

Trust in Irrevocable Life Insurance Trusts

Despite the generous \$5 million estate-tax exemption under current law, estate taxes remain a concern, especially for the future. Case in point: It may be necessary to change ownership of a life insurance policy.

Basic premise: Generally, life insurance proceeds are subject to federal estate tax if the insured party possesses any "incidents of ownership" in the policy. For instance, if he or she owns the policy, or even reserves the right to change beneficiaries, the proceeds are included in the individual's taxable estate.

One possible solution is to establish an irrevocable life insurance trust (ILIT). If the ILIT owns the policy, the death benefits are removed from the insured's taxable estate. Furthermore, the ILIT may be used to shield the funds from spendthrift children.

How it works: As the owner of the life insurance policy, the ILIT pays the premiums. When the insured person passes away, it collects the proceeds. Frequently, the trustee will use the insurance proceeds to purchase assets, such as a closely held company or real estate, from the estate. Alternatively, the trust may lend money to the estate, secured by the estate's assets.

In either case, the estate will receive cash that can be used to pay the estate tax. Subsequently, the trustee can distribute the assets to the trust beneficiaries. Or, if preferred, the assets can be maintained in the trust.

As a result, the insurance proceeds are available to help cover any estate tax due. The family keeps control over the assets and does not have to hold a "distress sale" of a business to meet estate-tax obligations.

Reminder: To qualify for estate-tax benefits, a life insurance trust must be irrevocable. Also, the insured person cannot act as the trustee. Typically, a family member or a financial adviser will fulfill this role. At the very least, seek professional guidance.