



IRREVOCABLE LIFE INSURANCE TRUSTS

Producer Guide



 **TRANSAMERICA**
INSURANCE & INVESTMENT GROUP

For producer use only. Not for distribution to the public.

The Key to Beneficial Estate Planning

An ILIT is a trust that is created to serve the specific purpose of owning one or more life insurance policies.

Life insurance death benefits that are paid to an insured's beneficiaries will not be subject to income tax. However, the face amount of a life insurance policy will be included in the insured's gross estate for estate tax purposes if the insured owns the policy outright. In other words, if a life policy is owned in the name of the insured—even though the insured does not enjoy the opportunity to spend the face amount of the policy during life—that amount will be tacked on to his or her gross estate and subject to estate tax. However, with a properly drafted and administered irrevocable life insurance trust (ILIT), life insurance proceeds can be excluded from the insured's gross estate.

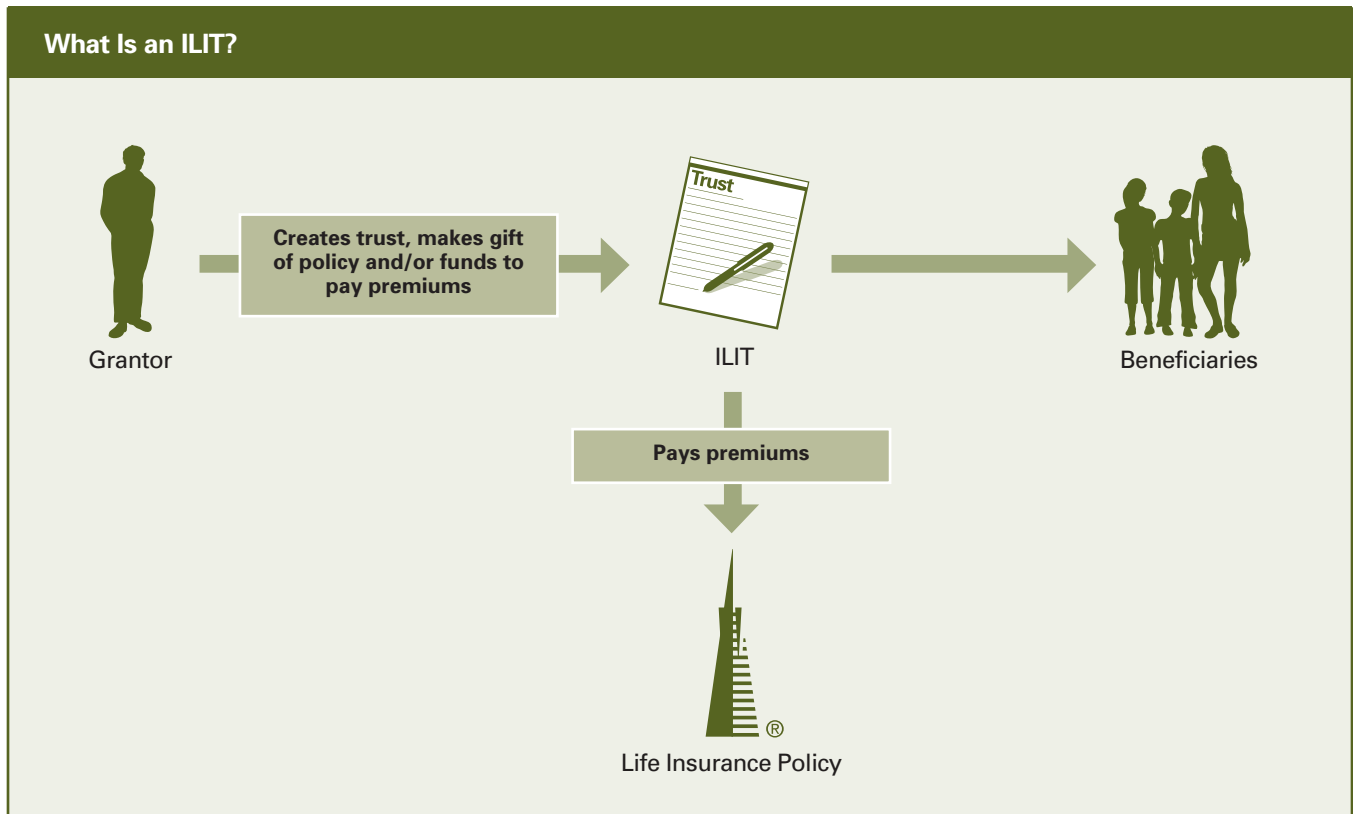
What Is an ILIT?

An 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 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 either fund the ILIT with assets other than the life insurance policy, which will hopefully produce sufficient income to pay the 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.



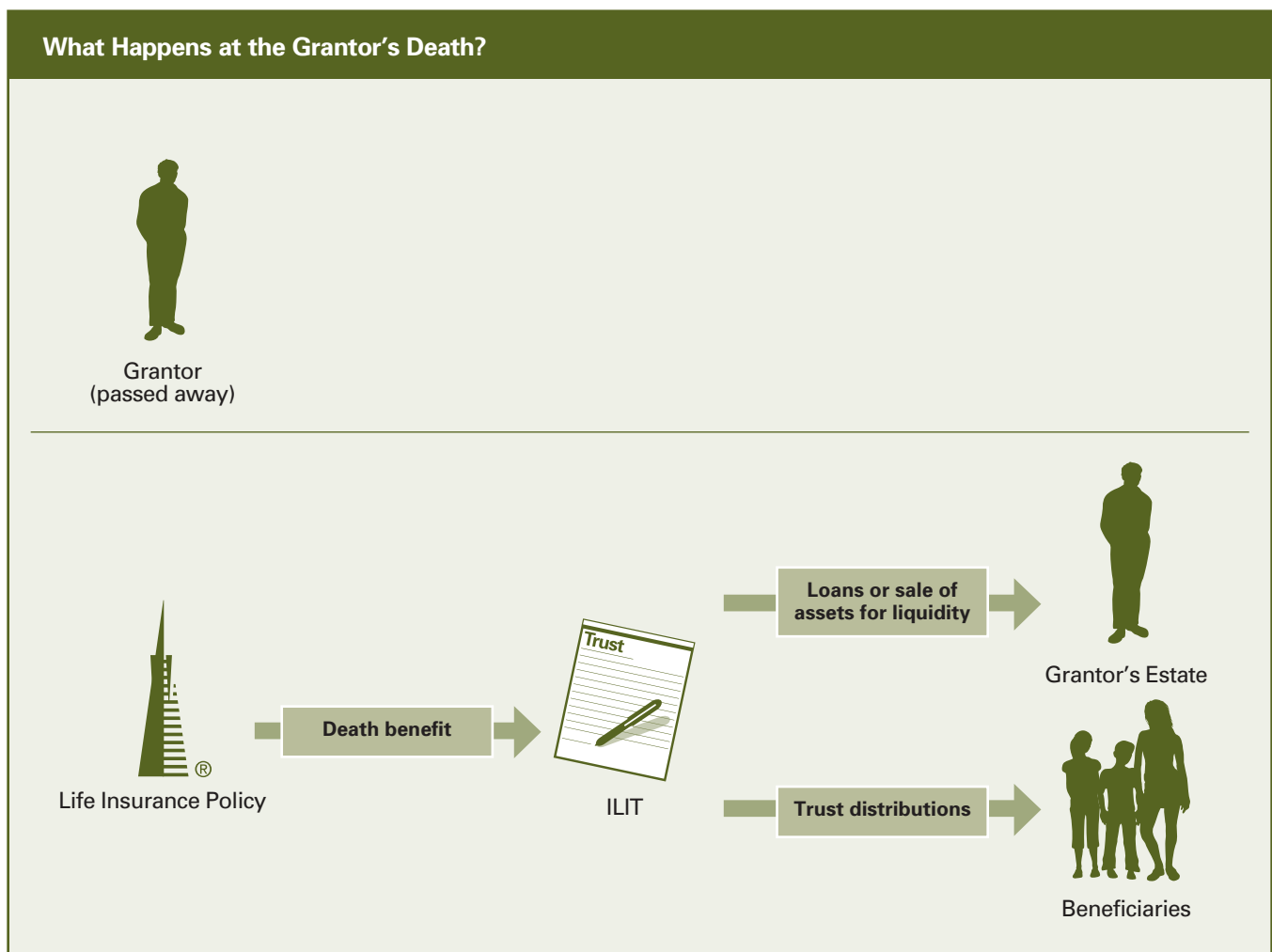
¹ IRC § 2035.

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 below
- Avoiding 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 2008, the amount of the annual exclusion is \$12,000.² A married couple may, together, gift up to \$24,000 since each spouse is entitled to the annual exclusion amount on the gift.³ 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 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.⁴

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 dismissed 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.

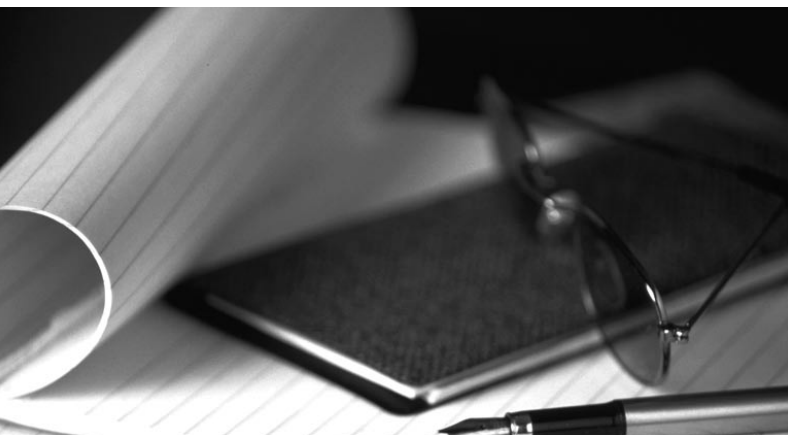
ILITs are often drafted so as to restrict each beneficiary’s withdrawal right to the amount of the annual gift tax exclusion. In some instances where the grantor’s spouse is a beneficiary of the trust and that spouse is not a grantor of the trust, the spouse’s annual withdrawal right is also limited 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.

² The annual gift tax exclusion is indexed for inflation per the Taxpayer Relief Act of 1997.

³ In addition, each grantor may gift \$1 million gift tax-free during his or her lifetime, known as the applicable exclusion amount.

⁴ See *Crummey v. CIR*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 80-261.

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, a Tax Court case allowed an annual exclusion gift to be made to a beneficiary with only a contingent remainder interest.⁵ 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 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 1996.⁶

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:

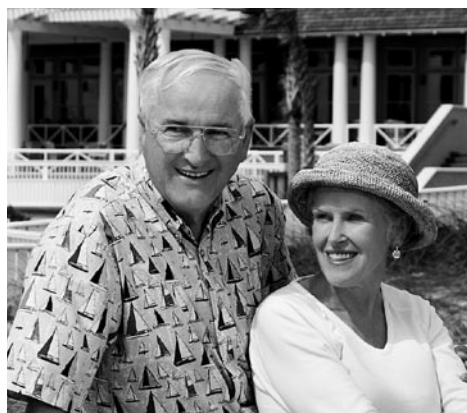
- a) The beneficiary possesses the right of current withdrawal and the trustee cannot legally deny the withdrawal,
- b) The beneficiary is granted an adequate period of time in which he or she may exercise his or her power of withdrawal,
- c) There is no prior arrangement between the grantor and beneficiary not to exercise the right of withdrawal, and
- d) The grantor’s use of the annual exclusion is not abusive in nature.

⁵ See *Cristofani v. CIR*, 97 T.C. 74 (1991), and also *Kohlstaad v. CIR*, T.C. Memo 1997-212.

⁶ See *Est. of Maria Cristofani*, 97 TC 74 (1991), acq. in result 1992-2 CB 1.

To fully understand their application, here is an example of how the Cristofani powers work:

Example: Meet Carl and Donna



- 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 \$10 million.
- Carl and Donna have already made lifetime gifts of \$2 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 \$4 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?

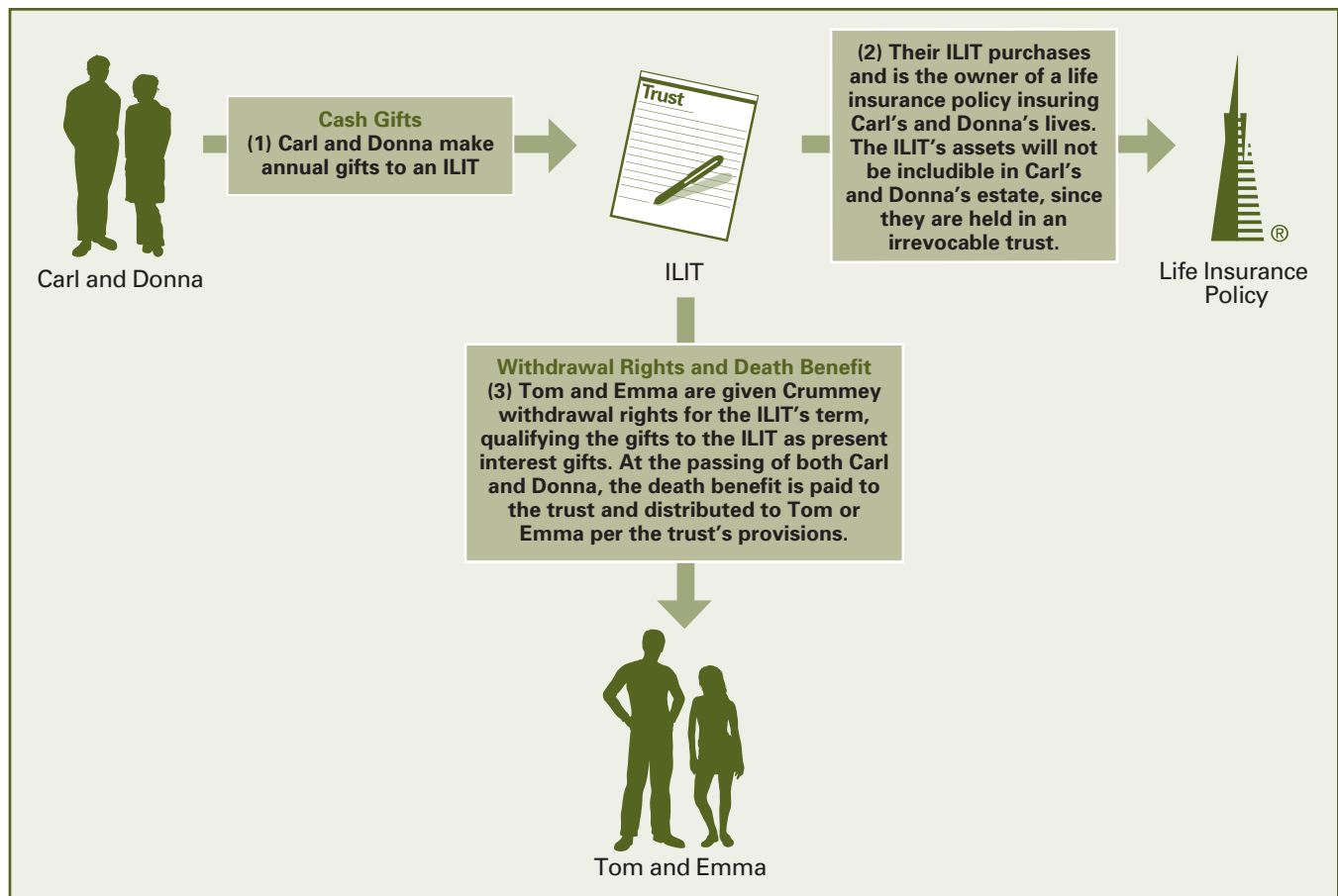
- Carl and Donna consider creating an ILIT to purchase a life insurance policy to maximize their annual gift exclusion amounts, and to ensure that the death benefit is excluded from their estate and not subject to estate taxes.
- If Carl and Donna set up a traditional ILIT, they would be able to make annual gifts of \$24,000, 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 \$24,000 premium on a survivorship policy would enable them to obtain a death benefit of \$2,545,106.⁷
- If Carl and Donna include Emma as a contingent beneficiary of the trust and also grant her Crummey withdrawal rights,⁸ their ability to make tax-free gifts increases to \$48,000 annually. This amount would purchase a death benefit of \$5,103,389.⁹

⁷ Based on TransACE Survivor[®]; male, age 60, Standard Nonsmoker; and female, age 62, Standard Nonsmoker; residents of CA; a level premium of \$24,000; and a 4% interest rate.

⁸ 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.

⁹ Based on TransACE Survivor[®]; male, age 60, Standard Nonsmoker; and female, age 62, Standard Nonsmoker; residents of CA; a level premium of \$48,000; and a 4% interest rate.

How Does It Work?



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

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 877-ADV-MRKT (877-238-6758).

This material was not intended or written to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code. This material was written to support the promotion or marketing of the products, services, and/or concepts addressed in this material. Anyone to whom this material is promoted, marketed, or recommended should be urged to consult with and rely solely on their own independent advisors regarding their particular situation and the concepts presented here.

Transamerica Insurance & Investment Group and its representatives do not give tax or legal advice. This material is provided for informational purposes only and should not be construed as tax or legal advice.

TransACE Survivor[®] 2008 is a nonparticipating, flexible-premium universal life insurance policy issued by Transamerica Life Insurance Company, Cedar Rapids, IA 52499. Policy Form No. 1-12111108 (CVAT), Group Certificate No. 2-72136108 (CVAT) for certificates issued under a group policy issued to the Rhode Island National Consumer Protection Trust. Policy form and number may vary, and this policy may not be available in all jurisdictions.



Transamerica Life Insurance Company

Transamerica Financial Life Insurance Company