The Death Benefit From Insurance on My Life Will Be Paid to an Irrevocable Life Insurance Trust (ILIT). What if Those Funds Are Needed to Pay My Estate Taxes?

My life insurance's death benefit will be paid to an ILIT. What if it's needed to pay estate taxes?

Life insurance death proceeds paid to a valid ILIT may escape estate taxation in your estate, as long as the trust owns the policy and you haven't retained any incidents of ownership in the policy, such as the right to change the beneficiary. Typically, the terms of the ILIT provide that the insurance proceeds be distributed from the trust to your beneficiaries in accordance with your wishes, which are spelled out in the trust document.

Generally, life insurance is purchased within a trust to provide for your family while ensuring that the death benefit is not reduced by estate taxes. Unfortunately, to keep the death benefit from being included in your estate, you cannot require the trustee to use the proceeds to meet estate settlement costs. However, your estate may run into liquidity problems and need to have access to the cash in the ILIT to avoid having to sell assets in the estate.

There are two ways to solve this dilemma. One is to include a provision in the ILIT that permits (but does not direct) the trustee to buy estate assets. The other is to give the trustee permission (but not instructions) to loan the estate some of the proceeds.

If these techniques are used, the estate will have access to the funds it needs to meet its obligations without causing the assets in the ILIT to be included in your taxable estate.

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