

Insights

Irrevocable Life Insurance Trusts

Tax-Efficient Distribution of Life Insurance



Life insurance is frequently used as a tool for estate planning. Proceeds often are used to provide liquidity to pay estate taxes, settle debts, fund gifts to charity, and transfer wealth to heirs. The funds may be included in the insured's taxable estate if the insured or their spouse is the owner of the insurance policy. This can lead to a substantial increase in the size of the insured's estate and in his or her tax burden. An Irrevocable Life Insurance Trust (ILIT) is a technique for removing life insurance proceeds from one's taxable estate while also arranging for the distribution of the proceeds.

Benefits of an ILIT

An ILIT offers a tax-effective way of arranging for the management and distribution of life insurance proceeds to beneficiaries. At the time of the insured's death, the life insurance company pays the death benefit to the ILIT. Proceeds are distributed according to instructions in the trust. If structured properly, an ILIT will keep the policy proceeds from being subject to estate tax. The top estate tax rate in 2011-2012 is 35% and based on current legislation will be 55% in 2013; avoiding this tax yields significant savings, which can be passed to heirs.

In addition to avoiding the estate tax on life insurance, an ILIT can provide an effective means of transferring proceeds to young, disabled, or financially immature beneficiaries. Giving assets directly to a beneficiary in these situations may not be in the beneficiary's best interests. Instead, through the use of an ILIT, insurance proceeds can be retained for the beneficiary and managed in the trust.

Establishing an ILIT

To establish an ILIT, an irrevocable trust must first be drafted by an attorney, and a trustee must be appointed. As the trust is irrevocable, the terms cannot be changed once it is established. The grantor may transfer ownership of his or her

existing insurance policy to the ILIT or the trustee can purchase a new policy with the ILIT as owner and beneficiary of the policy. If an existing policy is transferred, the donor must survive for three years from the date of the transfer in order for the proceeds to be excluded from his or her taxable estate.

Premiums on the insurance are paid by the trustee, but often the grantor transfers funds into the trust to cover those payments. Gifts made by the grantor to the trust may be exempt from gift tax if properly structured.

Additional Considerations

When transferring an existing policy, it is important to note that the transfer can trigger a taxable event if policy loans exceed the total premiums paid. Additionally the transfer of the policy will constitute a gift equal to the cash value of the policy.

The ILIT should not be payable to the grantor's estate or revocable living trust as the proceeds of the life insurance policy might be included in his or her taxable estate in that case.

As each situation is different an ILIT should be evaluated carefully in the context of one's overall estate plan and objectives. Your dedicated portfolio manager, leveraging the expertise of our estate planning specialists, can advise you on an effective strategy for your unique situation.

Planning strategies and trust structures should be reviewed with professional advisors to assure they still achieve their intended purposes.

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