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Life insurance and trusts

When you purchase life insurance, you name at least one beneficiary who will receive the death benefit proceeds upon your death. If you set up a life insurance trust, the trust is generally the owner and beneficiary. At your death, the trust receives the death benefit proceeds and the trustee distributes the proceeds to your beneficiaries in accordance with the wishes you outlined in the trust when it was established.

1	2	3	4	5
Grantor Gift cash to the trust	**Trust** Trustee purchases a policy and pays premiums	**Insurance company** Pays income and death benefit proceeds	**Trust** Distributes policy proceeds in accordance with trust terms	**Trust beneficiaries**

Trust types

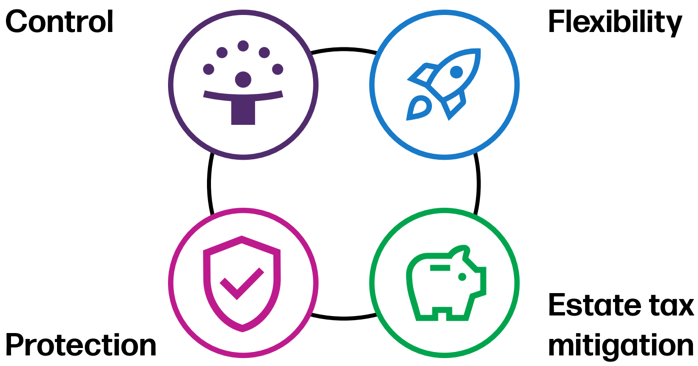
Revocable living trusts

A revocable trust is a fluid document that can be amended. During life, assets can be added or removed, terms and conditions can be modified, beneficiary designations can be changed or revised, and as the title conveys, the trust can even be revoked should the grantor's goals and objectives change. Furthermore, revocable trust taxation flows down to the grantor, so there is no need to file a separate income tax return.

Irrevocable trusts

An irrevocable trust is a trust that with few exceptions, cannot be modified, amended, or revoked once it has been created. An irrevocable trust is a separate tax-paying entity from the grantor; therefore, the trustee must file an annual income tax return.

Advantages of life insurance inside trusts



Control

There are several potential benefits to having a life insurance policy owned by a trust, including control over how the policy proceeds are distributed to the beneficiaries. If the death benefit proceeds of the policy are distributed outright to the beneficiaries, for example, there will be no restrictions on how the proceeds are utilized. An irrevocable trust can ensure the proceeds of the policy are used appropriately and persist with a degree of longevity.

Flexibility with revocable living trusts

A major benefit of having a policy owned by a revocable trust is flexibility. A revocable trust is a fluid document that can be amended. Assets can be added or removed, terms and conditions can be modified, beneficiary designations can be changed or revised, and as the title conveys, the trust can even be revoked should the grantor's goals and objectives change. Revocable trust taxation flows down to the grantor, so there is no need to file a separate income tax return. Assets included in a revocable living trust pass to beneficiaries outside of probate, avoiding the time, cost, and public nature of the probate process. If the grantor is well under the prevailing estate tax exemption amounts, a revocable living trust can be a powerful estate planning tool.

Estate tax mitigation with irrevocable trusts

Generally, the value of a life insurance policy death benefit, frequently the largest asset includable in an individual's gross estate, is included in the calculation of the estate tax. The Tax Cuts and Jobs Act of 2017 essentially doubled the estate tax exclusion, that is to say, how much of the estate is excluded from taxation to **$11,180,000** beginning in 2018, indexed for inflation (**$13,990,000** for 2025).[1] This amount will sunset after 2025, reverting back to approximately $7,000,000 if it is not made permanent or if the law is not modified in future legislative sessions. Future exclusion amounts could be higher or lower, and with a current top estate tax rate of 40%,[2] this could mean a hefty estate tax bill for some estates that can erode the overall value. Therefore, it is important to understand the attributes that determine when a life insurance death benefit is included in the gross estate for estate tax purposes.

A properly structured irrevocable trust precludes assets, including life insurance death benefit proceeds, from being includable in the gross estate. An irrevocable life insurance trust (ILIT) is a common class of irrevocable trust that removes the life insurance death benefit from inclusion in the gross estate, preserving the total death benefit value left to the heirs.

Due to the size of some life insurance death benefits, it is important to understand if it will be included in the taxable estate for estate tax purposes.

[1] "Estate Tax," irs.gov, accessed online May 2025
[2] "Instructions for Form 706 (10/2024)," irs.gov, accessed online May 2025

Estate inclusion

- Policy death benefit proceeds are includable in the gross estate of an insured who transferred ownership of the policy as part of a gift within three years of death (known as the "three-year lookback rule").[1]
- Policy death benefit proceeds are includable in the gross estate of an insured if they maintained any incidents of ownership, such as retaining the ability to change or modify the policy in any manner.[2]
- Policy death benefit proceeds are includable in the gross estate of an insured if they are made payable to the executor, or for the benefit of the insured's estate, regardless of who owned the contract or paid the premiums.[3]

Creditor protection

Creditor protection can be another valuable benefit of having a life insurance policy inside a trust. While most states provide some creditor protection of varying degrees for policy owners and beneficiaries, the protections in certain cases are not without limits and are based on how the respective state laws apply to a particular set of circumstances. An irrevocable trust may provide an additional layer of protection to ensure that a creditor cannot satisfy a judgment against the grantor or beneficiary for the cash value or the death benefit proceeds of the policy. It should be noted, however, that an irrevocable trust set up for the purposes of defrauding a creditor may eliminate the protections of an irrevocable trust.

Probate avoidance

Life insurance death benefit proceeds pass via beneficiary designation, and therefore transfer to beneficiaries outside of probate. Certain circumstances can subject an otherwise non-probate asset to the time, cost, headache, and public nature of the probate process. The most common causes for this are outdated or incomplete beneficiary designations and the absence of contingent beneficiaries. Additionally, a life insurance trust can be crafted to include multigenerational distribution planning, which can be more specific and comprehensive than typical per stirpes beneficiary designations.

Guardianship avoidance

Significant inheritances cannot be left to a minor. In the absence of a selected guardian, the courts will get involved, delaying access, incurring costs, and may ultimately designate a guardian who would not have been chosen by the policyholder when they were alive. A life insurance trust avoids these potential complications, as the trust will be receiving the death benefit proceeds which can be administered for the benefit of the minor without court intervention.

Special needs

Certain trusts may be useful for special needs individuals while preserving the ability of the individual to qualify for government benefit programs such as Medicaid and Supplemental Security Income (SSI) from the Social Security Administration.

[1] I.R.C. § 2035
[2] I.R.C. § 2042(2)
[3] I.R.C. § 2042(1)

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