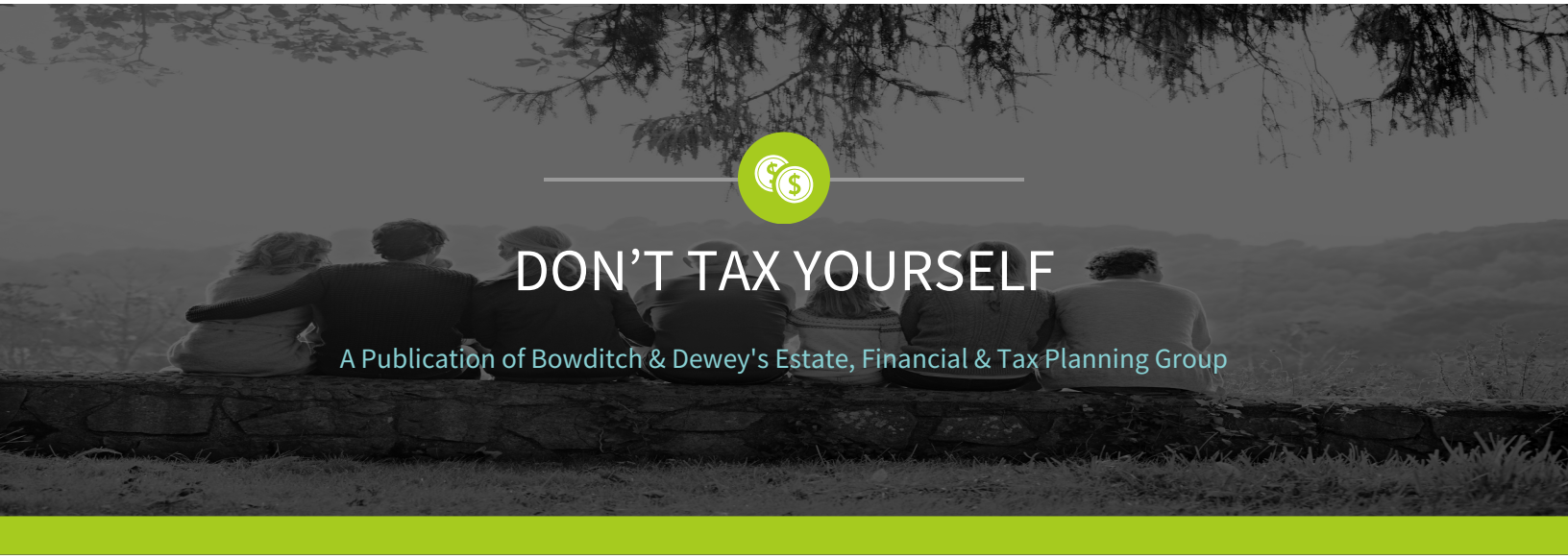

DON'T TAX YOURSELF

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Estate Planning: The Irrevocable Life Insurance Trust

BY EILEEN Y. LEE BREGER • MARCH 28, 2024

This post has been updated as of March 28, 2024, to reflect changes to the Massachusetts estate tax exemption and gift tax exclusion.

There is a common misconception that life insurance benefits are not subject to estate tax. While the proceeds of a life insurance policy are not taxable income to the beneficiaries, they are part of a person's taxable estate if the insured dies owning the policy. The threshold for Massachusetts estate tax is $2 million, which means that many families will need to consider estate tax planning.

As part of an overall estate planning strategy, an irrevocable life insurance trust (ILIT) can be used to remove life insurance proceeds from a donor's taxable estate. The donor must survive for three years after transferring the policy to the trust to exclude the proceeds from his or her estate for estate tax purposes. The donor should not be the trustee and should not retain any economic benefits of the policy (e.g., the power to change beneficiaries, cancel or surrender the policy, assign the policy, etc.)

If the donor is married, the surviving spouse can be a trustee, but in most circumstances the spouse should not be the sole trustee. A family member or professional trustee can serve as co-trustee with the spouse. The terms of the ILIT provide for distribution of funds to beneficiaries or can be linked to another trust, such as a revocable trust or a special needs trust. An ILIT can also offer a level of asset protection to beneficiaries from their creditors.

The ILIT pays policy premiums through gifts to the trust. These gifts do not qualify for the current $18,000 (2024) annual gift tax exclusion unless the beneficiaries of the trust are given "Crummey" powers, which is a right to withdraw the gift to the trust for a period of time. In a properly administered ILIT, the trustee should be sending "Crummey" notices to beneficiaries informing them of their withdrawal right when there is a contribution to the trust.

An ILIT can be funded with term insurance or permanent insurance that lasts for the insured's lifetime. Permanent insurance builds a cash value over time. In order to pass the proceeds outside of the donor's taxable estate, the donor

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cannot access or borrow against the cash value of the policy once the life insurance policy is transferred to the ILIT, but the donor could indirectly benefit from the cash value through his or her spouse, who is a beneficiary of the ILIT.

An ILIT can be established by a married couple and funded with a second-to-die policy. A second-to-die policy pays out on the surviving spouse's death and traditionally is a source of liquidity to pay estate taxes on illiquid assets such as property or businesses, or used to fund a special needs trust.

Does creating an ILIT make sense for you as part of your estate planning strategy? Please contact Bowditch & Dewey.

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