

In Insurance We Trust

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This is an article about the three things my mother always told me not to talk about at the dinner table: dying, money and taxes.

We begin with a short primer on insurance and estate taxes.

Estate Tax

Estate taxes are based on the taxable value of the decedent's estate. That value is determined by subtracting the applicable "exclusion" from the taxable value of the estate at death. Beginning in 2011 the maximum exclusion was \$5,000,000. If you state collects an estate tax, the combined federal and state estate tax rates can be estimated at about 55% of the taxable estate. These rates put the estate tax at about 15% higher than the highest ordinary income tax rate.

Life Insurance

There are several types of life insurance. Term, Cash Value, Whole Life, Universal Life, Variable Life and Survivorship life are the most common. Term has the least expensive premiums. The other types will yield a larger "cash value" and can be more advantageous depending on specific circumstances. Talk to a good insurance agent to learn more about which type may be best for your needs.

For most people the main purpose of life insurance is to replace the income of an income producer (typically in a family) in the case of an untimely death. However, life insurance proceeds provide an interesting tax advantage if placed properly: they are not taxed at the death of the decedent. However, depending on what Congress does about the estate tax rules, one thing you may not want to do is to make your estate the beneficiary of the life insurance proceeds as it would become a part of the taxable estate. To get life insurance out of your taxable estate, you should talk to your financial advisor about establishing an "Irrevocable Life Insurance Trust".

Setting Up an Irrevocable Life Insurance Trust

Here are the steps to setting up an ILIT:

1. Set up the trust

It's best to have an estate planning attorney do this. Typically this type of trust provides for income to go to your spouse, and when your spouse dies, to successor beneficiaries (typically your children), or the trust terminates and the principal is dispersed.

2. Make a gift to the trust

Make a gift that is the amount of the premium for the insurance policy. Currently you can gift up to \$13,000 of your taxable estate each year without tax consequences (this also reduces the value of the taxable estate).

3. Send a "Crummey Notice"

This is a notice to all beneficiaries of the trust that they are entitled to a distribution for a certain member of days from the notice (normally 30). If they decline to take a distribution, the distribution can be available for payment of the life insurance premium. Note: it's a good idea to keep proof that the notice was sent and that beneficiaries declined in case of an IRS audit.

4. Pay the premium

After expiration of the beneficiaries right to take a distribution, use the distribution that would have been otherwise dispersed to pay the premium on the insurance policy.

5. Fund the trust

At the death of the decedent, the trust is funded and the proceeds are used to pay the estate taxes or disburse to the beneficiaries.

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