Life Insurance Policy Not In An ILIT? Then Consider New Jersey Your Beneficiary

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An ILIT is an Irrevocable Life Insurance Trust. Why should you have one? An ILIT removes your life insurance policy from your estate, meaning that the proceeds will not be subject to estate taxes upon your death.

If you've been keeping up to date with the changes to the federal estate tax (and I know you have!), you know that the federal estate tax exemption was recently raised to $5 million per person. So you can now pass up to $5 million to your heirs tax-free upon your death.

Knowing this, you might think you don't need an ILIT because your estate - even including your life insurance policy – is under $5 million. But if you live in New Jersey, that sort of thinking is short-sighted. This is because, of course, the great State of New Jersey has its own estate tax that is separate from the federal estate tax. In New Jersey, the estate tax is imposed on your estate if it exceeds $675,000, although the rates are much lower in New Jersey then at the federal level.

For those of you who live in New Jersey, may own a home, have some stocks and bonds, and have a life insurance policy, you're probably over the $675,000 exemption. In many cases, a large portion of that wealth is the life insurance policy. Removing that policy from your estate could result in a huge tax savings. For example, removing a $2 million life insurance policy from your estate could result in an estate tax savings of almost $100,000. In other words, without an ILIT, a $100,000 check goes to New Jersey instead of your heirs.

When and how do you set up the ILIT?

The "when" is very important. If you don’t have a life insurance policy yet, but are looking to purchase one, then wait to purchase it. Set up the trust first. Here’s why: although you can transfer an existing policy to an ILIT, under the Internal Revenue Code, there is a three year look-back period. That means that if you transfer a policy to the trust, and then die within three years of the transfer, the policy goes back into your estate, which means it will be subject to estate taxes and make the ILIT worthless. Instead, set up the trust first, and then have the trustee purchase the life insurance policy on your life. I know it sounds strange for a trust to purchase a policy on your life, but it’s very common and will best protect your potential tax savings.

As for the terms of the trust, you can for the most part have the terms of the trust mirror the terms of your will. For example, if you have assets in your will going to your minor children in trust, you can have the same structure in the ILIT. One of the only catches of an ILIT is that the terms are irrevocable, which means that you cannot change them, including the individuals who you choose to receive the proceeds from the policy (although if you ask your estate planning attorney, there are some techniques to get around the irrevocable part).

Now that you know what an ILIT is and why you should set one up, you should speak with your attorney about it. Each person’s estate has different needs, but an ILIT is generally a “no brainer” to reduce estate taxes for those of you with life insurance policies.