Taking the sting out of the 45% estate tax!

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Introduction

Imagine writing your last will and testament with the intention of leaving the IRS a large portion of your estate. Of course most people would think that absurd, but the IRS is already eager to collect what they think is their fair share of your estate. Under today's tax code, the first $3.5 million of your estate is exempt from estate taxes, but after that the federal estate tax of 45 percent takes a whopping bite out of your estate.

Not only is the tax bite painful, it becomes a serious problem if the majority of assets are illiquid, such as real estate or private investments. The estate tax return must be filed and the tax paid within nine months after the date of death. Your trustee may be forced to sell assets below fair market value just to meet that deadline, and during slow economic times when prices are depressed it's even more painful. Your estate could lose significant value by selling at a bad time.

Even in good times, coming up with the cash to pay taxes on a large estate is problematic for most families, and not very desirable. An insurance policy you own does not solve the tax problem, because the policy's death benefits are included in your taxable estate, thereby increasing your estate's tax liability. As an example, a $2 million death benefit could pay up to $900,000 in taxes, leaving only $1.1 million to pay taxes.

However, if you are insured, and you don't personally *own* the insurance policy, it is outside of your estate and is not subject to estate taxes. This is what an irrevocable life insurance trust (ILIT) accomplishes. The trust owns the life insurance policy, not you; therefore, the death benefits are not included in your taxable estate, saving an enormous amount of taxes. The full proceeds of the death benefit can be used to pay estate taxes.

How it works

You work with an attorney with specialized expertise to draft the trust documents in which you designate a trustee (the person who will manage the trust for you) and the beneficiaries (the people you want to inherit your estate). In its simplest form, you deposit cash into the trust's checking account. Since you've given the cash to the trust and it's irrevocable (meaning, you can't take it back), you no longer own it. That money is used to pay the premiums on an insurance policy

owned by the trust. Upon your death, the proceeds of the insurance policy are paid to the trust, not to your estate, so no estate taxes must be paid on that amount. If there is a lot of real property in your estate, the trust can then purchase the property from your estate, providing it with the cash to pay taxes while keeping the property in the family. The trust can also loan money to the estate to pay the taxes. Both of those solutions avoid a heavily-discounted, forced sale.

Selecting the Trustee

Choosing the trustee is an important step. The trustee will administer all the business of the trust. You should not name yourself trustee, nor should your spouse be the trustee, especially if the life insurance policy is a second-to-die policy (a special policy that covers you and your spouse, but only pays when the second one passes away). You should also avoid naming beneficiaries as trustees. The best choice is to use a professional independent trustee. An independent trustee should not sell investment products or provide legal. This avoids any potential conflict of interest between the attorney, the investment adviser, and the trustee. For instance, many banks offer trust services and investment services. Often times the bank trust officer will direct trust investments to their own in-house investment service, even though less expensive, independent investment advisers are widely available.

The duties of the trustee are:

- Opening and maintaining a checking account
- Obtaining a taxpayer ID number from the IRS
- Applying for and purchasing life insurance policies
- Accepting funds from you to pay the policy premiums
- Sending annual withdrawal notices to beneficiaries
- Paying insurance premiums
- Making investment decisions
- Filing tax returns
- Claiming and distributing insurance proceeds upon your death, per the terms of the trust

Selecting the Beneficiaries

In order to avoid estate taxes on the insurance proceeds, you should avoid naming your estate, your executor or creditors as beneficiaries. Generally, your family heirs are beneficiaries of the trust. Near the annual anniversary date of the policy, you deposit cash into the trust to pay the policy premiums. At least thirty days before the anniversary date, the trustee will send a letter (called a "Crummey letter") to each of the trust beneficiaries, informing them of their right to withdraw their portion of your deposit. This right to withdraw is necessary so your deposit can qualify for the annual gift tax exclusion. After thirty days pass and the trustee has not received a request to withdraw from any beneficiary, the trustee uses that money to pay the annual policy premium.

Benefits of an ILIT

There are several benefits of an ILIT:

- Life insurance proceeds are distributed free of income taxes and estate taxes.
- The proceeds can eliminate the need to sell assets to pay estate taxes. This is especially valuable if the estate is otherwise forced to sell assets during weak market conditions.
- The policy is protected from future creditors and potential ex-spouses.

Considerations

Before making the final decision to form an ILIT, there are several issues you should consider:

- The ILIT is irrevocable. Therefore, the trust will remain in place until your death. Once you deposit cash, or any assets, into the trust you cannot revoke it; it is permanently owned by the trust.
- You must carefully plan for the cash flows to pay the policy premiums. For example, if after eight years you can no longer afford to pay the premiums, you may not have a cash surrender value in the policy, and all premiums paid are now wasted as the policy lapses.
- The beneficiaries have the right to withdraw their portion of your annual deposit. Therefore, they must understand that foregoing their annual withdrawal will ensure there will be

money to pay estate taxes down the road. If they decide to take the money, it will likely cost them dearly years down the road.

- The trustee cannot be one of the trust beneficiaries, and should be an independent advisor to the family or a professional independent trustee. Family members are strongly discouraged from being trustees – it's easy to get caught in the middle of family squabbles.
- Your annual deposit into the trust to pay the insurance premium is considered a gift. Therefore, you must coordinate this amount with other gifts to the beneficiaries using the annual gift tax exclusion as well as the unified gift and estate tax exemption.
- In some cases, it might prove beneficial to finance the annual premiums, significantly reducing the annual cash outlay. Some insurance companies will not write a policy if it is being financed, while others may quote a different premium if the policy is financed.
- In all cases, it's important to look at the total cost of premiums over the life of the policy to understand it's economic benefit. Depending on the rating of the insured, it may or may not make sense to try to pay for the estate taxes completely with an insurance policy.

Conclusion

If your estate is estimated to be over $3.5 million, you should give serious consideration to creating an ILIT. The ILIT is a well-known and proven strategy for handling the 45 percent estate tax. However, there are many complexities and considerations in planning, creating, maintaining and settling an ILIT, and mistakes can be very costly, even erasing all of the intended benefits. Proper financial planning and legal advice can help ensure you protect your wealth effectively to pass on to your heirs.

For further information on using an irrevocable life insurance trust, call Willow Ridge Capital Advisors in Monterey at 831.373.3936, or in Pleasanton at 925.462.8005. www.willowridgecapital.com

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