The Value of Life Insurance Trusts

An estate planning option more families ought to know about.

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You may think of life insurance in very simple terms: you buy a policy so that your loved ones will have some financial assistance when you die. Its functionality doesn't end there. If it looks like your accumulated wealth will be subject to estate taxes someday, life insurance may be a very useful tool for you. In fact, you might call life insurance the "Swiss army knife" of estate planning, especially when it is used in conjunction with trusts.

What does a life insurance trust do? It enables you and your family to do three things in particular. One, it provides you, your spouse and your heirs with life insurance coverage after it is implemented. Two, it allows a trustee to distribute death benefits from a life insurance policy as that trustee sees fit. Three, it gives you the chance to reduce your estate taxes.

When you create a life insurance trust, you are creating an entity (the trust) to own life insurance policies for you and/or your loved ones. Since the trust owns the policies rather than the insured individuals, the proceeds from the policies go into the trust when an insured party passes away.

As a result, the insurance proceeds aren't subject to probate, income taxes or estate taxes. A trustee can distribute those proceeds to one or more parties as stipulated in the language of the trust. Also, if your estate ends up really large, the trust can buy additional life insurance coverage to provide additional cash to pay additional estate taxes.

Who pays for the insurance? As the grantor (i.e., the creator) of the trust, you have a say over that. In most cases, the trust pays the premiums; the grantor transfers enough funds into the trust to make that happen. A grantor can actually pay the premiums rather than the trust itself; this act is not defined as an "incident of ownership." Sometimes another party pays the premiums, although this can mean flirting with gift tax issues. Some grantors just pay a lump sum for coverage – that is, they buy a single premium life policy.[1,2]

A life insurance trust must abide by three requirements. One, it needs to be irrevocable. That is, once created it is legally "set in stone," unlike a revocable trust which can be amended or revoked later on. (You can make a life insurance trust revocable, but that destroys the estate tax benefit. Making the trust revocable makes you the owner of the life insurance policy in the eyes of the IRS, so its proceeds will be included in your taxable estate.) Two, you can't be the trustee; it has to be someone else. Three, the trust has to be implemented (up and running, so to speak) at least three years prior to your death.[3]

Sometimes these trusts establish investment policies for the life insurance proceeds, and even timelines for who receives what when (families may want to delay an heir from legally receiving an inheritance until age 18 or 21, for example).

Why don't I just have someone else own my insurance policy? That scenario can lead to major financial and familial headaches. If that person dies before you die, the cash value of the policy will be included in their taxable estate. So the heirs (and relatives) of that person could face estate taxes, or higher estate taxes than they now anticipate. Also, if you do this, you surrender control of your policy; the loved one you trust could end up naming another beneficiary or even cashing your policy out.[3]

A decision for life. Establishing an irrevocable life insurance trust, or ILIT, is a big decision that can result in a big estate tax break for your heirs. If you'd like to know more about these trusts and their potential, talk to a qualified legal, financial or insurance professional today.

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Citations.

1 - nolo.com/legal-encyclopedia/life-insurance-trusts.html [9/3/14]
2 - fidelity.com/viewpoints/personal-finance/can-life-insurance-help [11/6/13]
3 - nolo.com/legal-encyclopedia/transfer-life-insurance-decrease-estate-tax-29585.html [9/3/14]