

Estate Planning with Life Insurance Trusts

By Bonnie J Orr, CPA

How will my spouse and children survive without my income? How will they pay the mortgage and college tuition? Will they be able to maintain our current lifestyle with what we've saved so far? Will they be able to pay estate taxes without having to sell our assets at fire sale prices? These are typical estate planning questions that estate planners strive to answer.

Life insurance is often included in the estate plan to provide the liquidity needed by the family to continue living the way they are accustomed to live, to provide for education for minor children, and to provide funds for estate taxes when an estate does not have liquid assets to cover them.

Although not usually subject to federal income tax, life insurance death benefits can be subject to federal estate tax. Life insurance policies can boost the value of your total estate, but the death benefits can also create unexpected federal estate tax consequences. This, coupled with the uncertainty in the future of the federal estate tax, calls for careful planning. An irrevocable life insurance trust (ILIT) can be a very useful estate planning tool for this purpose.

TAX SAVINGS

The purpose of an ILIT is to remove your life insurance policies from your estate, thereby reducing or eliminating federal estate tax on the death benefits. Cash contributions made to the ILIT to cover insurance premium payments can qualify for the annual gift exclusion (currently up to \$12,000).

Once the ILIT is created, the ILIT may purchase new policies or receive transfers in of your existing life insurance policies. Policies transferred in, (not purchased by the ILIT), are subject to a three year estate tax inclusion period. The trust owns the policies and is designated as the beneficiary of the policies insuring your life. The trustee (someone other than yourself) makes sure that the insurance premiums are paid, properly manages the trust, and follows the directions you built into the trust regarding distribution of the insurance proceeds after your death.

GREATER CONTROL

Your ILIT provisions can be customized to distribute the insurance proceeds in a way that insurance policies alone cannot. Whereas an insurance contract form generally only allows for a beneficiary designation, ILIT provisions can be specifically tailored. For example, an ILIT can direct that your spouse have the benefit of the income and some principal for his or her support during his or her lifetime, after which any remaining assets would be distributed to your children, either in trust or outright, once the children reach a certain age that you choose.

ILIT CAVEATS

Irrevocable life insurance trusts are, by definition, irrevocable: the trust cannot be changed once it is signed. Moreover, you must give up all ownership rights in the policies, including the right to modify the trust, change beneficiary designations, or borrow against policies. In addition, someone other than you must serve as trustee in order to satisfy the irrevocability requirement. This irrevocability is necessary, however, in order to remove the insurance policies from your estate for estate tax purposes.

TRUSTEE RESPONSIBILITIES

It is the responsibility of your trustee to adhere to fiduciary responsibilities. Sometimes trustees are unpleasantly surprised to find that they are personally liable if they do not act responsibly as a fiduciary of the trust. The trustee must understand the terms of the trust and properly manage the trust to conform to those terms. This includes the responsibility for determining if the current life insurance policies are prudent investments. The trustee should check the policies to be sure that they will continue as needed, check to see if the premiums paid could be less, or if the premiums could be buying more coverage. The trustee should also make sure they are not keeping unnecessary coverage in force, or the wrong type of policies for the estate plan requirements. These issues are sometimes neglected, and should not be. Many independent agents are equipped to review policies owned by ILITs. The trustee should have the policies reviewed by an independent reviewer on a regular basis. We recommend that this be done at least once every five years for current ILITs.

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