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Avoiding a Life Insurance Tax

Life insurance can be a powerful estate planning tool for providing financial security to family, planning for business succession and securing long-term care protection. By incorporating an Irrevocable Life Insurance Trust ("ILIT") into your estate plan, you can position your estate and family to reap the benefits of life insurance while also avoiding the negative tax consequences of life insurance which often come as a surprise to families.

TAXATION OF LIFE INSURANCE

The death benefit of a life insurance policy is generally not subject to *income* tax to the beneficiary. For this reason, life insurance is often advertised as being "tax-free." Such assertions are actually incorrect since as life insurance ownership and benefits could trigger *estate* tax consequences.

With federal estate tax rates at 40% and Massachusetts estate tax rates up to 16%, life insurance can cause a substantial estate tax problem. For wealthiest individuals, a $1 million policy can trigger a combined $560,000 in federal and state death tax.

When the estate tax is calculated all of a decedent's assets are taken into account, including real estate, retirement accounts, investment and personal belongings. Although the federal estate tax exemption is currently over $13 million and, therefore, not a major concern to most families, the Massachusetts estate tax exemption is only $2 million, which makes the estate tax a concern for even middle-class families because of how easily that threshold can be reached.

ILIT AS A TAX SHELTER

ILITs provide for a defense against life insurance being taxable for estate tax purposes. An ILIT is typically created for the purpose of being both the owner and beneficiary of a life insurance policy. Since you are not the owner of the policy or beneficiary of any benefits, this ensures that the policy will not be included in your estate.

After your death, life insurance benefits may be used to accomplish your estate planning goals, including inheritance planning for your children or other beneficiaries, without an incremental estate tax burden.

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ESTABLISHING AN ILIT

There are two ways to fund an ILIT. The first and simplest method of funding an ILIT is to (1) create the ILIT, (2) transfer funds to the ILIT for the purposes of purchasing a life insurance policy and (3) purchase a life insurance policy, naming the ILIT as both owner and beneficiary. This is the most advisable method because you personally never have any ownership over the life insurance policy.

The second method of establishing an ILIT is to (1) create a new ILIT and (2) transfer ownership of an existing life insurance policy into the ILIT. The transfer of a term life insurance policy into the trust constitutes a gift and could have gift tax consequences. However, the value of the policy for gift tax purposes is the then fair market value of the policy, not the amount of the death benefit. Therefore, to the extent there are gift tax consequences as a result of the transfer of a policy, such tax implications are often negligible and far less burdensome than allowing life insurance to ultimately be included in your estate.

Additional caution should be exercised if deploying the latter of these two options. If you die within three years of transferring your life insurance policy into an ILIT, the life insurance policy will still be included in your estate.

ADMINISTERING AN ILIT

When a life insurance policy is held by an ILIT, premium payments will need to be made. This is generally done by making cash gifts to the ILIT, thereby allowing the ILIT to pay such premiums. While the transfer of cash to the ILIT to pay for the premiums constitute a gift for gift tax purposes, the gift may qualify for a gift tax exclusion, provided that certain notices are sent to trust beneficiaries. Aside from these notice requirements and ensuring premiums payments are made, your ILIT will not require ongoing administration until your death.

While the life insurance policy is held by the ILIT it is important to not retain any "incidents of ownership," as defined by the Tax Code. Incidents of ownership include more obvious characteristics such as the power for you to change a beneficiary or cancel the policy, but also includes less obvious characteristics. If you retain any such incidents of ownership, the life insurance will be includable in your estate and the ILIT will be disregarded. Therefore, it is imperative to ensure that both the trust document and life insurance policy are structured to withstand IRS scrutiny.

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