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Removing Life Insurance Proceeds From Your Taxable Estate

Many people aren't aware that all of the proceeds from life insurance policies that they own at death will be included their estate for estate tax purposes. This is because if the policy owner can withdraw the cash value and change the beneficiary, then the policy owner will be deemed to have **incidents of ownership** over the proceeds and the IRS can then tax the proceeds at death.

At present (in late 2012), under the Bush tax cuts as extended by Obama, no federal estate tax is assessed upon the first $5.12 million of an individual's taxable estate. On January 1, 2013, federal estate tax exemption amounts will drop to $1 million per person. As such, it is about to be much easier for a person's assets to exceed $1 million once life insurance is included. While many of us in estate planning and financial planning world expect that the federal estate tax threshold will soon be raised to $3.5 million per person, there is still a window of time in which anything after the first $1 million will of an estate will be taxed at 55%.

Let me repeat that: While the federal estate tax exemption was set at $5,000,000 and the estate tax rate was set at 35% for the 2010 and 2011 tax years, and the exemption increased to $5,120,000 for 2012, on January 1, 2013 <u>the exemption and rate are scheduled to revert back to the numbers that were in effect in 2001/2002 – meaning a $1,000,000 estate tax exemption and 55% estate tax rate</u>.

Without proper planning, this could mean a **<u>big</u>** tax bill before insurance proceeds could be used for the needs of your spouse or partner, children, and other beneficiaries.

How an Irrevocable Life Insurance Trust Works

One way to avoid the taxing of life insurance proceeds at death is to establish an **Irrevocable Life Insurance Trust**, or **ILIT** (pronounced "eyelet") for short. An ILIT is a type of irrevocable trust that is specifically designed to hold and own life insurance policies. Once the ILIT has been set up, you will transfer ownership of your life insurance policies to the Trustee of the ILIT. While you can't be a Trustee of the ILIT - otherwise you'll be deemed to have **incidents of ownership** in the life insurance - your spouse and/or children can be Trustees.

Once you've transferred ownership of the life insurance to the Trustee of the ILIT, you will have given up all of your **incidents of ownership** over the policies. Since you'll no longer own the policies, the proceeds can't be taxed in your estate when you die.

Who Are the Beneficiaries of an ILIT?

The ILIT will also be designated as the primary beneficiary of your life insurance policies. Thus, after you die, the insurance proceeds will be deposited into the ILIT and held in trust for the benefit of your spouse during his or her remaining lifetime, and then the balance will pass to your children or other beneficiaries. Aside from this, the ILIT can provide your family with a quick source of cash to pay your estate tax bill while at the same time not increase your overall estate tax burden.

Another benefit of the ILIT is that since the insurance proceeds will be held in trust for the benefit of your spouse instead of going directly to your spouse, the proceeds can't be taxed in your spouse's estate either. If desired, you can take the ILIT one step further and set it up as a Dynasty Trust or Generation Skipping Trust for the benefit of your children and future generations.

If you want to discuss whether ILIT planning might be appropriate for you,
feel free to contact my office at ***404.410.6820*** *or by email at* ***paul@pvblack.com***