

# New Dimensions in Estate & Trust Planning

*An Article to Benefit Clients & Friends  
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*Trust & Estate Planning ♦ Probate & Estate Administration ♦ Business Formation & Planning*

## THE LIFE INSURANCE TRUST TAX FREE INSURANCE

*by Richard L. Ferris, Esq.*

### Why Life Insurance?

Let's examine some of the reasons for life insurance in your estate plan. In our society, we have financial "needs" that many times cannot be solved through our own income or capital resources. A few examples are the need to "create" money to replace income to the family at the death of the wage earner, to provide funds to pay college education costs, to pay down debts, to pay estate taxes, to provide liquidity to estates that consist of non-liquid assets (real estate, business, IRAs) and to benefit our favorite charity. These, as well as many other important "needs," must be fulfilled if one is to achieve their financial and estate planning goals.

As a result, you may have to look to a "deep pocket" to satisfy your needs. Life insurance is one of the most economical, feasible and reasonable ways for one to quickly "create" money, which is untouched,

untaxed and free of the claims of creditors and delays of probate to replace income or capital that we were unable to create by ourselves. Yes, it costs money (premiums) to purchase this money (insurance proceeds), but the cost of this money is probably no more than 30% of the capital received (insurance proceeds). In Wall Street parlance, this is called the **PARTIAL** or **DISCOUNT DOLLAR** method of paying estate taxes or providing income to your family.

By working with your experienced life insurance professional who has a strong working relationship with his/her home office underwriter, most insurance contracts can be secured at a competitive price. This may be either through the agent's company or the international re-insurance markets.

Once the life insurance "need" and "cost" have been determined between you and your insurance advisor, the next step is to make

sure the policy ownership and beneficiary designation are properly arranged to achieve the best tax and non-tax benefits.

### **Many Clients Believe**

When many of our clients hear that life insurance is subject to **Federal Estate Tax**, they are surprised! Most believe that life insurance proceeds are TAX FREE. Free from Income Taxes? YES! Free from Estate Taxes? NO! Insurance proceeds are not Estate Tax free if the insured has any rights or any "incidents of ownership" in the policy. This includes the right to change the beneficiary, borrow the cash values, or surrender the policy.

In other words, Uncle Sam gets first pick from your life insurance proceeds. If you are counting on the full power of your life insurance to help your family, consider this: If your life insurance is included in your estate, the Federal Estate Tax on those proceeds begins at 37% and can go as high as 55%. For example, a \$500,000 life insurance policy can lose \$200,000 to \$275,000 of value at death. Is that why you were paying premiums on a \$500,000 policy? To compound this tax disaster, although you may have bought that life insurance to pay FOR your federal estate tax, you have not only generated more federal estate tax, but you have also lost a major portion (50%) of the means to pay those taxes! You are paying twice as much for your life insurance as you should, because your beneficiary receives only half the benefit you purchased.

In order to avoid the estate tax, some insureds have their spouse, children or others own their life insurance policy. Their thinking is "if I (insured) don't own the policy, Uncle Sam can't tax it!" Be careful with this cross ownership technique. For example, with this cross ownership arrangement, you, the insured, lose control of the life insurance policy. The proceeds are usually estate taxed on the death of the policy owner if he or she is the beneficiary and dies

after the insured. The cash value of your policy will be subject to creditors of the owner and, if the owner is a child, may be subject to property settlement of a failed marriage. If the proceeds are payable to someone other than the cross owner, the entire proceeds are subject to gift tax when paid. Moreover, if you name an individual as beneficiary of an insurance policy and that person is incapacitated at the death of the insured, the Probate Court will take control of the proceeds.

### **Having Your Cake and Eating It Too**

The goal sought by insurance policy cross-ownership, which is to avoid Federal Estate Tax on the proceeds, is a noble one, but there is a better way to accomplish this goal. The planning solution is to structure your life insurance to be TOTALLY FREE from Federal Estate Tax upon your death and, if you are married, upon the death of your spouse as well. How can you make insurance proceeds TAX FREE?

### **Tax Free Insurance—The Irrevocable Life Insurance Trust**

An Irrevocable Life Insurance Trust, sometimes called an ILIT, is a separate trust that owns your life insurance, pays the premiums, and is your beneficiary. One or more trustees will operate your ILIT. You may choose your own trustees, but neither you nor your spouse can be a trustee. However, almost anyone else can be a trustee, as long as the ILIT is done in proper legal form. The beneficiaries of your ILIT are generally the same as those in your Will or Revocable Living Trust. Your ILIT is designed with the same or similar instructions you have provided in your Revocable Living Trust to take care of your loved ones by your named trustees. In other words, the terms of the ILIT parallel those of your Revocable Living Trust.

Too good to be true? Not if your ILIT is carefully and properly drafted and implemented by estate planning professionals.

ILIT drafting is no place for the inexperienced. One small mistake in an ILIT and all the tax benefits can be lost. Good, solid advice on the front end is critical to meet all of your tax and non-tax goals. Remember, irrevocable is irrevocable!!

### **How Does an ILIT Work?**

You may put your existing life insurance policy into an ILIT, or a new policy may be purchased by the ILIT trustee. Tax wise, it is best to purchase a new policy, if possible, to avoid the "three-year rule." This rule states that if you die within three years of transferring existing life insurance into an ILIT, the proceeds are included in your taxable estate.

The money that is used to pay the premiums for the life insurance in your ILIT comes from gifts of money made by you to your ILIT. To avoid a taxable gift on the contributions to the ILIT, your beneficiaries (family members) must be given a demand right. For example, when the cash gift is made to the trust, your trustee is required to notify your beneficiaries that a gift has been made. Within the next 30 days, the beneficiaries will sign a waiver of their right to the cash gift in the ILIT, and the trustee then sends the money to the insurance company as payment of the premium. This demand right, coupled with the fact that your cash gifts to the ILIT are within your \$12,000 annual exclusion for each beneficiary (\$24,000 if spouse consents), eliminates any Federal Gift Tax exposure. How insurance policies find their way into an ILIT, and how premiums are paid on those policies, are of critical planning importance. That is why each member of your Estate Planning team – attorney, insurance advisor, CPA, and trustee – must work together on the ILIT's implementation if the desired tax results are to be achieved.

### **Summary**

Buying twice as much life insurance as you need because Uncle Sam is entitled to as

much as 55% of it is not prudent. By having your life insurance policy secure in an Irrevocable Life Insurance Trust, you can buy all the life insurance you really need for half the price you would have to pay if it were paid out of your taxable estate. An ILIT achieves these benefits for you and your family:

(1) Provides income to a spouse without insurance proceeds being included in spouse's taxable estate.

(2) Provides income to your children without insurance proceeds being included in your children's taxable estate. This is called a Generation Skipping Tax ILIT.

(3) Provides immediate liquidity to your estate to pay estate taxes and other expenses after death.

(4) Proceeds avoid probate and creditors of the insured and beneficiaries.

(5) Prevents Probate Court from controlling insurance proceeds if beneficiary is incapacitated.

In light of the above tax and non-tax benefits of the Irrevocable Life Insurance Trust, it is easy to understand why Robert Esperti and Renno Peterson in **PROTECT YOUR ESTATE** described the ILIT as a way to "have your cake and **eat** it too."

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### ***About the Author***

Richard L. Ferris ("Dick"), Partner and Shareholder, established Ferris & Associates in 1993. Dick began his legal career in 1972 with the Ohio Attorney General's Office, Tax Section. He then served as General Agent, In-House Counsel and Director of a market leading insurance company's Estate and Business Analysis Department, for more than twenty years.

Dick earned his Bachelors Degree from University of Dayton, his Law Degree from Ohio Northern University School of Law, and his Master of Laws (LL.M.) in Taxation from

Boston University School of Law. Dick has also earned his CLU, ChFC, and Master of Science in Financial Services Degrees from the American College. However, Dick does not hold or maintain any insurance or financial licenses.

A frequent speaker and author, Dick has lectured and written extensively on Estate and Tax Planning subjects during his 30 plus-year career in this field of Law. He is published in the Virginia State Bar Journal and has co-authored three books on Estate and Trust Planning-LEGACY, GENERATIONS and LOVE, MONEY, CONTROL.

Dick is a member of many professional organizations including the Peninsula Estate Planning Council, the Society of Financial Service Professionals, and the National Network of Estate Planning Attorneys. Dick is a member of the Virginia, Ohio and District of Columbia Bars and he is admitted to practice before the U.S. Tax Court.

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