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October 13, 2010, 3-6 pm
Verena at Virginia Center

To register, e-mail Lauren at lkn@JGBLLP.com

ILITs - Shiny and New... Again

By Jeremy C. Johnson

“It's deja vu all over again” – applied to the current context of estate planning, this famous Yogi Berra quote could easily be made to refer to the resurgence of Irrevocable Life Insurance Trusts (“ILITs”). For the uninitiated, this begs the first question, “What is an ILIT?” The answer itself is somewhat of a paradox, being simultaneously simple and terribly complicated. First the simple answer: an ILIT is an irrevocable trust into which individuals place life insurance for the benefit of others. Now we will use the remainder of this article to discuss the complicated answer.

Harkin Back to the Estate Tax

Do you remember when the federal estate tax exemption was \$675,000, with a 55% maximum effective rate, during the Clinton administration? This would result in a hefty tax liability for any estate with a ‘gross estate’ in excess of the \$675,000 exemption. According to the IRS, your life insurance death benefit amount paid to your beneficiary(s) is part of your gross estate. As such, with a relatively low estate tax exemption amount available to taxpayers, ILITs became a popular method to remove the life insurance from inclusion in the gross estate calculation; effectively reducing the size of the estate substantially.

Fast forward to 2001; the Bush 2 administration makes a move to set the estate tax exemption amount on an increasing scale. However; this administration is unsuccessful in convincing Congress to make the increase of the estate tax exemptions permanent.



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Instead, they are set to increase over a 10 year time-frame, then be automatically repealed and return to pre-2001 levels as of January 1st 2011. During this false-utopian period of estate tax relief, most taxpayers have seemed to be lulled into a sense of bliss – having often overheard the statement “the estate tax is dead.”

Wake-Up Call

From this author’s perspective, January 1st 2010 seemed to catch everyone by surprise. On this fateful day, the federal estate tax went gently into that goodnight; being the first time our nation has been without some form of an estate tax since 1916. Prior to this occurrence, it seemed that most people felt that the government would never let this happen; that they would pass a patch to extend 2009 levels/rates into 2010 until they could come up with a better fix. The most disturbing aspect of this event was the government’s inability to provide even a temporary fix to this glaringly apparent fiscal issue. As such, many of the same people who previously felt warm, safe and secure with the prior, temporarily high estate tax exemptions amounts all of a sudden realized that we are venturing into a period of dystopia and a collective chill is felt running down their spines – “Maybe we will see a \$1,000,000 estate tax exemption in 2011 after all. Maybe we are not as safe as we thought with regard to possible estate tax liabilities.”

ILITs – The Once and Future King

So where does this leave us as taxpayers? If we do see a resetting of the estate tax exemption to \$1,000,000, there will be a great deal of re-working of existing estate plans. Again, I know it is easy to fall into a false sense of security; \$1,000,000 sounds like a great deal of money.

Upcoming Seminars

Please attend our upcoming seminars – Better still, invite a friend!

Virginia Beach

September 28 @ 7 pm

September 30 @ 2 pm

September 30 @ 7 pm

To register, please visit:

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Have you discussed your estate plan with your chosen executor/trustee and/or beneficiaries? Consider having a family estate document review meeting with your trusted JGB Attorney

However, remember that your 'gross estate' is defined by the IRS to generally be everything that you own or have dominion or control over; to include:

- the value of property to the extent of an interest held by the surviving spouse as a "dower or curtesy";
- the value of certain items of property in which the decedent had, at any time, made a transfer during the three years immediately preceding the date of death (i.e., even if the property was no longer owned by the decedent on the date of death), other than certain gifts, and other than property sold for full value;
- the value of certain property transferred by the decedent before death for which the decedent retained a "life estate", or retained certain "powers";
- the value of certain property in which the recipient could, through ownership, have possession or enjoyment only by surviving the decedent;
- the value of certain property in which the decedent retained a "reversionary interest", the value of which exceeded five percent of the value of the property;
- the value of certain property transferred by the decedent before death where the transfer was revocable;
- the value of certain annuities;
- the value of certain jointly owned property, such as assets passing by operation of law or survivorship, i.e. joint tenants with rights of survivorship or tenants by the entirety, with special rules for assets owned jointly by spouses;

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- the value of certain "powers of appointment"; and
- the amount of proceeds of certain life insurance policies.

Keeping these parameters in mind, anyone with a home, an IRA/401(k) and a reasonable amount of life insurance could very easily exceed his/her allotted estate tax exemption; resulting in an estate tax liability. Therefore, many of our clients have begun once again to turn to the tried and true strategy of shielding their life insurance within ILITs.

Benefits of Life Insurance

Yes, as with anything worthwhile, there is a price of admission to play the estate tax avoidance game. However, life insurance is particularly well suited to leverage current estate dollars against future tax estate tax liability if properly housed within an ILIT. Before I go further, I wish to make it clear; **NONE OF THE ATTORNEYS OR STAFF OF JOHNSON, GASINK & BAXTER, LLP HOLD ANY LIFE INSURANCE LICENSES.** Rather, we have had a great deal of experience working with clients and their chosen financial/insurance advisors to structure the proper application and implementation of life insurance within their estate plans. With that said, life insurance provides a means by which a taxpayer can purchase future estate tax dollars for current pennies. Now, when the premium dues notice is received, we all sometimes have a difficult time remembering this fact. However, I know of no other asset which provides the same dependable return on investment at one's death, which can provide immediate and income tax free liquidity to the taxpayer's family when they may need it most; and if it is properly structured within an ILIT, it will also be estate tax free.

ABOUT THE AUTHOR:

Jeremy C. Johnson is a member of the Board of Directors for the Peninsula Agency on Aging Endowment Fund (www.PAAinc.org); and he serves as the Treasurer for the Virginia Peninsula Estate Planning Council (www.peninsulaepc.org).

In addition, Jeremy is a member of the Virginia State Bar; VSB Section on Trusts & Estates, VSB Section on Taxation and the VSB Section on Business Law. Jeremy is also a member of the Massachusetts State Bar.



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For these reasons, where a client is insurable, we will often look first to underwriting their estate tax liability with proper insurance planning through the client's financial/insurance advisor.

Nuts and Bolts

Here's a very simplified description of how ILITs work. First, the ILIT document is created. The Grantor (you) cannot be a trustee or beneficiary of the ILIT; nor can you have any prohibited power over the ILIT that would cause the IRS to include the ILIT in your estate. You establish 'lifetime beneficiary(s)' within the ILIT (typically your children). Ideally, your new life insurance policy is purchased directly by the ILIT and the ILIT is made the beneficiary of the life insurance policy. This prevents the policy from being subject to the '3 year rule' – which would re-capture the policy as a gross estate item if you die within three years of placing an existing policy that you already own into the ILIT. Next, you make a 'gift' of the premium amount to the Trustee of the ILIT; who then deposits the same into an ILIT checking account. The Trustee is required to send out a notice (Demand Letter and/or Crummey Letter) to your lifetime beneficiary(s) informing the same that they have the legal right to withdraw this amount from the ILIT before the premium is paid – this makes the transaction a completed gift for income tax purposes. If your lifetime beneficiary(s) withdraw the gifted amount, more likely than not, the policy will fail as the premium is not paid. This is why most clients make their lifetime beneficiary(s) the same as the ILIT residuary beneficiary(s). That way, if they do anything to cause the ILIT to fail, then they are actually hurting themselves at a future date, when the tax man comes to collect on the estate tax liability. Therefore, properly educated lifetime beneficiary(s) are less likely to make the mistake of

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removing the gifted premium from the ILIT. After a pre-determined period, if the lifetime beneficiary(s) have not removed the gifted premium amount to the ILIT; then the Trustee pays the premium on the life insurance. This is repeated each year. When the grantor/insured dies, the life insurance matures within the ILIT, outside of the grantor's gross estate. This is what is often describe in the estate planning world as creating a 'private family bank' at the grantor's death; from which the funds can be used for any number of things, including, but not limited to providing liquidity to the estate in satisfying its estate tax burden, if any.

Conclusion

As my business partner Dan often says, "the estate tax is not dead, it is only sleeping; and when it awakes from hibernation, it's going to be very cranky." As a group, we attorneys, advisors, clients and taxpayers need to be flexible enough to take a second look at ILITs as a viable solution to the upcoming albatross around all of our necks should the estate tax exemption return to \$1,000,000 in 2011.

The Attorneys of Johnson, Gasink & Baxter, LLP have the experience and technical skill to help you and your family protect and transfer your estate with the least amount of government intrusion possible.

Do not hesitate to contact us to schedule an appointment at 757-220-9800, or email us at lkn@JGBLLP.com.

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