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Irrevocable Life Insurance Trusts and how they work

Despite the premium costs that no one ever enjoys paying, life insurance has become a necessity. So many of my clients initially say that they could care less about what happens when they're gone, until I describe to them the benefits that a life insurance policy can provide to family survivors.

In the realm of estate planning, life insurance certainly plays a significant role, for reasons most people are simply not aware of. First and foremost; life insurance proceeds paid upon death can (depending on the policy amount) provide a significant amount of assets passing to the surviving family members, usually the spouse or children. By having a life insurance policy, the estate will have the liquidity it needs to pay taxes and probate costs, thereby avoiding the forced sale of other assets.

Whether or not a life insurance policy is included as an asset of the estate depends upon ownership at the time of death. If a life insurance policy is owned by the decedent at the time of death, then the proceeds will be included in the estate for tax purposes, despite the fact that the proceeds (death benefits) may go to the beneficiary named on the policy tax free. Remember, probate taxes and costs always follow ownership and control.

Another reason for life insurance is the relatively quick access to the insurance proceeds, rather than the typical delay in estate assets tied up in Probate Court. Hence, the creation of the Irrevocable Life Insurance Trust. (ILIT)

When properly prepared, a ILIT can effectuate the transfer of the insurance proceeds to a Trust for the benefit of the survivors without exposure to estate taxation for either spouse.

There are two ways to establish this Trust; either transfer an existing policy to a newly created Trust, or create a new ILIT and have a new life insurance policy purchased by the Trust. Regarding the former, note that any transfer of an existing policy must be done at least three years prior to death in order to avoid the taxation.

Here's how it works:

Scenario one- Chris (the insured) establishes an ILIT. He then transfers an existing life insurance policy into the ILIT, which will become both the owner and beneficiary of the life insurance policy. Chris will also designate in the Trust documents who he wishes to be the beneficiaries of the Trust. Upon his death, the Trust is paid the insurance proceeds, which are then distributed in accordance with the Trust provisions.

Scenario two- Chris creates an ILIT. Then the ILIT purchases a new life insurance policy through the Trustee, who signs the policy. The rest of the first scenario stays the same.

An ILIT also serves as an additional Bypass Trust which benefits the surviving spouse because there will be no estate tax liability on the remaining proceeds of the policy. Also, the ILIT pays no income tax on the insurance proceeds.

What should you be concerned about? ILIT's should not be created or funded without the assistance of legal counsel. Cash values of existing policies, as well as the method used to make insurance premium payments, will effect gift tax calculations. Also, as is the case with the creation of any type of Trust, the wording of the Trust provisions and the powers provided under the terms of the trust are extremely important. A poorly written trust can result in devastating, and often unsuspected, tax consequences.

The benefits of an ILIT are boundless in estate planning and are another cornerstone of a quality estate plan. They are uncomplicated and cost efficient. Considering the benefits and financial savings to the surviving family, I highly recommend the use of the ILIT.

Anthony J. Medico, Esq., *has practiced law for over 27 years. To ask a question regarding this article, send an e-mail to info@medicoandassociates.com or call us at (203) 661-8151. To read more highly informative Estate Planning articles, visit our website at www.medicoandassociates.com, where you can also download our free Estate Planning Survival Guide. Enjoy.*

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