Your Estate and Life Insurance: It All Adds Up

It’s easy to underestimate your net worth. After all, without a crystal ball, the future value of your home and savings is hypothetical. What’s not hypothetical, however, is the fixed amount of the **death benefit** provided by your **life insurance** policy. Adding this often significant sum to your asset pool could expose your estate to Federal **estate taxes**. Fortunately, there are **trusts** that can exclude life insurance from an estate.

Many people assume that because death benefit proceeds from a life insurance policy are generally not considered taxable income to the beneficiary, a life insurance policy is out of the reach of the Internal Revenue Service (IRS). However, when the policy’s death benefits are added to the appreciated value of your home and savings, it may come as a shock to find that the value of your estate may exceed the **applicable exclusion amount**.

Taxpayers should be aware that, under current law, the Federal estate tax is repealed in 2010, according to provisions established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). However, EGTRRA contains a “sunset” provision, whereby all provisions automatically expire in 2011, effectively reinstating estate taxes with an applicable exclusion amount of $1 million and a top tax rate of 55%.

Although the **unlimited marital deduction** allows spouses to transfer assets between them without assessment of estate taxes, nonspousal heirs face the possibility of seeing a life insurance policy inflate an estate’s value past the scheduled exemption amount in the year of death.

One Strategy: A Credit-Shelter Trust

One way to get the life insurance policy out of your estate is to use a type of **bypass trust** known as a **credit-shelter trust** that can be created through a **living trust**. Essentially, a trust is a contract between a named donor, a managing trustee, and a beneficiary—all roles often assumed by the donor himself or herself.

Either way, such a trust could be set up so that an amount equal to the scheduled per person exclusion amount of a married person’s estate passes to the trust at death to benefit the surviving spouse, with the remainder of the assets passing outright to the spouse. Then, at the death of the surviving spouse, the proceeds from the death benefit and the remaining assets in the credit-shelter trust could be paid to the couple’s children—without being subject to Federal estate tax. Any assets outside the trust upon the surviving spouse’s death, and therefore potentially subject to estate tax, could be further sheltered by the second spouse’s applicable exclusion amount for that year.

Another Approach: An Irrevocable Trust

When children are the beneficiaries of a life insurance policy, and the owner wants to exempt the policy from the estate’s total worth, an **irrevocable life insurance trust (ILIT)** is another approach. Keep in mind, however, the term “irrevocable” means beneficiaries may *not* be changed and loans may *not* be paid out from the policy once it is put into the trust. Putting a hefty life insurance policy into such a trust could help beneficiaries finance the purchase of a family business or pay estate taxes. However, funding an ILIT may result in gift taxes due.

Park Your Policy in the Right Spot

A trust, depending on the type, can help reduce or defer taxes on high-value assets such as a life insurance policy. More broadly, a trust can be the means to help ensure the policy’s benefits go directly to the intended beneficiary. With the flexibility of trusts, however, comes complexity. It is always best to consult with an estate attorney who is experienced in tax matters before proceeding.

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