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Benefits of a Life Insurance Trust

- Provides immediate cash to pay estate taxes and other expenses after death.
- Reduces estate taxes by removing insurance from your estate.
- Inexpensive way to pay estate taxes.
- Proceeds avoid probate, and are free from income and estate taxes.
- Gives you maximum control over insurance policy and how proceeds are used.
- Can provide income to spouse without insurance proceeds being included in spouse's estate.
- Prevents court from controlling insurance proceeds if beneficiary is incapacitated.

Should I seek professional assistance?

Yes. If you think an irrevocable insurance trust would be of value to you and your family, talk with an insurance professional, estate planning attorney, corporate trustee, or CPA who has experience with these trusts.

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Understanding LIFE INSURANCE TRUSTS

How to Reduce or Eliminate Your Estate Tax Cost

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What does an irrevocable life insurance trust do?

An irrevocable life insurance trust gives you more control over your insurance policies and the money that is paid from them. It also lets you reduce or even eliminate estate taxes, so more of your estate can go to your loved ones.

What are estate taxes?

Estate taxes are different from, and in addition to, probate expenses and final income taxes which are due on the income you receive in the year you die. Federal estate taxes are expensive (historically 45%-55%) and they must be paid in cash, usually within nine months after you die. Because few estates have the cash, it has often been necessary to liquidate assets to pay these taxes. But if you plan ahead, estate taxes can be reduced or even eliminated.

Who has to pay estate taxes?

Your estate will have to pay federal estate taxes if its net value when you die is more than the exempt amount set by Congress at that time. In 2011 and 2012, the federal exemption is $5 million (adjusted for inflation in 2012) and the tax rate is 35%. If Congress does not act before the end of 2012, the exemption in 2013 will be $1 million and the top tax rate will be 55%. Some states also have a death or inheritance tax.

Year of Death	Exempt Amount	Top Tax Rate
2011 and 2012	$5 million*	35%
2013 and thereafter	$1 million	55%

* Adjusted for inflation in 2012

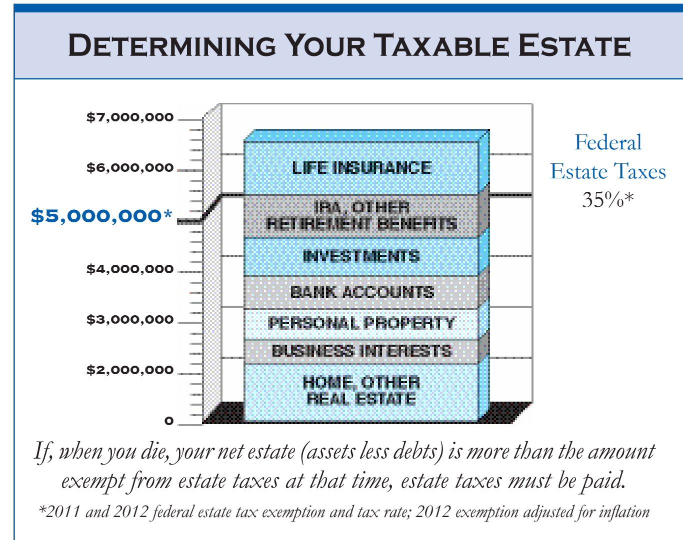
What makes up my net estate?

To determine your current net estate, add your assets (see chart at right) then subtract your debts. Insurance policies in which you have any "incidents of ownership" are included in your taxable estate. This includes policies you can borrow against, assign or cancel, or for which you can revoke an assignment, or can name or change the beneficiary. You can see how life insurance can increase the size of your estate and the amount of estate taxes that must be paid.

How does an insurance trust reduce estate taxes?

The insurance trust owns your insurance policies for you. Since you don't personally own the insurance or have any incidents of ownership, it will not be included in your estate—so your estate taxes are reduced. (There is a three-year rule for existing policies, which is explained later.)

Determining Your Taxable Estate



If, when you die, your net estate (assets less debts) is more than the amount exempt from estate taxes at that time, estate taxes must be paid.

**2011 and 2012 federal estate tax exemption and tax rate; 2012 exemption adjusted for inflation*

With the exemption currently at more than $5 million, you may not need the estate tax savings right now. But it's important to understand how this works, because the exemption may be reduced as soon as 2013 and the value of your net estate may increase substantially by the time you die.

Let's say you are married, with a combined net estate of $3 million, $1 million of which is life insurance, and both you and your spouse die when the estate tax exemption is $1 million and the top tax rate is 55%. A tax planning provision in a living trust or a will could protect up to $2 million from estate taxes. But your estates would have to pay $435,000 in estate taxes on the additional $1 million. With an insurance trust, the $1 million in insurance would not be in your estate. That would save your family $435,000 in estate taxes.

What if my estate is larger than this?

If your estate will still have to pay estate taxes after you transfer your insurance to a trust, you can reduce your estate tax costs—by having the trust buy additional life insurance. Here are three very good reasons to do this:

1. If the trust buys the insurance, it will not be included in your estate. So the proceeds, which are not subject to probate or income taxes, will also be free from estate taxes.
2. Insurance proceeds are available right after you die. So your assets will not have to be liquidated to pay estate taxes.
3. Life insurance can be an inexpensive way to pay estate taxes and other expenses (see chart at right). So you can leave more to your loved ones.

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How does an irrevocable insurance trust work?

An insurance trust has three components. The grantor is the person creating the trust—that's you. The trustee you select manages the trust. And the trust beneficiaries you name will receive the trust assets after you die.

The trustee purchases an insurance policy, with you as the insured, and the trust as owner and (usually) beneficiary. When the insurance benefit is paid after your death, the trustee will collect the funds, make them available to pay estate taxes and/or other expenses (including debts, legal fees, probate costs, and income taxes that may be due on IRAs and other retirement benefits), and then distribute them to the trust beneficiaries as you have instructed.

Can I be my own trustee?

Not if you want the tax advantages we've explained. Some people name their spouse and/or adult children as trustee(s), but often they don't have enough time or experience. Many people choose a corporate trustee (bank or trust company) because they are experienced with these trusts. A corporate trustee will make sure the trust is properly administered and the insurance premiums promptly paid.

Why not just name someone else as owner of my insurance policy?

If someone else, like your spouse or adult child, owns a policy on your life and dies first, the cash/termination value will be in his/her taxable estate. That doesn't help much.

But, more importantly, if someone else owns the policy, you lose control. This person could change the beneficiary, take the cash value, or even cancel the policy, leaving you with no insurance. You may trust this person now, but you could have problems later. The policy could even be garnished to help satisfy the other person's creditors. An insurance trust is safer; it lets you reduce estate taxes and keep control.

How does an insurance trust give me control?

With an insurance trust, your trust owns the policy. The trustee you select must follow the instructions you put in your trust. And with your insurance trust as beneficiary of the

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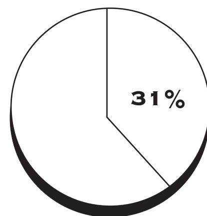
Cost of Federal Estate Taxes for $3 Million Estate

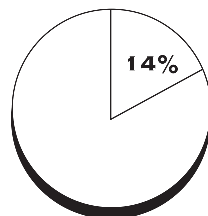
Here's how much it would cost a married couple to pay federal estate taxes on a $3 million estate, assuming a $1 million individual exemption and 55% top tax rate, depending on the tax planning options used. State taxes may also apply but are not included.

LEAVE EVERYTHING TO SPOUSE (NO PLANNING)



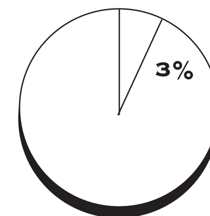
$945,000

LIVING TRUST WITH TAX PLANNING



$435,000

LIVING TRUST & INSURANCE TRUST



$94,584

1) If your spouse is a U.S. citizen, you can leave him or her an unlimited amount when you die with no estate tax. But unless you plan ahead, when your spouse dies the full estate will be taxed. In this example, $945,000 of the $3 million estate (31%) would be consumed by estate taxes. In addition, you would have no control over how your share of the estate is managed or distributed.
2) A tax-planning provision in a revocable living trust* will protect $2 million from estate taxes by using both estate tax exemptions, but $435,000 (14% of the estate) would still be owed in estate taxes. However, this planning would allow you to keep control over how your share of the estate is managed and distributed, and your share would be valued and taxed only when you die; any appreciation after your death will not be included in your spouse's taxable estate. Yet, all of the assets could be available for anything your spouse needs.
3) Combining the tax planning in a revocable living trust* with an insurance trust reduces the cost of paying the $435,000 in estate taxes to just $94,584,** 3% of the estate's value. In this example, our married couple can purchase $435,000 in life insurance for $94,584. It's a great return for their investment: every dollar they pay in insurance premium will pay $4.59 in estate taxes.

* The same tax planning can be done in a will, but you would not avoid probate or enjoy the other benefits of a living trust.

** Estimated costs for a male age 65 and a female age 63, using rates believed to be representative of those available from various life insurance companies offering second-to-die policies. Actual costs will vary.

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policies, you will even have more control over the proceeds.

For example, your trust could allow the trustee to use the proceeds to make a loan to, or purchase assets from, your estate or revocable living trust, providing cash to pay taxes and expenses. You could provide your spouse with lifetime income and keep the proceeds out of both of your estates. You could keep the money in the trust for years and have the trustee make distributions as needed to trust beneficiaries, which can include your children and grandchildren. Proceeds that stay in the trust can be protected from courts, creditors (even spouses) and irresponsible spending.

By contrast, if your spouse or children are beneficiaries of the policy, you will have no control over how the money is spent. If your spouse is beneficiary and you die first, all of the proceeds will be in your spouse's taxable estate; that could create a tax problem. Also, your spouse (not you) will decide who will inherit any remaining money after he or she dies.

Are there other benefits to naming the trust as beneficiary of an insurance policy?

Yes. If you name an individual as beneficiary of a policy and that person is incapacitated when you die, the court will probably take control of the money. Most insurance companies will not knowingly pay to an incompetent person and will usually insist on court supervision. But if your trust is beneficiary of the policy, the trustee can use the proceeds to provide for your loved one without court interference.

Who can be beneficiaries of the trust?

You can name any person or organization you wish. Most people name their spouse, children and/or grandchildren.

Where does the trustee get the money to purchase a new insurance policy?

From you, but in a special way. If you transfer money directly to the trustee, there could be a gift tax. But you can make annual tax-free gifts of up to $13,000 ($26,000 if your spouse joins you) to each beneficiary of your trust. (Amounts may increase periodically for inflation.) If you give more than this, the excess is applied to your federal gift/estate tax exemption.

Instead of making a gift directly to a beneficiary, you give it to the trustee for the benefit of each beneficiary. The trustee notifies each beneficiary that a gift has been received on his/her behalf and, unless the beneficiary elects to receive the gift now, the trustee will invest the funds—by paying the premium on the insurance policy. Each beneficiary must understand the consequences of taking the gift now; for example, it may reduce the trustee's ability to pay premiums.

Are there any restrictions on transferring my existing policies to an insurance trust?

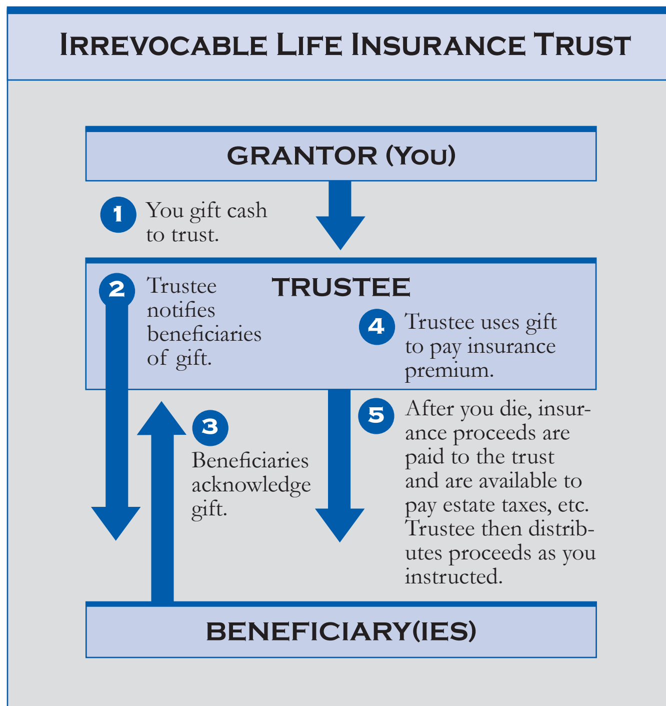
Yes. If you die within three years of the date of the transfer, it will be considered invalid by the IRS and the insurance will be included in your taxable estate. There may also be a gift tax. Be sure to discuss this with your advisor.

Can I make any changes to the trust?

An insurance trust is irrevocable, which generally means you cannot make changes to it. However, under the Uniform Trust Code (UTC) and decanting provisions in some states, you may be able to make some changes. Still, you should read the trust document carefully before you sign it.

When should I set up an insurance trust?

You can set up one at any time, but because the trust is irrevocable many people wait until they are in their 50s or 60s. By then, family relationships have usually settled. Just don't wait too long; you could become uninsurable. And remember, if you transfer existing policies to the trust, you must live three years after the transfer for it to be valid.



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