IRREVOCABLE INSURANCE

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The Revocable Living Trust is a trendy topic for seminar, these days. When you strip away all the hype, however, the Revocable Living Trust is merely a device to avoid probate proceedings. It will not help you avoid estate tax.

If you are looking for a way to lessen the tax burden on your estate, one of the most effective strategies still available is the structuring of an Irrevocable Life Insurance Trust, or an "ILT". The proceeds of an ILT insurance policy are not considered part of your estate, thereby you avoid paying estate tax.

An ILT is a trust designed to be separate and distinct from the grantor the person who creates the trust and places funds into it. The trust maintains its own existence as defined by the trust document and once the trust is established, the grantor has no right to alter, amend or revoke it. Since there is no right to alter, amend or revoke an ILT, the property owned by the trust is not considered owned by the taxpayer upon his or her death. This is the key to eliminating estate taxation. Since an estate tax is only upon the property owned by the taxpayer at death, the ILT is not considered owned by the taxpayer, and the ILT is not considered part of the taxable estate.

How it works:

To set up an ILT, the taxpayer will generally obtain a competent tax and trust counsel to draft the document. The trust is designed so that the taxpayer has no ownership. The taxpayer generally makes annual gifts to the trust which would allow for the purchase of a life insurance policy on the taxpayer or on the joint lives of the taxpayer and his or her spouse. After the annual contributions or transfers of property are made to the trust, the trust would have funds available to pay life insurance premiums. There are various provisions that can be drafted into the trust which would also create a gift tax exclusion for up to $10,000 per beneficiary per year for such gifts. The benefit here is that annual contributions to the trust for life insurance premiums are exempt from gift taxes in most cases.

The trust would continue paying for the policy premium, and upon the taxpayers death, the face value of the policy would be paid to the trust. On a theoretical estate of 51.5 million. the estate tax is approximately $560,000. If insurance proceeds are paid to the ILT, the funds could be utilized to pay the estate tax. If the estate instead had owned the insurance policy or proceeds, the increase in the estate tax would have been $252,000 dollars. In this hypothetical case, the $252,000 of estate tax is saved and would be available for the taxpayer's taxpayer's family.

Many parties try to avoid tax by setting up a life insurance trust. Instead they opt to have either their children or their spouse own life insurance policies. Neither strategy is as effective because of the many problems that can occur.

For instance, when a parent sets up a child as the owner of a life insurance policy, the parent will usually have to transfer gifts of funds to the child to pay the premiums by transferring these funds, the parent can be construed as having an incidence of ownership in the life insurance policy. If this occurs, then the proceeds of the policy will be included in the parent's estate and taxed accordingly. This defeats the purpose of the strategy. Furthermore, the proceeds of the policy passed to the children may not be used to pay the estate tax.

If either spouse owns the policy proceeds, then all property, including the insurance proceeds, passing from the deceased to the surviving spouse will later be taxed on the second spouse's death. This needlessly increases the estate tax by increasing the value of the estate. ILT's on the other hand, can be utilized to hold the new "second-to-die" life insurance policy proceeds.

An ILT. when properly drafted and structured, eliminates estate tax inclusion. This assures that the bulk of the parents' estate will pass to their heirs, because the estate tax can be paid with far fewer funds than direct payment of estate.

NOTE: Purchasing a new insurance policy avoids the Internal Revenue code three-year look back rule. This is the rule that allows the Internal Revenue Service to look back within three years of death at all gift transfers in an attempt to include the transferred property in the gross estate.