

**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 income you receive in the year you die). Some states also have their own death/inheritance taxes. Federal estate taxes are expensive – in 2003 they start at 41% and quickly go up to 49%. And they must be paid in cash, usually within nine months after you die. 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.....	Estate Tax "Exemption"
2002 & 2003.....	\$1 million
2004 and 2005.....	\$1.5 million
2006, 2007 & 2008.....	\$2 million
2009.....	\$3.5 million
2010.....	N/A (repealed)
2011.....	\$1 million

In addition, family-owned businesses and farms that qualify can take a special deduction of up to \$675,000, making a total of up to \$1.3 million exempt from estate taxes. (This deduction will be eliminated in 2004.)

**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 for 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, 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 \$2.5 million, \$500,000 of which is life insurance. With a tax planning provision in a revocable living trust or will, you can protect up to \$2 million in 2003 from estate taxes. But your estate would have to pay \$210,000 in estate taxes on the additional \$500,000. With an insurance trust, the \$500,000 in insurance would not be in your estate. That would save your family \$210,000 in 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:

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 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?**

An insurance trust has three 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. 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 IRAs 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 adult children as trustee(s), but often their children don't have enough time or experience. Many people choose a corporate trustee (bank or trust company) because they are experienced with these trusts. A corporate trustee will make sure the trust is properly administered and the insurance premiums promptly paid.

## **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 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. 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 follow the instructions you put in your trust. And, with your insurance trust as beneficiary of the policies, you will have more control over the proceeds.

For example, you could tell the trustee to use the proceeds to purchase assets from your estate or revocable living trust, providing cash to pay expenses. You can provide your spouse with lifetime income and keep the insurance proceeds out of both of your estates. You could also keep the money in the trust and have the trustee make periodic distributions to the beneficiaries of the trust.

By contrast, if your spouse or children are beneficiaries of the policy, they will receive all of the money right away – and 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 – which could create a tax problem. And 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. You see, most insurance companies will not knowingly pay to an incompetent person, and will usually insist on court supervision.

But if your trust is the beneficiary of the insurance policy, the trustee can use the insurance proceeds to provide for this person without court interference.

## **12. Who can be beneficiaries of the trust?**

You can name any person or organization you wish, but most people name their children and/or spouse.

## **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 you can make annual tax-free gifts of up to \$11,000 (\$22,000 if your spouse joins you) to each beneficiary of your trust. (This amount may be adjusted each year 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. The trustee then notifies each one 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. Of course, the beneficiaries must understand not to take the gift now.

## **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, 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. 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.

## **16. When should I set up an insurance trust?**

You can set up one 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—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 an insurance professional, estate planning attorney, corporate trustee, or CPA who has experience with these trusts.

## **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 to spouse without insurance proceeds being included in spouse's estate.
- Prevents court from controlling insurance proceeds if beneficiary is incapacitated.