

Utilizing Trusts for Life Insurance in Estate Planning: A Guide for Non-Experts

June 29, 2023



**BY JOSH SHAPIN AND KEVIN KRSINIC,
MEMBERS OF ANCHIN PRIVATE CLIENT**

Life insurance plays a vital role in estate planning for individuals who wish to secure their legacy and provide financial support to their loved ones after they pass away. While many people are aware of the benefits of life insurance, improper ownership can potentially lead to significant estate taxes. In this article, we will explore how the use of a trust, specifically an Irrevocable Life Insurance Trust (ILIT), can help remove the life insurance death benefit from one's estate, minimizing or even eliminating estate taxes. We will discuss the basics of life insurance, the importance

of trust ownership, and key considerations for effective estate planning.

Understanding Life Insurance in Estate Planning

Life insurance is a form of insurance where individuals pay premiums in exchange for a payout, known as the death benefit, upon their demise. The premium amount depends on factors such as the policy length and the desired death benefit. Common types of life insurance include whole life and term policies. Whole life insurance covers the insured for their entire life, while term policies provide coverage for a fixed number of years. It's important to note the relevant parties involved in life insurance, including the insured (whose life is covered), the beneficiary (recipient of the death benefit), and the policy owner.

Minimizing Estate Taxes with an ILIT

If the policy owner is also the insured, the life insurance policy is considered an asset of the estate. This inclusion can substantially increase the taxable estate's value and potentially trigger federal estate taxes of up to 40%, as well as state taxes like the 16% tax for New York residents. However, establishing an ILIT, where a third-party acts as the policy owner, offers a solution to enjoy the benefits of life insurance without the burden of significant estate taxes.

Transferring a Policy to an ILIT

Ideally, an ILIT should own the life insurance policy from its inception. The insured can gift cash to the trust, enabling it to directly obtain the policy from the insurance company. However, if the policy is already owned by the insured, it is still possible to remove the life insurance proceeds from the estate by gifting the policy to the trust. Although utilizing the lifetime exemption will be required for the gift, the value of the policy for gift tax purposes is typically lower than the value of the proceeds which otherwise would be included in the estate.

Avoiding a Three-Year Rule

A special federal rule applies to life insurance, stipulating that if the insured passes away within three years of gifting the policy to the trust, the value of the proceeds will be added back to the estate. To avoid this rule, the insured can gift cash to the

trust equivalent to the policy's value and have the trust purchase the policy from the insured. In this scenario, even if the insured does not survive three years after the transfer, the proceeds will be excluded from the estate as the life insurance policies were not gifted, but rather purchased with gifted capital. It's important to note that New York has a similar rule that applies to **all** gifts made within three years, requiring them to be added back to the estate for tax purposes. However, if the policy transfer is structured as a cash gift to the ILIT before death (and a subsequent purchase of the policy by the ILIT), only the cash gift used for the purchase would go back into the estate for tax purposes and it can still be advantageous for New York estate tax purposes. This is because the difference between the value of the policy at the time of the gift and the actual proceeds received after death will still be exempt from New York estate tax.

Considering Premium Payments and Gift Tax

Before creating the trust, careful consideration should be given to the question of who will pay future premiums. If the policy owner (e.g., ILIT) does not pay them directly, the payments made by others may be considered additional gifts. These gifts could utilize a portion of the lifetime exemption. However, beneficiaries can be granted "Crummey Powers," allowing them to shelter gifts of up to \$17,000 per beneficiary per year in 2023. Alternatively, gifting income-producing assets into the trust can ensure the trust itself has its own funds to pay the premiums, eliminating the gift issue entirely.

By establishing an Irrevocable Life Insurance Trust (ILIT) and transferring ownership of life insurance policies to the trust, individuals can effectively remove the life insurance proceeds from their estates, minimizing estate taxes. However, navigating the complexities of an ILIT requires careful consideration and expert guidance. Consulting with estate planning professionals can ensure a comprehensive understanding of the process and help individuals utilize life insurance as a powerful tool in their estate planning, providing financial security and a lasting legacy for their loved ones. For more information or to discuss specific related matters, contact your Anchin Relationship Partner or [Josh Shapin](#) and [Kevin Krsinic](#), members of Anchin's Private Client group.