UNDERSTANDING LIFE INSURANCE TRUSTS

1. WHAT DOES A 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.

2. 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 35%-55%, currently 40%) 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. State estate taxes are generally lower, but come into play at a much lower threshold. If you plan ahead, both of these can be reduced or even eliminated.

3. 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. Currently, the federal exemption is $5.45 million (for deaths during 2016 - this amount adjusts annually for inflation) and the tax rate is 40%. State estate taxes vary, but because they typically apply at a lower threshold, your estate could be exempt from the federal tax but still have to pay a state tax.

4. WHAT MAKES UP MY NET ESTATE?

To determine your current net estate, add your assets 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. Because life insurance proceeds are included in your estate, you can see how having life insurance can increase the size of your estate and the amount of estate taxes that must be paid.

5. 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 estate taxes are reduced.

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 in the future and the value of your net estate may increase substantially by the time you die.

6. 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 (possibly at “firesale” prices or at an inopportune time) to pay estate taxes.

3. Life insurance can be an inexpensive way to pay estate taxes and other expenses so you can leave more to your loved ones.

7. HOW DOES AN IRREVOCABLE INSURANCE TRUST WORK?

Like other irrevocable trusts, an insurance trust has three basic 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. The trustee makes sure the trust is properly administered and the insurance premiums promptly paid. When the insurance benefit is paid after your death, the trustee will collect the funds, make them available to pay expenses and then distribute them to the trust beneficiaries as you have instructed.

8. CAN I BE MY OWN TRUSTEE?

Generally not, because it will cause the insurance to be included in your estate (more later). Some people name their spouse or an adult child as trustee, but they often don't have the time and/or experience. Remember, the trustee is responsible for making sure the trust is properly administered and the insurance premiums promptly paid. Your CPA may be willing to do this for a short time. But many people choose a corporate trustee (bank or trust company) because of their experience with trusts, their objectivity and their longevity (critical if the trust will continue to exist for years after your death).

9. WHY NOT JUST NAME SOMEONE ELSE AS OWNER OF MY INSURANCE POLICY?

If someone else, like your spouse or an adult child, owns a policy on your life and dies first, the cash/termination value will be in his/her estate. That could create a tax problem.

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 and has many more benefits.

10. HOW DOES AN INSURANCE TRUST GIVE ME MORE 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 policies, you will have even more control over the proceeds.

For example, you could allow (but not require) 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 expenses without having to liquidate other assets. This can help prevent the sale of assets at "firesale" prices or at an inopportune time. Expenses may include debts, legal fees, probate costs, estate taxes and income taxes that may be due on IRAs and other retirement benefits.

You could also keep the proceeds in the trust and have the trustee make distributions as needed to trust beneficiaries, which can include your spouse, children and grandchildren. Proceeds that stay in the trust are protected from courts, creditors (even divorce proceedings) and irresponsible spending. You can also provide your spouse with lifetime income and keep the proceeds out of both of your estates.

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.

11. 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.

12. 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.

13. 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 if set up properly, you can make annual tax-free gifts of up to $14,000 ($28,000 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.

14. ARE THERE ANY RESTRICTIONS ON TRANSFERRING MY EXISTING POLICIES TO AN INSURANCE TRUST?

Yes. Generally, 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. But there are strategies to avoid the so-called three-year rule, so be sure to discuss this with your advisor.

15. 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.

16. 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.

17. SHOULD I SEEK PROFESSIONAL ASSISTANCE?

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

18. BENEFITS OF A LIFE INSURANCE TRUST

•Gives you maximum control over insurance policy and how proceeds are used.
•Inexpensive way to provide for children and/or grandchildren when the estate includes assets that are not readily susceptible to equal division, such as businesses, real estate, art, and collections.
•Assets kept in trust are protected from beneficiaries' creditors (including divorce proceedings) and irresponsible spending.
•Proceeds avoid probate, and are free from income and estate taxes.
•Can provide income to spouse without insurance proceeds being included in spouse's estate.
•Prevents court from controlling insurance proceeds if a beneficiary is incapacitated.
•Provides immediate cash to pay expenses after death, including estate taxes if necessary.
•Reduces estate taxes by removing insurance from your estate.