

Getting the Most Out of Your Life Insurance:

The Irrevocable Life Insurance Trust

If you own life insurance, congratulations. Sadly, most of us put off this critical element in our family's financial planning, which may have devastating consequences on the loved ones left behind.

You probably know why life insurance is so important. Young families need it to replace part of a breadwinner's income. Mature Americans find it provides their heirs with a source of funds to pay estate taxes. Investors have discovered that innovative insurance products help them build cash value, tax deferred, for long-term goals like retirement.

But remember, buying life insurance may be only part of the solution. Without proper planning, it can actually add to your estate tax bill.

THE MISTAKE THOUSANDS OF AMERICANS MAKE

Countless well-meaning parents, spouses and others make a simple but costly mistake when buying life insurance policies. They do not think about who should own the policy.

Unfortunately, that simple act could cost your heirs plenty. Here's why.

Every American is entitled to an estate tax exemption on the first \$3,500,000 of his or her estate. With proper planning, a married couple can shelter up to \$7 million. You need to take every precaution possible to reduce the value of your estate for estate tax purposes, and that includes life insurance planning.

While your beneficiaries will receive the death benefit income tax free, the proceeds are not estate tax free. Say, for example, that you are single, that your home, retirement benefits, and other assets total \$3,500,000. Your estate will pass to your heirs estate tax free. But add in a life insurance policy with a death benefit of \$1,000,000. Your estate is now worth \$4,500,000 and subject to estate taxes.

Estate taxes are 45 percent for 2009, rising to 55 percent after 2010. So, that is quite a tax bite to which you have exposed your estate.

The net result: your heirs will see part of your legacy lost needlessly to the government via estate taxes.

PRESERVING YOUR LEGACY FOR THOSE YOU LOVE

A simple solution exists that not only avoids the estate tax problem but also provides a host of other benefits. It is called an Irrevocable Life Insurance Trust— or ILIT for short— and allows you to protect your loved ones without adding to your estate taxes. Because your ILIT actually owns your policy, its death benefit will not be taxable in your estate. Here's how it works.

You set up your ILIT and name a Trustee other than yourself. Trustees are most often the beneficiaries of the trust or a financial advisor. (If your beneficiaries are your minor children, you will want to name as Trustee the person you have chosen to be their guardian or some other responsible adult.) The fact that you are not actively involved as a Trustee should give you no cause for concern. Your Trustee—or Trustees— must precisely follow the instructions you provide in your trust documents.

IT MAY BE CRUMMEY, BUT IT'S STILL A GOOD IDEA

After you create your Trust, your Trustee purchases a life insurance contract on your life with funds you provide. If you have an existing policy, you can assign ownership of it to the ILIT, but there are conditions imposed on these transactions that should be carefully considered before you do so. For instance, if you die within three years of the transfer, the life insurance contract will be included in your estate.

Annually, a taxpayer may give up to \$13,000 (indexed for inflation) to another person gift tax-free. Married couples, therefore, can give a combined total of \$26,000 gift tax-free to any one person. Other than this per-person rule, there is no limit on the total amount you can give away. For example, if you have five children and eight grandchildren, you and your spouse could give each one \$26,000, for a total of \$338,000 annually! That can buy a lot of life insurance coverage.

By carefully following the IRS rules, you can employ this gift-tax exemption to make the policy's premium payments. When you provide your Trustee with the funds to pay your annual premium, your Trustee must notify your beneficiaries in writing that a gift has been made in their names. Your beneficiaries will have the option of withdrawing these funds from your ILIT during a specified period, usually a minimum of 30 days. When they do not exercise their option, your Trustee will use the money to pay your insurance premium. This written notification of your gift to your beneficiaries is the so-called Crummey Letter, bearing the name of the taxpayer who succeeded in getting the IRS approval of this process. An annual Crummey Letter to your beneficiaries is an essential element of a successful ILIT.

STAYING IN CONTROL— TODAY, TOMORROW AND FOR YEARS TO COME

Reducing your estate tax liability is a powerful incentive for considering the ILIT. But that is just the beginning of the long list of benefits it provides.

The ILIT provides you control over how proceeds from your life insurance policy are spent. It is a mistake if you fail to control how the beneficiaries receive the policy's proceeds. Even an adult with experience may find the large sum of money overwhelming. But when the beneficiaries are young adults who lack the maturity to handle such a windfall, the results can be devastating.

With the ILIT, you control who receives the proceeds, and how they receive it. Whatever distribution strategy makes most sense for you and your loved ones, the ILIT gives you the opportunity to put it into effect.

In many states, ILITs offer you the best— if not the only— way to protect the cash value of your policy from creditors. Over the years, your premiums and interest earnings can accumulate to considerable sums, making cash value policies a tantalizing target for creditors. Creditors may be successful in getting to the cash value if you own the policy. When the policy is owned by the ILIT, however, it is out of your creditor's reach.

A SHORT-CUT THAT DOESN'T WORK

If you have taken this cautionary tale of life insurance and estate taxes to heart but do not want to implement an ILIT, you may be considering short cuts. One often-employed strategy is to make someone else the owner of your policy. It solves the estate-tax problem, but it also spawns a host of others, all involving your loss of control over the disposition of the policy. For example:

- The policy's owner can reassign it, pledge it as collateral, or expose it to threats from creditors.
- There is nothing to keep the owner from spending your annual premiums on his or her own priorities, instead of keeping the policy in force.
- If the owner gets divorced, an ex-spouse can end up with a piece of your policy.
- You will have no option for controlling how your beneficiaries spend the policy's proceeds.

Let's look at a worst-case scenario. Say your son, Junior is the owner of the policy on your life. Over the years, the policy builds up a considerable cash value. Junior launches a business partnership, which soon fails. His creditors seize some of the policy's cash value to settle his debt. Later, Junior gets divorced. His ex-wife gets a piece of the cash value. However, the policy is still in force. So you continue to send Junior money for annual premium payments. Then one day, your insurance agent tells you that the policy has lapsed. It seems that Junior has been spending your money on his own priorities. Although Junior's story is extreme, it paints a clear picture of how much control you give up when you let someone else own your life insurance policy.

GETTING STARTED TODAY

An ILIT is a reasonably simple process, and should involve very little of your time or energy. There are details that require the expert attention of a knowledgeable estate planning attorney. For instance, your ILIT will require a separate federal tax ID number, a separate bank account and maybe its own annual tax return.

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