

Robin & Peter on LIFE SETTLEMENTS



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Now is the Time to Review Your Clients' ILITs

For decades, the Irrevocable Life Insurance Trust (ILIT) has been a popular and fundamental strategy that formed the cornerstone of many estate plans. Recent events make it more important than ever to closely review those trusts and the policies they own.

The popularity of the ILIT for estate planning purposes stems from its ability to shelter the proceeds of the life insurance owned by the trust from estate taxes while giving the grantor the ability to direct, in the trust document, how the proceeds are to be used and for whom. A relatively small annual gift of the premium amount can be leveraged into a large liquid death benefit at precisely the time cash is needed to pay estate taxes and to preserve the assets of the decedent that otherwise might have to be sold off to meet that tax obligation. Additionally, the ILIT can be used to efficiently pass significant amounts of wealth to the grantor's beneficiaries free of not only estate taxes, but income and capital gains taxes as well. But there are two important reasons why all ILITs should be reviewed now.

The American Taxpayer Relief Act of 2012 (ATRA)

ATRA has substantially reduced or eliminated the federal estate tax burden for most taxpayers. This law increased the estate tax exclusion to \$5.25 million indexed to inflation and made the exclusion portable for married couples so that a total \$10.5 million of wealth can be easily transferred to the succeeding generation without any type of sophisticated estate planning. No less important is that the top estate tax rate was reduced to 40%. And, at least in theory, the law is permanent - or at least as permanent as any tax legislation can be - because it has no expiration date.

The magnitude of the reduction to prospective estate tax liabilities cannot be overstated. According to estimates by the Urban-Brookings Tax Policy Center, the changes to the estate tax exclusion mean that only a very small number of estates, 3,780 in 2013 for

example, (0.12 percent of the U.S. population) will be subject to federal estate taxes. Additionally, even those who are subject to the tax will see their average effective rate drop to only 16.6 percent, which is well below the top estate tax rate of 40 percent set by ATRA. So, even the small number of estates subject to federal estate taxes will see a significant reduction in their estate tax liability.

Although the federal estate tax is not the only reason for an ILIT, it has been the primary one. An ILIT may still be used for wealth transfer, estate liquidity, equalizing estate distributions among beneficiaries, paying state inheritance taxes and many other reasons. It may even be desirable to continue some or all of the policies in an ILIT just as a precaution against future estate tax increases. However, with the elimination of the major reason for most taxpayers to have an ILIT, it certainly warrants examining whether or not it makes sense to maintain the trust and the policies it owns.

Rising Premiums

Interest rates have been at historic lows for an extended period of time prompting insurers to lower crediting rates on interest sensitive policies like participating whole life and universal life. Additionally, variable life policies have been hit hard by the lackluster performance of the stock market. As a result, virtually any policy (except those with secondary guarantees funded on a guaranteed basis) is likely to be underperforming the projections that were made when the policy was issued. For an ILIT, this could mean a significant increase in the premiums required to keep the policy in force.

An increase in the premium requirement has a two-fold impact on ILITs. First, there is the issue of whether the grantor can afford to, or wants to, gift the additional premium cost to the ILIT. Second, even if the increased cost is affordable, the annual gift tax exclusion (\$14,000 per donor per donee in 2013) must be considered. It is possible that the higher premium could require annual gifts in excess of the available annual gift tax exclusions. This could result in actual out-of-pocket outlays to pay gift taxes or using up part of the estate tax exclusion (unified credit). Fortunately, the increased estate tax exclusion resulting from ATRA might mean that using some portion of it is not a problem.

What Can Be Done?

If it is determined that some or all of the insurance in an ILIT is no longer wanted, needed or affordable, it is the trustee's fiduciary duty to maximize the value of such policies on behalf beneficiaries of the trust. One option might be to reduce the face amount of one of more of the policies held in the ILIT. Another option could be surrendering a policy for whatever cash value the policy may have. Not to be overlooked, however, is the option to sell the policy to a family member or to sell it as a

life settlement. A life settlement could provide significantly higher value than surrendering a policy. Furthermore, if there are multiple policies in the trust, the life settlement of one policy could provide sufficient proceeds to help maintain any others in the trust. Although a life insurance policy is typically a unique and valuable asset, the current tax and interest rate environment may indicate that surrendering it would be advisable. In that case, the option of a life settlement, to maximize the policy's value, should certainly not be overlooked.

If you haven't contacted your clients to review their ILITs, now is definitely the time to do so. To help educate and motivate your clients, a consumer version of this article, which can be sent to them, may be obtained by clicking [here](#).

Changing circumstances may signify that modifications to your clients' ILITs are necessary, which gives you the opportunity to provide your clients with alternative products and services like a life settlement. As the noted author, businessman, and motivational speaker, Nido Qubein, said, "*Change brings opportunity.*"

Contact us:

Robin S. Weinberger, CLU, ChFC, CLTC

(617) 451-3343

rsw220@aol.com

Peter N. Katz, JD, CLU, ChFC

(860) 673-3642

pkatzlife@yahoo.com

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