Estate Planning
Practical Solutions to Common Issues

I'm Buying Life Insurance; Do I Really Need A Trust And If So What Kind?

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Introduction and Overview

A client is buying life insurance, do they really need to set up an irrevocable life insurance trust ("ILIT") to own that insurance?

This is a common situation encountered by practitioners, and as with so many aspects of estate planning the answer is more nuanced, than many may anticipate. This creates opportunities for practitioners in all disciplines to provide value-added advice to clients on this and ancillary issues. On the threshold issue of who should own the insurance, the answer is more complex than the binary choice between using an insurance trust or having the individual insured own the policy directly. Another overly simplistic and common mistake is to assume that the only reason to use a trust is to mitigate estate taxes.

With high federal estate tax exemptions, do most clients need to consider ILITs in the first place? Is this discussion even relevant for most clients?

Absolutely! The question itself is misleading, as it implies somewhat that avoiding federal estate tax is the only reason to have insurance held in an ILIT. It is true that, for many decades, the relatively low estate tax exemptions made the use of ILITs standard planning for anyone purchasing even a moderate sized life insurance policy, even if the policy was only term. Low exemptions made the analysis rather simple and led to the conclusion that an ILIT was the right answer in many situations.

While the current high exemption amounts have made the analysis somewhat more complicated, the right answer for most clients will be to use some type of irrevocable trust to hold life insurance policies. These days, the type of trust and plan involved should likely differ in important and valuable ways from traditional life insurance trust planning.

The discussion following will review many of the pros and cons of having a trust own life insurance and why trust ownership of life insurance continues to be advantageous for at least a few reasons:

1. Consider that the estate tax exemption declines in 2026 by half, as a matter of current federal law.
2. Clients who reside in a state with an estate or inheritance tax may face death taxes on personally owed life insurance even if the estate is not otherwise subject to a federal estate tax. For some clients, an ILIT might be useful to mitigate future federal estate taxes or state estate or inheritance taxes.
3. For clients with no foreseeable federal or state estate or inheritance tax exposure, an ILIT may be prudent to protect the death proceeds for the benefit of intended beneficiaries. Asset protection remains a critical reason to protect insurance proceeds with ILITs.

Possible Ways to Own Life Insurance

There are many possible ways for a client to structure the ownership of life insurance. Practitioners might review, as appropriate, several of these options with a client buying new or reviewing existing insurance coverage:

1. ***Client owns coverage***. The client could own insurance themselves.
    a. Tax considerations. The policy death benefit will be included in the insured's estate but if the insured resides in a state with no death taxes, and if the insured's estate is below the estate tax exemption even after possible reduction by half in 2026, there may be no relevant estate tax consequence. This analysis is overly simplistic and is likely inadequate for most clients.
    b. Asset protection. There is no asset protection when the policy is owned directly by the insured. Even if an insurance policy is a term policy that may have only a modest value (unamortized premium), the death benefit is still important to protect. The insured's creditor could bring a claim against the insured and attach the insurance policy to collect on the debt, leaving the insured's family without access to the death benefits. Simplistic outright ownership approach is not likely adequate in many cases.
    c. Flexibility. Owning the policy directly provides the most flexibility as to what can be done with the policy as the owner/insured can do whatever they wish with it. However, if the insured were to become incapacitated, they will have to rely on an agent under a power of attorney to act on behalf of any policy decisions. It may be advantageous in most instances to have the structure of succession a trust provides.
    d. Complexity. None, this is the simplest option.
    e. Comment. If the policy has a long-term care feature, the most preferable option may very well be for the insured to own the policy directly. It may not be practical to have a policy with a long-term care feature owned by an irrevocable trust and still get the desired benefit to the insured.
2. ***Client Owns Policy But Names Trust under Will or Revocable Trust as Beneficiary***. The client may have a revocable trust or might create one as part of their estate plan, and that trust could them own the life insurance on the client's life. Alternatively, the client may own the policy but name a trust, e.g., the common family or credit shelter type trust created under a will, as beneficiary.
    a. Tax considerations. The policy death benefit will be included in the insured's estate but if the insured resides in a state with no death taxes, and if the insured's estate is below the estate tax exemption even after possible reduction by half in 2026, there may be no relevant estate tax consequence.
    b. Asset protection. There is no protection when the policy is owned by the insured and the proceeds may be reached if the insured dies and is subject to a claim. This is a very important nuance that many clients overlook when opting for simpler/cheaper cost approaches. For example, if the insured dies in a car accident, a lawsuit from that accident could reach the policy proceeds that are essential to protect family. If there are no such claims and the beneficiary designation result in the proceeds flowing into a trust formed under the insured's will or revocable trust, the proceeds may be protected thereafter.
    c. Flexibility. Having the client own the policy provides the most flexibility as to what can be done with the policy as the owner/insured can do whatever they wish.
    d. Complexity. Little should be necessary as all that would be required would be to name a specified trust under the client's will or revocable trust as beneficiary. But that may be an understatement of the situation. If the client/insured ever changes their will or revocable trust, the beneficiary designation should likely be updated. Otherwise, policy proceeds might be payable to a trust that no longer exists and possibly result in the policy by default of the beneficiary designation merely being paid to the default

beneficiary under the policy terms. Will insureds remember to update beneficiary designations to reflect revisions to their estate plan?

e. Comment. For a client with a low risk profile who wishes to protect insurance proceeds for heirs without the costs of setting up an ILIT, naming a revocable or testamentary trust as a beneficiary could present a viable option. In such circumstances, the client should understand that a claim against his or her estate could decimate coverage and that ongoing monitoring when estate planning documents are updated may be necessary. Perhaps the modest cost of a simple home state ILIT, versus a more complex irrevocable trust, may be worthwhile to minimize these risks.

3. ***Client Revocable Trust owns coverage***. The client may have a revocable trust or might create one as part of their estate plan, and that trust could them own the life insurance on the client's life.
    a. Tax considerations. The policy death benefit will be included in the insured's estate but if the insured resides in a state with no death taxes, and if the insured's estate is well below the estate tax exemption even after possible reduction by half in 2026, there may be no relevant estate tax consequence. Depending on the size of the estate, the trajectory of growth possibilities for the estate, etc. that may be an acceptable risk for the client to take.
    b. Asset protection. There is no protection when the policy is owned by the insured's revocable trust. A claim against the insured's estate may reach these proceeds. However, protection may be afforded to the proceeds for the heirs after being paid to a trust formed under the revocable trust.
    c. Flexibility. Having the client's revocable trust own the policy provides, it would seem, about the same the most flexibility as to what can be done with the policy as the owner/insured can do whatever they wish.
    d. Complexity. Little as all that would be required would be to have the revocable trusts named owner and beneficiary. There may be little difference in having the client/insured own the policy and just name the revocable trust beneficiary so that the death benefit pays into the trusts provided under the revocable trust. However, having the revocable trust as owner should avoid probate and may provide a more efficient mechanism to manage the policy during disability then if the client owned the policy directly in which case the agent under the client's durable power of attorney would have to act to make any change to the policy.
    e. Comment. For a client with a low risk profile who wishes to protect insurance proceeds for heirs without the costs of setting up an ILIT, naming a revocable or testamentary trust as a beneficiary could present a viable option.
4. ***Traditional ILIT formed by client owns coverage***. The client could form a traditional life insurance trust to own insurance. This historically had been common advice. Now, with much higher estate tax exemptions, clients without an estate tax exposure often do not pursue this option. Traditional ILITs with simplistic trust terms (e.g. spouse as sole trustee, payout to heirs at some specified age like 30, etc.) are often inadequate. At minimum, a more robust "modern" trust drafting approach should be considered. That approach need not add significant cost to the preparation of the trust document.
    a. Tax considerations. The policy death benefit should not be included in the insured's estate. Be cautious about the three-year rule. Sometimes insurance policies are sold to the insured and thereafter transferred to the ILIT. In such events the insured must survive for three years or the proceeds will be included in their estate. A marital savings

clause could be included in the ILIT or if feasible, the policy should preferably be purchased directly by the ILIT from inception. If trust income can be used, directly or indirectly, to benefit the grantor, the grantor will be treated as the owner of the trust. IRC Sec. 677. This includes the application of income to pay premiums on life insurance policies insuring the life of the grantor or the grantor's spouse. IRC Sec. 677(a); Treas. Reg. Sec. 1.677(a)-1. Specifically, the grantor is deemed the owner of any portion of the trust or the trust income which can be used (without the consent of an adverse party) to pay premiums on life insurance policies. IRC Sec. 677(a)(3). Prior cases, under a predecessor statute, held that the grantor was only taxable on trust income actually used to pay premiums. Rand v. Comr., 40 B.T.A. 233 (1939), acq., 1939-2 C.B. 30, aff'd, 116 F.2nd 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941). The IRS has held that if trust income is used to purchase life insurance even in contradiction of the terms of the trust, the trust wills still be characterized as a grantor trust. PLR 8839008.

Crummey powers may create an issue of having other grantor's (i.e., those persons holding Crummey powers). However, in PLR 200603040 IRS said grantor trust rules override Crummey rules and 678 issue people were concerned about is not a problem so you can have Crummey powers in these trusts.

b. Asset protection. There should be an additional measure of protection when the policy is owned in trust rather than directly by the insured. If the insured has a particularly worrisome liability exposure, an insurance trust could have situs in a trust friendly jurisdiction that may provide significant asset protection over a high cash value policy with a large death benefit.
c. Flexibility. Owning the policy in a traditional ILIT provides less flexibility than when the insured owns the policy directly. However, the offsetting benefits of using a trust versus direct ownership should make the loss of flexibility worthwhile.
d. Complexity. Creating a non-grantor trust, funding annually with annual gifts and having the trustee issue Crummey powers, possible gift tax reporting, for larger plans more complex funding mechanisms, all add complexity and cost to the process. Too often many or even most of these formalities and steps are not addressed properly, or not at all, creating potentially further costs, complications and risks that could unravel the intended benefits of the plan.
e. Comment. For many clients creating a traditional ILIT was a worthwhile endeavor. Practitioners should review all traditional ILITs and endeavor to confirm that they have been operated as set forth in the trust instrument, that the insurance policy reflects the trust correctly as owner and beneficiary with current trustee information, that the ILIT has its own bank account, that Crummey powers have been issued, etc. Further, many traditional ILITs can be improved by decanting them into more robust modern trusts that eliminate the typical payout at some specified age. Consideration should be given to making a late allocation of GST exemption to these traditional ILITs pre- or post-decanting if the insured/settlor's GST exemption will be lost/wasted in part in 2026 when the exemption amounts decline.

5. ***Non-ILIT grantor trust (e.g., SLAT) formed by client owns coverage***. The client could have a plan resulting in the insurance being owned in a grantor trust other than a traditional ILIT. This could be a simple but more robust trust than the typical or traditional ILIT, e.g., with no mandated distributions at specified ages, GST allocation,

independent trustee, trust protector provisions and more. A trust with more robust provisions does not necessarily have to be more costly than a traditional ILIT. Many clients may already have robust grantor trusts created specifically to safeguard and secure exemption before it is reduced, either in 2026 by operation of the current law or earlier by legislation that has already been proposed or that may be proposed. A common type of more sophisticated trust planning is the non-reciprocal spousal lifetime access trust or "SLAT." This trust is generally similar to many traditional ILITs in that a spouse and descendants are named as beneficiaries. However, and this is a generalization that will not always be correct, many SLATs are more robust than the typical or traditional ILIT. Many (but not all) such trusts are drafted to last for as long as applicable state law rule against perpetuities permits, etc. Also, most SLATs, in general, have been funded with material assets in order to safeguard exemption. Thus, these SLATs or other grantor trusts may have sufficient assets to pay annual insurance premiums and thus avoid the need to make annual gifts and issue annual Crummey powers before premiums are paid.

a. Tax considerations. The policy death benefit should not be included in the insured's estate. The more robust SLAT will likely have specific provisions to assure grantor trust status, such as a swap or loan provision. Thus, there may actually be more certainty in this more robust type of trust as to grantor trust characterization. Thus, if the SLAT will engage in a transaction involving life insurance, it may more assuredly be grantor to avoid transfer for value or other issues.
b. Asset protection. There is asset protection when the policy is owned directly by a robust irrevocable trust. If the trust is more robustly drafted, has an independent trustee, has situs in a trust friendly jurisdiction, etc. it may prove more beneficial from an asset protection lens than the traditional ILIT, certainly it would seem to be no less beneficial than the simpler traditional ILIT.
c. Flexibility. There is less flexibility owning an insurance policy in a SLAT than for the insured to own the policy directly. However, the incremental benefits may be material. Also, with a trust protector, independent trustee, GST allocation, perhaps substantial funding, etc. the ownership of the insurance policy in such a robust trust, while less flexible may provide the insured/donor some planning options that might not otherwise be available if the policy were merely held directly.
d. Complexity. This is likely a more complex option then not only individual ownership but then the traditional ILIT which may be a simpler home state trust.
e. Comment. Be certain that the SLAT or other grantor trust is appropriate to hold life insurance. For example, if the SLAT is a directed trust and the insured is the investment advisor or investment trustee it may be advisable, or even necessary, to carve out a separate insurance advisor or trustee position and be certain that the insured cannot serve in that capacity to avoid a Sec. 2042 estate inclusion issue.

6. ***Non-grantor or complex trust formed by client owns coverage***.
The client may have created a non-grantor irrevocable trust and funded it with assets to use exemption.

a. Tax considerations. The policy death benefit may not be included in the insured's estate. The tricky item is to maintain non-grantor trust income tax status. While theoretically such a trust might be able to own life insurance on the settlor, that may be a fine line to walk and this is generally not done. The issue that might arise is that if the trustee can use trust income to pay for insurance premiums on the life of the settlor that right alone may characterize the trust as a grantor trust undermining the non-grantor trust status of the trust. While it may be feasible to mandate that the trustee is prohibited from using trust income to pay for insurance premiums on life insurance on the life of the grantor

that may be complex to achieve. For example, would the trustee have to pay out all trust income before making a premium payment? Administration of such a trust may be challenging and some practitioners would avoid this situation if feasible.

b. Asset protection. There is protection when the policy is owned directly by an irrevocable trust.
c. Flexibility. Flexibility is limited when the policy is owned by an irrevocable trust. See comments above.
d. Complexity. This would seem to be more complex than other trust ownership structures given the issue of not being able to use trust income to pay for life insurance premiums.
e. Comment. This approach may be feasible but likely would only be considered in unusual circumstances.

7. ***Non-grantor or complex trust formed by someone other than the client owns coverage***. The client's family may have an irrevocable trust, e.g., one that was formed on the death of a parent, and that non-grantor trust could own life insurance on the insured.
    a. Tax considerations. The policy death benefit should not be included in the insured's estate and may avoid taxation in other family member estates depending on the plan. Caution has to be exercised if any transactions might be consummated with the policy given that the trust is not a grantor trust as to the insured.
    b. Asset protection. There should be a measure of asset protection when the policy is owned directly by an irrevocable trust.
    c. Flexibility. Flexibility is limited when the policy is owned by an irrevocable trust. Flexibility is further limited when the trust is not a grantor trust as to the insured.
    d. Comment. While this may not be a common structure there may be family goals that would suggest coverage be purchased in this manner.
8. ***Client's Spouse owns coverage***. The client's spouse could own the life insurance.
    a. Tax considerations. The policy death benefit will be included in the insured's spouse's estate but if the insured spouse resides in a state with no death taxes, and if the insured spouse's estate is well below the estate tax exemption even after reduction by half in 2026, there may be no relevant estate tax consequence.
    b. Asset protection. There may be some asset protection when the policy is owned directly by the insured's spouse if the insured is sued. But there will be no protection if the spouse/owner is sued. If the insured is viewed as having significant liability, the couple may view the policy as better protected if owned by the spouse if the spouse is not viewed as being subject to the same level of risk. However, having the insured's spouse own the policy may create incremental risk in the event of a divorce. However, if the couple resides in a state using equitable distribution state the handling of the policy may not, in theory, be changed based on whichever spouse owns the policy.
    c. Flexibility. If the spouse owns the policy there is potentially as much flexibility as if the insured owned the policy so long as the couple remains married and continues to view finances from the same lens.
    d. Complexity. None, this is the simplest option next to the insured owning the policy directly.
    e. Comment. Some clients may favor having their spouse own the policy from the perspective that it would provide some asset protection benefits but that may prove limited incremental protection.

9. ***Client's ex-spouse pursuant to a divorce decree owns the coverage.*** This is a common, but not always optimal (for either ex-spouse) arrangement.
    a. Tax considerations. The policy death benefit will be included in the insured's ex-spouse's estate but if the insured spouse resides in a state with no death taxes, and if the insured spouse's estate is well below the estate tax exemption even after reduction by half in 2026, there may be no relevant estate tax consequence.
    b. Asset protection. None for the ex-spouse.
    c. Flexibility. Perhaps none as the ownership by the ex-spouse may be contingent on the insured spouse paying premiums and often little formal arrangements are made to assure payments other than just a general obligation under the marital separation agreement ("MSA"). Even in those instances at minimum an obligation to have the ex-spouse/beneficiary receive notifications or duplicate premium bills from the insurance company may be advisable.
    d. Complexity. While this is a simple approach conceptually, for the ex-spouse/beneficiary there is typically no mechanism to monitor the policy and costly and unpleasant matrimonial action may be required if the insured spouse misses a payment. For the insured spouse, the arrangement may be simple, just pay the premiums, but the process to try to maintain the policy once the MSA obligation ends may be very complex or impossible.
    e. Comment. Sometimes these third-party ownerships are reasonable, even if not ideal. However, in some instances, a more complex ownership structure might be advantageous. For example, an ex-spouse could own a policy as required pursuant to a divorce decree. That may be simple but perhaps a mistake if the requirement for the insurance ends and the client thereafter wants to keep the coverage. A trust could provide the ex-spouse with all the protection required under the MSA but also protect the policy, assure the policy is paid for by having an independent trustee involved, etc. Also, when the obligations to the ex-spouse end, e.g., if he or she remarries, the insurance can be continued if the insured spouse wants it. If the policy is owned outright but the ex-spouse continuation may not be feasible. Also, there may be no control over the ex-spouse selling the policy into the secondary market. This type of planning may have to be done at the time that the MSA is negotiated to be possible.
10. ***Children from a prior marriage own coverage***. It could be that children from a prior marriage of the client own an insurance policy. The client/insured may want to benefit them and may not feel the amounts involved warrant a trust, or for personal reasons wants them to have coverage outright. This is not an uncommon approach where the client has remarried and wishes to avoid any need for the new spouse and children from a prior marriage to interact over estate administration matters.
    a. Tax considerations. The policy death benefit should not be included in the insured's estate so long as no incidence of ownership are retained. But the children will have estate inclusion if no trust is used. Also, annual gifts may be made to the children directly for them to pay premiums, or indirectly to the insurance company to pay premiums. If those gifts exceed the annual exclusion amount then gift tax implications will occur and a gift tax return may have to be filed and exemption used. Depending on the amount of premiums, and family involved, it may be preferable to have an ILIT own the policy and include children and their descendants as beneficiaries to support a larger annual gift plan.

b. Asset protection. There may be asset protection for the client as the client's creditors may have no basis to reach the policy or policy proceeds, if the client/insured has not retained any interests in the policy. However, there will be no protection for the children/beneficiaries so that if the amounts are material to them a trust may be a preferable option.
c. Flexibility. If the insured's children from a prior marriage own the policy the insured will have little flexibility to make changes to or decisions about the policy.
d. Complexity. This on the surface may appear to be a simple option for the insured to benefit children from a prior marriage. However, coordinating the overall plan and being certain to achieve the client's goals as to both the children from a prior marriage and the current spouse may be quite complex and difficult to monitor.
e. Comment. This approach will be appealing to some clients, but while seemingly simple and likely inexpensive, it will not be the optimal approach for some.

11. ***A business entity owns the insurance coverage as key person insurance.*** A business entity the client is involved in may own life insurance directly as part of a key person insurance plan. For example, if the insured dies the business entity may use the insurance proceeds to hire a replacement and cover other costs.
    a. Tax considerations. The policy death benefit will be included in the value of the business and may thereby affect the valuation of the decedent insured's estate tax. There may be income tax implications to consider under Code Sec. 101(j).
        i. Death benefits paid to employers may be taxable unless certain requirements and exceptions are met.
        ii. (A)Exceptions based on insured's status
            1. Any amount received by reason of the death of an insured who, with respect to an applicable policyholder—
            2. (i)was an employee at any time during the 12-month period before the insured's death, or
            3. (ii)is, at the time the contract is issued—
            4. (I)a director,
            5. (II)a highly compensated employee within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or
            6. (III)a highly compensated individual within the meaning of section 105(h)(5), except that "35 percent" shall be substituted for "25 percent" in subparagraph (C) thereof.
        iii. (B)Exception for amounts paid to insured's heirs
            1. Any amount received by reason of the death of an insured to the extent—
            2. (i)the amount is paid to a member of the family (within the meaning of section 267(c)(4)) of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured, or
            3. (ii)the amount is used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described in clause (i).
        iv. Notice and consent requirements may also apply.

b. Asset protection. The insurance proceeds will be reachable by creditors of the business. The insurance proceeds will be outside the estate of the insured and should not be reachable by the insured's claimants but the insured's interest in the business may be owned by the insured and reachable.
c. Flexibility. The business owns and controls the policy and has flexibility as to decisions with respect to that policy. What input the insured has will depend on the control the insured has over the business.
d. Complexity. Entity owned life insurance may entail a range of complications. How complex is the overall buy-out plan and key person plan? If the requirements of Sec. 101(j) are triggered considerable complications may be involved.
e. Comment. Key person insurance remains a common planning tool.

12. ***Insurance partnership or LLC owns coverage pursuant to a buy-sell agreement***. If there is a business cross-purchase arrangement, where each owner owns insurance on the life of the other, the number of policies expands substantially when there are more than two equity holders. That may be avoided by having a partnership or LLC taxed as a partnership own the policy.
    a. Tax considerations. The ownership of the insurance partnership or LLC should be considered. Under a Connelly argument a pro-rata portion of that entity may also be included in the deceased insured's estate unless the ownership is held in a trust structure outside of the estate.
    b. Asset protection. Having the insurance held outside the entity (i.e., not as a redemption) and in an entity rather than directly by the other equity holders may provide protection.
    c. Flexibility. The degree of control or flexibility will be addressed by the documents governing the plan.
    d. Complexity. Significant.
    e. Comment. After the Connelly case, using insurance funded redemption arrangements may not be advisable given the estate inclusion so that using a cross-purchase arrangement may now be favored. If there are more than two equity owners using an insurance partnership or LLC may be worth evaluating to limit the number of policies involved.
13. ***A business entity owns coverage pursuant to a redemption buy-sell agreement.*** It had been common to have insurance held in a business entity and then on the death of an owner the entity would repurchase the deceased owner's shares using life insurance proceeds. However, in the recent Connelly case the Court held that the insurance proceeds must be included in the valuation of the business entity. That could increase the estate tax cost to a deceased shareholder. Some advisers suggest the use of a cross-purchase arrangement instead of a redemption arrangement for this reason.
    a. Tax considerations. The policy death benefit will be included in the value of the business under Connelly.
    b. Asset protection. There is no protection when the policy is owned directly by the entity from entity creditors.
    c. Flexibility. The degree of control or flexibility will be addressed by the documents governing the plan.
    d. Complexity. Significant.
    e. Comment. After the Connelly case, using insurance funded redemption arrangements may not be advisable given the estate inclusion so that using a cross-purchase arrangement may now be favored.

14. ***A business partner could own coverage pursuant to a cross-purchase buy sell***. As noted above, a common approach to buying out the interests of a deceased equity owner in a business entity is for each owner to own a policy on every other owner's life.
    a. Tax considerations. The policy proceeds held by one equity owner should not be included in the estate of a deceased owner.
    b. Asset protection. The policy and policy proceeds are not protected as to the equity owner owning the policy. Even the insured equity owner's estate may be reached when the proceeds are paid to the estate as part of the buyout.
    c. Flexibility. The degree of control or flexibility will be addressed by the documents governing the plan.
    d. Complexity. Significant.
    e. Comment. See comments above.
15. ***Split-Dollar Life Insurance Structures***.
    a. Not addressed here.

Transfer for Value Rule

If there a transfer for value issue might be raised on a transfer of an insurance policy from one trust to another, grantor trust status may solve the problem. The transfer for value should not apply if the transfer is made to a grantor trust. This can be important such that the use of grantor trusts can salvage an otherwise problematic insurance plan. This is illustrated in the following example.

Example: The taxpayers established an ILIT which purchased substantial life insurance on their joint lives. The ILIT was drafted to be irrevocable and provided that when the children attained the age of 35 they would receive their share of the insurance proceeds outright. Years after the establishment of the trust, the insureds/grantors and children/beneficiaries all became involved with a significant lawsuit against their family business in which they were all participants. All the children/beneficiaries had passed age 35 so that if their parents (the insureds) died, all of the insurance proceeds would be distributed to the ILIT, but immediately paid outright to the children and hence withing the reach of their claimants. What possible steps could be taken to address this significant dilemma, and how might grantor trust status help?

Scenario 1: The ILIT could cancel the insurance and the grantor's could establish a new ILIT to purchase a new policy. The new ILIT would include lifetime trusts for the children. However, if the parents are uninsurable, or don't have the same insurance rating, it would be more costly or impossible to achieve. The old policy could be converted to paid up policy to retain as is. This is unlikely to be a viable option.

Scenario 2: Assume that the cash surrender value of the policy is substantial. If trustee had discretion to distribute principal during the grantors' lifetimes, the trustee could distribute the policies to the children without court approval if state law permits. For example, New York State EPTL 10-6.6, would permit this. However, terminating the ILIT by distributing the cash value of the old policy would expose the cash value of the policy to the children's creditors since the cash value would have to be distributed to them as they have passed the age 35 trusts included in the ILIT. This approach is the equivalent of jumping from the frying pan into the fire.

Scenario 3: If the trustee can invade trust principal, then the trustee can appoint the policies to a new ILIT for the same beneficiaries. However, since the children/beneficiaries are all concerned about claimants, their consent could be viewed as tainting the new ILIT as a self-settled trust, such that their creditors could reach it. Better, but still problematic.

Scenario 4: Another option would be for the parents/grantors/insureds to create a new ILIT that is structured as a grantor trust. Assume that the initial ILIT was also structured as a grantor trust. The first ILIT/grantor trust could sell the insurance policy it owns to the new second ILIT/grantor trust for its cash surrender value. The new ILIT would have more creditor protective terms (such as lifetime trusts for the children/beneficiaries) with full discretion of trustee to make distributions or not.

The IRS has held that since both trusts are grantor trusts the transfer for value rules won't apply and no gain will be triggered on the sale.

Proper Care and Administration of ILITs

Irrevocable Life Insurance Trusts ("ILITs") are one of the most common estate planning tools, but too often clients do not permit their advisers to give ILITs the care and attention they require. No trust, estate plan or asset protection technique will work if not administered properly and regularly with a collaborative team. There can be a significant number of documents, steps, and nuances (lots of variation between ILITs). These are not "standard" and be careful making assumptions. Consider the following.

Modern vs. Traditional or Old-Style ILIT: One of the first considerations practitioners may raise with clients is how old the ILIT instrument is and whether it may be advantageous to decant or otherwise modify the instrument to provide for longer trusts, GST planning, a trust protector or other modern trust conventions. The challenge to this step is the client must consult with advisers about the ILIT for these important points to be raised.

ILIT File: The settlor , the trustee, and all advisers should each have a complete and current compilation of all information and documents so each can fulfil their role and the ILIT can be properly administered. That may include: Memorandum explaining the plan as initially formulated and any follow up adviser communications. Insurance projections when the policy was issued and every few years when the policy is reviewed and evaluated. The initial insurance application should list the trust as owner (or if the policy was later transferred to the trust that documentation). A PDF of the insurance policies and an indication where the originals are. Fully signed trust document and an indication where the original is. Any modifications or actions pertaining to the trust (e.g., a death of an initial trustee, etc.). Over the years there may be new bank accounts opened, trustee changes, actions by various persons holding powers under the trust (e.g., a trust protector), etc. PDF copies of all those documents should be held in chronological order so that the current status of the trust can be proven. All Crummey or annual demand powers. Gift tax returns that reported any transfers to the trust. For a more complex plan that may entail GRATs rolling into the ILIT or split-dollar arrangements, all relevant documentation for those components of the plan should be included.

Insurance Coverage: Insurance policies are the heart of ILITs but too often clients and individual trustees make the dangerous assumption that if the policy made sense when the trust first purchased it that it makes sense decades later. Insurance is not a "buy it and forget it" decision. Having the policy and your client's circumstances reviewed every few years to see if the policy is working as desired and that it continues to meets current needs is vital, but too often not addressed. Sometimes policies are great, sometimes they need to be added on to (i.e., more coverage). Sometimes they can be sold or cancelled.

TIN: ILITs probably should have their own Tax Identification Number although some advisers suggest using the settlor's Social Security Number since ILITs are almost if not always grantor trusts. If there is a TIN identify and save the documentation from the IRS assigning the TIN to the trust. If the client's Social Security number was used determine if it might be prudent to obtain a separate trust TIN.
Investments: Most ILITs never need an investment plan or tax return because they have nominal bank balances and an insurance policy. But many ILITs have investment assets as a result of the plan to prefund the trust, etc. So be sure that if your client's ILIT has investments apart from the policy those are being properly managed and all steps related to that investment asset addressed. In 2020-2021 because of the harsh proposals to restrict grantor trusts some clients made larger gifts to their ILITs to provide for many years or decades of future premium payments. If that occurred the ILIT should have an investment account, investment policy statement, income tax return, and a gift tax return should have been filed reporting the large gifts.
Bank Account: LITs should have their own bank account and personal and trust funds should never be commingled. Some trustees never set up a trust bank account and the client pays the premiums directly to the insurance company. Although the IRS lost challenges to that type of arrangement, the ILIT is an independent trust and that independence should be respected with a separate bank account.
Gifts: When your client makes a gift to the trust most trusts require that the trustee give written notice to the beneficiaries to qualify the gifts for the annual gift tax exclusion. These Crummey notices are often ignored by individual trustees, or records of them are not kept. When was the last time the client and trustee reviewed the trust language to confirm exactly what requirements for notice are (or is not) included in the governing instrument? Review with the client exactly what their trust says about these as there are lots of different nuances. Some advisers suggest beneficiaries waive the requirement of notice. That may be prudent in lieu of annual notices, but some practitioner's prefer compliance with the literal language of the trust. Too many clients (and individual trustees)_ just ignore the notice requirements. Perhaps remind the trustee (or the client if you are not representing the trustee) to consider that the trustee should adhere to the terms of the trust even apart from gift tax considerations. If there is a lawsuit creditors might not be required to respect the trust if the trustee didn't. Save PDF copies of every year's notices. If the premiums are significant there may be documentation on a split-dollar loan or other financial arrangement to fund the trust (e.g., a tier of GRATs the back end of which may pass to the ILIT).
Gift Tax Returns: If your client made taxable gifts to fund the ILIT a gift tax return might have been required. If your client only made annual gifts with Crummey powers you might (discuss with your client) the pros/cons of reporting those on a gift tax return to run the statute of limitations on audit. Similarly, if gifts were made between spouses before funding the trust (e.g., from one spouse to the other if the couple only has a joint checking account) some tax advisers recommend those be disclosed on the gift tax return as non-gift transfers.
Plan Review: Every few years clients should review their ILIT plan. Might it be beneficial to change insurance coverage, remove and replace a trustee, move the trust to a better state, decant or merge the trust into a newer trust, etc.? Over years, and certainly over decades, much can change and your client's ILIT plan should, to the extent feasible, evolve with those changes.

Trust Review: Most insurance trusts are irrevocable but, as practitioners know (but many clients do not realize) that doesn't mean that they might not be changed. Review the trust instrument periodically or if there are major personal changes. Trustees can resign and new ones may be appointed. Old trusts often have inefficient or inadvisable administrative provisions. Those might be modified be decanting or merging the old ILIT into a newer trust. A common issue is old trusts paid all money out to beneficiaries at some age, e.g., 30, and that is rarely ideal. Review the trust and discuss with your client changes that might be desirable and whether they can be achieved.

Investment Considerations and the ILIT

The Prudent Investor Act addresses how trust assets should be invested. Fiduciaries must first adhere to the investment standards in the governing instrument (e.g., will, trust, deed, agreement, etc.). If the governing instrument is silent, then they must apply the Prudent Investor Rule under applicable state law. The status of a trust as a grantor trust is important for a trustee to evaluate in determining the steps necessary to comply with the Act. “The expected tax consequences of investment decisions or strategies” are a factor to consider. N.J.S.A Sec. 3.d.(3).