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MORRIS HALL PLLC
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888.222.1328

Getting the Most Out of Your Life Insurance: The Irrevocable Life Insurance Trust

If you own life insurance, congratulations! Sadly, many people have overlooked this critical element in their family's financial planning, which may have devastating consequences on the loved ones left behind.

Why is life insurance so important? Young families need it to replace part of a breadwinner's income. Mature Americans find that life insurance provides their heirs with a source of funds to pay estate taxes. Investors have discovered that innovative insurance products help them build cash value, tax deferred, for long-term financial goals—like retirement.

Although buying life insurance may be a beneficial financial planning tool, it is only part of the solution—life insurance can actually add to your estate bill without proper estate planning.

The Mistake Thousands of Americans Make

Numerous parents, spouses, and other well-intentioned individuals, make a simple but costly mistake when buying life insurance policies—they fail to think about who should own the policy.

Unfortunately, that simple mistake could substantially cost your heirs. Here's why.

Every American is currently entitled to an estate tax exemption on the first $5.43 million (indexed for inflation) of his or her estate. With proper planning, a married couple can shelter up to $10.86 million.

While your beneficiaries will receive the death benefit income tax free, the proceeds are not estate tax free. For example, say that you are single with assets totaling $5.43 million, comprised of your home, retirement benefits, and other assets. Your estate will pass to your heirs estate tax free. Now add in a life insurance policy with a death benefit of $1 million. Your estate is now worth $6.43 million and subject to estate taxes.

Estate taxes are 40% for 2015. That is quite a tax bite to which you have exposed your estate.

The net result—your heirs will see part of your legacy needlessly lost to the government via estate taxes.

Preserving Your Legacy for Those You Love

A simple solution exists to avoid the estate tax problem, while also offering a host of other benefits. It is called an Irrevocable Life Insurance Trust (ILIT). An ILIT allows you to protect your loved ones without adding to your estate taxes. Because an ILIT actually owns the policy, its death benefit will not be taxable in the estate. Here's how it works.

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You set up your ILIT and name someone (other than yourself) as the trustee. Trustees are most often the beneficiaries of the trust, a family member, or a trusted financial advisor. If your beneficiaries are your minor children, you will want to name your children's guardian or another responsible adult as trustee. The fact that you are not actively involved as a trustee should give you no cause for concern. Your trustee (or trustees) must precisely follow the instructions you provide in your trust documents.

It May Be Crummey, But It's Still a Good Idea

After you create your ILIT, your trustee then purchases a life insurance contract on your life with funds that you provide. If you have an existing policy, you can assign ownership of it to the ILIT; however, there are conditions imposed on these transactions that should be carefully considered before assigning ownership. For instance, if you die within three years of the transfer, the life insurance contract will be included in your estate.

Annually, a taxpayer may give up to $14,000 (indexed for inflation) to another person gift tax free. Married couples, therefore, can give a combined total of $28,000 gift tax free to any one person. Other than this per-person rule, there is no limit on the total amount you can give away. For example, if you have five children and eight grandchildren, you and your spouse could give each one $28,000, for a total of $364,000 annually. That can buy a lot of life insurance coverage.

By carefully following the IRS rules, you can employ this gift tax exemption to make the policy's premium payments. When you provide your trustee with the funds to pay your annual premium, your trustee must provide your beneficiaries with written notification that a gift has been made in their names. Your beneficiaries will have the option of withdrawing these funds from your ILIT during a specified period— usually a minimum of 30 days. When they fail to exercise their option, your trustee will use the money to pay your insurance premium. This written notification of your gift to your beneficiaries is called a *Crummey* Letter—bearing the name of the taxpayer who succeeded in getting the IRS approval of this process. An annual *Crummey* Letter to your beneficiaries is an essential element of a successful ILIT.

Staying in Control— Today, Tomorrow and for Years to Come

Reducing your estate tax liability is a powerful incentive for considering the ILIT. But that is just the beginning of the long list of benefits it provides.

The ILIT provides you control over how proceeds from your life insurance policy are distributed. It is a mistake if you fail to control how the beneficiaries receive the policy's proceeds. Even an adult with financial experience may find the large sum of money overwhelming. But when the beneficiaries are young adults who may lack the maturity to handle such a windfall, the results can be devastating.

With the ILIT, you control who receives the proceeds and how they receive it. Whatever distribution strategy makes most sense for you and your loved ones, the ILIT gives you the opportunity to put it into effect.

In many states, ILITs offer you the best (if not the only) way to protect the cash value of your policy from creditors. Over the years, your premiums and interest earnings can accumulate to considerable sums, making cash value policies a tantalizing target for creditors. Creditors may be successful in getting to the cash value if you own the policy. When the policy is owned by the ILIT, however, it is out of your creditors' reach.

A Shortcut that Doesn't Work

If you have taken this cautionary tale of life insurance and estate taxes to heart, but do not want to implement an ILIT, be careful that you do not consider using shortcuts. One often-employed strategy is to make someone else the owner of your policy. It solves the estate-tax problem, but it also spawns a host of others—all of which involve your loss of control over the disposition of the policy. For example:

- The policy's owner can reassign it, pledge it as collateral, or expose it to threats from creditors;
- The owner can spend your annual premiums on his or her own priorities, instead of keeping the policy in force;
- If the owner gets divorced, an ex-spouse can end up with a piece of your policy; and
- You cannot control how your beneficiaries spend the policy's proceeds.

Let's look at a worst-case scenario. Say your son, Junior, is the owner of your life insurance policy. Over the years, the policy builds up a considerable cash value. Junior launches a business partnership, which soon fails. His creditors seize some of the policy's cash value to settle his debt. Later, Junior gets divorced. His ex-wife gets a piece of the cash value. However, the policy is still in force, so you continue to send Junior money for annual premium payments. Then, out of the blue, your insurance agent tells you that the policy has lapsed. It seems that Junior has been spending your money on his own priorities. Although Junior's story is extreme, it paints a clear picture of how much control you give up when you let someone else own your life insurance policy.

Getting started today

An ILIT is a reasonably simple process for those experienced in estate planning, and should involve very little of your time or energy. There are details that require the expert attention of a knowledgeable estate planning attorney at MHK. For instance, your ILIT will require a separate federal tax ID number, a separate bank account, and maybe its own annual tax return. Contact Morris Hall and Kinghorn to answer your questions concerning ILIT's and how they can benefit you.

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For over forty years, the attorneys at Morris Hall, PLLC (MH) have provided quality estate planning documents for our clients. Helping our clients protect their assets for those they love has been our goal from the very beginning. We are recognized throughout the Southwest for our expertise in educating individuals about the importance of proper estate planning. We do this through various speaking engagements and seminars; and further, we keep our clients up-to-date through frequent communication, complimentary reviews and phone calls, and more advanced seminars.

At Morris Hall, we focus on protecting families from the expense and delay of probate and minimizing tax consequences. We also implement basic and advanced estate planning strategies for clients, and assist in the administration of our clients' estates upon death or disability. Since we practice estate planning exclusively, we are able to answer the complex questions and concerns consumers have about estate planning.

MH is staffed with experienced attorneys and paralegals who are trained in the complex areas of probate, trust, elder law, life care planning, and tax law. Our firm's aim is to help you, our client, understand the basic principles of estate planning and why each individual needs a plan. We have helped thousands of individuals secure their assets. We are confident that our experience will help ease your mind and the minds of the family you leave behind. By taking advantage of the services that MH has to offer, you can be assured that your legacy and your family will be protected.

If you would like a current schedule of seminars in your area or would like a consultation with an attorney, please visit www.morristrust.com or call toll free 888.222.1328.

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