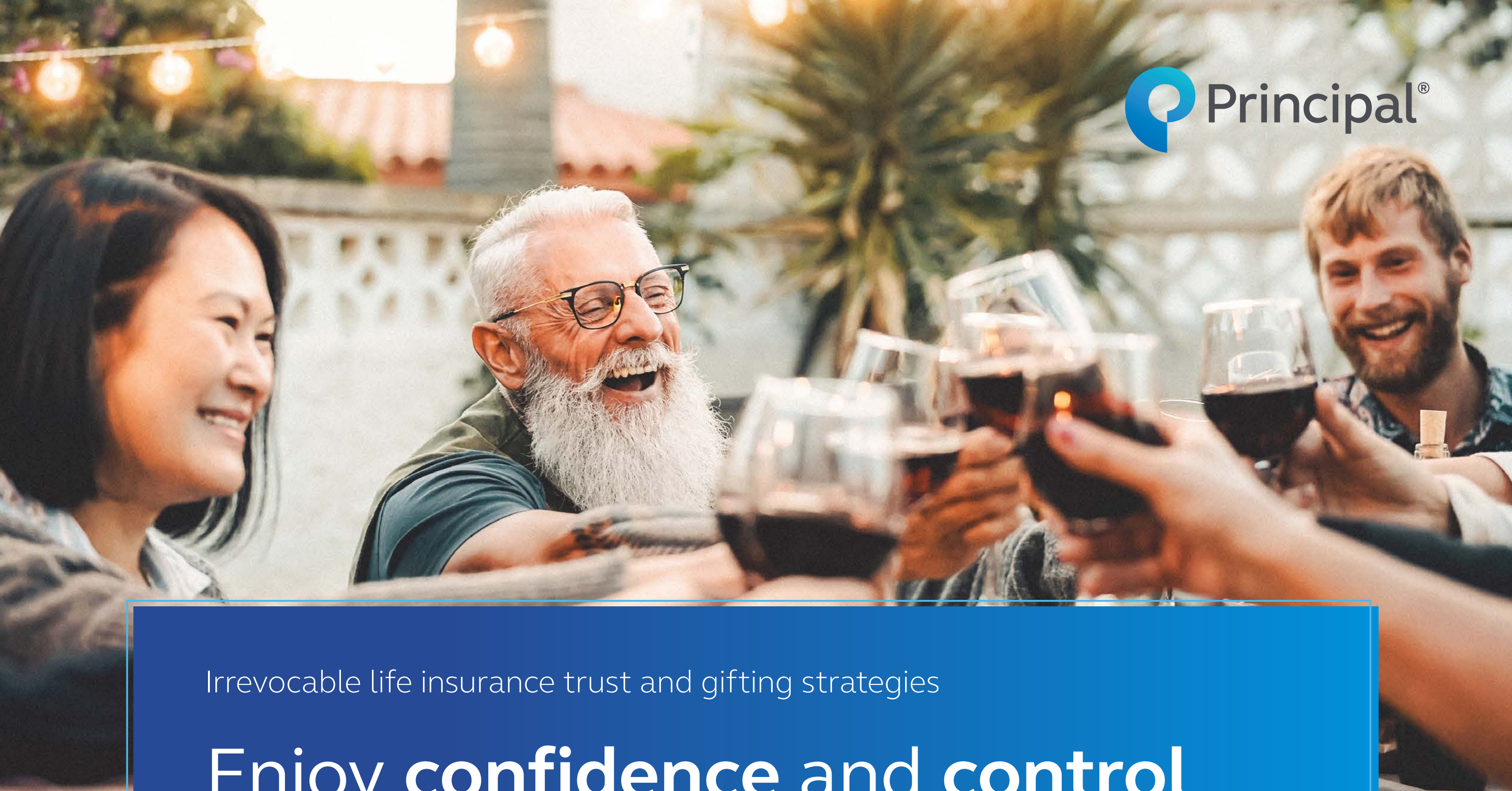


Irrevocable life insurance trust and gifting strategies

Enjoy **confidence** and **control** in your estate plan.

Have you thought about the legacy you'd like to leave?

By planning now, you can help ensure your estate goals are met when the time comes. You can also address important issues, such as:

Who
you want to benefit from your estate

What
your goals are for distributing your assets

How
to minimize the impact of taxes

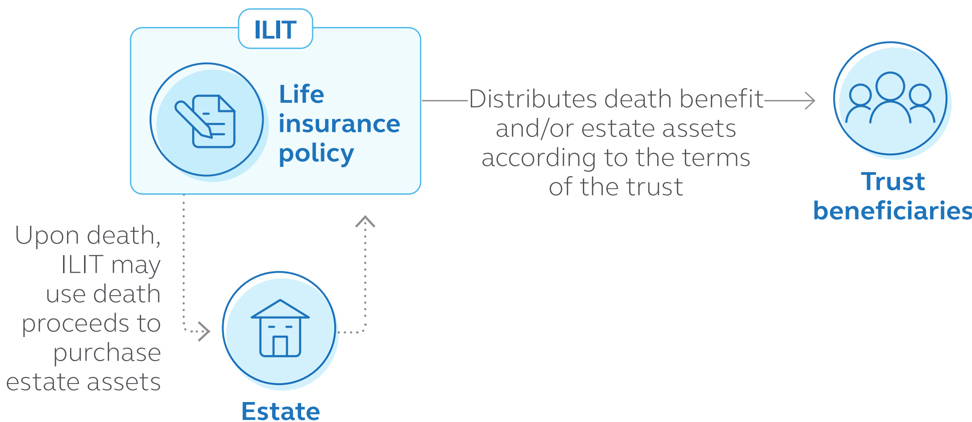
An irrevocable life insurance trust may help protect your estate.

People with estates of all sizes share this common concern: making sure their family receives the full benefit of their lifetime's work. However, those with larger estates, potentially subject to the federal estate tax, have the added concern of the effect of the tax on their legacy. An irrevocable life insurance trust (ILIT) can address this issue. It can help you do the following:

- Meet the liquidity needs of your estate.
- Generate income for your family members.
- Avoid estate taxation of the death proceeds.
- Provide creditor protection of your property.

How an ILIT works

- As the grantor, you establish the ILIT and gift cash or assets to the trust.
- Generally, the trust then purchases, pays for, and is the owner and beneficiary of an insurance policy on you, or you and your spouse.
- Upon death, the trust receives the life insurance death proceeds.
- Typically, the trustee uses the proceeds to purchase assets from your estate, or lend money to the estate. This helps assure your estate will have cash to pay the taxes.
- The trust distributes any assets to the beneficiaries according to your wishes.



What does it all mean?

Let's start with defining some of these terms:

Grantor. The person/people who create the trust.

Irrevocable. When a trust is irrevocable, it means it's final and generally can't be changed. You give up rights to the property transferred to the trust.

Trust beneficiaries. The people you want to receive the benefits paid from the trust. In most instances, your beneficiaries are family members—your spouse (if not a co-grantor), children, grandchildren, and perhaps their spouses.

Trustee. The person or firm you select to administer and carry out the terms of the trust.

How an ILIT helps protect your estate

An ILIT can provide liquidity to pay final expenses without subjecting the money to estate or inheritance tax. Using spendthrift and other clauses, it can protect your estate from claims by future creditors, or divorcing spouses of trust beneficiaries. However, the most important benefit of an ILIT is that it can help address potential tax concerns.

Here are the transfer taxes that could affect what's available to your loved ones and how an ILIT can make a difference:

Estate tax

An ILIT can help you exclude life insurance proceeds.

Generally, when you're the owner and the insured of a life insurance policy, the death benefit proceeds paid are included in your estate for federal estate tax purposes. But, a properly drafted ILIT can exclude these proceeds from the federal estate tax calculation for you and your spouse.

There are a few guidelines, however, that need to be followed to keep the life insurance proceeds estate tax-free. The grantor (or grantors) to the trust:

- Can't be the owner or indirect owner of the life insurance policy;
- Can't have any direct control over operation of the trust; and
- Can't receive any benefit from trust assets.

What else you should know:

- If you're already insured on a life insurance policy, it can be transferred to your ILIT as a gift. To avoid proceeds being taxed in your estate, you must live at least three years after the transfer (three-year rule). This same method can be used for both an individual and survivorship life policy.
- An alternative to gifting the policy is to sell it to the ILIT for its fair market value. This helps avoid the three-year rule, as long as certain requirements are met. And if the ILIT is a grantor trust with respect to the insured for income tax purposes, sale of the policy to the ILIT won't violate the transfer for value rule.

Gift tax

An ILIT can help you make the most of annual exclusion gifts.

Cash gifts you make to the ILIT are generally one of two types.

1 | Annual exclusion gifts

These allow you to make an annual gift to the ILIT of up to $19,000 in 2025 ($18,000 in 2024) without paying gift tax. (The annual exclusion gift is limited to $19,000 per recipient, which would include all gifts you give to that person.) Annual exclusion gifts aren't subject to gift tax, and generally don't require filing a gift tax return. You typically can make the same number of annual exclusion gifts as the number of ILIT beneficiaries.

In order for a gift to qualify for the gift tax annual exclusion, the gift must provide trust beneficiaries with a present interest in the transferred property. This generally is accomplished by trust beneficiaries having the right to withdraw their share of the contribution (known as a "Crummey power," named after a court case in which the taxpayer's last name was Crummey).

Any gifts in excess of the annual exclusion amount will be applied to the lifetime gift tax exemption. Annual exclusion gifts and appreciation of any gifts are generally removed from the donor's taxable estate.

2 | Taxable gifts

Any gifts in excess of the annual exclusion amount are considered taxable gifts and will be applied to reduce the lifetime gift tax exemption of $13,990,000 in 2025 ($13,610,000 in 2024)[1]. Generally, you and your spouse may **each** make gifts up to this amount without paying any gift tax. Any gifts above that require the payment of gift tax.

Taxable gifts also simultaneously reduce the estate tax exemption of $13,990,000 in 2025 ($13,610,000 in 2024). The result is the appreciation of taxable gifts isn't estate taxed.

Annual exclusion gifts you make to the ILIT to pay for life insurance typically amount to much less than the value of the death benefit they purchase. So, you may be able to turn these smaller gifts into greater trust assets at death. Plus, taking advantage of the annual exclusion gifts available to you reduces your taxable estate.

Income tax

An ILIT can help you be strategic with income tax.

With life insurance being the most commonly used asset inside the ILIT, any cash value accumulation growth is tax-deferred and no annual income tax will be payable.

What else you should know:

- Giving income-producing assets into the trust permits the trust to use income from those assets to pay life insurance premiums, lessening the need of the grantor to make gifts to the trust to pay premiums in future years.
- If your ILIT is a grantor trust for income tax purposes, any trust income is reportable on your personal income tax return. This helps senior generations pay any income tax relating to assets in the trust that ultimately belong to later generations without being deemed to make additional gifts to those later generations.
- If your ILIT is not a grantor trust for income tax purposes, it will need a tax ID number and must pay its own income tax. The income tax rates on trusts are generally higher than those applying to individuals.
- When done properly, a life insurance policy owned by an ILIT can generally be exchanged for a new policy without incurring a current tax liability.

Generation-skipping transfer tax

An ILIT can help you plan transfers through multiple generations.

A generation-skipping transfer (GST) tax is imposed on transfers of assets to those who are two or more generations removed from you. This would include your grandchildren, great-grandchildren, and other similar relatives. Both you and your spouse each have a GST tax exemption of $13,990,000 in 2025 ($13,610,000 in 2024)[1], which can be used for transfers during your life and at death.

A common strategy used to minimize any GST tax is to allocate the GST exemption to gifts to the ILIT (that are in turn used to make premium payments for ILIT-owned life insurance).

[1] The exemption amount is scheduled to sunset after 2025 and revert to its 2017 numbers, adjusted for inflation, effectively cutting the exemption in half.

Factors to consider with an ILIT

As you consider implementing an ILIT, here are some things to keep in mind:

It's irrevocable. It's difficult to amend the trust if the situation or your wishes change. Also, you can't access any cash value from the life insurance policy or use it as collateral. You should make sure the benefits outweigh this inflexibility.

It can be complex. Strategies that deal with tax law are often complex, and an ILIT is no exception. It's possible that an advantage provided by one area of tax law could result in an unintended disadvantage in another area. Therefore, it's important to to consult your tax and legal advisors.

It may require alternative financing. If available gift tax annual exclusions aren't enough to pay for the ILIT-owned life insurance, you may need different strategies to pay for the coverage.

It may require extra administration. In addition to directing premium payments through a trust bank account, when "Crummey" powers are included, you'll generally also need administrative services to manage annual "Crummey" notices.

It comes with a cost. Applicable attorney and trustee fees should be considered.

An ILIT serves many purposes in wealth transfer planning and may offer flexibility that can be customized to your unique situation.

Leave more with gifting and buying life insurance.

Using an ILIT as part of a gifting strategy can increase the amount you leave for your loved ones and provide more liquidity for the estate. Let's see how it can work in an example:

Pat and Chris have a $50 million estate. They're considering making a $10 million gift of an appreciating asset (real estate or a business, for example). Here are three possible decisions they might make:

- **Do nothing.** The **assets and all future appreciation are included** in their taxable estate.
- **Gift an appreciating asset to heirs today.** The **appreciation of the assets is removed** from the taxable estate. If the value of the gifted assets fits within the annual exclusion, those assets' values are removed from the taxable estate too.
- **Gift cash or an asset to an ILIT and purchase life insurance.** Again, the **value of annual exclusion gifts and their appreciation is removed** from the taxable estate, and the appreciation of taxable gifts is removed from the taxable estate. The life insurance death benefit not only can be ample "appreciation" (to the extent it exceeds the cumulative premiums), the fact that it's not income taxed makes it similar to receiving a step-up in basis despite not being in the estate.

Let's review the impact of gifting to a trust: assets that appreciate, versus gifting those same assets but using some of the assets to purchase life insurance.

Gifting illustration[2]

Year	$10 million gift to heirs		$10 million gift to an ILIT and purchase life insurance		
	Total trust assets after 5% growth[3]	Benefit to heirs	Total trust assets after premium & 5% growth[3]	Life insurance death benefit[4]	Benefit to heirs (assets + insurance)
5	$12,762,816	$12,762,816	$12,435,240	$5,000,000	$17,435,240
10	$16,288,946	$16,288,946	$15,543,291	$5,000,000	$20,543,291
15	$20,789,282	$20,789,282	$19,510,040	$5,000,000	$24,510,040
20	$26,532,977	$26,532,977	$24,572,728	$5,000,000	$29,572,728
25	$33,863,549	$33,863,549	$31,034,144	$5,000,000	$36,034,144

[2] In both instances, assume the $10 million gift is taxable but is completely covered by the gift tax exemption.

[3] Pre-discounted value of assets transferred to the trust is $10 million. Growth rates in this presentation aren't guaranteed, and actual results may be more or less favorable.

[4] $5 million death benefit is based on a male, age 60 Preferred Non-Tobacco, and a female, age 60. An annual premium of $56,460 is paid for 39 years and guarantees coverage to female's age 100.

What you need to know about lifetime gifting

Here are some things to keep in mind:

Gifts generally can't be recovered by the grantor. You must give up complete control of the asset and any income it provides.

There's no adjustment in basis for lifetime gifts. Only assets in the estate receive a basis adjustment to date-of-death value (step-up in basis). This means beneficiaries who receive an appreciated asset will have the same cost basis in the asset as the donor (you) did. This may result in a greater amount of capital gain tax for the beneficiary when the asset is sold. However, life insurance proceeds are received income tax-free, so this is similar to receiving a step-up in basis even though the proceeds are in an irrevocable trust and not estate taxed.

Gifts and estate taxes are unified. The value of annual exclusion gifts to an ILIT, and their appreciation, escape both gift and estate tax. The value of taxable gifts is effectively estate taxed (due to their simultaneous reduction of the unified gift and estate tax exemption) but the post-gift appreciation and income of taxable gifts escape estate tax.

Gifting opportunities before sunset at end of 2025. Under current law, the gift and estate tax exemptions are set to be cut in half when 2026 begins. This "sunsetting" of the current exemptions basically means that a married couple can give away about $14 million more in 2025 than they can in 2026 (or after) without triggering additional gift or estate taxes. This presents a limited and valuable opportunity to make substantial gifts to loved ones.

Lifetime gifting strategies offer a tax-efficient way to transfer wealth. And when you use gifts for ILIT-owned life insurance, you can provide greater liquidity and enhanced gift value to your estate.

The role of the trustee

Each trust has a trustee. This is a person or institution you choose to carry out the objectives and follow the terms of your trust. Because of the importance of the role, you want it to be someone you have confidence in. The trustee shouldn't be a grantor to the trust and shouldn't be an insured on the policy in the trust. Some of the characteristics you should look for in a trustee are:

- Competence
- Availability
- Ability to act as a fiduciary for the beneficiaries of the trust
- Experience as a trustee or good business knowledge
- Impartiality, with no conflict of interest
- Willingness to do it

A trustee is generally a family member, friend, business associate, private investment advisor, attorney, accountant, corporate trustee, or a combination of these. You should also name a successor trustee in case your trustee becomes unable to perform the duties.

8 steps to help protect your estate

Once you decide an ILIT is right for you and your family, here are the steps to gain confidence and control in your estate plan. Your financial professional will help you along the way.

1 | The attorney **drafts an ILIT** that gives the trustee the authority to purchase life insurance on you, or you and your spouse.

2 | You open a **non-interest-bearing trust account** and secure a tax ID number.

3 | You and your financial professional select the **Principal® life insurance policy** that works best for your situation. The trustee applies for the policy with the trust as the initial owner and beneficiary. You, and your spouse if it's a survivorship policy, will be the insured(s).

4 | **Underwriting** takes place as part of the application process, and may require you to take a medical exam.

5 | You make **gifts** to the trust.

6 | The trustee sends **"Crummey" notices** to the beneficiaries to inform them of the gifts and that they have a certain time (generally 30 days) during which they can withdraw their share of the gift.

7 | After the **right of withdrawal period** has expired, the trustee pays the premium.

8 | The trustee gains access to **policy details** at **principal.com** to effectively manage the policy and meet the objectives of the trust.

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