

## TAX CHANGES IN 2011 MAKE LIFE INSURANCE PLANNING CRITICAL

Most clients are shocked to learn that the death proceeds of their life insurance are subject to federal estate taxation. Clients believe that life insurance escapes estate taxes and passes to their loved ones intact. On January 1, 2011, the Tax Relief Act of 2000 expires, and the Federal Estate Tax Exemption returns to \$1,000,000.00 per individual. For clients with taxable estates, estate taxes will consume up to 55% of their life insurance proceeds.

The Irrevocable Life Insurance Trust (or "ILIT") has proven to be a highly effective method of avoiding estate taxes. The ILIT has been tested extensively in court and an experienced estate planning attorney should have no trouble in properly drafting this document.

ILITs are planning tools used to keep life insurance proceeds outside of the taxable estate.

For example, if a married couple has an estate of \$3 million, beginning January 1, 2011 they can pass \$2 million to the next generation with no tax if they set up the proper trust arrangement to take advantage of the maximum lifetime unified credits. That leaves \$1 million still subject to tax under the current law.

The logical thing to do is to purchase a survivorship life insurance policy for the projected tax. However, a policy purchased in the manner most people are familiar with, the problem is not solved; it is compounded.

If the couple has any "incidences of ownership" in the policy, it will be included in the estate. The purchase of \$2 million dollar face amount policies increases the estate to \$5 million. Two million dollars passes tax-free, but now the taxable estate is \$3 million. This increases the tax by \$1 million dollars.

### **Enter the Irrevocable Life Insurance Trust.**

Attorneys draft Irrevocable Life Insurance Trusts. The trust will apply for its own Federal Tax ID number. The trust will then apply for the survivorship life insurance policy. It will be the applicant, owner and beneficiary of the policy. Typical wording is "The [Client] Irrevocable Life Insurance Trust dated January 1, 2011, Vera E. Responsible, trustee."

In this example, since neither client have any "incidence of ownership" in the policy, it will not be part of their taxable estate.

Typically, the life insurance premiums are paid by the parents in the form of annual gifts to the Irrevocable Life Insurance Trust. Currently (2010) a person can give up to \$13,000 each year to as many people as they want without paying gift tax or having the amount subtracted from their lifetime exclusion.

Upon death, the Trustee receives the death benefit. These proceeds can be distributed to your family, held in trust, or used to purchase assets from your estate. This last option would be important if your estate had insufficient liquid assets to pay estate taxes. Those with large estates

may not have enough cash to pay estate taxes in a reasonable time frame. Life insurance can provide that money.

In sum, the ILIT is an IRS approved means of removing your life insurance proceeds from your taxable estate, and yet still have the proceeds available to provide for your spouse and children according to your desires. Gifts made each year to the ILIT can be exempt from gift tax. For those with taxable estates, the savings in estate taxes can exceed 55% of the death proceeds. The ILIT can also protect your family after you are gone. Many types of trusts are available to protect children from lawsuits, divorce, or their own indiscretion.

If you have a taxable estate and own a large insurance policy, or are contemplating purchasing one, see us today to discuss how the ILIT might benefit your family.