxes on the assets above $2,000,000 in your estate (assuming you were married and properly used your A&B marital trusts to minimize estate taxes), or 3) you can purchase life insurance to pay for those estate taxes. For clients with estates over $5,000,000, it is easy to justify the purchase of 2-3 million dollars of death benefit for estate planning.

Income tax free death benefit

As you are probably aware, life insurance death benefits pass to beneficiaries Income Tax Free. That is one of the wonderful things about life insurance. (Let's also not forget that any death benefit can pass to your spouse income and estate tax free). Unfortunately, unless you are giving the entire death benefit to your spouse, there will be estate taxes due on your life insurance death benefits unless the life insurance policy is owned by an irrevocable life insurance trust (ILIT).

Estate tax free death benefit

As we indicated above, death benefits will pass to your spouse income and estate tax free. That is why many people think that there is little need for an ILIT. However, ask yourself what happens if your spouse, who lived on after your death, happened to die the next day, or the next year, or within five years. That is where good planning really pays off.

We spell out for clients the problem of passing the entire death benefit to the living spouse and, typically, they agree that they are, in fact, underinsured. That living spouse many times will not be able to spend down the estate before he/she dies, and the life insurance benefit that passed to the living spouse will get zapped with estate taxes anyway. Careful budgeting is needed to determine how much, if any, of the death benefit should be given to the surviving spouse.

Many times the surviving spouse will only need a fraction of the death benefit because the rest of the estate is already several million dollars, of which hundreds of thousands are liquid IRA/401(k) money or stocks, which the spouse can live on until death.

We would prefer to set up an ILIT and have the death benefit poured into the ILIT at the death of the breadwinning client. The ILIT will, typically, have the children as the beneficiaries and have special language in it not to give the children the money until the second spouse dies (where the death benefit can be used to pay estate taxes, if needed). The special language of the trust will allow the trustee to provide for the well being of the surviving spouse, if needed, so that, even though the ultimate beneficiary may be the children, if the spouse needs money to keep up her lifestyle, the trustee can take money out of the ILIT to fund such needs.

With the special language, you have accomplished all your goals of having the entire death benefit of your life policy pass to your children or a living benefit to your spouse while living.

ILIT has to own the policy

In order for the death benefit to pass income and estate tax free, the ILIT needs to be the owner of the policy and should also pay the premiums for the policy. Many times we will see that an ILIT is set up and is either not the owner of a policy or not paying the premiums of the policy.

The proper way to fund a policy in an ILIT is as follows:

1) Set up the ILIT;

2) Gift money to the ILIT for the first year's premium (and every year thereafter);

3) Send crummy powers to the heirs to complete the gift to the ILIT.

4) Have the ILIT set up a bank account;

5) Have the ILIT pay the premium on the policy it owns from the ILIT's own bank account. Funding a policy in an ILIT any other way is simply wrong.

Conclusion

ILITs are not necessarily needed for the younger client with a small estate (although keep in mind that, if you have a 2-million-dollar life policy and if you have any other assets, your estate is already over the cap where estate taxes will come into play).

If you have an estate of more then $2,000,000 (usually closer to $3,000,000 and up (which includes any life insurance)), then you should consider having an ILIT.

If you are 45 years and older with a large estate and you think you have enough life insurance, make sure you get your calculator out and see if you really have 50% too little life insurance due to the fact that 50% of the life insurance could go to the government via estate taxes.

No one likes insurance, but it is vitally important to your heirs that you have not only the right amount of life insurance but have the insurance owned by the right entity (which for many clients is an ILIT).

We advocate that you purchase a will at your earliest convenience.

To purchase a will by a pre-certified attorney, please contact us and we will help facilitate the process.