GETTING THE MOST OUT OF YOUR LIFE INSURANCE

The Irrevocable Life Insurance Trust

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If you own life insurance, congratulations. Sadly, most of us put off this critical element in our family's financial planning, which may have devastating consequences on the loved ones left behind.

You probably know why life insurance is so important. Young families need it to replace part of a breadwinner's income. Mature Americans find it provides their heirs with a source of funds to pay estate taxes. Investors have discovered that innovative insurance products help them build cash value, tax deferred, for long-term goals like retirement.

But remember, buying life insurance may be only part of the solution. Without proper planning, it can actually add to your estate tax bill.

THE MISTAKE THOUSANDS OF AMERICANS MAKE

Countless well-meaning parents, spouses and others make a simple but costly mistake when buying life insurance policies. They don't think about who should own the policy.

Unfortunately, that simple act could cost your heirs plenty. Here's why.

Every American is entitled to an estate tax exclusion on the first part of his or her estate. The exclusion is $5.49 million in 2017. You may need to take every precaution possible to reduce the value of your estate for estate tax purposes, and that includes life insurance planning.

While your beneficiaries will receive the death benefit income tax-free, the proceeds are not estate tax-free. Say, for example, that your home, retirement benefits, and other assets total $3.1 million. Your estate will pass to your heirs estate tax-free. But add in a life insurance policy with a death benefit of $3 million. Your estate is now worth $6.1 million and subject to estate taxes. Estate taxes are levied to a 40% rate after your exclusion, so your estate would owe a hefty estate tax.

The net result: your heirs will see part of your legacy lost needlessly to the government.

PRESERVING YOUR LEGACY FOR THOSE YOU LOVE

There's a simple solution that not only avoids the estate tax problem but also provides a host of other benefits. It's called an Irrevocable Life Insurance Trust— or ILIT for short— and it allows you to protect your loved ones without adding to your estate taxes. Because your ILIT actually owns your policy, its death benefit won't be taxable in your estate. Here's how it works.

You set up your ILIT, and name a trustee other than yourself. Trustees are most often the beneficiaries of the trust or a financial advisor. (Obviously, if your beneficiaries are your minor children, you'll want to name as trustee the person you've chosen to be their guardian or some

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other responsible adult.) The fact that you are not actively involved as a trustee should give you no cause for concern. Your trustee—or trustees—will have to precisely follow the instructions you provide in your trust documents.

IT MAY BE CRUMMEY, BUT IT'S STILL A GOOD IDEA

After you create your trust, your trustee purchases a life insurance contract on your life with funds you provide. If you have an existing policy, you can assign ownership of it to the ILIT, but there are conditions imposed on these transactions that should be carefully considered before you do so. For instance, if you die within three years of the transfer, the life insurance contract will be included in your estate.

Annually, a taxpayer may give up to $14,000 (indexed for inflation) to another person gift tax-free. Married couples, therefore, can give a combined total of $28,000 gift tax-free to any one person. Other than this per-person rule, there's no limit on the total amount you can give away. For example, if you have five children and eight grandchildren, you and your spouse could give each one $14,000, for a total of $364,000 annually! That can buy a lot of life insurance coverage.

By carefully following the IRS rules, you can employ this gift-tax exemption to make the policy's premium payments. When you provide your trustee with the funds to pay your annual premium, your trustee must notify your beneficiaries in writing that a gift has been made in their names. Your beneficiaries will have the option of withdrawing these funds from your ILIT during a specified period, usually a minimum of 30 days. When they don't exercise their option, your trustee will use the money to pay your insurance premium. This written notification of your gift to your beneficiaries is called the Crummey Letter, bearing the name of the taxpayer who won a court case against the IRS resulting in approval of this process. An annual Crummey Letter to your beneficiaries is an essential element of a successful ILIT.

STAYING IN CONTROL—TODAY, TOMORROW AND FOR YEARS TO COME

Reducing your estate tax liability is a powerful incentive for considering the ILIT. But that's just the beginning of the long list of benefits it provides.

The ILIT provides you control over how proceeds from your life insurance policy are spent. It is a mistake if you fail to control how the beneficiaries receive the policy's proceeds. Even an adult with experience may find the large sum of money overwhelming. But when the beneficiaries are young adults who lack the maturity to handle such a windfall, the results can be devastating.

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With the ILIT, you control who receives the proceeds, and how they receive it. Whatever distribution strategy makes most sense for you and your loved ones; the ILIT gives you the opportunity to put it into effect.

In many states, ILITs offer you the best—if not the only—way to protect the cash value of your policy from creditors. Over the years, your premiums and interest earnings can accumulate to considerable sums, making cash value policies a tantalizing target for creditors. They may be successful in such an action if you own the policy. When the policy is owned by the ILIT, however, it is generally out of your creditor's reach.

A SHORT-CUT THAT DOESN'T WORK

If you've taken this cautionary tale of life insurance and estate taxes to heart but don't want to implement an ILIT, you may be considering short cuts. One often-employed strategy is to make someone else the owner of your policy. It solves the estate-tax problem, but it also spawns a host of others, all involving your loss of control over the disposition of the policy. For example:

The policy's owner can reassign it, pledge it as collateral, or expose it to threats from creditors.

There's nothing to keep the owner from spending your annual premiums on his or her own priorities, instead of keeping the policy in force.

If the owner gets divorced, an ex-spouse can end up with a piece of your policy.

You'll have no option for controlling how your beneficiaries spend the policy's proceeds.

Let's look at a worst-case scenario. Say your son, Junior is the owner of the policy. Over the years, the policy builds up a considerable cash value. Junior launches a business concern, which soon fails. His creditors seize some of the policy's cash value to settle his debt. Later, Junior gets divorced. His ex-wife gets a piece of the cash value. However, the policy is still in force. So you continue to send Junior money for annual premium payments. Then one day, your insurance agent tells you that the policy has lapsed. It seems that Junior has been spending your money on his own priorities.

Although Junior's story is extreme, it paints a clear picture of how much control you give up when you let someone else own your life insurance policy.

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