Irrevocable life insurance trust

Rethinking your ILIT in times of change

Establishing an irrevocable life insurance trust (ILIT) is a commonly used strategy in estate planning. It's a popular way to keep assets out of your taxable estate, while allowing them to be passed on to your family. And life insurance used in an ILIT offers liquidity and flexibility that can be helpful in common planning situations such as when you have a business, a need for estate equalization, a blended family, noncitizen heirs, a family member with special needs, or other unique circumstances.

But sometimes situations change

Many things could cause you, as the trust grantor, to rethink the need for your ILIT. And, since an ILIT is irrevocable—or final and binding—certain rights over the trust assets must be surrendered for the assets to be removed from your estate. The trustee controls them, but has a legal responsibility to follow the terms of the trust document and act in the best interest of the beneficiaries.

In times of change, the irrevocable nature of an ILIT may seem challenging. And, there may be benefits to retaining your ILIT that you might want to think about.

Benefits to maintaining your ILIT

Before taking action on your trust, review the benefits it could provide, such as:

- Protection in the event of future changes to the estate tax
- Creditor protection
- Providing care for a beneficiary with special needs
- Oversight of assets for beneficiaries

If you still have a need for these types of benefits, your current ILIT may still make sense.

Options if you need to eliminate or replace the trust

SCENARIO 1: The ILIT owns term insurance and your health is good. It may be relatively simple to start over. The old policy could be discontinued, a new one purchased[1], and a new trust set up, if desired. The new policy could be owned either individually or in a new ILIT.

SCENARIO 2: The ILIT owns cash-value life insurance and/or your health has declined.

There are **four common options** you might consider.

1 You, or a new trust, buy the policy from the existing ILIT.

This may be helpful if you want to preserve the policy and have the liquidity to purchase it. One option is for you to buy the policy for its fair market value, and you may then gift it to a new trust. Another option is for you to gift money to a new trust to have it purchase the policy from the old ILIT. With any change of ownership, it's important to consider the transfer for value rule,[2] the three-year rule,[3] and any taxable gain in the policy.

2 The trustee distributes the trust assets.

Depending on the ILIT terms, the Trustee may be able to distribute the cash values or the policy itself to the beneficiaries. They could keep the assets or, if they all agree, the assets could be gifted back to you. Here, it's important to consider beneficiary cooperation and any creditor or spouse-related concerns.

3 The trustee makes a loan to you.

The trustee may be able to access policy cash values for a loan. This may be a good option if you don't have the current liquidity to buy the policy or don't want to rely on gifts from the ILIT beneficiaries. Interest on the loan and your financial circumstances should be considered.

4 Decanting might be a possibility.

Decanting involves transferring the policy to another trust, which could have different terms. This could be a solution if you want to keep the assets intact, but change the trust terms, the trustee, the location of the trust, or certain other characteristics. Decanting laws vary by state, and not all states have them, so it's important that you work with a local attorney familiar with decanting provisions in your state.

While you might have ILIT regrets, review the original purpose for the ILIT and consider the pros and cons before making potential changes. Then, work with your tax advisor to decide which one might be the best for your circumstances, based on your trust terms and state laws.

[1] Keep in mind that you may need to go through medical underwriting in order to get a new policy. And the underwriting risk classification offered for the new policy may be more or less favorable than your classification on the prior policy.

[2] IRC Sec. 101(a)(2)(B).

[3] IRC Sec. 2035(a).

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