Irrevocable Life Insurance Trusts Can Reduce Estate Taxes

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Many people are not aware that life insurance death benefit proceeds are part of their taxable estate and thus can potentially increase the amount of estate taxes that must be paid. Federal estate taxes are expensive and must be paid in cash, usually within nine months after the date of death. Since very few estates have this kind of cash, estate assets often have to be liquidated. If you plan ahead, however, estate taxes can be substantially reduced or even eliminated.

An irrevocable life insurance trust (ILIT) lets you lower your estate taxes so more of your assets can go to your loved ones. For example, suppose a father owns a $500,000 life insurance policy that names his wife and two children as beneficiaries. The death benefit is not taxable to his wife and children as income, but it is generally taxable as part of his gross estate. These taxes could reduce the amount available to support the family after his death.

The ILIT is useful in this situation because it avoids estate taxation by removing the father's "incidents of ownership" over the life insurance policy. The ILIT owns your life insurance policy for you and is the beneficiary of the death benefit proceeds. Since you do not own the policy, the death benefit proceeds are not included in your estate. The trustee makes the premium payments and must follow the instructions you put in your insurance trust document, giving you control over your policy and death benefit proceeds.

People interested in utilizing these trusts should be aware of the tax pitfalls associated with improper planning. One major consequence relates to an IRS rule that taxes life insurance death benefits to the estate if the policy owner dies within three years of transferring the policy to the ILIT. The most efficient solution is to establish an ILIT first and then allow the ILIT to purchase the life insurance policy.

Another area of concern is gift taxation. If you transfer an existing policy that has a cash value to an ILIT, gift taxes may be due. The ILIT is considered a separate entity and any funds contributed to such a trust are considered gifts subject to gift taxes. This includes amounts contributed to pay the insurance premiums. A properly drafted ILIT normally includes language that alleviates some of the negative effects of gift taxation by efficiently utilizing the annual exclusions available.

ILITs are used extensively in estate planning because they remove assets from an individual's estate, thus reducing estate taxes. An ILIT should be drafted by an estate planning attorney to ensure compliance with state and federal laws. Proper tax planning also should be done in advance. Properly designed and implemented, ILITs allow a surprisingly high degree of flexibility coupled with significant estate planning benefits.

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