LEGALLY SPEAKING

Wills, Trusts & Estates: Plain And Simple

Irrevocable Life Insurance Trusts (ILITs) Can Help You Save Estate Tax

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When a loved one dies, the family and the attorney go over the assets included in the decedent's estate for estate tax purposes. Most times, I have to specifically ask whether there was life insurance on the decedent's life, as people are unaware that proceeds of life insurance are included in the decedent's estate for estate tax purposes (assuming the decedent owned the policy). If the proceeds are payable to a spouse or a charity, a deduction is applied equal to the proceeds, and they are, therefore, not subject to estate tax. If the proceeds, however, are payable to anyone else, they are included in the decedent's taxable estate and will be subject to estate tax if the estate assets, including the proceeds, exceed the estate tax exemption amounts (NY – currently $3.125 million; Federal – currently $5.43 million).

One easy way to keep life insurance proceeds out of your estate is to have an Irrevocable Life Insurance Trust (an "ILIT") own the policy. You create the ILIT; the beneficiaries and terms of the ILIT can be whomever and whatever you would like. The trust is irrevocable. If you contribute cash to the ILIT and the Trustee purchases the life insurance with the funds from the ILIT, the policy proceeds are out of your estate. If you transfer an existing policy to an ILIT, you must live three years from the date of the transfer for the policy proceeds to be out of your estate for estate tax purposes. (Note that a way around the three year rule is for you to transfer cash to the ILIT [a gift, which may fall within your annual exclusion amounts - - $14,000 individually; $28,000 married couple] and then have the ILIT purchase the policy from you.)

Life insurance is purchased for many reasons, including to protect loved ones, to pay for estate taxes and to equalize bequests to children (ex., one child gets the $5 million business and the other gets $5 million of insurance proceeds). If you are single, have a $5 million business and $5 million of life insurance that you individually own, your tax bill is computed on $10 million, thereby subjecting your estate to federal estate tax on $4,570,000 (about $1.4 million) and NY estate tax on $6.875 million (about $1.1 million). If you had put the life insurance in an ILIT, your tax bill would have been computed on $5 million, resulting in $0 federal estate tax (a savings of about $1.4 million) and a NY estate tax of about $400,000 (a $700,000 savings).

ILITs have some technical rules that your estate planning lawyer can further explain to you. Using an ILIT is a simple way to protect your family and lower your estate tax burdens – really!

If there is a trusts or estates topic that you would like to know more about, please feel free to email me at pmarcin@farrellfritz.com with your suggestion and I will do my best to cover it in a future column.

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