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## **Irrevocable Life Insurance Trusts: Still Useful for New Jersey Residents?**

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*In addition to the usual tax planning reasons for an ILIT, ILITs may be used creatively by practitioners in a variety of circumstances to help achieve a client's goals effectively and efficiently, and should still remain a valuable tool in a practitioner's arsenal.*

In the past, New Jersey estate and trust practitioners regularly used irrevocable life insurance trusts, or "ILITs," to shield life insurance proceeds from New Jersey's estate tax. Generally, with a few exceptions, making an ILIT the owner and beneficiary of a life insurance policy removed the death proceeds of the policy from a client's estate for estate tax purposes. As a result, it was common practice to include ILITs as part of the estate plan for New Jersey clients that owned their home, had modest savings and a life insurance policy with a death benefit that placed the client above the \$675,000 New Jersey estate tax exemption in place from Dec. 31, 2001, to Jan. 1, 2017 (in 2017 the New Jersey estate tax exemption increased to \$2 million). In 2018, New Jersey repealed the New Jersey estate tax and the federal estate tax exemption is over \$11 million per person today. As a result, many trust and estate attorneys have found less need for ILITs. However, despite the repeal of the New Jersey estate tax and the high federal exemption level, there are still circumstances where practitioners may want to consider the use of ILITs.

### **Divorce Settlements**

Life insurance policies are often utilized in the context of a divorce as a risk management tool in order to protect alimony and/or child support payments in the event of the untimely death of the payor spouse. Since support payments typically stop at the payor spouse's death, a life insurance policy on the payor's spouse's life provides a source of funds to cover the expected support payments if the payor spouse were to pass away prematurely. Although life insurance works well as a security tool for these types of obligations, there are practical issues with keeping the policy in force with the agreed-upon terms and amounts and correctly naming beneficiaries. ILITs provide a great mechanism to account for these practical concerns.

Typically, the payor spouse is the insured and minor children are the designated beneficiaries of the policy. In this example, what happens when the payor spouse passes away? Most likely, there would need to be a guardianship or conservator proceeding with respect to the life insurance proceeds, as a minor cannot legally take ownership of inherited property that is left to them directly. These types of proceedings and continued court supervision can add significant expense (and these expenses are typically paid out of the minor's property) and inconvenience. Another scenario may be that the payee spouse is named as beneficiary with the intention that the ex-spouse will use the funds for the support and education of the children. In this situation, what if the payee spouse has personal financial issues? The temptation of using a lump-sum life insurance payment for his or her financial wants and needs, as opposed to using it for the minor children's support, may be too great, resulting in the funds being depleted in a manner not intended by the payor spouse. In other words, while the life insurance proceeds will cover the projected future child support obligations, the funds are vulnerable to the whims of a fiscally imprudent ex-spouse and may be subject to a costly guardianship or conservatorship process.

Also, if the payor spouse is the owner of the policy for the benefit of the minor children, there is no true oversight on whether the policy is being maintained in accordance with the divorce settlement agreement. The payor spouse may decide

not to pay the policy premiums, letting the policy lapse, or perhaps decide to change the beneficiary designation on the policy altogether. In any event, allowing the payor spouse unfettered discretion over the life insurance policy as the owner of the policy brings its own set of risks.

These concerns can be minimized through the use of an ILIT. An ILIT can be established by the payor spouse, but both parties can agree to name a trusted party as the trustee. As trustee, the trusted party has a fiduciary duty to administer the trust property for the benefit of the trust beneficiaries pursuant to the terms of the trust agreement. By naming an appropriate party to serve as trustee, with the exclusive authority to administer the trust property as dictated in the trust agreement, the payor spouse minimizes the possibility that the trust funds are being managed by a fiscally imprudent ex-spouse or other untrustworthy party, and that the trust funds are being used for their intended purpose. To add an additional layer of security, it is also possible to name a "trust protector" to monitor the administration of the trust by the trustee. If the trust protector learns of any mismanagement of the trust proceeds by the trustee, the trust protector has the power to remove that trustee and appoint a successor trustee.

Since the policy proceeds are held in trust for the benefit of a minor beneficiary pursuant to the terms of the ILIT, the need for an expensive court proceeding and continued court supervision is eliminated, resulting in more funds available for the beneficiaries. Typically, the costs of setting up and administering an ILIT are minimal when compared to an ongoing guardianship or conservatorship.

The terms of the ILIT can be crafted to fit the particular family situation and can provide more flexibility than a guardianship or conservatorship, and much more efficiently. For example, if a child-beneficiary has special needs, the ILIT can include language establishing a supplemental needs trust for the benefit of that child-beneficiary, so that the child-beneficiary's government benefits are not jeopardized. In addition, many parents have legitimate concerns about a beneficiary inheriting a significant sum of money even upon reaching the age of majority. If appropriate, the ILIT may contain sub-trusts for each child-beneficiary to hold such beneficiary share of the policy proceeds until such beneficiary reaches a certain age (or for the beneficiary's lifetime) which provides enhanced asset protection for the beneficiary and additional protection from bad influences in the beneficiary's life. Specific concerns regarding issues such as substance abuse, divorce of the beneficiary, etc., may also be addressed in the ILIT trust agreement.

From the perspective of the obligee spouse, an ILIT can provide peace of mind because the trustee of the ILIT provides independent oversight over the ongoing policy maintenance. For example, as the owner of the policy, the trustee will receive all notifications relating to premium payments. If a premium is not paid, the trustee may notify the appropriate parties that the payor spouse is not in compliance with the terms of the divorce settlement agreement. In addition, the ILIT can be initially funded with enough cash to cover a certain amount of premiums.

In sum, life insurance as a security tool for support obligations in connection with a divorce can be further leveraged with the use of an ILIT. Although the former couple may have competing interests, an ILIT provides benefits and security to both sides, and most importantly, provides the best assurance that the children will receive the greatest benefit from the policy proceeds in a manner that addresses the family's individual circumstances and needs.

## **Inheritance Tax**

The repeal of New Jersey's estate tax did not affect New Jersey's inheritance tax. Inheritance tax is not based on the value of a decedent's assets, but rather on the relationship of the beneficiary to the decedent. Accordingly, if a client wishes to

significantly benefit someone other than a Class A beneficiary (Class A beneficiaries include a spouse, child or grandchild), they may consider the use of an ILIT. An ILIT is appropriate if the client is concerned about the outright payment of the death proceeds to the beneficiary, such as the case of a minor beneficiary, a beneficiary receiving government assistance, or a beneficiary with a history of creditor problems. Importantly, the New Jersey inheritance tax provides an exemption for life insurance paid directly to a beneficiary and, therefore, the use of an ILIT for the avoidance of inheritance tax will only be helpful where there are other underlying concerns that suggest the use of a trust.

## Changes in the Law

There still remains uncertainty regarding the future of the New Jersey and federal estate taxes. Accordingly, clients with above-average wealth may still wish to consider an ILIT to protect against a reduction in the federal estate tax exemption levels (currently scheduled to be reduced to \$5 million indexed for inflation as of Jan. 1, 2026) or a possible reinstatement of the New Jersey estate tax. If history is a guide, these laws change frequently, and moderately wealthy clients may find ILITs attractive as a hedge against these potentially unfavorable tax law changes, especially where non-tax considerations, such as creditor protection, planning for special needs, and fiduciary management of the insurance proceeds, are especially compelling.

## Conclusion

While ILITs used to be commonplace in traditional estate planning, practitioners have been utilizing them much less due to the elimination of the New Jersey estate tax and the high federal estate tax exemption level. However, in addition to the usual tax planning reasons for an ILIT, ILITs may be used creatively by practitioners in a variety of circumstances to help achieve a client's goals effectively and efficiently, and should still remain a valuable tool in a practitioner's arsenal.

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