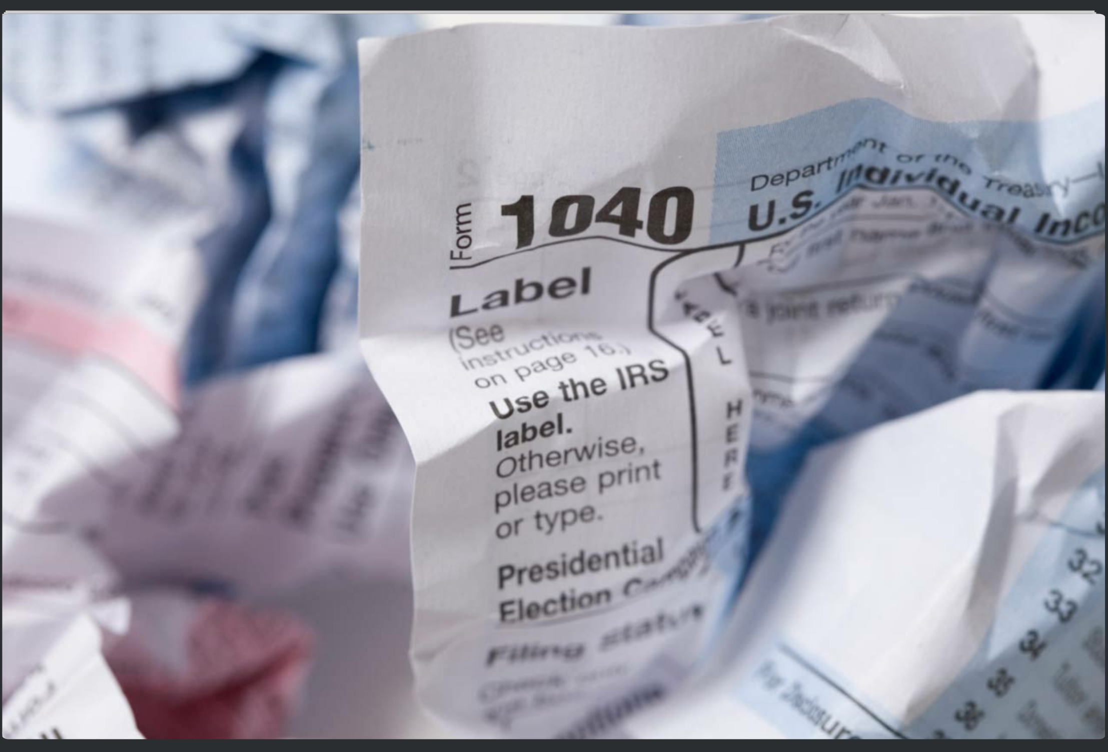
SMART INSIGHTS FROM PROFESSIONAL ADVISERS

Myth: Life Insurance is NOT Taxable

The reality is that life insurance is treated as an asset in your estate. And if the payout pushes your estate past federal or state estate tax exclusion limits, you could be facing a hefty estate tax bill. There is something you can do, though.



By KEN MORAIF, CFP®, CEO and Senior Adviser | Retirement Planners of America
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You may think that life insurance is tax-free. Unfortunately, the "no tax on life insurance" idea is only partly true: Life insurance is *income tax*-free. In other words, recipients of a decedent's life insurance policy do not have to pay income tax on that sum.

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However, if it's large enough, the decedent's estate — including any life insurance proceeds — could be subject to federal and/or state estate taxes. As an example, let's say you have a $1 million life insurance policy. The IRS deems that policy an asset, just as if you had an investment portfolio worth $1 million. And upon your death, the IRS sees it as a million-dollar asset you just transferred to your beneficiaries, and taxes it accordingly. That estate tax is usually due upon death, and it can be substantial.

If you're among those wealthy enough to be concerned about this possibility, how can you avoid having your life insurance proceeds included in your estate and therefore possibly subject to the estate tax? You can create an irrevocable life insurance trust (ILIT) and name that trust the owner of your life insurance. By doing so, that particular asset will be removed from your estate. Upon your death, the proceeds from your life insurance will pass on to your heirs not only income tax-free but estate tax-free as well.

Who might be a candidate for an ILIT? If your estate is in excess of the federal "application exclusion amount" ($11.18 million for single individuals and $22.36 million for couples under the Tax Cuts and Jobs Act of 2017)*, an ILIT could save your family up to 40% in federal estate taxes. It's a benefit worth the legal fees and complexity associated with setting up an ILIT. Keep in mind, 12 states, plus the District of Columbia, have their own estate taxes, and their exclusion amounts may be much lower than the federal limits.

Another benefit: An ILIT can help you can avoid tax on *both* spouses' estates. Life insurance proceeds can be held in a trust for the benefit of the surviving spouse during his/her lifetime. When that person dies, the proceeds will not be included as part of his/her estate either, but will pass tax-free to your children and then to your grandchildren, as an ILIT in a multigenerational trust.

Be forewarned: The IRS scrutinizes ILITs carefully. In order to make sure your ILIT passes IRS inspection, you must:

1. Transfer any polices you already own to the ILIT by completing an "absolute assignment" or "change of ownership" form.
2. Relinquish *all* ownership rights to the trust. It's not as simple as you may think. In fact, you can be charged with retaining an ownership right in the life insurance policy without ever having held title to that policy. If you want to keep insurance proceeds out of your estate, you need to:

- Give up all ownership rights to the policy, including the right to change beneficiaries, borrow from cash values, and make premium payments;
- Enter into an annual cash partition agreement in order to create separate funds from which premiums are paid so that there is no mistake as to whom the payor/owner really is; and
- Maintain a change of ownership in an existing policy for at least three years before the insured's death. In other words, you must survive for at least three years after transferring your policy to the trust. Otherwise, the proceeds will be taxed in your estate as if you retained ownership of the policy.

Bottom line: Your heirs will not pay income tax on any life insurance proceeds they receive, but if the estate is large enough, they will pay estate taxes on the policy — unless you set up an ILIT at least three years before your death. And though ILITs can save some families a great deal of money, it's best to enlist a professional to design a trust that will pass IRS muster.

**The Act sunsets on Dec. 31, 2025, after which the amount will adjust to the old $5 million exemption, indexed for inflation.*

SEE ALSO:
What to Do with an Old Life Insurance Policy

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