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Reasons to Avoid Irrevocable Life Insurance Trusts

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No one wants to pay more taxes than they have to, so some people commit large sums of money and implement long-term, inflexible strategies to maximize tax savings. One of these strategies is using irrevocable life insurance trusts (ILITs). These trusts own life insurance policies while denying the creator direct control over of the trust. By divesting the creator control of the trust the IRS allows the life insurance proceeds to pass to the the beneficiaries estate tax free. However, this is only a small part of the picture. Here are five reasons you may not want to fund an irrevocable life insurance trust.

1. The Insurance Policy Is Against You

While a handful of people use term life insurance policies to fund ILITs, most are funded with permanent life insurance policies. The mechanics of permanent life insurance policies tend to be stacked against you. First, when you view a life insurance policy illustration you are usually shown cash value amounts illustrated at 4%, 5% or 6% returns, but these returns never seems to materialize. The life insurance company is only required to pay a much lower "guaranteed minimum" on your cash value, which a less-seasoned salesman rarely focuses on. In addition, the cost of insurance increases as you age, so the cash values in these under-performing policies depletes exponentially faster the longer you live. (For related reading, see: *When Is It a Good Idea to Use An Irrevocable Life Insurance Trust?*)

And while you are often given a 30 day grace period on paying premiums to avoid lapsing a policy, if you purchase a guaranteed universal life rider you typically cannot be even one day late to maintain the rider, meaning the policy lapses anyway after all cash value has been diminished (I.e. after you have paid premiums for many years).

2. Ongoing Requirements

When a life insurance premium is due, the funding is first supposed to be deposited into a cash account owned by the trust and the beneficiary (or his/her legal guardian) is supposed to receive a "crummey notice." It tells the beneficiary he/she is allowed to take the funds in the account (perhaps $5,000 to $15,000) for the next 30 to 60 days, or leave them to pay for life insurance premiums that will pay out a much larger future life insurance payment (perhaps a few million dollars). Crummey notices are a farce. The beneficiary never takes the funds. Why have a few thousand dollars today when you can have millions in the future? And yet the tedium, stress and expenses of creating crummey notices every time a premium is supposed to be paid is required.

3. Estate Tax Laws Constantly Change

Due to legislative voting requirements (the U.S. Senate requires 60 votes to authorize legislation that substantially adds to the federal deficit) estate tax laws change approximately every eight to 10 years. In 2000, the federal estate tax exemption was $675,000, in 2006 it was $2 million and in 2009 it was $3.5 million. In 2010 there was no direct federal estate tax and then it was $5 million. Now it will be $11.2 million in 2018, so they are currently only appropriate for the wealthy. Of course, this shall only apply for the next several years. What then? No one knows.

Tax policy is unpredictable in the long term and ILITS tend to be long-term planning tools. A family owning a business and few other assets might require a large amount of liquidity provided by life insurance to pay estate taxes, unless there are no estate taxes due. The inability to predict estate tax law coupled with the inflexibility of changing an ILIT makes life insurance in an ILIT undesirable compared to insurance owned by the decedent outright if there is no estate tax. (For related reading, see: *10 Questions to Ask Your Estate Planning Attorney.*)

4. You Can't Easily Change the Trust

ILITs are inflexible. If you have a falling out with one of the beneficiaries or tax laws change you may be locked in to continuing the ILIT anyway. You can give your trustee a good deal of discretion on how much money to give to each beneficiary. But this risks the trustee "picking favorites" and neglecting to give money to less-favored beneficiaries, which tends to be the opposite of what most parents want to do when they create a trust for their children.

There are actually ways to modify, and even revoke, irrevocable trusts, but the creator of the trust can't be the person to do this. Some states allow a trustee to "decant" an irrevocable trust, provided they hold certain distributive powers. Other states allow a trust to be terminated if all beneficiaries agree to its termination, but this only works if all beneficiaries are competent adults that agree to the trust's termination. One minor or stubborn beneficiary can confound the desired change. The bottom line is that the creator of the trust must hope that the trustee or beneficiaries will agree to change the trust, which is never certain.

5. Your ILIT Will Probably Never Pay Out

Permanent insurance can be expensive, especially when we age. It's simple math that the insurance company must make a profit on at least half the people in a certain group, which they make up for on higher premiums for older individuals. So the older you are, the less likely you are to "win" the insurance gambit. And due to permanent insurance's sub-optimal investment returns and increasing prices, many people choose to surrender their policies in its later years when the premiums become ludicrously expensive.

When you establish an ILIT, the insurance policy is against you, the trust itself is against you, and tax policy may either be against you or irrelevant, but you are still locked-in to a long-term, all-or-nothing strategy. And these detriments exist even if you are a healthy individual. If you are unhealthy, the cost of the insurance policy will negate any tax savings you would have made.

Don't rush to set up an ILIT. If you do, expect low investment returns on the policy, choose a premium amount you know you can live with for the rest of your life, choose a trustworthy trustee and knowledgeable drafting attorney and accept that the end result will likely not be what you had anticipated. (For related reading, see: *Pick the Perfect Trust*.)

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