Irrevocable Life Insurance Trusts

Producer Guide

Transamerica
Insurance & Investment Group

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An In-Depth Look at the ILIT

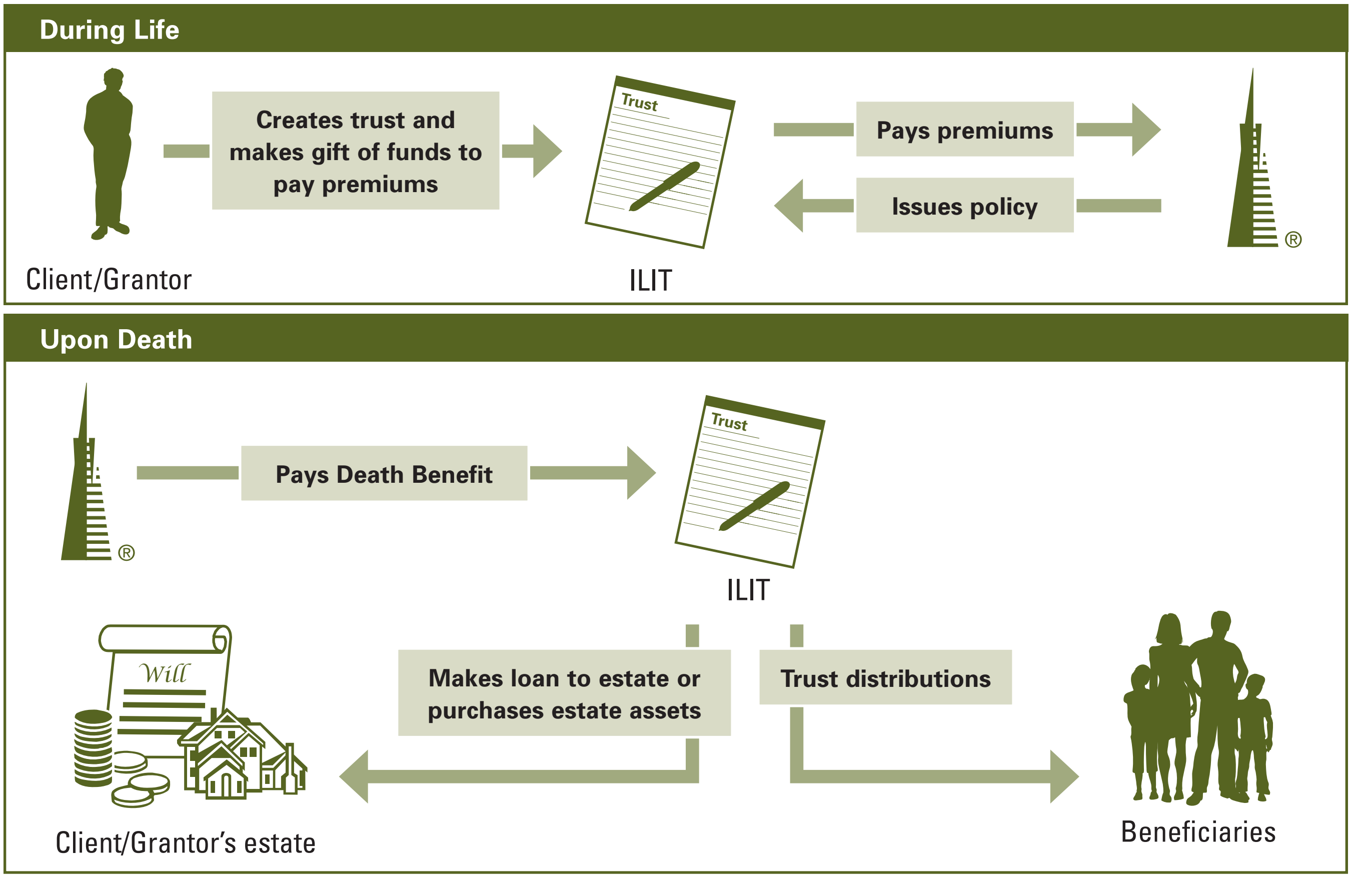
An irrevocable life insurance trust (ILIT) is a trust that is created to serve the specific purpose of owning one or more life insurance policies. An ILIT is primarily used to achieve tax savings.

It removes the trust creator, often referred to as the grantor, from the process of acquiring the insurance policy to the greatest extent possible. Rather, the third-party trustee of the ILIT applies for the policy on the grantor's life, executing a beneficiary designation naming the ILIT as beneficiary of the proceeds. Alternatively, an existing life insurance policy can be transferred to an ILIT. In this case, the grantor/transferor must survive the gift of the policy by three years or the "three-year look-back rule" will apply, causing the face amount of the policy to be included in the grantor's gross estate for estate tax purposes.[1]

By cutting the grantor out of this process, the ILIT serves to remove property from his or her gross estate for federal estate tax purposes, thereby eliminating federal estate taxes on the full face amount of the policy. In addition, an ILIT can help minimize federal gift taxes. The grantor can make annual gifts to the trust to cover insurance premiums and these gifts can be sheltered from tax up to the annual gift tax exclusion amount.

Even though the grantor is not the owner of the policy, he or she may still be responsible for ensuring that the premium payments are made. To accomplish this, the grantor has two options. The grantor can fund the ILIT with assets other than the life insurance policy, which will hopefully produce sufficient income to pay premiums. Alternatively, the grantor may make annual gifts to the trustee in the amount of the premiums. The trustee then uses this money to pay policy premiums.

How Does an ILIT Work?



[1] IRC § 2035.

What Happens at the Grantor's Death?

Upon the death of the grantor, the life insurance policy's death benefit is paid to the trust. If the trustee applied for and purchased the policy or if the grantor gifted the policy to the ILIT and outlived the three-year look-back rule period and did not retain any beneficial interest in the trust, the policy's death benefit would be received federal estate tax–free.

If the purpose of the life insurance policy is to simply transfer wealth to the next generation, the trustee will make distributions to the trust beneficiaries as dictated by the terms of the trust. Alternatively, if the purpose of the life insurance policy is to provide liquidity to pay estate taxes, the trustee may either make loans to or purchase assets from the grantor's estate in order to provide the cash necessary to pay this liability. However, it should be noted that the ILIT's provisions cannot "require" the trustee to make the trust assets available for payment of estate taxes. Thus, this decision must be left to the discretion of the trustee.

What Are Some of the Advantages of Creating an ILIT?

An ILIT accomplishes a multitude of objectives, including:

- Providing a stream of income or cash resources for the trust's beneficiary(ies)
- Providing a source of liquidity to pay estate settlement costs, which can include unpaid debts, state and federal transfer taxes, administrative fees, burial costs, and professional fees such as those charged by accountants and attorneys
- Protecting trust assets from the beneficiary's creditors and from legal claims arising from lawsuits, divorce, or bankruptcy
- Establishing financial management of assets for the grantor's loved ones, which is especially helpful if the loved ones live in separate states, have differing interests or goals, or have difficulty managing money effectively
- Maintaining confidentiality, since trusts are private documents
- Avoiding probate and its attendant costs with regard to assets held by the trust
- Maximizing the advantage of the lifetime gift tax exemption and/or annual gift tax exclusion, as long as the gifts to the trust are "present interest gifts," explained in more detail on the following pages
- Minimizing federal income and estate taxes on life insurance policies held by the trust

Utilizing Gift Tax Annual Exclusions: Crummey Powers

As previously discussed, the grantor may be responsible for gifting the amount of the premium to the ILIT every year. Gift tax problems can present themselves when policies with a large face amount require the grantor to gift significant premiums. However, there is a way to shelter these annual gifts from gift tax. The Internal Revenue Code allows every individual to give away, on an annual basis, a specified amount of money to an unlimited number of persons without any gift tax consequences. In 2011, the amount of the annual exclusion is $13,000. A married couple may, together, gift up to $26,000 since each spouse is entitled to the annual exclusion amount on the gift.[2] In addition, since the annual exclusion amount applies to each recipient of a gift, the more people that can be named as beneficiaries of an ILIT, the more money that can be shielded from gift tax.

However, there is a potential problem. In order for a gift to qualify for the annual gift tax exclusion, it must be a gift of a "present interest." In other words, a beneficiary must be able to currently enjoy the gift. However, the payment of cash to an ILIT—intended to pay premiums on a policy that will eventually pay out a death benefit

[2] In addition, each grantor may gift $5 million gift tax–free during his or her lifetime, known as the applicable exclusion amount.

to the beneficiary—fails this test. Rather, the grantor's gift of the premium amount is a gift of a "future interest." The beneficiary does not get to enjoy the gift until some day in the future.

The solution to this problem is to give the trust beneficiaries, typically the grantor's children, the right to withdraw their pro rata share of the annual contribution to the ILIT. This immediate right to withdraw, also known as a Crummey power, makes the transfer to the ILIT a gift of a present interest which will be sheltered from gift tax under the annual gift tax exclusion.[3]

Typically, Crummey powers are granted for a specific period of time. In other words, if the beneficiaries allow this period of time to lapse, the power will expire. And that is the idea. Ideally, the beneficiaries will allow their respective powers to lapse; the trustee may then use the gift amount to pay policy premiums. However, in order to ensure that this Crummey power is respected and not dimissed as illusory, beneficiaries must be promptly notified of each gift that has been made and be given reasonable time and opportunity to request a withdrawal.

ILITs are often drafted so as to restrict each beneficiary's withdrawal right to the amount of the annual gift tax exclusion. In some instances where the grantor's spouse is a beneficiary of the trust and that spouse is not a grantor of the trust, the spouse's annual withdrawal right is also limited to the greater of $5,000 or 5% of the trust principal (sometimes referred to as the "five-by-five power") to prevent inclusion of trust assets in the surviving spouse's estate.

An Additional Variation: The Cristofani Trust

Usually a Crummey power holder is a primary trust beneficiary with a substantial economic interest in the trust. However, in a tax court case known as Cristofani v. Commissioner the court allowed an annual exclusion gift to be made to a beneficiary with only a contingent remainder interest.[4] For instance, a grandchild who would only receive a benefit from a trust if his or her parent—the primary beneficiary of the trust—has passed away would be considered a contingent beneficiary. If both the primary and contingent trust beneficiaries are granted Crummey withdrawal rights, then the

[3] See *Crummey v. CIR*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 80-261.

[4] See *Cristofani v. CIR*, 97 T.C. 74 (1991), and also *Kohlstaat v. CIR*, T.C. Memo 1997-212.

grantor may be able to make larger contributions to the ILIT gift tax–free. The IRS was not initially supportive of trusts with provisions similar to those in the *Cristofani* case, but acquiesced regarding their validity in 1996.[5]

Cristofani trusts usually work best if the additional power holders have a contingent interest in the trust. This means that they would receive benefits from trust assets in the event of some condition occurring, rather than having no beneficial interest in the trust. A beneficiary who has only Crummey withdrawal rights and no other beneficial interest in a trust is sometimes referred to as having "bare" or "naked" Crummey powers. In addition, the designation of a beneficiary with a remote and contingent interest and in whose name a gift is made would most likely have that gift qualify as a gift of a present interest if:

a) The beneficiary possesses the right of current withdrawal and the trustee cannot legally deny the withdrawal,

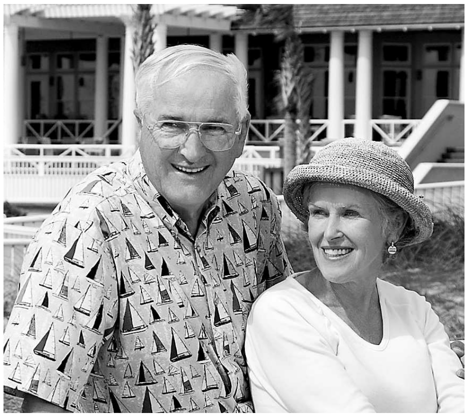
b) The beneficiary is granted an adequate period of time in which he or she may exercise his or her power of withdrawal,

c) There is no prior arrangement between the grantor and beneficiary not to exercise the right of withdrawal, and

d) The grantor's use of the annual exclusion is not abusive in nature.

[5] See *Est. of Maria Cristofani*, 97 TC 74 (1991), acq. in result 1992-2 CB 1.

How Do the Cristofani Powers Work?



- Carl is 60, and Donna is 62.
- They have one adult child, Tom.
- They have one grandchild, Emma.
- Carl receives a company pension, and Donna has a large 401(k) plan balance.
- Carl and Donna are both recently retired.
- Their current estate value is $20 million.
- Carl and Donna have already made lifetime gifts of $10 million that were gift tax–free.
- Between both of their qualified retirement plans, Carl and Donna have enough assets to provide them with a comfortable retirement.
- Carl and Donna are concerned about losing what they have worked so hard to accumulate to federal estate taxes, which are currently estimated at $3.5 million.
- Carl and Donna would like to leave a legacy to Tom and, in the event that Tom predeceases them, to Emma.

How can Carl and Donna minimize their estate taxes and maximize the legacy they leave their loved ones?

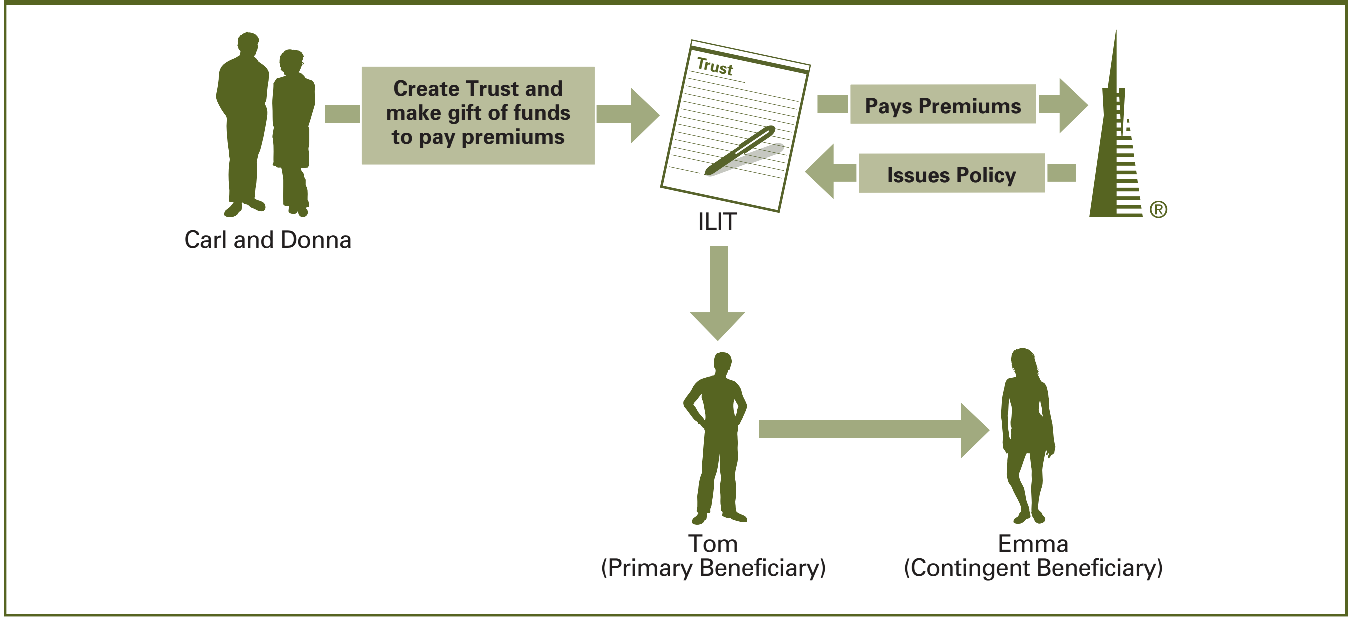
- Carl and Donna consider creating an ILIT to purchase a life insurance policy to maximize their annual gift exclusion amounts, and to ensure that the death benefit is excluded from their estate and not subject to estate taxes.
- If Carl and Donna set up a traditional ILIT, they would be able to make annual gifts of $26,000, and Tom would be the primary beneficiary of the trust. They are limited in their ability to make tax-free gifts, since they have already used up their lifetime gift exclusion. A $26,000 premium on a survivorship policy would enable them to obtain a death benefit of $2,110,637.[6]
- If Carl and Donna include Emma as a contingent beneficiary of the trust and also grant her Crummey withdrawal rights,[7] their ability to make tax-free gifts increases to $52,000 annually. This amount would purchase a death benefit of $4,232,559.[8]

[6] Based on TransACE Survivor®, male, age 60, Standard Nonsmoker; and female, age 62, Standard Nonsmoker; residents of CA; a level premium of $26,000; and a 4% interest rate.

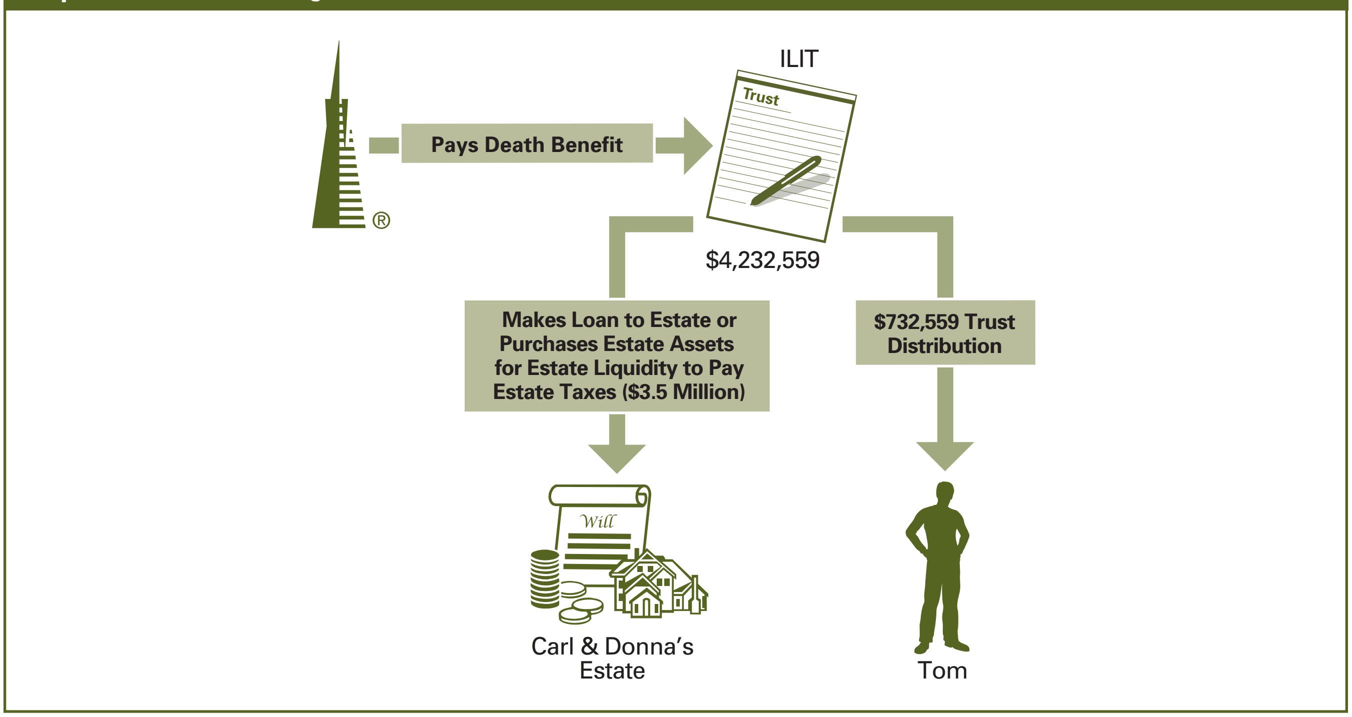
[7] Trusts must be drafted by a competent attorney whose focus is estate planning matters. Inclusion of a grandchild as a trust beneficiary may have generation-skipping transfer (GST) tax implications and, if the primary beneficiary passes away, may require the allocation of GST tax exemption amounts to the trust.

[8] Based on TransACE Survivor®, male, age 60, Standard Nonsmoker; and female, age 62, Standard Nonsmoker; residents of CA; a level premium of $52,000; and a 4% interest rate.

During Life



Upon Death (Assuming Tom Does Not Predecease His Parents)



What has been accomplished?

By using the ILIT strategy along with the granting of Crummey and Cristofani withdrawal rights, Carl and Donna are able to:

- Create a pool of assets sufficient to cover their estimated estate tax liability, and thereby transfer 100% of their estate to their loved ones
- Maximize the amount they are able to make as tax-free annual gifts
- Create centralized financial management as well as creditor protection for the assets they pass on to their loved ones
- Pass a legacy of wealth on to their beneficiaries that is federal income and estate tax–free for the assets held in the ILIT

Iterations of an ILIT: The Framework for Various Estate-Planning Strategies

There are many tax and non-tax advantages to implementing an ILIT. These advantages can be enhanced by modifying an ILIT to address a client's specific goals and circumstances. Below is a brief discussion regarding the many variations of the standard ILIT.

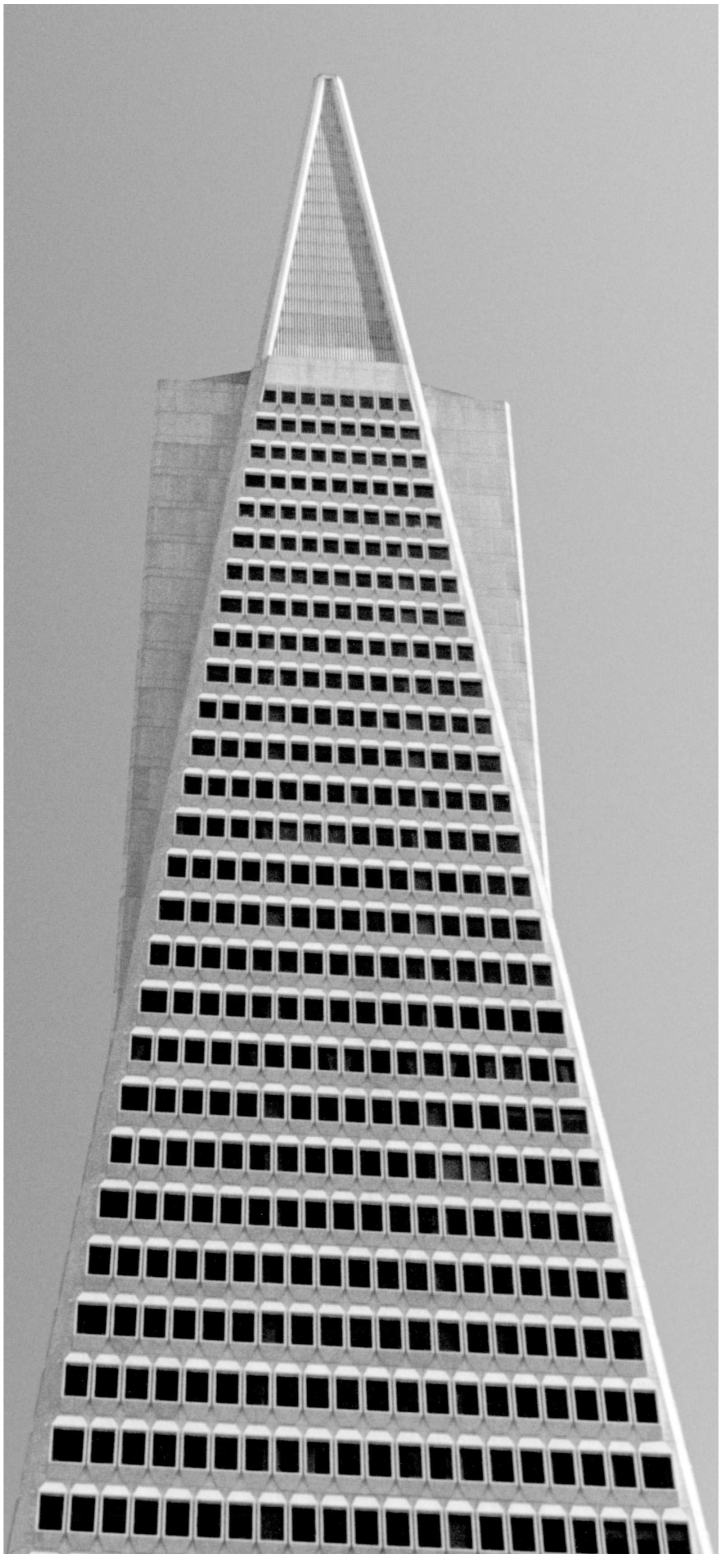
Variation	Salient Features
Dynasty Trust Maximizes the financial legacy that a client leaves to children, grandchildren and future generations.	**Long Trust Term** The trust's term is stretched out to the greatest extent possible as prescribed by state law in order to benefit the maximum number of generations. In some states, a trust term can last for two or three generations and in certain states a trust can theoretically exist forever. **Transfer Tax Minimization** By extending the trust's term, a client is able to minimize transfer tax exposure, passing wealth from generation to generation without the burden of estate, gift and the Generation-Skipping Transfer Tax (GSTT). **Creditor Protection** Over time, assets are lost due to claims from creditors and/or a divorcing spouse. In fact, the clients' beneficiaries can themselves pose a threat to wealth preservation. The terms of a Dynasty Trust can address these concerns, thus providing significant asset protection. **Incentive Provisions** A client can promote specific goals and values in future generations of beneficiaries by requiring that they adhere to specific standards in order to be entitled to trust distributions.
Spousal Support Trust Gives a married couple "the best of both worlds"—access to cash values and an estate tax–free death benefit.	**Married Couples Only** It is a trust created by one spouse (grantor spouse) for the benefit of the other spouse (uninsured spouse). The grantor spouse makes cash gifts from his or her separate property to the trust and the independent trustee then uses the cash gifts to buy a permanent life insurance policy on the life of the grantor spouse.[9] The policy is the only trust asset. **Access to Cash Values** The beneficiaries of the trust are the uninsured spouse and the couple's children, if any. During the lifetime of the grantor spouse, the trustee may generally make distributions to the uninsured spouse and/or the children for their health, education, maintenance, and support. Since the life insurance policy is the only trust asset, the trustee can access the policy's cash value through loans or withdrawals to make distributions.[10]
Intentionally Defective Grantor Trust (IDGT) Maximizes the legacy that a client leaves to loved ones by providing various tax advantages.	**Trust Income Taxable to Trust Creator** The client will be considered the owner of the trust for federal income tax purposes and will pay taxes on the income generated within the IDGT—as if the client and the IDGT were one and the same. This benefits trust beneficiaries since trust assets are not depleted to pay the tax liabilities created by the trust's taxable income. This, in essence, is equivalent to making additional gifts to the trust without diminishing any gift tax exemptions or paying a gift tax. **Tax-Efficient Sale to IDGT** The client can maximize the benefit of an IDGT by making an initial gift to the trust of a certain amount and then selling an asset to the IDGT in exchange for an installment note. Per the note's terms, the trust must pay the client interest and a final balloon payment of principal. The note is secured by trust assets, including the property initially sold to the trust. Because the client and the trust are one and the same for federal income tax purposes, the client will not recognize gain or loss on the sale to the trust and should not be taxed on interest payments received from the trust. If the total net return on trust assets exceeds the interest rate on the note, the excess value passes to beneficiaries—free of gift, estate, and GST tax.
Special Needs Trust (SNT) Provides the disabled beneficiary with funds to supplement the state and/or federal assistance he or she is currently receiving.	**Must Be Carefully Drafted** The trust must be carefully drafted by an experienced attorney. The potential pitfall lies in the fact that a disabled person who receives an outright inheritance will be required to deplete those funds before the government will pay for governmentally sponsored services via Social Security Income (SSI) and Medicaid. This can quickly exhaust even a large inheritance. Under current SSI eligibility requirements, ownership of assets in excess of $2,000 disqualifies a disabled person from receiving benefits. **Supplement Funds While Preserving Eligibility** With a properly structured SNT, the client can preserve a loved one's eligibility for government assistance and ensure that funds are available for benefits that are not offered through most programs including travel, computers, higher quality medical and dental care, education, and rehabilitation.

[9] In some situations, an agreement between spouses may be necessary to create separate property.

[10] Under some circumstances, distributions from the trust cannot be used to pay expenses that would normally be the legal responsibility of the grantor spouse and the uninsured spouse.

The tax benefits of an ILIT are impressive. A client can shelter death benefits from estate tax by establishing an ILIT to own a life insurance policy insuring his or her life. In addition, the money a client gifts to an ILIT to pay premiums may be sheltered from gift tax. Furthermore, these gifts reduce the value of a client's estate, removing not just the gifted assets but also any appreciation that would have accumulated on those assets. And a smaller estate value translates into a smaller estate tax bill.

For more information about this and other advanced marketing estate planning strategies, be sure to visit our Web site at www.tatransact.com, or call the Transamerica Advanced Marketing department at: (866) 545-9058.



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