

Money Matters

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Question of the Month: What is an ILIT?

By Aaron Skloff

Q: My colleague at work mentioned the importance of an ILIT for estate planning purposes. What is an ILIT and how can it benefit our family?

With an Irrevocable Life Insurance Trust (ILIT) you can protect one of your largest assets, the proceeds from your life insurance policy, from both federal and state estate taxes. Sorry tax collectors — those are the rules.

In 2008, each U.S. citizen is entitled to a federal estate tax exemption of \$2 million, with a 45% tax rate thereafter. Each NJ resident is entitled to a state estate tax exemption of \$675,000, with an approximately 11%-16% tax rate (depending upon the beneficiaries and size of your estate) thereafter.

While many married couples utilize the unlimited spousal exemption to transfer assets and life insurance proceeds without tax, they are setting themselves up for a potentially huge tax burden when the second spouse passes away. While the beneficiaries of life insurance policies are not subject to taxation, the owner's estate could be — as life insurance is added to the estate's value.

For example, assume that between the value of their home, retirement plans and savings Bob and Myrna have \$2 million in assets. In addition, Bob purchased a life insurance policy for \$2 million to protect his family, naming Myrna as the beneficiary.

When Bob passes away, neither his estate nor Myrna will be responsible for federal or state estate taxes due to the spousal exemption.

But if Myrna passes away shortly thereafter, she will leave behind a \$4 million estate. If her children are the beneficiaries, Myrna's estate will be subject to \$900,000 in federal estate taxes. If her siblings are the beneficiaries, Myrna's estate will be subject to over \$1.1 million in combined federal and state estate taxes.

Rather than paying unnecessary estate taxes, Bob worked with an estate planning attorney to establish an ILIT. After they established a trust, they named a Trustee other than Bob to purchase a life insurance policy on Bob's life. Bob then gifted the price of the policy to the trust. Bob stipulated who the beneficiaries were on the policy, how the beneficiaries will receive the proceeds and what conditions must be met to receive the proceeds.

By utilizing the ILIT, Bob has removed \$2 million from his estate and will pass \$2 million in other assets to Myrna. The trust was designed to pay Myrna \$100,000 per year and each of their children \$50,000 per year. When Myrna passes away she leaves behind the full \$2 million to her children, without the \$900,000 tax bill discussed above.

Establishing an ILIT is a critical part of good estate planning. Your family will thank you for generations to come.

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