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MATSUMURA LAW FIRM

Wills, Trusts, Probate
And Estate Planning

Life Insurance Proceeds Are Subject to Estate Taxes at the 45% Rate (for 2007)

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Irrevocable Life Insurance Trusts: How They Work To Avoid Paying Policy Proceeds to Uncle Sam

Like most people, you probably own life insurance on your life. After all, life insurance can help you achieve important goals, such as to provide a replacement income for your family, or create an equalizing inheritance for children, or provide liquidity to pay anticipated estate taxes and other debts.

However, your life insurance goals can be defeated unless you do pro-

per planning to protect the proceeds from estate taxes. While policy proceeds are generally free from income taxes, life insurance proceeds are included in your estate for estate tax purposes and as a result, are subject to estate taxes (the 2007 estate tax rate is 45%).

Many people merely purchase life insurance policies and do no other policy planning. Unfortunately, the lack of planning is equivalent to naming the IRS as a beneficiary of up to 45% of the policy proceeds!!!

To avoid sharing the policy with the IRS, an irrevocable life insurance trust (ILIT) can be used to remove the proceeds from your estate, and ensure that your beneficiaries receive 100% of the proceeds. This month's article will describe how ILITs work.

Mechanics of an ILIT. An ILIT keeps life insurance out of your

estate for estate tax purposes. The mechanics of an ILIT are as follows:

1. Settlor, S, creates an ILIT.
2. An irrevocable trust is funded by S with cash.
3. The trustee of the ILIT uses the cash to purchase a life insurance policy on S's life.
4. The ILIT is the owner and the beneficiary of the life insurance policy.
5. S makes annual gifts to the ILIT in advance of the policy's annual premium due date.
6. The trustee uses the gifts to pay the policy yearly premiums.
7. Upon S's passing, the proceeds are paid to the ILIT.
8. The ILIT specifies that the funds are to be used to benefit S's family.

Because the ILIT purchases the policy, pays the policy premiums and has the power to change policy beneficiaries, the IRS considers the ILIT as the owner of the policy. S does not own the policy. Therefore, when S dies, the policy is not included as an asset that S owns in his estate.

Selection of Initial and Successor Trustees.

In selecting initial and successor trustees of the ILIT, you need to select someone other than yourself or anyone related to you. "Related" for this purpose means:

- Your spouse.
- Your parents, siblings, children and grandchildren (issue).

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Irrevocable Life Insurance Trusts (continued)

- A subordinate employee of a company in which you are an executive.

The IRS requires a non-related party to serve as trustee to be sure that you do not exert any control over or influence the trustee. If you do have this control, the IRS will consider you to be the owner of the policy and require that the proceeds be included in your estate, thereby defeating the goal of the ILIT.

after the gift is made. Normally, gifts to individuals *in trust* are not present interest gifts because the donee does not receive the gift outright.

Nevertheless, it is still possible to qualify gifts in trust as present interest gifts by drafting *Crummey* withdrawal powers in the trust. The *Crummey* withdrawal power derives its name from case law, *Crummey v. Commissioner* (9th Cir 1968). Basically, a *Crummey* power gives the trust beneficiary the authority to request the gift outright from the trust immediately

“Because the ILIT is the owner of the policy, it is not included as an asset in the decedent’s estate”



Annual Gift to the ILIT for Use in Payment Premiums.

The ILIT, as the owner of the life insurance policy, will need to pay annual premiums to maintain the policy. If you set up an ILIT, you will make yearly cash gifts to the ILIT, and the ILIT will use the cash to pay the premiums.

As you may be aware, an annual gift tax exclusion exists to exempt \$12,000 per donee (for 2007) from gift tax. To qualify the gifts for the annual gift tax exclusion, the gifts need to be “present interest” gifts. A present interest gift is a gift which is made *outright* to an individual donee so that the donee has full control over the gift immediately

after a gift is made to the trust. Because the beneficiary has this election, the gift qualifies as a present interest gift and the first \$12,000 of the gift is excluded from gift tax consequences. The ILIT beneficiary typically understands the goal of the ILIT, and does not elect to take the annual cash gifts to the trust outright. The ILIT then uses the funds to pay the annual policy premiums.

Conclusion. The ILIT is a powerful estate planning tool to ensure that 100% policy proceeds will accomplish family goals. All the proceeds escape estate taxation, and are available for the uses you specify, i.e., income replacement, estate liquidity, children’s education, etc. ✪

About Me

I graduated cum laude from the University of the Pacific in Stockton, California in Business and received my law degree (J.D.) from King Hall School of Law at U.C. Davis. I was admitted to the California State Bar in 1993 and completed my Masters in Taxation (LL.M.) at Golden Gate University in 1998.

I have practiced exclusively in the area of estate planning, pro-

bate and trust administration for approximately nine years. My main office is in Pleasanton, but I often travel to homes or other locations to make the process of estate planning easy for my clients.

Good Luck to the Pac-10 in the 2007 NCAA Division I Basketball Championships! (Respect the West!)

Next Issue:

How to Choose Guardians for Your Minor Children