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Special Report on

Understanding Life Insurance Trusts

How to Reduce or Eliminate Your Estate Tax Cost

1. What does a life insurance trust do?

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

2. What are estate taxes?

Estate taxes are different from, and in addition to, probate expenses and final income taxes (which must be paid on any income you receive in the year you die). Some states also have their own death/inheritance tax; you could be exempt from the federal tax and still have to pay a state tax.

Federal estate taxes are expensive -- the rate is 45% -- and they must be paid in cash, usually within nine months after you die. State death taxes can add between 8% and 14% on top of this amount. Since few estates have this kind of cash, assets often have to be liquidated. But estate taxes can be substantially reduced or even eliminated -- if you plan ahead.

3. Who has to pay estate taxes?

Your estate will have to pay estate taxes if its net value when you die is more than the "exempt" amount set by Congress at that time. Here is the current schedule:

Year of Death   Federal Estate Tax "Exemption"

2011 and after..........$5 million (increased each year based upon inflation)

Currently, the Illinois State Death Tax Exemption is $4 million (in 2017) per person and the Federal Death Tax exemption is $5.49 million (in 2017) per person.

4. What makes up my net estate?

To determine your current net estate, add your assets then subtract your debts. Many people are surprised that insurance policies in which they have any "incidents of ownership" are included in their taxable estates. 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.

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 your estate taxes are reduced.

Let's say you are married, with a combined net estate of $12 million, $1 million of which is life insurance. With the use of tax planning provisions in two revocable living trusts (one for each spouse) and no insurance Trust, you can protect up to $10,980,000 from Federal estate tax in 2017 and $8 million from Illinois Estate Tax in 2017 . If you both die in 2017, your Federal Estate Tax would be $408,000 (nearly all of which is due to the extra $1,000,000 of life insurance included in your estate) and you would have an Illinois estate tax of $680,634 some of which ($115,031) is caused by the $1 million of life insurance proceeds. With an insurance trust, the $1 million in insurance would not be included in your estate. That would save your family over $500,000 in Illinois and Federal Estate Taxes.

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:

a. If the trust buys the insurance, it will not be included in your estate. The insurance proceeds, which are not subject to probate or income taxes, will also be free from estate taxes.

b. Insurance proceeds are available right after you die. So your fixed and investment assets will not have to be liquidated to pay estate taxes.

c. 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?

An insurance trust has three components. The grantor is the person creating the trust - that's you. The trustee you select manages the trust. This can often be spouse or other family member. 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 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 IRA's and other retirement benefits), and then distribute them to the trust beneficiaries as you have instructed.

8. 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 be sure that they have enough time and financial experience. Some people choose a corporate trustee (bank or trust company) because they are experienced with these trusts.

9. 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 included 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 on. The policy could even be garnished or attached to help satisfy the other person's creditors or be dragged into a divorce as an asset to be divided by the Court. An insurance trust is safer - it lets you reduce estate taxes and ***keep control***.

10. How does an Insurance Trust give me control?

With an insurance trust, your trust owns the policy. The trustee you select ***must by law,*** follow the instructions you put in your trust (this is called a fiduciary duty). And with your insurance trust as beneficiary of the 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 expenses. You could provide your spouse with lifetime income and limited use of principal and ***keep the proceeds out of both of your taxable 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 (or can be paid to a **special asset protection (PAT) trust for generations to come)** can fend off courts, creditors (even ex-spouses) and irresponsible spending and you can set it up so that the funds are guaranteed to pass down through your line of descendants and not to in-laws or others.

By contrast, without an Insurance Trust, if your spouse or children are direct 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 included in your spouse's taxable estate and subject to the claims of your spouse's creditors; that could create a tax problem and an asset protection 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 through a guardianship proceeding. This would be very long and very costly. 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. Special Personal Asset Trusts™ (PAT's) can even be a beneficiary(see #10 above.)

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. However, under current law (2017), 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 will increase periodically for inflation.) If you give more than this, the excess is taken against your federal gift/estate tax exemption. If you are married and have 3 children as beneficiaries, you can make premium payments through the trust of up to $84,000 annually ($28,000 X 3) without any taxable gifts being made.

Instead of making a gift directly to a beneficiary, you give it to the trustee. The trustee then notifies each trust beneficiary that a gift has been received on his/her behalf and, unless he/she 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. The notification provided to the beneficiaries has an unusual name, a “Crummey Notice”, after the Circuit Court of Appeals case, approving the practice.

14. 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 of an existing policy, it will be considered invalid by the IRS and the insurance will still be included in your taxable estate. There may also be a gift tax depending on the current cash value of the transferred policy. Be sure to discuss this with your advisor.

15. Can I make any changes to the trust?

An insurance trust is irrevocable, so you can't make changes after it has been set up. Read your trust document carefully, and be sure it's exactly what you want before you sign. Sometimes, certain provisions can be incorporated into the trust, using a totally independent party referred to as a “Trust Protector”, who can make specific limited changes to the trust to comply with unexpected changes in the law or family dynamics. The use of the Trust Protector make the irrevocable Trust considerably more “flexible”.

16. When should I set up an insurance trust?

You can set up one any time, but because the trust is irrevocable, some people wait until they are in their 50's or 60's. By then, family relationships have usually settled - and you know whom you want to include as a beneficiary.

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 both an insurance professional and an estate planning attorney who have experience with these trusts. The tax laws related to these trusts are tricky and complicated and they must be set up exactly in compliance with tax regulations and tax court decisions, to be effective.

18. Benefits of 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 and principal to spouse without insurance proceeds being included in spouse's estate.
•• Prevents court from controlling insurance proceeds if beneficiary is incapacitated.
•• Can provide asset and creditor protection over the insurance proceeds.

...for your peace of mind

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