# Addressing Estate Planning Uncertainty Using a Flexible Irrevocable Life Insurance Trust (ILIT)

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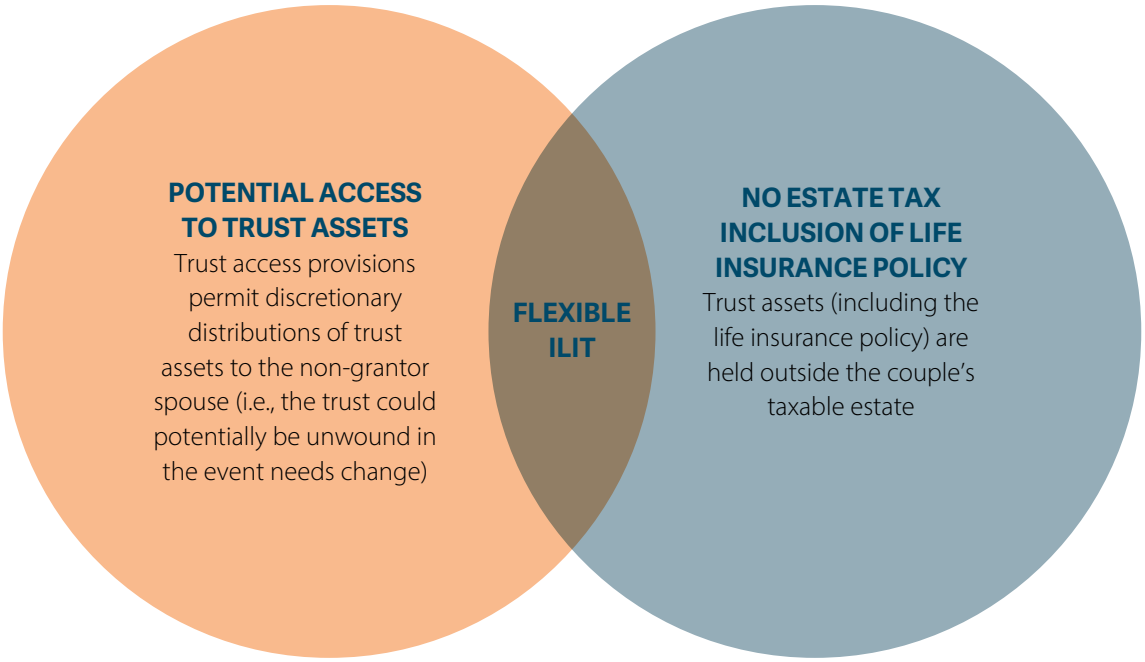
## PLANNING FOR THE UNCERTAINTIES IN LIFE

Even when dealing with certainties like death and taxes, a degree of uncertainty can remain. This is especially true when it comes to estate liquidity planning using life insurance.

- Will there be state and/or federal estate tax in effect upon your death?
- Will your estate size be large enough to incur estate and inheritance[1] taxes?
- Will your estate liquidity needs change during your lifetime, creating a potential need to access the life insurance policy's cash value?
- Will your goals and desires for leaving life insurance proceeds to your heirs change?

## IRREVOCABLE DOESN'T MEAN INFLEXIBLE

Irrevocable life insurance trusts (ILITs) may be an attractive planning strategy for affluent individuals seeking smooth estate transfer. Buying and holding a life insurance policy within an ILIT[2] offers three benefits: 1) The policy's tax-free death benefit[3] may be used to pay taxes and other estate settlement costs, helping to keep other estate assets intact; 2) the ILIT-owned policy is excluded from your taxable estate value, and 3) policy premiums may be funded using gift tax exclusions.[4] Because ILITs are irrevocable, a common concern may be the loss of control over the assets held within the trust. Irrevocable, however, does not necessarily mean inflexible. Incorporating flexibility into an ILIT may allow you to plan for a potential estate tax liability, lock in your life insurance insurability, and maintain the ability to adapt to future estate planning needs.




[1] According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).

[2] Life insurance is subject to underwriting and approval of the application and will incur monthly policy charges.

[3] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2)(i.e. the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

[4] As of January 1, 2025, the annual gift tax exclusion is $19,000 per donee (indexed for inflation). Rev. Proc. 2019-44.

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## What is a Flexible ILIT?

While a traditional ILIT offers benefits for estate planning, it may lack the flexibility you need to help address concerns about a future change in your estate liquidity needs.

A flexible ILIT, however, may offer greater versatility and may be used by high-net-worth married couples, such as yourself. In a flexible ILIT, one spouse is the grantor of the trust and the other spouse is the trust beneficiary. The trustee is given broad discretion to make distributions to the spousal beneficiary for any reason and to the exclusion of other trust beneficiaries. If the federal estate tax is permanently repealed, or if the estate tax exemption is so high that neither the grantor's estate nor the grantor's spouse's estate will not be subject to estate tax or if estate liquidity is no longer needed for any other reason, the trustee may distribute all trust assets to the spousal beneficiary, thus effectively unwinding the ILIT.

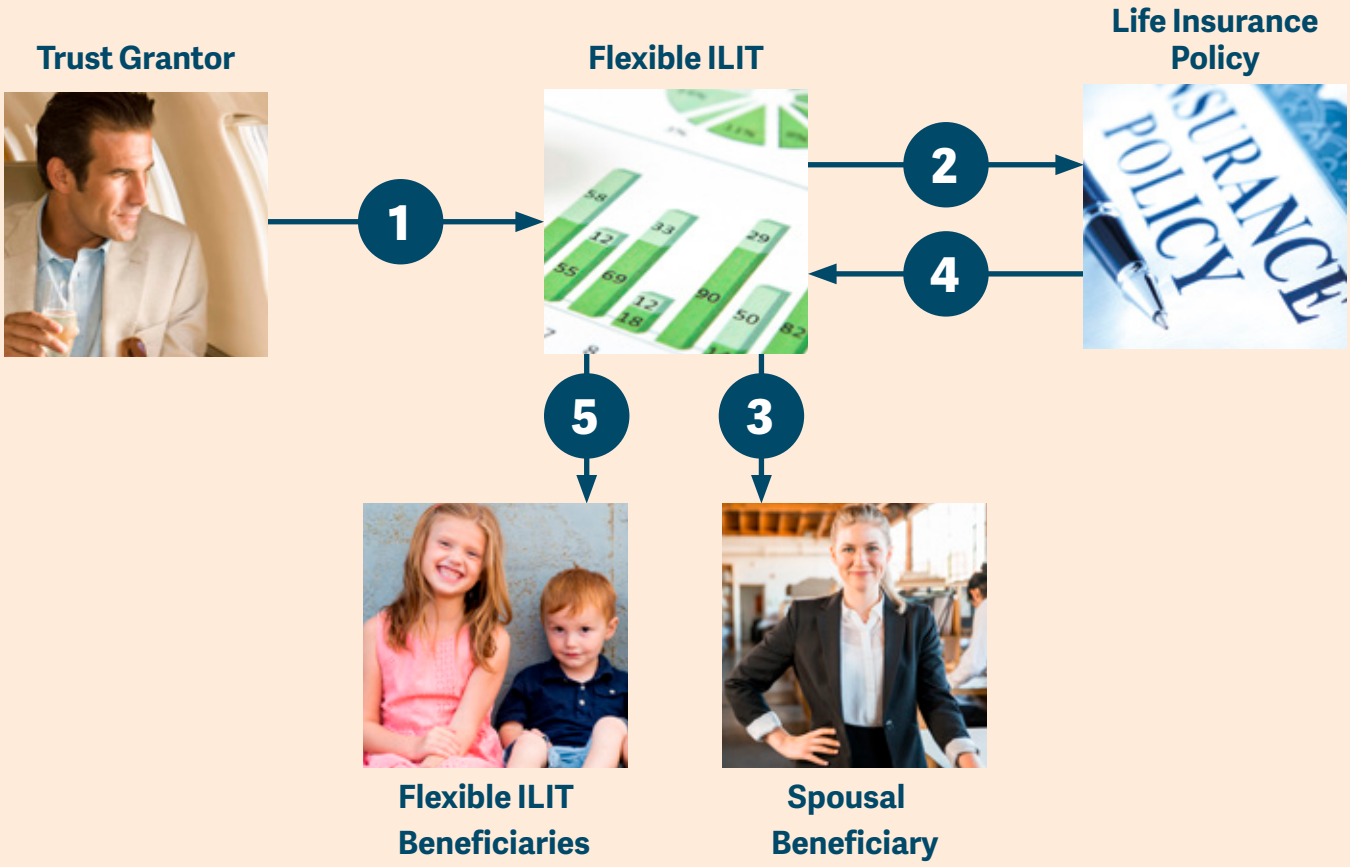
If there is concern about the grantor spouse losing flexibility and the ability to have indirect access to the trust assets in the event of divorce or death of a spousal beneficiary, then additional flexibility can be incorporated into the trust in two ways. First, the trustee may be given the ability to make arm's length loans to the grantor spouse, thus enabling the grantor spouse to potentially access the policy's cash value. Second, rather than designating the spousal beneficiary by name in the trust document, use language such as "my current spouse." Then, if the grantor spouse were to remarry, the new spouse could become the new spousal beneficiary of the trust.

Uncertainty over future estate tax exemption amounts or estate tax repeal, as well as uncertainty over your future financial situation, are good reasons to incorporate flexibility into your estate liquidity planning. Flexible ILITs, when combined with flexible life insurance products, may be a solution to overcoming uncertainty regarding your estate planning needs.

### ARE YOU A GOOD CANDIDATE FOR A FLEXIBLE ILIT? YOU MAY BE IF YOU CAN ANSWER "YES" TO ALL OF THE FOLLOWING QUESTIONS:

- Are you married?
- Do you have a current or potential federal estate tax liability?[1]
- Do you want to purchase life insurance to provide liquidity for estate settlement costs?
- Do you want to avoid inclusion of the life insurance proceeds in your taxable estate?
- Do you have a desire for flexibility in your estate liquidity plan so you may adapt to future circumstances?

## How a Flexible ILIT Works




**CREATE A FLEXIBLE ILIT**

With the help of an attorney, one spouse (the trust grantor) creates a flexible ILIT and the other spouse is designated as a lifetime beneficiary of the trust. The trust provisions provide the trustee[5] with absolute discretion to make distributions to the spousal beneficiary for any reason, to the exclusion of any other trust beneficiaries (i.e., distributions do not have to be pro rata).

**1 GIFTS TO ILIT**

The grantor spouse gifts separate property funds to fund the flexible ILIT assets. These gifts may be subject to gift tax depending on the grantor's use of his or her annual gift exclusions and/or lifetime gift tax exemptions.[6]

**2 LIFE INSURANCE PREMIUM**

Using the gifted funds, the trustee of the flexible ILIT pays ongoing premiums for a life insurance policy insuring one or both spouses (i.e., the life insurance can be either a single life or survivorship policy). The flexible ILIT is the owner and beneficiary of the life insurance policy.

**3 LIFETIME DISTRIBUTIONS**

The trustee, at his or her discretion, may make distributions from the trust (including from the life insurance policy cash value) to the spousal beneficiary. Furthermore, at the trustee's discretion, trust assets may be distributed to any other trust beneficiaries.

**4 DEATH BENEFIT PROCEEDS PAID TO ILIT**

At the death of the insured(s), the flexible ILIT will receive the life insurance death benefit proceeds free from estate and income tax.[7]

**5 DISTRIBUTIONS**

The trustee may make distributions of the death proceeds to the flexible ILIT beneficiaries, which may or may not include the spousal beneficiary.

[5] The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

[6] According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).

[7] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

## ADVANTAGES OF A FLEXIBLE ILIT

- Adding flexibility to estate planning allows clients to continue planning for their future despite uncertainty in estate tax liabilities or future estate planning goals.
- The life insurance death benefit proceeds will be kept outside the taxable estate of the couple.
- The trustee's broad discretion to make distributions to the spousal beneficiary may provide a way to effectively unwind the trust and return the assets to the couple's estate if the trust is no longer needed for estate planning purposes.

## ADDITIONAL CONSIDERATIONS

- An irrevocable trust does not give the grantor control over trust assets.
- Due to the broad discretion given the trustee to make distributions, the trust assets may be included in the grantor's estate unless the trustee is not considered to be related or subordinate to the grantor (i.e., an independent trustee may be required. See discussion in "Who Can Serve as Trustee of the Flexible ILIT" section of this brochure).
- The complete discretion to make distributions of trust assets is in the hands of the trustee, who may not act in accordance with the couple's wishes.
- Potential access to trust assets is via the spousal beneficiary, so divorce or death of the spousal beneficiary may eliminate the grantor's ability to have indirect access to the trust assets (depending on whether (1) the trust specifically identifies the spousal beneficiary by name or uses more generic "my current spouse" language, and/or (2) the trust permits the trustee to make arm's length loans to the grantor).

## WHO CAN SERVE AS TRUSTEE OF THE FLEXIBLE ILIT?

A key issue when implementing a flexible ILIT is determining who is suitable to be the trustee.[8] The following are considerations for various trustee designations. To help address the issues that may be related to each trustee designation, also see the "Improving Your Chances of Your Intentions Being Carried Out by the Trustee" section.

Spousal Beneficiary Trustees and Potential Distribution Limits—To provide the couple with more control, traditional ILITs often name the nongrantor spouse (i.e., the spousal beneficiary) as the trustee. However, to avoid estate tax inclusion of the life insurance policy held within the ILIT, the spousal beneficiary as the trustee may only make ILIT distributions to himself or herself if such distributions are limited to the ascertainable standards of health, education, maintenance, or support. Although making the spousal beneficiary the trustee may add some flexibility, the ascertainable standards may inhibit that flexibility to some extent. For example, a spousal beneficiary acting as trustee, likely would not be able to distribute the entire trust assets in the event of estate tax repeal or other change in estate tax liquidity circumstances.

Subordinate Trustees and Potential Estate Inclusion—The key to a flexible ILIT is naming someone as the trustee who is neither the grantor nor the nongrantor spouse, and giving that trustee absolute discretion to make distributions not limited to ascertainable standards. If the trustee is considered subordinate to the wishes of either spouse, the trust assets may potentially be included in their taxable estate per Internal Revenue Code (IRC) Sections 2036 or 2038. For that reason, estate planners may desire an independent trustee to be designated instead. Per IRC Section 672(c), the following are considered to be related or subordinate to either spouse and would not qualify as independent trustees:

- Spouse
- Father or mother
- Children, grandchildren, etc.
- Brother or sister
- Employee of either spouse, or
- Subordinate employee of a corporation in which either spouse is an executive.

However, even if someone is related or subordinate to either spouse, they can still potentially qualify as an independent trustee of the flexible ILIT if they are considered to have interests that are "adverse" to those of the spousal beneficiary. An individual may be considered "adverse" to the extent that individual has a substantial beneficial interest in the flexible ILIT, and his or her interests would be adversely affected by exercising his or her broad distribution powers in favor of the spousal beneficiary.

[8] The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

A potential concern of using an independent trustee is that they may be unwilling to exercise their absolute discretion to make distributions to the spousal beneficiary. Thus, the choice of who to use as the independent trustee is an important one. Corporate trustees, such as banks, may not always be the best choice, as they often take a conservative approach to distributions due to fiduciary liability concerns.[9] The following might be potential candidates to consider:

- A close family friend
- An aunt, uncle, or cousin
- A professional advisor, such as the client's attorney or CPA, if they believe it wouldn't be a conflict of interest to do so
- A brother-in-law or sister-in-law
- A remainder beneficiary of the trust who is considered to have an interest in the trust that is adverse to the spousal beneficiary.

## IMPROVING THE CHANCES OF THE TRUST GRANTOR'S INTENTIONS BEING CARRIED OUT BY THE TRUSTEE

The more clearly the grantor of the trust expresses the intent for why the trustee was given the absolute discretion to make distributions to the spousal beneficiary, the more likely that such discretion will be exercised for the purposes it was created.

One option is for the trust grantor to include within the trust document a general purpose statement which stipulates the following: (1) the purposes of the trust (e.g., to provide liquidity to pay federal estate taxes in the event the estate is large enough to be subject to federal estate taxes), (2) the factors which the grantor would like the trustee to consider when exercising absolute discretion to make distributions to the spousal beneficiary (e.g., whether the federal estate tax has been repealed or reformed such that liquidity is no longer needed to pay federal estate taxes, or the spousal beneficiary's financial situation has substantially declined), and (3) that the trustee should consider the needs of the spousal beneficiary be given priority over the remainder beneficiaries, even if it requires the trustee to exhaust the trust.

Instead of, or in addition to including a general purpose statement in the trust document, the trust grantor may wish to issue a letter of wishes, which is a separate non-binding document in which the trust grantor can more freely state his or her intentions for creating the trust. While it is not binding on the trustee, this document can be very useful in making sure these intentions are clearly communicated to the trustee.

[9] Naming a family member as trustee can pose challenges. For this reason, for some, a better alternative may be appointing a corporate trustee while granting a trust protector the authority to remove and replace the trustee if necessary. When combined with clear trust language defining the grantor's distribution standards, this structure helps ensure that the spousal beneficiary receives distributions as intended, even with a corporate trustee in place.

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