

# Creating Your Legacy

A GUIDE TO HELP YOU UNDERSTAND

ESTATE PLANNING AND THE USES OF LIFE INSURANCE



ESTATE PLANNING INVOLVES PLANNING

AROUND FAMILY RELATIONSHIPS.



**PACIFIC LIFE**

# The Continuing Estate Tax

## NEW ESTATE TAX LAW

At the end of 2010, Congress passed legislation impacting the estate tax. This legislation puts in place a \$5 million estate tax exemption and 35% estate tax rate (more details provided below), until January 1, 2013.

Beginning in 2013, the estate and gift tax laws return to the law in effect prior to 2001, unless Congress takes further action. This may cause some confusion and uncertainty as to whether you need estate planning at this time. During this time of uncertainty, it is nevertheless important to move forward with your estate planning objectives.

*1 From January 1, 2011 to December 31, 2012, the federal estate tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); the maximum estate tax rate is 35%; and, the rules regarding step-up in basis for property transferred at death are reinstated. Also over the same time period, if the executor of a deceased spouse's estate so elects, the surviving spouse could later use his or her own unused estate tax exemption, plus the unused exemption of his or her most recent deceased spouse.*

## WHAT'S IN STORE FOR BEYOND 2012?

Although it is impossible to predict what future laws will be, a permanent estate tax repeal is highly unlikely. Thus, the safest approach is to plan under the assumption that there will be an estate tax and make your estate planning documents as flexible as possible.

## WHAT IF YOU WAIT?

If you fail to plan at this time, you not only put yourself but also your family at risk. Without the proper estate planning documents, your estate may not be distributed as you wish. By waiting, you may also lose out on the opportunity to make annual exclusion gifts and to use common estate planning techniques to reduce and/or “freeze” the value of your estate. Also, your estate may be faced with a large federal estate tax liability and possibly even a state estate tax liability at your death without the sufficient liquidity to pay those taxes.

This may force your estate to liquidate your hard-earned assets quickly, causing a “fire sale” of assets, in order to pay the estate tax due nine months after your death. By taking a “wait-and-see” approach, you also may have missed out on the opportunity to purchase life insurance to help pay for estate taxes and other expenses incurred at your death.

If life insurance is not a part of your estate plan now and you realize you need it later, there is the possibility you may die before it can be purchased or that your health may decline, making life insurance economically unavailable. Therefore, it is important that you plan today rather than wait to plan in the future.

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## What are your goals?

### ESTATE PLANNING

Estate planning involves planning around family relationships. Estate planning is not just for the very old or very wealthy. If you are concerned about your loved ones, you need to take action now to lessen the financial and emotional burden your incapacity or death will bring. Estate planning encompasses more than just planning to minimize estate and gift taxes; it includes your goals now and your legacy in the future. Estate planning should provide for the efficient use of your assets during lifetime, the disposition of your assets after death, and the minimization of taxes and costs associated with transferring your assets to your heirs.

The most important steps in planning your estate are determining who should make decisions for you in the event of your incapacity and what you want to happen to your loved ones and your assets after you have passed away.

Begin by asking yourself the following questions:

Who should manage my assets and take care of me in the event of my incapacity?

*Family? Friends? Bank or Corporate Trustee?*

Who should carry out my estate plan after my death?

*Family or Friends? Bank or Corporate Trustee? Probate Court?*

Who should take care of my children if they are minors at my death?

*Parents? Siblings? Friends?*

Who should receive my assets at my death?

*Family? Friends? Charity?*

When should my assets be distributed?

*Immediately after my death? At some specified time after my death? Upon beneficiaries reaching certain ages?*

How should my assets be distributed?

*Should my spouse have a right to the income before my assets pass to others? Will my children need a Corporate Trustee to handle their inheritance? Should my beneficiaries attain certain goals I specify before they receive my assets?*

## What will the transfer costs be?

You cannot determine which tools will help you realize your goals until you have all the facts. Ask your attorney, accountant, or life insurance professional to estimate the cost of transferring your assets to heirs at your death. Without proper preparation, taxes and fees may deprive your heirs of almost half of your total net worth.

**PROBATE FEES:** Probate is a court-supervised process of distributing your assets. If you do not have any estate planning documents or only have a will, the court may distribute your assets for you and may charge your estate a fee. Probate fees typically range from one to four percent of the property passing through probate, depending on state law.

**TRANSFER TAXES:** The federal government may impose three types of transfer taxes: gift tax, estate tax, and generation-skipping transfer tax (GST tax). The gift tax may be applied to transfers made during your lifetime, and the estate tax may be applied to transfers made at your death. The GST tax may be applied to transfers made during life and at death to persons two or more generations younger than you, such as your grandchildren. In addition to these federal transfer taxes, many states impose separate gift, estate, inheritance, and GST taxes.

YEAR	ESTATE TAX EXEMPTION	ESTATE TAX CREDIT	HIGHEST ESTATE TAX RATE	HIGHEST GIFT TAX RATE
2011-2012	\$5,000,000	\$1,730,800	35%	35%
2013 AND BEYOND	\$1,000,000	\$345,800	55%	55%

**MARITAL DEDUCTION:** Amounts transferred during life and at death to a U.S. citizen spouse are not taxable transfers. A married individual is allowed an unlimited marital deduction for the value of any property transferred to a spouse. If you distribute assets to your surviving spouse, the spouse receives them free from gift and estate taxes. However, those assets may be included in the taxable estate of your spouse at his or her death.

**LIFETIME GIFT TAX EXEMPTION:** Until December 31, 2012, you are able to gift up to \$5,000,000 (in addition to your annual gift tax exclusion amount) without incurring any federal gift tax because of the lifetime gift tax exemption. The \$5,000,000 lifetime gift tax exemption is the total amount that each person can transfer to individuals, other than a spouse, during lifetime without incurring gift tax. After the lifetime gift tax exemption has been reduced to zero, you would then pay gift taxes. Any use of the lifetime exemption reduces the estate tax exemption available at death. Under current law, the lifetime exemption is scheduled to be \$1,000,000 in 2013 and beyond.

**ESTATE TAX EXEMPTION:** The federal estate tax affects individuals who die leaving a taxable estate of more than the estate tax exemption amount. For 2011 and 2012, the federal estate tax exemption amount is \$5 million. For 2013 and beyond, the federal estate tax exemption is \$1 million. The exact year with corresponding estate tax exemption and highest estate tax rates are shown at the bottom of the previous page. If you are married, the estate tax will most likely be an issue when the second spouse dies because the marital deduction will ensure that assets left to the surviving spouse pass free from estate tax.

**PORTABILITY:** For married individuals dying in 2011 or 2012, the first spouse to die can transfer his or her unused estate tax exemption amount to the surviving spouse. This is commonly referred to as the portability of the estate tax exemption. For example, if a married individual previously made gifts of \$1 million during his or her lifetime and passes away in 2011 or 2012, he or she has \$4 million of unused estate tax exemptions available. This amount can be transferred to the surviving spouse (by the executor electing to do so on the decedent's estate tax return). The surviving spouse would then have his or her own estate tax exemption amount in addition to the \$4 million transferred from the decedent spouse.

**GENERATION-SKIPPING TRANSFER TAX EXEMPTION (GST TAX EXEMPTION):** The federal GST tax applies to transfers made during life and at death to persons two or more generations younger than you, such as grandchildren. Your GST tax exemption allows you to give or leave assets to grandchildren without imposing this additional transfer tax. For 2011 and 2012, the GST tax exemption is \$5,000,000. For 2013 and beyond, the GST tax exemption is \$1 million (indexed for inflation). The structure of the GST tax will follow the same exemption amount and top tax rate as the estate tax.

**ANNUAL GIFT TAX EXCLUSION:** In 2011, any person is allowed to give any other person gifts in a calendar year that have an aggregate value of up to \$13,000 per recipient. This annual gift tax exclusion amount will be increased for inflation. Annual exclusion gifting is a valuable estate planning tool because it allows you to transfer assets free from gift tax during your lifetime in addition to the assets transferred using your lifetime gift tax exemption and estate tax exemption. Also, making annual exclusion gifts does not utilize any of your lifetime gift tax exemption.

THE FOLLOWING IS AN EXAMPLE OF THE POSSIBLE ESTATE TAX LIABILITY UNDER CURRENT LAW  
FOR A MARRIED COUPLE DYING IN THE SAME YEAR:

SIZE OF ESTATE	2011-2012	2013
\$1,000,000	\$0	\$0
\$3,000,000	\$0	\$435,000
\$5,000,000	\$0	\$1,495,000
\$7,000,000	\$0	\$2,390,800
\$10,000,000	\$0	\$4,404,800
\$20,000,000	\$3,500,000	\$9,900,000

*The calculations assume that each spouse will use the full amount of his or her estate tax exemption available in the year of death or the first spouse to die transferred his or her estate tax exemption to the surviving spouse.*



## What fits for you? Determining the Proper Tools and Strategies

You spend countless hours caring for your loved ones and accumulating wealth. Wouldn't it be reasonable for you to spend a few hours with your legal and tax advisors to determine which estate planning tools to implement? Your family's needs and overall net worth will help determine the proper course of action to accomplish your estate planning goals.

A **Will** is a legal document that expresses how you want to dispose of your assets at your death. It may allow you to:

- ❖ Designate the individuals who should receive your assets;
- ❖ Designate the conditions under which your heirs receive your assets;
- ❖ Nominate the person best suited to serve as guardian of your minor children; and
- ❖ Ensure that you take advantage of your ability to transfer property free from estate tax using your estate tax exemption.

A **Revocable Living Trust** is established and funded during your lifetime to hold your assets that do not pass by beneficiary designation. Similar to a Will, it is a legal document that includes your instructions for how you want to dispose of your assets at your death. It may allow you to:

- ❖ Avoid probate and thus prevent your heirs from waiting months or years for the court to distribute your assets in a probate proceeding;
- ❖ Prevent the court from imposing probate fees, typically ranging from one to four percent of the assets passing through probate;
- ❖ Prevent the relatively expensive and time-consuming process of appointing a conservator to manage your assets if you become incapacitated; and
- ❖ Prevent the relatively expensive and time-consuming process of appointing a guardian or trustee to manage assets for your minor children.

**Powers of Attorney** for financial matters and health care decisions are used to appoint an individual to make financial and health care decisions for you. These separate documents may allow you to:

- ❖ Designate the person who will make financial and health care decisions on your behalf if you become incapacitated; and
- ❖ Prevent the relatively expensive and time-consuming process of appointing a conservator to manage your assets not held in a Revocable Living Trust if you become incapacitated.



## How will you pay the transfer costs?

Federal estate tax is due nine months after your death. Even using basic estate planning tools, you should be able to reduce your taxable estate. Nevertheless, if you have a large net worth, it is likely that your estate will be subject to the federal estate tax. The last step in planning your estate is to determine how your estate will pay the federal estate tax.

### YOUR ESTATE WILL PAY THE RESULTING FEDERAL ESTATE TAX:

- ONE** by using cash;
- TWO** by borrowing funds;
- THREE** by liquidating assets; or
- FOUR** with life insurance death benefit proceeds that, if properly structured, can provide the liquidity necessary to help pay the estate tax.

METHOD	ADVANTAGES	DISADVANTAGES
CASH	SIMPLE	FEW ESTATES HAVE ENOUGH CASH AND/OR LIQUID ASSETS
BORROWING	PREVENTS POSSIBLE "FIRE SALE" OF ASSETS	DEFERS AND COMPOUNDS THE LIQUIDITY PROBLEM SINCE LOANS MUST BE REPAYED WITH INTEREST
LIQUIDATING	PREVENTS PAYMENTS OVER TIME WITH ASSOCIATED COSTS	MAY BE FORCED TO HAVE A "FIRE SALE" OF ASSETS MAY CAUSE THE SALE OF A CLOSELY-HELD FAMILY BUSINESS
LIFE INSURANCE HELD BY AN IRREVOCABLE LIFE INSURANCE TRUST (ILIT)	PREVENTS POSSIBLE "FIRE SALE" OF ASSETS  IF PROPERLY STRUCTURED AND FUNDED, LIFE INSURANCE DEATH BENEFIT PROCEEDS SHOULD PASS TO HEIRS FREE FROM INCOME <sup>2</sup> AND ESTATE <sup>3</sup> TAXES	TERMS OF AN ILIT ARE IRREVOCABLE AND CANNOT BE CHANGED  COST OF LIFE INSURANCE PREMIUMS MAY INCUR EXPENSES IN ESTABLISHING AND MAINTAINING AN ILIT

<sup>2</sup> For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

<sup>3</sup> From January 1, 2011 to December 31, 2012, the federal estate tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); the maximum estate tax rate is 35%; and, the rules regarding step-up in basis for property transferred at death are reinstated. Also over the same time period, if the executor of a deceased spouse's estate so elects, the surviving spouse could later use his or her own unused estate tax exemption, plus the unused exemption of his or her most recent deceased spouse.

## What strategies for the future?

Even if you have executed estate planning documents in the past, there is still work for you to do. As tax laws change, it is a good idea to re-evaluate your current estate plan.

### **USING TRUSTS TO MAKE THE MOST OF YOUR ESTATE TAX EXEMPTION:**

You can make the most of you and your spouse's estate tax exemption by arranging for your estate to be divided into two parts at your death. One part passes to your spouse without being taxed because of the unlimited marital deduction; these assets will either be distributed outright to your spouse or placed in a Marital Trust for your spouse's benefit. The second part of your estate, equal to the federal estate tax exemption, is placed in a Credit Shelter Trust created by your Will or Revocable Living Trust. Using this strategy, no federal estate tax will be due at the first spouse's death.

If you have a net worth well in excess of the estate tax exemption, the creation and funding of the Credit Shelter Trust at your death may not adequately reduce the federal estate tax due on all assets outside of the Credit Shelter Trust at your spouse's death.

On the other hand, if you have a net worth approximately the same as the estate tax exemption, the Credit Shelter Trust may hold a significant portion of your assets and no estate tax would be due at your spouse's death. However, it is important to remember that the estate tax exemption returns to \$1,000,000 in 2013 under current law. While your estate may not be currently subject to estate tax, there is the possibility that it may be subject to estate tax in the future.

If you or your spouse die in 2011 or 2012, portability of the estate tax exemption may be an alternative to using a Credit Shelter Trust. Portability refers to the transfer by the decedent spouse of his or her unused estate tax exemption amount to the surviving spouse. For more information see Page 4.

Finally, you should review your state estate tax laws to determine if state law provides for an estate tax exemption that is less than the federal estate tax exemption. If there is a difference in the state and federal estate tax exemption amounts, then funding a Credit Shelter Trust with the full federal estate tax exemption may create a state estate tax liability at the first spouse's death.

### **REMOVING LIFE INSURANCE FROM YOUR ESTATE AND KEEPING FLEXIBILITY:**

The key to estate planning using life insurance during this time of uncertainty is flexibility. People that need life insurance for estate planning purposes will want to purchase the life insurance inside of an irrevocable life insurance trust to avoid the death benefit being included in their taxable estate. However, the traditional irrevocable life insurance trust may be too restrictive. Fortunately, there are ways to add flexibility to your irrevocable trust. The irrevocable trust could be drafted to allow for a spouse to be a beneficiary, or the irrevocable trust could allow for the trustee to make discretionary loans to the insured or the insured's spouse. Another way to add flexibility to life insurance planning is to reduce the face amount of the life insurance death benefit later if or when the need arises.



**IRREVOCABLE LIFE INSURANCE TRUST (ILIT):** If you own a life insurance policy on your life, the death benefit proceeds will be included in your estate when calculating your taxable estate. However, if the same policy is purchased and owned by an ILIT, the death benefit proceeds should pass to your heirs free from income<sup>4</sup> or estate<sup>5</sup> taxes. Some of the steps in accomplishing this include:

- ❖ After establishing the ILIT with the assistance of an attorney, the trustee of the ILIT purchases a life insurance policy insuring your life or a second-to-die life insurance policy insuring your life and your spouse's life.
- ❖ The trustee pays the life insurance premiums using funds you transfer to the ILIT each year. Depending upon the amount of the premiums, you may be able to shield all of your transfers to the ILIT from gift tax by having the transfers qualify as annual exclusion gifts to the ILIT beneficiaries.
- ❖ At your death, the trustee of the ILIT can then use all of the life insurance death benefit proceeds to lend money to or purchase assets from your estate, thereby providing the estate with the liquidity necessary to pay the transfer taxes imposed at death.

**SPOUSAL LIFETIME ACCESS TRUST (SLAT):** If you are married and looking for more flexibility than the traditional ILIT because you are concerned that you are transferring a large amount of assets into an irrevocable trust of which you and your spouse are not beneficiaries, you may want to consider a SLAT. Similar to an ILIT, a SLAT can achieve many estate planning goals:

- ❖ A SLAT is an ILIT established by one spouse, the grantor spouse, and drafted with more flexible distribution provisions.
- ❖ The trustee of the SLAT can be given discretion to distribute SLAT assets to the non-grantor spouse or other beneficiaries during the insured's lifetime and after the insured's death.
- ❖ Similar to an ILIT, the trustee of the SLAT purchases a life insurance policy and pays the life insurance premiums using the grantor spouse's separate property funds transferred to the SLAT each year; at the grantor spouse's death, all of the life insurance death benefit proceeds can be used to lend money to or purchase assets from the grantor spouse's estate, thereby providing the estate with the liquidity necessary to pay the transfer taxes imposed at death.

<sup>4</sup> For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

<sup>5</sup> From January 1, 2011 to December 31, 2012, the federal estate tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); the maximum estate tax rate is 35%; and, the rules regarding step-up in basis for property transferred at death are reinstated. Also over the same time period, if the executor of a deceased spouse's estate so elects, the surviving spouse could later use his or her own unused estate tax exemption, plus the unused exemption of his or her most recent deceased spouse.

## What strategies for the future? (cont...)

**BUY NOW, REDUCE FACE AMOUNT LATER:** If you want to structure your life insurance planning with additional flexibility in case the estate tax exemption returns to \$1,000,000 in 2013 or in case the estate tax exemption continues to increase, then this strategy may appeal to you. A life insurance policy would be purchased inside of an ILIT or SLAT with a death benefit equal to your projected estate tax liability. You will need to re-evaluate your life insurance death benefit need every few years. However, you will have achieved your life insurance planning goals:

- ❖ The death benefit could still be used to provide liquidity to pay for estate taxes or other estate settlement costs.
- ❖ If your needs change in the future and your policy has sufficient cash value, you could reduce the face amount of the life insurance policy so additional premiums may no longer be required.<sup>6</sup>
- ❖ During your lifetime, the trustee of the ILIT could lend money to you or the trustee of the SLAT could make distributions to the non-grantor spouse so you would have indirect access to the cash surrender value of the life insurance policy.

**OTHER TAX PLANNING STRATEGIES:** It is important to continue to use estate planning techniques such as annual exclusion gifts and other strategies that do not incur gift tax. Ask your attorney, accountant, or life insurance professional for information about additional estate planning techniques that may be appropriate to reduce your estate tax liability.

## What if you own a business?

If a large part of your estate consists of an interest in a closely-held business, you should also consider:

- ❖ Establishing a buy-sell agreement to ensure the smooth passage of your business to a surviving partner while providing cash to your heirs;
- ❖ Qualifying your business as a closely-held business so your estate can make an election under Internal Revenue Code Section 6166, deferring the payment of estate tax attributable to your closely-held business for a period of four years, paying only interest, and then making payments of unpaid estate tax plus interest up to a period of ten years; and
- ❖ Instituting a program of intra-family gifts and/or sales of all or a portion of your business to “freeze” the value of your estate and transfer future appreciation of the business to heirs.

<sup>6</sup> Please note that the reduction in the face amount of the life insurance policy may have additional tax consequences. A reduction in the face amount will not necessarily result in a proportionate reduction of all associated policy fees and charges. The life insurance policy may need to be retested under the 7-pay test for Modified Endowment Contract (MEC) purposes. Prior to authorizing the reduction in the face amount, consult your insurance professional and tax advisor as a reduction may cause the policy to become a MEC.



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