Larson Gross
CPAs & Consultants

Protecting Wealth With a Life Insurance Trust

A life insurance trust is an estate planning tool for maximizing the value of an estate passed to one's heirs. More specifically, a life insurance trust is an irrevocable trust with a life insurance policy as the main asset that enables a grantor to:

- Take advantage of potential tax savings, such as avoidance of state and federal inheritance tax,
- Use gift tax provisions to cover the cost of annual insurance premiums,
- Control when beneficiaries will have access to life insurance payments, and
- Protect life insurance assets from the creditors of a beneficiary.

This document takes a brief look at how life insurance trusts work and the purpose behind them.

How Does a Life Insurance Trust Work?

An irrevocable life insurance trust or "ILIT" can be established by the owner of a life insurance policy or someone who intends to purchase such a policy. The creator of the trust is referred to as the Grantor. While the Grantor sets the terms of the trust, they cannot change or revoke the trust once it is signed - this is what makes it irrevocable.

The Grantor may transfer an existing life insurance policy into the trust, or the trust may purchase a new life insurance policy. Regardless, once the trust owns the life insurance policy, it is considered outside the Grantor's control and will not count toward their taxable estate.

ILITs are often set up to help pay estate taxes on the value of assets in an estate that exceed the lifetime gift tax exemption. Currently, the lifetime gift tax exemption is $11.7 million per individual, but proposed legislation may cut this in half. If enacted, a lower lifetime exemption would cause a greater number of estates to be subject to taxes.

ILITs can also be used to protect youthful beneficiaries from unexpected losses or mismanagement of funds. When creating the trust, the Grantor can specify how, when and to whom distributions will be made. For example, a trust with two minor beneficiaries and a $1 million policy might specify that each child receives $250,000 to attend college and $250,000 once they graduate.

An irrevocable trust also provides certain legal protections against creditors because the beneficiaries do not legally own the assets in the trust, nor do the beneficiaries control how funds are distributed.

Rules to Know About Irrevocable Life Insurance Trusts

Life insurance policies must be transferred to an ILIT at least three years before the Grantor's death; otherwise, the life insurance proceeds may be included in the Grantor's taxable estate. To bypass the 3-year rule, an ILIT that has existed for at least three years can directly purchase the life insurance policy instead of transferring an existing policy into the trust.

Also, if you name minor children as beneficiaries of the policy, a court may have to appoint a conservator to manage the assets on behalf of the minors. This can be a lengthy, costly, complicated process that is best avoided by designating a trustee responsible for complying with the terms of the trust. No matter who you choose as trustee, they are obligated to act in the trust's best interest and use reasonable care in performing their duties.

You can take advantage of the annual gift tax exclusion by using a tool known as the Crummey Power. With Crummey powers, annual insurance premiums paid by your ILIT may qualify for the annual gift tax exclusion (up to $15,000 currently). By doing so, the annual premium payments will be deductible in addition to the asset bypassing inheritance taxation.

What is the Purpose of a Life Insurance Trust?

An ILIT is ideal for clients whose life insurance policies, combined with other assets, put their heirs at risk of paying state or federal estate or inheritance taxes. With an ILIT, you can protect life insurance from taxation, loss to creditors or former spouses of your heirs, and losses due to mismanagement. You can also specify how you want insurance proceeds to be distributed, potentially preventing a lump-sum payment to youthful heirs ill-equipped to manage a large payout. ILITs are particularly useful for dependents with disabilities, minor children, or those experiencing financial difficulties like bankruptcy or divorce.

Final Thoughts

This document is meant to provide an overview of life insurance trusts and is not a substitute for speaking with one of our advisors. If you have any questions about life insurance trusts or would like to discuss your unique situation, please contact our office.

About Larson Gross

Ted Larson and Dennis Gross founded our firm in 1949. They built the business based on excellence, passion, integrity, trust and pro-action — values still important to us more than seven decades later.

Even well into their retirement years, Ted Larson and Dennis Gross continued to have the best interest of the firm at heart. Mr. Larson would come into the office on a regular basis to meet every new face and make a personal connection with each of our team members. He remembered the name of every employee, as well as the names of their spouses and children, and would greet clients by name as he passed by the reception desk. Sometimes, you'd even find a newspaper clipping on your desk that Mr. Larson dropped off, highlighting that your son made the honor roll. This is the example of a genuine relationship we strive to embody with our people and clients.

Today, we're led by ten partners who are growing our firm with respect for where we've come from and a new vision for future success. Our 120-plus team members and three offices located in Bellingham, Lynden and Burlington make us the 10th largest public accounting firm in the Puget Sound region. While we're determined to expand our impact and help strengthen as many businesses and individuals as we can, we're also committed to remaining a locally-owned organization. We're incredibly proud of where we've come from and look forward to a future of possibility

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