Winter News

This quarter I am writing about an estate planning technique which can avoid estate taxes.

As you may remember, life insurance proceeds are includable in your estate for estate tax purposes. To avoid having your insurance proceeds includable in your estate and to pass your insurance estate tax free, an estate planning technique called an “Irrevocable Life Insurance Trust,” or ILIT, can be created.

The idea is to create a trust to hold your life insurance policy. You name the ILIT as the owner and beneficiary of the policy, and you name whomever you want to receive the proceeds as the beneficiaries of the ILIT.

If it’s done right, the policy proceeds will go to the beneficiaries you select and not be included in your taxable estate.

Once a year, you’ll transfer to the ILIT enough money to pay the policy premiums. This transfer to a trust would ordinarily be subject to the gift tax. But there’s a way around that problem, too.

Under the gift tax laws, you can give $12,000 per person per year to any individuals you want before the gift tax applies. So the idea is to “give” the money to your trust beneficiaries for tax purposes, while actually having it go to the ILIT.

This is done by making a transfer to the ILIT with the condition that the beneficiaries of the ILIT can claim it if they want to. Whenever a transfer is made, the trustee will send a letter to the beneficiaries – or their parents or guardians, if they’re children – saying the beneficiaries have a specific period of time (usually 30 or 60 days) to withdraw the money if they want to do so.

Presumably, if you’ve explained the tax advantages to your beneficiaries, they won’t withdraw the money. (In practice, beneficiaries almost never do.) However, for gift tax purposes, you’ve “given” the money to the individual beneficiaries, rather than to the ILIT, so the gift tax is avoided.

When you die, the policy proceeds will be paid to the ILIT, and will be disbursed according to the terms of the trust. In many cases, they will simply be turned over to the beneficiaries.

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But you can also create other options as part of your estate planning. For instance, the trust could continue, invest the proceeds, and provide funds to the beneficiaries over time.

It's also possible to use an ILIT to create liquidity for your estate to pay the estate taxes, by permitting the ILIT to purchase estate assets for cash or loan the estate money.

You can set up the trust before getting life policy.

In general, ILITs work best if you set them up before you obtain a life insurance policy. If you transfer an existing policy to an ILIT, then the estate tax benefits will be lost if you happen to die within three years of the transfer. Of course, this may be a gamble that is well worth taking.

If you don't currently have a life insurance policy, or you're thinking of getting a new one, and you want to use an ILIT, then you'll want to be careful about your timing. The key date to keep in mind is the "issuance date" of the policy, which is the date when the policy becomes effective. (This is different from the "policy date," which is the date the insurance company uses to determine your premiums.)

To avoid the three-year problem – and other possible problems – the ILIT must be created prior to the issuance date. If you're concerned that you might be turned down for a policy, or that the premiums will be more expensive than you'd like to pay, then you might want to wait to create the ILIT until you've actually applied for a policy and gotten assurances about its terms. However, don't let the insurance company actually issue the policy until the ILIT is in place.

We'd be happy to answer your questions, if you are interested in finding out more about this important estate planning technique.

Stay Warm!

Meg E. Goblet

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