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IRREVOCABLE LIFE INSURANCE TRUSTS FOR ESTATE AND TAX PLANNING

(*Estate Planning Advisory No. 1)*

This Advisory discusses the general estate planning and asset protection benefits of an irrevocable life insurance trust (ILIT). By funding an ILIT separate and distinct from an individual's assets and estate, the life insurance proceeds are not included within the individual estate, are not taxed upon death, are available for payment of estate taxes and are not accessible to the individual's creditors. An ILIT is easy to set up and is an effective estate planning tool.

This Advisory is neither exhaustive nor tailored to your specific situation, but only intended to give you enough information to discern whether this is an option you may consider implementing to reduce your estate tax liability. Our firm representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

What is an ILIT? An irrevocable life insurance trust, or an ILIT (pronounced "Eye-Lit"), is a special type of trust used in estate planning to reduce or even eliminate estate taxes, so that more of your estate can go to your loved ones, or other beneficiaries. The life insurance proceeds are not taxed within your estate or to the trust's beneficiaries and the full amount of the proceeds are available for the payment of estate taxes or other trust administration expenses. Because you designate how the proceeds may be used, it gives you more control over insurance proceeds than merely designating a beneficiary who can use the proceeds in any way he or she chooses.

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. Under the current schedule, a person dying in 2015 or later has an estate tax exemption of $5,430,000 (to be adjusted for inflation each year), which means that estates are payable only for individuals whose taxable estate exceeds this amount. This amount will increase each year as in the future since the exemption amount is indexed for inflation. Assets included in your taxable estate include your home, business interests, personal property, bank accounts, investments, IRA and other retirement benefits and life insurance (if not in an ILIT), so the reality is that anyone owning a home in Santa Barbara County will likely face an estate tax liability.

How Does an ILIT Reduce Estate Taxes? An ILIT owns insurance policies on your life, which removes your life insurance from your taxable estate since you are not the owner. The proceeds of the insurance are not subject to probate, income or estate taxes and the funds

are available right after you die. This may prevent your other assets from having to be liquidated in order to pay estate taxes, which are due nine months after your death.

How Does an Irrevocable Life Insurance Trust Work? An ILIT is an irrevocable trust created by you as the grantor. You designate someone other than yourself as trustee and determine all terms of the trust. The trustee purchases an insurance policy with you as the insured, or you can transfer ownership on an existing policy to the ILIT. When the insurance benefit is paid to the trustee of the ILIT after your death, insurance proceeds are distributed to the trust beneficiaries or held in trust for their benefit according to the terms set out in the ILIT.

Your trustee or your children (or other designated beneficiaries) receive the insurance proceeds and then can purchase your estate assets from your executor or the successor trustee of your revocable living trust (i.e. your home, business or other assets), or they can loan the funds to your estate to pay debts, estate taxes, legal fees, probate or trust administration costs and income taxes that may be due on IRAs and other retirement benefits. Now, your ILIT or your beneficiaries own the house or other assets purchased from your estate/trust and can keep or sell it, and your estate has liquid funds to pay the estate taxes.

Where Does the Trustee Get the Money to Pay Insurance Premiums? The premiums come from you, but in a special way. If you transfer money directly to the trustee, there could be a gift tax depending on the amount of the premium because your beneficiaries receive the benefit of the gift. You can make annual tax-free gifts of up to $14,000 to each beneficiary of your trust ($28,000 if your spouse joins you and creates a joint ILIT with a second-to-die policy). If the premiums are more than this amount annually, one option is that the excess can be applied toward your $5,430,000 lifetime federal gift/estate tax exemption if you have not already used it to make other gifts.

When you make an annual or semi-annual gift to the trust of an amount that will cover the insurance premiums, your trustee then pays the premiums, but only after a particular process is followed. The beneficiaries of the ILIT must receive notice of their right to receive their designated portion of the gift made to the ILIT, which requires proper documentation by the trustee. The beneficiaries must understand that if they exercise their right to receive the gift it could reduce the trustee's ability to pay the premium. This usually requires some candid instruction to the beneficiaries by the attorney preparing the ILIT, or by you directly so that they understand the process and won't defeat the purpose of establishing the ILIT by requesting a withdrawal.

The notice required to be given to an ILIT beneficiary is commonly referred to as a "Crummey Notice" based on a precedent tax court case. Thirty days after the notice is sent, the beneficiary's right to withdraw funds lapses and the insurance premium is then paid by the trustee. If a beneficiary exercised the right to withdraw funds and the sum exceeded $5,000 or

5% of the trust assets, it could be deemed a taxable release and the beneficiary would become an owner of a portion of the ILIT. That portion would then be part of the beneficiary's taxable estate which would further complicate the ILIT operation and the beneficiary's estate tax at death, so it is recommended that beneficiaries allow their withdrawal right to lapse. There are other available, but more complex procedures if an individual beneficiary's withdrawal right exceeds the $5,000 or 5% amount, but this is just another reason to make sure a knowledgeable person is administering and advising the operation of the ILIT. If you already have an ILIT, you should occasionally have your trustee's actions reviewed regarding the sending of the withdrawal notices to make sure the correct process is being followed.

Can I Be My Own Trustee? You cannot be the trustee if you want the tax advantages we've explained. If you own the policy, or are the trustee of your own ILIT, you will possess the "incidents of ownership" meaning you have the right to cash in the policy, name beneficiaries, select methods of payment, borrow against the policy or cancel it. If you retain these rights, the policy is deemed to be owned by you and will be included in your taxable estate. This is why someone other than you must be named as trustee to receive the tax benefits. Who can be the trustee? It can be a friend, relative, trust company, or a trusted advisor (perhaps your accountant or attorney). The choice is important because the trustee must be responsible enough to understand the operation of the ILIT and follow the procedural requirements and timely pay the premiums.

Why Can't I 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 before you, the cash or termination value will be part of his or her taxable estate. That doesn't help much. But more importantly, if someone else owns the policy, you lose control. This person could change your 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 and the policy could even be garnished to help satisfy the other person's creditors. An insurance trust is safer because it lets you reduce estate taxes *and* keep control by its irrevocable nature.

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 since the ILIT is irrevocable, the instructions cannot be changed. This means that the instructions set out in the trust must be carefully drafted, but ultimately results in you having full control over how the insurance proceeds will be handled. For example, your trust can designate that the trustee may use the proceeds to purchase assets from your estate or revocable living trust, providing cash to pay taxes and expenses. You can have terms in the ILIT that provides your spouse with lifetime income *and* keep the proceeds out of *both* of your estates. You can keep the money in the trust for years and have the trustee make periodic distributions to the trust beneficiaries, which can include your children and grandchildren. Proceeds that stay in the trust can be protected from the courts, creditors (even ex-spouses) and irresponsible spending.

By contrast, if your spouse or children are beneficiaries of the policy, you have no control over how the money is spent. If your spouse is the beneficiary and you die first, *all* of the proceeds will be in your spouse's taxable estate; that could create a tax problem. Also, your spouse (not you) will decide who will inherit any remaining money after he or she dies.

Are There Restrictions on Transferring Existing Policies to an Insurance Trust? You can transfer ownership of existing policies to an ILIT, but 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.

Can I Make Changes to the Trust in the Future? 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.

When Should I Set Up an Insurance Trust? You can set up an ILIT at 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 because if your health begins to fail, you could become uninsurable or the insurance cost may be prohibitive.

Should I Seek Professional Assistance? Yes. If you think an irrevocable insurance trust would be of value to you, your family and the preservation of your estate or your business, talk with an estate planning attorney or other professional who has experience with these trusts.

As always, you should be sure that additional legislation has not been enacted or that court decisions have been rendered that would change the above advisements. This advisory is neither exhaustive nor is it tailored to your specific situation. If you have questions or concerns, you should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

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This Advisory is one of a series of estate planning and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

Buynak, Fauver, Archbald & Spray, LLP provides legal services to individuals, business owners and families including for estate and tax planning, long-term legacy and charitable gifting and business exit and wealth preservation strategies.

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