Don't throw away those old ILITs just yet

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Under the American Taxpayer Relief Act of 2012 (ATRA), the gift, estate and GST exemptions are $5.25 million in 2013 (indexed for inflation), and the top tax rate is 40 percent. The Tax Policy Center estimates that only 3,800 estates in the entire country — which is a miniscule 0.14 percent, or 1 in every 700 people who die — will pay an estate tax in 2013. Thus, for over 99.8 percent of Americans, the estate tax has effectively been repealed.

Even for non-taxable estates, life insurance remains a valuable estate and financial planning tool. It continues to help individuals accomplish important financial objectives, including (1) replacing future earnings lost through a premature death; (2) equalizing inheritances in a family business; (3) providing supplemental retirement income; and/or (4) creating wealth at death.

Obviously, ATRA has negatively impacted the use of life insurance in the estate liquidity market, since only high-net-worth individuals now need estate liquidity. Many grantors who established irrevocable life insurance trusts (ILITs) to provide estate liquidity will be inclined to cancel their insurance because they no longer face an estate tax. However, for the following reasons, most grantors are well advised to maintain their ILITs.

1. Future changes in the estate tax laws could reduce the gift, estate and GST exemption as the government looks for ways to reduce its debt. For example, the President's 2014 budget proposal would return estate tax rates (in 2018) to their 2009 levels, when the estate tax exemption was $3.5 million, the gift tax exemption $1 million, and the top rate was 45 percent. Moreover, a change in the estate tax law could occur at a time when the affected person is no longer insurable.

2. The after-tax appreciation in asset values may exceed the owner's consumption, resulting in a taxable estate at the time of the owner's death.

3. A good policy might make sense to retain as a part of a larger investment portfolio. The policy's internal rate of return will often be competitive with non-life insurance alternatives (without the volatility of the stock market), particularly for more conservative investors.

4. The assets in the ILIT are protected from creditors, and the policy's cash values can be accessed through tax-favored policy loans and withdrawals, thereby making the ILIT a valuable financial planning tool.

5. The inside buildup of life insurance cash values is not subject to the new Medicare tax, nor are the death proceeds that are excluded from the income tax, making life insurance a valuable asset class for income and capital gains tax planning. 6. When appropriate (and with the advice of tax counsel), a single life policy can be exchanged for an annuity to create a source of retirement income for the grantor-insured's spouse. The policy can also supplement the spouse's retirement income through tax-favored policy loans and withdrawals. Thus, the grantor's spouse has direct access to the ILIT's funds for his/her lifetime, and the grantor has "indirect" access through his/her spouse.

7. For those grantors living in the 20-plus states with a death tax or inheritance tax, the ILIT can provide the liquidity to cover the state death tax, or the ILIT may help to avoid the state death tax altogether.

8. Without concern for gift and estate taxes, ILITs are now easier to administer. Grantor-insureds can pay their premiums directly to the insurance company without the complexity of *Crummey* powers. Alternatively, a one-time initial written *Crummey* notice might be used in lieu of annual notices.

9. If desirable, the policies may be restructured (by reducing coverage duration and/or the death benefit) so that the policy can be maintained with no further premiums.

10. Finally, the increased gift tax exemption will allow many grantors with existing split-dollar and premium financing arrangements (that have not been unwound) to do so by making simple gifts to the ILIT that received funds under such arrangements.

While ATRA may have eliminated the estate tax for all but the wealthiest of Americans, for the reasons listed above, ILITs remain a valuable estate and financial planning tool. Most importantly, ILITs are about more than just estate taxes. They are about the four "Rs": getting the right assets to the right people at the right time and in the right way.