

What the Wealthiest Families Know: *2011 & Beyond*



Determine How Estate Planning Strategies and Life Insurance
May Help You Turn Your Goals into a Wealth Legacy

**Whether you acquired it or inherited it,
wealth represents so much more than money.**

This is especially true when you begin to consider what you actually want to leave your heirs. Planning begins by working with your financial professional to identify your goals. This guide helps you explore an array of different estate planning strategies that may help you achieve your personal objective.



PACIFIC LIFE

Find your objective under the “Your Goal” portion of the tables, review the “Strategies to Consider,” and then read the convenient summaries of available estate planning strategies that describe how each works with life insurance.

Do you want to create a family legacy for future generations of your family?

Your Goal	Your Questions	Strategies to Consider
You want to leave assets for the benefit of your children, grandchildren and as many future generations of your family as possible	<ul style="list-style-type: none"> • How can I leave assets to help provide for my children, grandchildren, and future generations? • If my children are already wealthy, how can I benefit my grandchildren and other future generations in an efficient manner? 	Irrevocable Life Insurance Trust (ILIT) drafted as a Dynasty Trust (see pages 7 and 8)
You want to benefit future generations of your family and encourage positive behavior	<ul style="list-style-type: none"> • How can I encourage my heirs to become productive members of society? • How can I encourage my heirs to attend college and graduate school? • Is it possible to allow distributions from an irrevocable trust only when the beneficiaries achieve certain goals? • If one of my children has a career helping others but does not earn a lot of money, is it possible to make special provisions for that child and allow him or her to receive more assets than my other children who have higher salaries? • How can I supplement the income of my child who truly enjoys his or her job working at a charity but does not earn a lot of money? 	Incentive Trust provisions in a Dynasty Trust (see page 8)
You want to create a charitable legacy that can be carried on by future generations of your family	<ul style="list-style-type: none"> • How can I be remembered for my philanthropy? • Is there a way to involve my heirs in carrying out my philanthropic work during and after my lifetime? • How can I instill the value of charitable giving to future generations of my family? • Can I create a charitable legacy without disinherit my heirs? 	Private Foundation in conjunction with a Wealth Replacement Strategy (see pages 17 and 29)

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Do you have a family business that you would like to keep in your family?

Your Goal	Your Questions	Strategies to Consider
You want to keep your business in your family	<ul style="list-style-type: none"> • How can I keep my business in the hands of my family? 	Family Buy-Sell (see page 9) Intentionally Defective Irrevocable Trust (IDIT) Sale in conjunction with a Dynasty Trust (see pages 8 and 11)
You want to transfer your business to your children	<ul style="list-style-type: none"> • Is it possible to transfer my family business to my children but limit the potential gift tax liability? • Is there a way to transfer my business while retaining some income from it? 	Grantor Retained Annuity Trust (GRAT) (see page 12) Installment Sale to an Intentionally Defective Irrevocable Trust (IDIT Sale) (see page 11) Family Buy-Sell (see page 9) Discounted Entities (e.g., Family Limited Partnerships (FLPs), Family Limited Liability Companies (LLCs) (see page 13)
You want to transfer your business to your children and grandchildren	<ul style="list-style-type: none"> • I am not in good health. Are there any strategies that I can use to effectively transfer my business to my children while I retain an income stream? 	Private Annuity (see page 14) Self-Cancelling Installment Note (SCIN) (see page 15)
You want to transfer your business to your children and grandchildren	<ul style="list-style-type: none"> • What are some gift tax saving strategies I can use to transfer my business to my children and grandchildren? 	IDIT Sale in conjunction with a Dynasty Trust (see pages 8 and 11) Family Buy-Sell (see page 9) Discounted Entities (e.g., Family Limited Partnerships (FLPs), Family Limited Liability Companies (LLCs) (see page 13)
You want to transfer your business to family members active in the business without disinheriting those who are not active in the business	<ul style="list-style-type: none"> • If my spouse is not active in the business, how can a family member active in the business buy the business from my estate or my spouse at my death? • How can I leave my business to family member(s) active in the business without disinheriting those who are not active in the business? • Is there a way to equalize my estate to my children by leaving my family business to one child and cash to another? 	Family Buy-Sell (see page 9) Wealth Equalization Using Life Insurance (see page 29)
You want your business to eventually pass to your heirs but want to first benefit a charity	<ul style="list-style-type: none"> • Is there a way to benefit a charity for a period of years before the business is ultimately passed to my heirs? 	Charitable Lead Trust (CLT) (see page 17)
You want your business to pass to your children from a prior marriage and want to ensure that your current spouse has enough assets for his or her living expenses	<ul style="list-style-type: none"> • I have children from a prior marriage. How can I transfer my business to my children from a prior marriage and also ensure my current spouse has enough assets for his or her living expenses? 	Family Buy-Sell (see page 9) Life Insurance for the Blended Family (see page 10)

Do you want to be remembered for your philanthropy?

Your Goal	Your Questions	Strategies to Consider
<p>You want to leave a meaningful gift to your favorite charity at your death</p>	<ul style="list-style-type: none"> • Can I name a charity as the sole beneficiary of a life insurance policy? • What type of tax benefit will I receive if I name a charity as the beneficiary of my life insurance policy? • What type of tax benefit will I receive if I name a charity as the owner and beneficiary of my life insurance policy? • How can I receive a charitable income tax deduction for the life insurance premiums I pay when a charity is the beneficiary of the life insurance policy? 	<p>Charitable Gifts of Life Insurance (see page 18)</p>
<p>You have highly appreciated assets that you want to sell and use the proceeds as income; you also want to benefit a charity</p>	<ul style="list-style-type: none"> • Is it possible to avoid or delay the immediate capital gains tax on the sale of a highly appreciated asset? • Is there a way to create an income stream from a highly appreciated asset without triggering immediate capital gains tax? • Is it possible to create an income stream as well as benefit a charity? • Is it possible to leave assets to a charity at death but replace that amount by providing other assets to my children? 	<p>Charitable Remainder Trust (CRT) used in conjunction with a Wealth Replacement Strategy (see pages 16 and 29)</p>
<p>You want to create a charitable legacy that can be carried on by future generations of your family</p>	<ul style="list-style-type: none"> • How can I be remembered for my philanthropy? • Is there a way to involve my heirs in carrying out my philanthropic work during and after my lifetime? • How can I instill the value of charitable giving to future generations of my family? • Is it possible to carry out my philanthropic goals without disinheriting my heirs? 	<p>Private Foundation used in conjunction with a Wealth Replacement Trust (see pages 17 and 29)</p>

Do you have specific assets that you would like to transfer?

Your Goal	Your Questions	Strategies to Consider
You want to transfer appreciating assets to your heirs	<ul style="list-style-type: none"> • What are some gift tax saving strategies that I can use to transfer highly appreciating assets to my heirs? • Is it possible to transfer my appreciating assets to my heirs but limit the potential gift tax liability? 	Grantor Retained Annuity Trust (GRAT) (<i>see page 12</i>) Installment Sale to an Intentionally Defective Irrevocable Trust (IDIT Sale) (<i>see page 11</i>)
	<ul style="list-style-type: none"> • If I am not in good health, are there any strategies that I can use to efficiently transfer my appreciating assets to my heirs while I retain an income stream? 	Private Annuity (<i>see page 14</i>) Self-Cancelling Installment Note (SCIN) (<i>see page 15</i>)
You want to sell an appreciated asset and are charitably inclined	<ul style="list-style-type: none"> • If I am charitably inclined, is there a way to sell my appreciated assets without recognizing immediate capital gain taxes while also retaining an income stream? 	Charitable Remainder Trust (CRT) (<i>see page 16</i>)
You want to transfer your primary residence or your vacation home to your children	<ul style="list-style-type: none"> • Is there a way to transfer my primary residence and/or vacation home to my children at a reduced gift tax cost while retaining the right to live in the property for a certain period of time? • Is there a way of freezing the value of my primary residence and/or vacation home for gift tax purposes? 	Qualified Personal Residence Trust (QPRT) (<i>see page 19</i>)
You do not need the income from your annuity and want to maximize wealth transferred to heirs	<ul style="list-style-type: none"> • Knowing that my annuity will be subject to both income and estate taxes if I die with my children as beneficiaries, what options are there to avoid or minimize the taxes my children may face? • When I take money out of my annuity, how can I increase the value of these annuity distributions for my children if I do not need the distributions? 	Annuity Maximization (<i>see page 20</i>)
You do not need the income from your individual retirement account (IRA) and want to maximize wealth transferred to heirs	<ul style="list-style-type: none"> • If I do not need the income from my IRA, is there a way to maximize the amount of wealth transferred to my heirs? • Knowing that my IRA will be subject to both income and estate taxes if I die with my children as beneficiaries, what options are there to avoid or minimize the taxes my children may face? • When I take money out of my IRA, how can I increase the value of these IRA distributions for my children if I do not need the distributions? • If I am charitably inclined and do not need the income from my IRA, is there a way to benefit my heirs as well as the charity of my choice while also minimizing adverse tax consequences? 	Maximizing IRA Assets (<i>see page 21</i>) Dynasty IRA (<i>see page 22</i>) IRA Bequest and Wealth Replacement (<i>see page 23</i>)
You do not need the income from a trust created by your deceased spouse and want to maximize assets transferred to heirs	<ul style="list-style-type: none"> • If I do not need the income from the B-Trust (or Bypass Trust) created by my deceased spouse, is there a way to maximize the trust assets that pass to my heirs? 	Maximizing B-Trust Assets (<i>see page 24</i>)

Are you concerned about the impact of estate taxes on your estate?

Your Goal	Your Questions	Strategies to Consider
You want to provide liquidity to your estate to pay estate taxes while minimizing gift taxes	<ul style="list-style-type: none"> ◦ How can I provide liquidity to my estate to pay estate taxes? ◦ If I have enough cash flow to pay life insurance premiums, how can I reduce the gift tax cost of life insurance premiums? ◦ If my annual exclusions and/or lifetime gifting are already being used, how can I fund life insurance premiums while minimizing gift taxes? ◦ If my premiums exceed my annual exclusions and/or available lifetime exemption amounts, is there a way to fund my life insurance premiums at a reduced gift tax cost? 	<p>Irrevocable Life Insurance Trust (ILIT) (<i>see page 7</i>)</p> <p>Private Financing: Private Split Dollar (<i>see page 25</i>)</p> <p>Private Financing: Intra-Family Loans (<i>see page 27</i>)</p>
	<ul style="list-style-type: none"> ◦ If I am concerned about liquidating assets to pay life insurance premiums, is there a way to keep my assets invested and reduce the gift tax cost of my life insurance premiums? 	<p>Premium Financing (<i>see page 28</i>)</p>
	<ul style="list-style-type: none"> ◦ If I have income-producing assets, is there a way to use them to reduce the gift tax cost of life insurance premiums? 	<p>Installment Sale to an Intentionally Defective Irrevocable Trust (IDIT Sale) (<i>see page 11</i>)</p> <p>Grantor Retained Annuity Trust (GRAT) with an ILIT (<i>see pages 7 and 12</i>)</p>



Do you want to minimize family acrimony?

Your Goal	Your Questions	Strategies to Consider
You want to provide for both your current spouse as well as your children from a prior marriage	<ul style="list-style-type: none"> ◦ Can I provide for my current spouse to maintain his or her life-time after my death without disinheriting my children from a prior marriage? ◦ Is there a way to provide an inheritance for my children from a prior marriage at my death rather than after my current spouse's death without triggering estate tax? ◦ Is there a way to provide a more equitable division of assets if I have children from a prior marriage? 	Life Insurance for the Blended Family (see page 10)
	<ul style="list-style-type: none"> ◦ If my children from a prior marriage are active in the family business, how can I leave my business to them without disinheriting my current spouse? 	Family Buy-Sell (see page 9)
You want to transfer your business to those family members active in the business without disinheriting those individuals that are not active in the business	<ul style="list-style-type: none"> ◦ If my spouse is not active in the family business, is there a way to get the business into the hands of active family members after my death while providing for my spouse? ◦ If I have some heirs who are not active in the business, how can I transfer the business to those who are active in the business without disinheriting those who are not? 	Family Buy-Sell (see page 9) Wealth Equalization Using Life Insurance (see page 29)
You want to leave a meaningful gift to a charity without disinheriting your heirs	<ul style="list-style-type: none"> ◦ I am charitably inclined but do not want to disinherit my heirs. How can I leave a meaningful gift to my favorite charity without disinheriting my heirs? 	Wealth Replacement Using Life Insurance (see page 29)

The Current State of the Federal Estate Tax: 2011 and Beyond

On December 16, 2010, Congress passed the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." This new legislation made significant changes to the transfer tax system. Specifically, from January 1, 2011 to December 31, 2012, the following rules apply:

- **Estate, Gift & Generation-Skipping Transfer (GST) Tax:** The estate tax, GST tax and lifetime gift tax exemption amount are all \$5,000,000 per individual or \$10,000,000 for combined marital estate (all are indexed for inflation starting on January 1, 2012). The annual gift tax exclusion amount is \$13,000 per donee (indexed for inflation).
- **Maximum Tax Rates:** The top estate, GST and gift tax rate is 35%.

- **Step-Up in Cost Basis:** Most assets transferred at death will be eligible for a step-up in cost basis (as opposed to a carryover basis).
- **Portability:** The executor of a deceased spouse's estate may elect to transfer the decedent's unused estate tax exemption amount to the last deceased spouse of the surviving spouse. This limitation eliminates the ability to accumulate exemptions from successive marriages.

If Congress does not act to change the estate tax laws, on January 1, 2013, the estate, gift and GST tax exemption amounts all decrease to \$1,000,000.

Given these changes to the estate tax system, it's important to take action NOW to ensure your family's legacy is preserved. Life insurance can help you plan now for 2011 and beyond.



Irrevocable Life Insurance Trust (ILIT)

An ILIT is an irrevocable trust used to prevent life insurance death benefits from being subject to estate taxation in the insured's estate.

With the assistance of an attorney, you establish an ILIT to be the owner and beneficiary of a life insurance policy insuring your life or the lives of you and your spouse. You transfer cash to the ILIT in order for the trustee¹ of the ILIT to pay life insurance premiums. Whether or not these transfers are subject to gift tax depends on your ability to make annual exclusion gifts and/or to use your lifetime gift tax exemption.²

In addition to life insurance, an ILIT may own most types of assets such as cash, stocks, bonds, mutual funds, and real estate. If structured properly, all assets owned by an ILIT, including the life insurance death benefit proceeds, will be excluded from your taxable estate and, as a result, will not be subject to estate tax.³ After your death, the life insurance death benefit proceeds can be used by the trustee of the ILIT to purchase assets from or lend money to your estate in order to provide your estate with the liquidity necessary to pay any estate tax due.

It is important to remember that an ILIT is irrevocable and you will not be able to change its terms after the ILIT has been established. Also, the assets that you transfer to the ILIT are no longer your assets. The person or entity you have designated as the trustee will manage the ILIT's assets, and the individuals who have been named as beneficiaries will receive those assets pursuant to the terms of the ILIT.

CONSIDERATIONS:

- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

Dynasty Trust Using Life Insurance

A Dynasty Trust is an irrevocable trust used by individuals who want to leave a legacy for children, grandchildren, and future generations. Unlike other types of irrevocable trusts, a Dynasty Trust is designed to continue for as many generations as permissible under state law. The primary objective with this type of trust is to protect the assets in the Dynasty Trust from not only gift and estate taxes but also from the generation-skipping transfer (GST) tax.⁴ While a Dynasty Trust can be funded with many types of assets, life insurance is often used in order to maximize the amount of wealth transferred to the trust beneficiaries.

With the assistance of an attorney, you establish a Dynasty Trust to be the owner and beneficiary of a life insurance policy insuring your life or the lives of you and your spouse. You transfer cash to the Dynasty Trust in order for the trustee¹ of the Dynasty Trust to pay life insurance premiums. Whether or not these transfers are subject to gift tax depends on your ability to make annual exclusion gifts and/or to use your lifetime gift tax exemption.² In addition, you will need to allocate some or all of your GST tax exemption to the contributions made to the Dynasty Trust to avoid the GST tax.⁵

If structured properly, assets owned by a Dynasty Trust, including the life insurance death benefit proceeds, will be excluded from your taxable estate and, as a result, will not be subject to estate tax or GST tax. The duration of the Dynasty Trust may be indefinite or limited to a number of years, depending on the applicable state's Rule Against Perpetuities (RAP), (which limits the duration of a trust). If the trust is established in a state with no RAP, the trust may continue indefinitely for the benefit of future generations or until the trust assets are depleted.

CONSIDERATIONS:

- Who will be the trustee of the Dynasty Trust?
- Who will help the trustee administer the Dynasty Trust?
- Should a corporate trustee or a corporate co-trustee be named because the Dynasty Trust will continue for many years?
- Who will be the beneficiaries of the Dynasty Trust?
- When will the beneficiaries receive the Dynasty Trust assets?
- How will the Dynasty Trust be funded?
- Who will help file the annual gift tax returns necessary because GST tax exemption will need to be allocated to the contributions in order to properly fund the Dynasty Trust?

Incentive Trust

The name "Incentive Trust" typically refers to an irrevocable trust with certain provisions that can promote positive behaviors in beneficiaries or deter negative behavior. These incentive provisions can be used in Irrevocable Life Insurance Trusts (ILITs), Dynasty Trusts, B-Trusts and any other type of trusts. The goal of incentive trust planning is to ensure that inherited wealth creates a positive rather than a negative legacy. If you want to convey your values, foster education, and encourage productivity in your heirs, you may consider including incentive provisions in your estate planning documents. Common provisions contained in incentive trusts include: rewarding educational goals that are achieved such as earning a degree or maintaining a certain grade point average, recognizing work-related success by providing funds which match earnings, and providing additional income to a beneficiary in an important yet low-paying career.

CONSIDERATIONS:

- Who will be the trustee¹ of the incentive trust?
- Who will be the beneficiaries of the incentive trust?
- When will the beneficiaries receive the incentive trust assets?
- Who will help the trustee administer the incentive trust?
- How will the incentive trust be funded?
- Will annual gift tax returns need to be filed when funding the incentive trust?

Family Buy-Sell

The Family Buy-Sell Strategy is designed to provide family members who are active in the family business with a source of cash to purchase the business from your estate or from your surviving spouse after you have passed away. Your children who are active in the family business will be the owners and beneficiaries of a life insurance policy insuring your life. Given that these children are likely employees or partial owners, the family business can help pay the life insurance premiums. Generally, this would be accomplished through bonus payments. The active family members would use these bonus payments, after paying income tax, to pay premiums on a life insurance policy insuring your life.

Upon your death, the business will be included in your estate but should pass estate tax-free³ to your spouse using the unlimited marital deduction. The life insurance death benefit proceeds should be paid income tax-free* to the active family members who in turn, would use these funds to purchase the family business from your estate or your surviving spouse under the terms of the family buy/sell agreement. Your surviving spouse will use those funds for living expenses. By using this strategy, the business should pass to those family members active in the business while also providing for your surviving spouse.

CONSIDERATIONS:

- Which family members will be the owners and beneficiaries of the life insurance policy insuring your life?
- How will life insurance premium payments be made?
- What assets will be distributed to children not involved in the family business?
- Who will benefit from your assets that are distributed from your will or living trust?



See relevant endnotes on page 30.

* 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).

Life Insurance for the Blended Family

Traditional estate plans may not anticipate the special considerations and planning needed for blended families. If you have children from a prior marriage, a life insurance policy on your life may help provide an equitable division of assets.

With the assistance of an attorney, an Irrevocable Life Insurance Trust (ILIT) will be established to be the owner and beneficiary of a life insurance policy insuring your life; the beneficiaries of this ILIT will be the children from your previous marriage. You will transfer cash to the ILIT in order for the trustee¹ of the ILIT to pay life insurance premiums. Whether or not these transfers are subject to gift tax depends on the availability of your annual exclusions or lifetime gift tax exemption amount.² At your death, all the assets owned by the ILIT, including the life insurance death benefit proceeds, will be excluded from your taxable estate and, as a result, will not be subject to estate tax.³ The death benefit proceeds will be distributed to your children from your previous marriage as directed by the terms of the ILIT. This will provide your children an inheritance without having to wait until the death of your current spouse, thereby reducing any possible discord. The rest of your estate may pass to the surviving spouse estate tax-free using the unlimited marital deduction.

CONSIDERATIONS:

- Will children from a previous marriage also benefit from your assets that are distributed from your will or living trust?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?



Installment Sale to an Intentionally Defective Irrevocable Trust (IDIT Sale)

An IDIT Sale is a deferred sale arrangement between you and an irrevocable trust. This irrevocable trust is “intentionally defective” for income tax purposes. This means that you, as grantor, are responsible for all income taxes generated in the trust. This type of irrevocable trust is also known as a “grantor trust.”

With the help of your attorney, you establish an IDIT. You gift cash or assets to the IDIT to “seed” the trust using all or a portion of your lifetime gift tax exemption.⁶ If the IDIT is drafted as a dynasty trust to benefit many future generations of your family, your generation-skipping transfer (GST) tax exemption should also be allocated to this initial gift.⁵ These “seed” assets should give the IDIT economic substance in order to enter into the installment sale. Next, you sell property to the IDIT in exchange for an interest-bearing installment note payable over a term of years you select. The trustee¹ of the IDIT uses the income from the assets held by the IDIT to make the installment note payments. Because the IDIT is “intentionally defective,” all income generated by the assets held in the IDIT is reported on your income tax return; there will be no change from an income tax perspective after this arrangement has been established. As a consequence, the installment note payments from the IDIT to you are not subject to income tax.

The IDIT Sale allows you to reduce your taxable estate if the assets sold to the IDIT produce income and appreciate at a rate that is greater than the interest the IDIT owes on the installment note because the IDIT retains excess income and appreciated asset value. If you die during the term of the installment note, the value of the remaining note payments will be included in your estate for estate tax purposes.³

Oftentimes, the IDIT has sufficient excess income after making the annual payments on the installment note to fund the purchase of a life insurance policy insuring your life. By having the IDIT as the owner and beneficiary of the life insurance policy, the income generated by the assets in the IDIT will pay the life insurance premiums due. This avoids the need to establish a separate Irrevocable Life Insurance Trust (ILIT) and also eliminates the need to make further gifts to a trust to fund life insurance premiums. Upon your death, all assets owned by an IDIT, including the life insurance death benefit proceeds, should be excluded from your taxable estate and, as a result, should not be subject to estate tax.

CONSIDERATIONS:

- What highly income-producing and appreciating assets do you have which would be appropriate to sell to an IDIT?
- Who will be the beneficiaries of the IDIT?
- Who will be the trustee of the IDIT?
- Who will help the trustee administer the IDIT?
- Who will help file the gift tax return necessary because all or a portion of lifetime gift tax exemption will be used when the IDIT is established?
- What interest rate is used for the installment assets in the note?
- What is the anticipated growth rate of the IDIT?

Grantor Retained Annuity Trust (GRAT)

A GRAT is an irrevocable trust that allows you to retain an income stream for a defined time period with the remainder passing to your designated trust beneficiaries.⁷ While there is an initial gift when the property is contributed to the GRAT, the taxable gift is equal to the fair market value of the property reduced by your retained annuity interest. Based on the term and the retained annuity stream of the GRAT, there may be little or no gift tax imposed at the time the GRAT is established.⁸ At the expiration of the term of the GRAT, ownership of the remaining property passes to the remainder beneficiaries of the GRAT without the imposition of additional gift tax. If you fail to survive the selected term of the GRAT, all or a portion of the trust will be included in your estate for estate tax purposes.³ Similar to other types of irrevocable trusts, a GRAT should be established only with the assistance of an estate planning attorney.

If your desire is to benefit grandchildren, a GRAT would not be an appropriate strategy because generation-skipping transfer (GST) tax exemption cannot be allocated to the initial transfer of assets to the GRAT.⁹

Likewise, life insurance should not be purchased in the GRAT because there is the possibility that you will not survive the GRAT term; if life insurance is inside the

GRAT, all or a portion of the GRAT assets, including the life insurance death benefit proceeds, will be included in your taxable estate. However, a GRAT can be used in conjunction with a separate Irrevocable Life Insurance Trust (ILIT).

With the assistance from an estate planning attorney, you establish an ILIT in addition to the GRAT and name your heirs as beneficiaries of the ILIT. The ILIT is named as the beneficiary of the GRAT. The ILIT will be the owner and beneficiary of a life insurance policy insuring your life. You transfer cash to the ILIT in order for the trustee¹ of the ILIT to pay life insurance premiums. A portion of the income you receive from the GRAT can be used as the source of funds to transfer to the ILIT. Whether or not these transfers are subject to gift tax depends on your ability to make annual exclusion gifts or to use your lifetime gift tax exemption.² At the end of the GRAT term, any assets remaining in the GRAT should pass to the ILIT (the GRAT beneficiary) without any additional gift tax. The ILIT can use those assets to pay the remaining life insurance premiums or to repay any obligations that the ILIT may have. At your death, all assets owned by the ILIT, including the life insurance death benefit proceeds, will be excluded from your estate.

CONSIDERATIONS:

- What highly income-producing and appreciating assets do you have which would be appropriate to fund to a GRAT?
- What is the anticipated growth rate of the assets in the GRAT?
- Who will be the beneficiaries of the GRAT?
- Who will be the trustee of the GRAT?
- Who will help the trustee administer the GRAT?
- Who will help file the gift tax return if a portion of the lifetime gift tax exemption will be used when the GRAT is established?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- Who will help the trustee administer the ILIT?
- When will the beneficiaries receive the ILIT assets?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

Based on the **term** and the **retained annuity** stream of the GRAT, there may be **little or no gift tax** imposed at the time the **GRAT** is established.



Discounted Entities

Discounted entities such as family limited partnerships (FLPs) and family limited liability companies (LLCs) are legal entities established under applicable state laws. They are used to consolidate and manage wealth, provide some asset protection and, in the estate planning context, to transfer property to junior generations at a reduced transfer tax cost.

With the help of an attorney, you transfer your property to an FLP (or family LLC) in exchange for general and limited partnership interest. After formation of the entity, you transfer the limited partnership interest to your heirs or to a trust established for the benefit of your heirs. If a qualified appraiser determines that the gift of the limited partnership interests are entitled to a discount for lack of marketability and/or lack of control, you would be entitled to use the discounted value for determining the gift tax value of the interest transferred.

Discounted entities such as FLPs can often be subject to IRS attack. You should first consult your tax advisor for up-to-date information and to determine the appropriateness of such technique in your particular situation.

CONSIDERATIONS:

- Who will help establish the discounted entity under applicable state law?
- What type of discounted entity will be used?
- What asset will be transferred to the discounted entity?
- Which qualified appraiser will be used for the discount valuation?
- Who will participate in the business?
- Is there a valid business purpose?
- Will other family members also contribute assets to the discounted entity? If so, who will help them negotiate the terms of the discounted entity agreement?
- Will there be enough assets separate from the discounted entity for living expenses?

Private Annuity

In a typical private annuity arrangement, an individual transfers property to another individual or entity in exchange for an unsecured promise to a stream of income for the transferor's lifetime. Private annuities are most commonly used by a senior generation family member with a shorter than average life expectancy to transfer appreciating property to the junior generation at a reduced gift tax cost.

With the help of an attorney, you enter into a private annuity arrangement with the heir(s) to whom you would like to transfer your property. In exchange for that property, your heir(s) agrees to pay you an annuity stream for your lifetime.

The transfer will not be a gift because it is a transfer in exchange for a private annuity. You will be taxed on any gain in the property at the time of the transfer. At your death, the asset will not be included in your taxable estate for estate tax purposes.³ A private annuity can be very effective for those transferors who are in poor health because the annuity payments are determined using life expectancy tables as opposed to the actual life expectancy. This means that your heir(s) will pay less for the transferred property than it is worth if you die prematurely. However, if there is a greater than 50 percent probability that the transferor will die within one year,

the Treasury Regulations mandate that the annuity factor reflects the actual life expectancy of the individual. Accordingly, there is rarely an advantage to entering into a private annuity arrangement if the transferor is terminally ill.

If your heir(s) predeceases you, his or her estate will still be responsible for continuing the annuity payments to you. Accordingly, a life insurance policy on your heir's life with his or her spouse as owner and beneficiary may help his or her family continue the annuity payments to you in the event of an untimely death.



CONSIDERATIONS:

- Given your life expectancy, does a private annuity make sense?
- What income-producing and appreciating assets do you want to transfer in exchange for a private annuity?
- Which family member will you enter the private annuity arrangement with?
- Does the family member to whom you will be transferring the asset have sufficient assets of their own to satisfy the annuity obligations?
- How much gain will you recognize on the initial transfer of the asset?
- Will you and your spouse have enough for living expenses?
- Who will own and be the beneficiary of the life insurance policy?

Self-Cancelling Installment Note (SCIN)

A SCIN is a sale arrangement whereby an individual transfers property to another individual or entity in exchange for an interest bearing note for a specified term. The note contains a self cancellation clause triggered by the transferor's death. In other words, the note payments stop (or are cancelled) at the transferor's death. The SCIN, therefore, must contain a "risk premium" to compensate the transferor for the possibility that his or her death may cancel the note obligation. Accordingly, like a private annuity, SCINs are generally used by those individuals who are in poor health but not terminally ill and who want to transfer property at a reduced gift tax cost.

With the help of an attorney, you transfer a property to your heir(s) in exchange for a SCIN. A valuation expert determines the appropriate amount of risk premium to apply to the note interest or principal. You will report any gain in the property over the term of the note. When you die, the

SCIN payments stop and your heir(s) will own the property without having to pay any more payments. In addition the asset will not be included in your taxable estate for estate tax purposes.³ However, if you live longer than normal life expectancy, the payments will continue and your heir(s) may overpay for the property. Therefore, SCINs are generally used by those individuals who are in poor health but not terminally ill.

If your heir(s) predeceases you, his or her estate will be responsible for continuing the SCIN payments to you. A life insurance policy on your heir's life with his or her spouse as owner and beneficiary may help his or her family continue the SCIN payments to you in the event of an untimely death.

CONSIDERATIONS:

- Given your life expectancy, does a SCIN make sense?
- What income-producing and appreciating assets do you want to transfer in exchange for the SCIN?
- Which family member will you enter the SCIN with?
- How much will the risk premium be? Who will help appraise the appropriate risk premium for the SCIN?
- How much gain will you recognize over the period of the note?
- Will you and your spouse have enough for living expenses?
- Who will own and be the beneficiary of the life insurance policy?



Charitable Remainder Trust (CRT)

A CRT is an irrevocable trust that can benefit a charity, provide you with an income stream from the sale of a highly appreciated asset without immediate capital gains, and qualify you for a charitable income tax deduction.

With the assistance of an attorney, you establish a CRT and transfer a highly appreciated asset to the CRT. You may receive a charitable income tax deduction based on the calculated value of the gift to the charity. The trustee¹ of the CRT sells the highly appreciated asset without incurring capital gains tax on the sale and reinvests the sale proceeds in income-producing assets. Depending on how the CRT income stream is structured, you

will receive taxable income from the CRT for your life, for the lives of you and your spouse, or a specified term not to exceed 20 years. At the termination of the CRT term, the remaining assets in the CRT will be distributed to the designated charity.

A CRT can be used in conjunction with a Wealth Replacement Strategy to benefit the charity of your choice and your heirs. As part of the Wealth Replacement Strategy, you establish an Irrevocable Life Insurance Trust (ILIT) and name your heirs as beneficiaries. The ILIT will be the owner and beneficiary of a life insurance policy insuring your life or the lives of you and your spouse. All or a portion of the income stream you receive from the

CRT can be used as the source of funds to transfer to the ILIT in order for the trustee of the ILIT to pay the life insurance premiums. Whether or not these transfers are subject to gift tax depends on your ability to make annual exclusion gifts or to use your lifetime gift tax exemption.² At your death, all assets owned by the ILIT, including the life insurance death benefit will be excluded from your taxable estate and, as a result, will not be subject to estate tax.³ The death benefit proceeds distributed to ILIT beneficiaries will “replace” the asset that was transferred to the CRT and ultimately to the charity.

CONSIDERATIONS:

- Which charity or charities do you want to name as beneficiary of the CRT?
- What highly appreciating assets do you own that could be funded to the CRT?
- Who will be the trustee of the CRT?
- Who will help the trustee administer the CRT?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

Charitable Lead Trust (CLT)

A CLT is an irrevocable trust established to benefit a charity for a term of years. Once the period is over, the CLT assets can revert back to you as donor or can pass to your heirs depending on the type of CLT used. If the CLT is established to benefit your heirs, there will be gift tax consequences when the CLT is first established but the gift tax value will be based on the remainder interest passing to the heirs but reduced by the charity's interest in the CLT. There are many different types of CLTs and depending on the type that you select, you may or may not qualify for an income tax deduction.

CONSIDERATIONS:

- What type of CLT will you use?
- How long will the term of the CLT be?
- Which charity do you want to name as beneficiary of the CLT?
- What assets do you own that could be used to fund the CLT?
- Who will be the trustee¹ of the CLT?
- Who will help the trustee administer the CLT?
- Who will receive the CLT assets at the end of the CLT term?
- Will a gift tax return need to be filed when funding the CLT?
- Do you want to use life insurance to replace the income that the charity will stop receiving after the end of the CLT term?

With the help of an attorney, you establish a CLT and transfer assets to the CLT. During the term of the CLT, distributions will be made to the charity of your choice. Once the term is over, the assets remaining in the CLT will be distributed according to the trust provisions.

Given that the charity will no longer receive distributions from the CLT after the term of the CLT is over, you may consider purchasing a life insurance policy on your life or the lives of you and your spouse for the benefit of the charity to replace the income from the CLT. If the charity owns and is the beneficiary of the policy, you may receive an income tax deduction for life insurance premiums contributed to the charity. If you own the life insurance policy and name the charity as beneficiary, your estate should get an estate tax deduction³ for life insurance death benefits paid to the charity.

Private Foundation

A private foundation is a charitable organization founded and controlled by an individual or a family. Private foundations are created by those individuals who want to be more actively involved in the charitable giving process and who want to create a charitable entity that their heirs can continue after their death. Given the private nature of this type of charitable organization, private foundations are subject to strict rules and requirements.

With the help of an attorney, you can establish a private foundation during life or at death. Lifetime contributions to the private foundation are deductible for income tax purposes within certain limits depending on the type and amount of contribution. Bequests to the private foundation at death are deductible for estate

tax purposes.³ You can name your family members to the Board of Directors of the private foundation to control the private foundation's investments and annually determine which charities will receive the foundation's support.

One potential drawback of donating an asset to a private foundation is that you are disinheriting the heirs who would have received the asset. A potential solution is to use a wealth replacement strategy (discussed in detail on page 29) whereby you purchase a life insurance policy on your life in an Irrevocable Life Insurance Trust (ILIT) to "replace" the wealth lost to your heir when you made the gifts to charity.

CONSIDERATIONS:

- Will the private foundation be created during life or at death?
- Who will help establish the private foundation?
- What will be the name of the private foundation?
- Who will be on the board of the private foundation? Which family members will participate in the private foundation?
- Who will help the board operate the private foundation?
- What assets will be used to fund the private foundation?
- Which public charities do you want the private foundation to benefit?
- Do you want to use life insurance to replace for your heirs the asset going to the private foundation?

See relevant endnotes on page 30.

Charitable Gifts of Life Insurance¹⁰

Charitable gifts of life insurance are usually structured in one of the following ways: 1) the charity is the owner and beneficiary of the life insurance policy insuring your life; 2) you are the owner and the charity is the beneficiary of the life insurance policy insuring your life; or 3) you donate an existing policy insuring your life to a charity so the charity is the owner and beneficiary of the life insurance policy.¹¹

If you want to receive an immediate charitable income tax deduction for life insurance premium amounts, the charity must be the owner and beneficiary of the life insurance policy.¹² You donate cash directly to the charity so the charity may pay the life insurance premiums. At your death, the charity receives the life insurance death benefit proceeds free from income tax* and estate tax.³

If you want to retain ownership of the life insurance policy, you may name a charity as the beneficiary of the policy. This does not provide you with a charitable income tax deduction and the death benefit proceeds will be included in your estate for estate tax purposes; however, the life insurance death benefit proceeds paid to the charity will qualify for a charitable estate tax deduction. This structure would be appropriate if you want the ability to take income tax-free loans or withdrawals¹³ from the life insurance policy as a means to supplement your retirement but you ultimately want to benefit a charity.

If you have an existing life insurance policy that you no longer need, you may donate the policy to a charity. You may receive a charitable income tax deduction up to certain limits depending on the type of charity you are benefiting. If further life insurance premiums are needed, you may continue to make annual donations to the charity for the additional premium payments. These additional donations may also be income tax deductible up to certain limits. At your death, the charity should receive the life insurance death benefit proceeds estate and income tax-free.

Because the rules regarding charitable income tax deductions are complex, consult your legal and/or tax advisor to determine the amount of your deduction.

If you have an existing **life insurance policy** that you no longer need, you may **donate the policy** to a charity.

CONSIDERATIONS:

- Which charity or charities do you want to benefit?
- Will the charity be the owner and beneficiary of the life insurance policy so you can receive a charitable income tax deduction?
- Will continuing life insurance premiums need to be made?
- Will the charity only be the beneficiary of the life insurance policy so you can receive a charitable estate tax deduction?

* 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).

Qualified Personal Residence Trust (QPRT)

A QPRT is an irrevocable trust to which you can transfer your residence, reserving the right to live in the residence rent free for a term of years, with the remainder interest passing to specified beneficiaries. While there is an initial gift upon the transfer of the remainder interest in the QPRT, the gift amount will be reduced because you have retained the right to live in the residence for a term of years. At the end of the QPRT term, if you survive the term of years, ownership of the residence should pass to the trust beneficiaries without the imposition of additional gift tax. If the residence appreciates in value, that appreciation will also pass to your heirs outside of your estate. If, however, you do not survive the QPRT term, all or a portion of the value of the residence will be included in your gross estate.

Like any other type of trust, an attorney will help you establish a QPRT. A QPRT can hold your primary residence and/or a second residence. You can only transfer a rental vacation home to a QPRT if you occupy the vacation home for the greater of 14 days or 10 percent of the number of days it is rented to another during the taxable year. If your desire is to benefit grandchildren, a QPRT would not be an appropriate strategy because generation-skipping transfer (GST) tax exemption cannot be allocated to the initial transfer of assets to the QPRT.⁵

While a successful QPRT may help reduce the potential estate tax liability on your estate, it may create a liquidity problem because the residence cannot be sold to pay any estate tax that may due on the balance of your gross estate. The life insurance death benefit is an excellent source of liquidity to prevent the forced sale of other assets to pay the estate tax due upon your death. The distribution of the residence to certain family members, but not others (e.g., the grandchildren), may also cause family dissension. Life insurance on your life or the lives of you and your spouse can help in equalizing the passage of wealth among all family members (see page 29 for a discussion on wealth equalization).

CONSIDERATIONS:

- Do you want to keep your home in the family?
- Do you want to continue living in the home?
- How long will the term of the QPRT be?
- Who will be the beneficiaries of the QPRT?
- Who will be the trustee¹ of the QPRT?
- If you are considering a vacation home for a QPRT, how many days do you occupy the vacation home during the year?
- Will a gift tax return need to be filed upon the initial transfer of the house to the QPRT?
- Do you want to equalize your estate with life insurance?

If the residence **appreciates in value**,
that **appreciation will also pass**
to your heirs outside of your estate.

Annuity Maximization

Annuities have traditionally been a vehicle for accumulating wealth in a tax-deferred manner for retirement. Over time, however, your objectives may change from accumulating assets to transferring assets to your heirs. Unfortunately, when you die owning an annuity, it is subject to both income* and estate³ taxes. These taxes can significantly reduce the benefit that heirs will receive. In the proper circumstances, using distributions from an annuity to pay premiums on a life insurance policy held by an Irrevocable Life Insurance Trust (ILIT) may increase the wealth transferred to heirs.

With assistance from an estate planning attorney, you establish an ILIT and name your heirs as beneficiaries. The ILIT will be the owner and beneficiary of a life insurance policy insuring your life. All or a portion of the distributions¹⁴ from your annuity can be used as the source of funds to transfer to the ILIT in order for the trustee of the ILIT to pay the life insurance premiums.¹⁵ Whether or not these transfers are subject to gift tax depends on your ability

** 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).*

to make annual exclusion gifts or to use your lifetime gift tax exemption.² You will pay income tax on distributions from the annuity. However, at your death, all assets owned by an ILIT, including the life insurance death benefit proceeds, will be excluded from your taxable estate and, as a result, will not be subject to income tax or estate tax. If there are any assets remaining in your annuity at your death, your heirs will receive that annuity balance subject to income and estate taxes.

CONSIDERATIONS:

- Will any annuity distributions be needed for living expenses during retirement?
- Who will be the trustee¹ of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?



Maximizing IRA Assets

You have diligently saved for retirement but now realize that all your Individual Retirement Account (IRA) assets will not be needed for retirement. If you die and leave your IRA assets to your heirs, the IRA balance will eventually be subject to both income and estate taxes.³ These taxes can significantly reduce the benefit that your heirs will receive. In the proper circumstances, using distributions from an IRA to pay premiums on a life insurance policy held by an Irrevocable Life Insurance Trust (ILIT) may increase the wealth transferred to your heirs.

With assistance from an attorney, you establish an ILIT and name your heirs as beneficiaries. The ILIT will be the owner and beneficiary of a life insurance policy insuring your life. All or a portion of the distributions from your IRA can be used as the source of funds to transfer to the ILIT in order for the trustee¹ of the ILIT to pay the life insurance premiums. Whether or not these transfers are subject to gift tax depends on your ability to make annual exclusion gifts or to use your lifetime gift tax exemption.² You will pay income tax

on all distributions from the IRA. However, at your death, all assets owned by the ILIT, including the life insurance death benefit proceeds, will be excluded from your taxable estate and, as a result, will not be subject to income tax* or estate tax. If there are any assets remaining in your IRA at your death, your heirs will receive the IRA balance subject to estate taxes at death and income taxes when distributions are taken.

CONSIDERATIONS:

- Will any IRA distributions be needed for living expenses during retirement?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?



See relevant endnotes on page 30.

* 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).

Dynasty IRA

If you do not plan on taking distributions, you may be looking for ways to plan for your Individual Retirement Account (IRA). An IRA cannot be gifted during life without triggering income and gift taxes. Moreover, when you die, the IRA balance is included in your estate and your beneficiaries will be subject to income in respect of decedent (IRD) when they take distributions from the IRA.

The Dynasty IRA strategy may be a way to maximize the wealth you pass to your heirs. The Dynasty IRA is a strategy that attempts to stretch out distributions over multiple lives, thereby allowing the IRA assets to grow income tax-deferred for as long as possible. This tax-deferred growth may be able to overcome the loss of wealth to your heirs due to the potential double taxation on an IRA. If your estate is subject to estate tax³ it will need liquidity to pay the taxes. In order to keep the IRA intact however, estate taxes must be paid from another source. Rather than using the funds in your IRA or selling your assets, life insurance purchased in an Irrevocable Life Insurance Trust (ILIT) can effectively provide the needed liquidity.

The Dynasty IRA strategy begins with you taking required minimum distributions (RMD) while alive. You pay income tax on the RMD and gift all or a portion of the RMD to an ILIT. The ILIT purchases a life insurance policy on your life or a second-to-die policy on you and your spouse's lives. At your death, your surviving spouse completes a rollover of your IRA into his or her own IRA. The unlimited marital deduction should eliminate estate taxes at your death. Your surviving spouse names your children or grandchildren as beneficiary of the IRA. RMDs will be based on and spread out over the lives of the spouse and children. If more than one child is to be a beneficiary, the spouse may establish multiple IRAs, naming one child as beneficiary of each IRA. This allows minimum distributions for that particular IRA to be based on the life expectancy of that particular child after the spouse dies. When your surviving spouse dies, the IRA plan balance will be included in his or her estate and could be subject to estate taxes.

Sufficient estate liquidity will be needed to pay estate taxes and generation-skipping transfer (GST) taxes (if benefiting grandchildren). Life insurance purchased in an ILIT can help provide that liquidity. By leaving the plan intact and taking only minimum distributions, long-term income tax deferral can be achieved. Upon your spouse's death, the beneficiaries may elect to continue minimum distributions over their remaining life expectancies. The actual life expectancy of the child can be used. The children have the flexibility to take more than the minimum distribution if needed, or to take a lump sum at any time. If the child does not immediately need more income than the minimum distributions, however, the Dynasty IRA allows the IRA to continue growing on a tax-deferred basis.

CONSIDERATIONS:

- Will IRA distributions be needed for living expenses during retirement?
- Who will be the beneficiaries of the IRA?
- Will grandchildren be beneficiaries of the IRA?
- Who will be trustee¹ of the ILIT?
- Who will be the beneficiaries of the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

The **Dynasty IRA strategy** may be a way to **maximize the wealth** you pass to your heirs.



IRA Bequest and Wealth Replacement

If you are not planning on taking distributions from your Individual Retirement Account (IRA) and are charitably inclined, the IRA bequest and Wealth Replacement Strategy may be an effective way to provide a meaningful gift to your favorite charity and leave an inheritance to your heirs while eliminating the impact of the income and estate³ tax that can be imposed on your IRA distributions.

Under this strategy, you will bequest the balance of your IRA to your favorite charity by naming the charity as the beneficiary of your IRA. If you are married, your surviving spouse will be named as the beneficiary and the charity will be the contingent beneficiary. With the help of an attorney, you will establish an Irrevocable Life Insurance Trust (ILIT) to own and be the beneficiary of a life insurance policy on your life or a second to die policy on you and your spouse's lives. You will take your Required Minimum Distributions (RMDs), pay income taxes on the RMDs and gift them to the ILIT to provide the trustee¹ with the funds to pay life insurance premiums. After your death or the deaths of both you and your spouse, the IRA will be distributed to the charity and your estate will receive a charitable estate tax deduction. The life insurance death benefit proceeds will be paid income and estate tax-free to the ILIT and will be paid to your heirs as trust beneficiaries replacing the value of the IRA going to charity.

CONSIDERATIONS:

- Will IRA distributions be needed for living expenses during retirement?
- Which charity do you want to benefit?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

Maximizing B-Trust Assets

In a typical estate plan, a B-Trust is established by the decedent spouse's will or living trust funded with an amount equal to the deceased spouse's estate tax exemption.³ A B-Trust is sometimes referred to as a "Credit Shelter Trust," "Exemption Trust," or "Bypass Trust." A B-Trust generally provides income to the surviving spouse during his or her lifetime and then passes to the trust beneficiaries estate tax-free.

If you do not need the income from a B-Trust set up by your decedent spouse, you may be able to maximize the amount of trust assets for the trust beneficiaries by

purchasing a life insurance policy on your life in the B-Trust. The B-Trust would be the owner and beneficiary of a life insurance policy on your life. Because your decedent spouse's estate tax exemption was allocated to the B-Trust at his or her death, assets held in the B-Trust should pass estate tax-free to the trust beneficiaries.

Frequently, the surviving spouse is named as the trustee¹ of the B-Trust and is given a power of appointment over the assets in the B-Trust. Before the life insurance policy is purchased, however, you must resign as trustee and must relinquish any powers of appointment over the B-Trust

assets. This will prevent the life insurance policy death benefit proceeds and other B-Trust assets from being included in your taxable estate at your death. If structured properly, the life insurance death benefit should pass income* and estate tax-free to the B-Trust beneficiaries after your death.

CONSIDERATIONS:

- How much assets are available in the B-Trust?
- Will the income from the B-Trust be needed for living expenses?
- Is the surviving spouse the trustee of the B-Trust? If so, who will be the successor trustee of the B-Trust?
- Who will help the successor trustee administer the B-Trust?
- Does the surviving spouse have any powers of appointment over the B-Trust assets that must be relinquished before the purchase of the life insurance?

If you do not need the **income** from a B-Trust,
you may be able to **maximize** the amount
of trust assets for the **trust beneficiaries**
by purchasing a **life insurance policy**.

* 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).

Private Financing: Private Split Dollar

Private split dollar is a premium sharing arrangement typically between an Irrevocable Life Insurance Trust (ILIT) and an insured. It is used to reduce the gift tax cost of life insurance premiums in situations where the life insurance premiums may exceed an insured's annual gift tax exclusions and lifetime gift tax exemption.²

With the help of an attorney, you establish an ILIT to be the owner and the beneficiary of a policy on your life or the lives of you and your spouse. At the same time,

you or your spouse enter into a private split dollar arrangement with the ILIT where you or your spouse agree to pay the life insurance premium in exchange for a collateral assignment over the cash value of the policy. The ILIT agrees to pay the cost of the current life insurance protection as measured by the reportable economic benefit (REB).¹⁶ You and/or your spouse will gift at least enough cash to the ILIT so that the trustee¹ can pay the REB. At the death of the insured(s), an amount

equal to the cash value is paid to the premium payor; if you are the premium payor, an amount equal to the cash value will be included in your estate for estate tax purposes. The remainder of the death benefit proceeds will be paid to the ILIT free from income tax* and estate tax.³

A private split dollar arrangement can help reduce the gift tax cost of life insurance premiums because the payment of premiums by you or your spouse are not gifts to the ILIT because they are pursuant to the

See relevant endnotes on page 30.



split dollar arrangement. The only gifts to the ILIT are the REB costs which can be relatively small, especially in the early years of the policy. However, the cost of the REB increases every year and it may become necessary to end the split dollar arrangement. Upon termination, an amount equal to the cash value must be repaid to the premium payor and may deplete the policy. It is important that you and your attorney implement an exit strategy for the split dollar arrangement (i.e., a GRAT or a CLT).

CONSIDERATIONS:

- How much annual gift tax exclusion and lifetime gift tax exemption do you have available?
- Who will be the premium payor of the life insurance premiums?
- Who will be the trustee of the ILIT?
- Who will help the trustee administer the ILIT, including the annual payment of the REB?
- How much are the projected REB costs?
- When will the private split dollar be terminated?
- What exit strategy will be implemented?
- Will gift tax returns need to be filed when funding the ILIT with cash needed to pay the REB?

A private split dollar arrangement can help reduce the gift tax cost of life insurance premiums.

* 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).

Private Financing: Intra-Family Loans

Life insurance purchased in an Irrevocable Life Insurance Trust (ILIT) is typically funded with gifts made by the insured(s). If the premiums exceed available annual exclusions and lifetime gift tax exemption amount, gift taxes may be triggered.² Intra-family loans are a way to reduce the gift tax cost of funding a life insurance policy inside of an Irrevocable Life Insurance Trust (ILIT). Intra-family loans are sometimes referred to as “private loans” or “private section 7872 loans.”

With the help of an attorney, you establish an ILIT. You make an initial gift of cash to the ILIT using your available annual gift tax exclusions and lifetime gift tax exemption. Instead of gifting cash to the ILIT to pay the premiums, you or your spouse enter into a loan arrangement with the ILIT and lend cash to the ILIT to pay life insurance premiums on a policy on your life or the lives of you and your spouse. The loan can be a one-time lump sum loan or can be yearly loans. The ILIT trustee¹ uses any asset available

to the ILIT to pay loan interest to you or your spouse as lender. At your death(s), part of the death benefit is used to repay you or your spouse as lender. The balance of the death benefit should pass to the ILIT free from income tax* and estate tax.³

Intra-family loans can help reduce the gift tax cost of life insurance premiums because you are lending money to the ILIT rather than gifting them. Although the premium payments themselves are not gifts, you may wish to make gifts to the ILIT.

CONSIDERATIONS:

- How much annual gift tax exclusion and lifetime gift tax exemption do you have available?
- Who will be the lender of the life insurance premiums?
- Who will be trustee of the ILIT?
- Will the premiums be borrowed in one lump-sum loan or in a series of loans?
- What is the interest rate on the loan?
- When will the intra-family loan be terminated?
- Who will help the trustee administer the ILIT, including the annual payment of the loan interest?
- Will gift tax returns need to be filed when funding the ILIT with cash needed to pay the loan interest?

See relevant endnotes on page 30.

* 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).



Premium Financing

Life insurance purchased in an Irrevocable Life Insurance Trust (ILIT) is typically funded with gifts made by the insured(s). You, however, may be concerned about liquidating your investments to pay the premiums and would prefer to find a way to keep your money in your investments.

With premium financing, you establish an ILIT with the help of your attorney. The ILIT borrows the life insurance premiums from a third-party lender and purchases a life insurance policy on your life or the lives of you and your spouse. You gift cash to the ILIT so that the trustee¹ can pay loan interest to the lender. These gifts may be gift tax-free depending on your ability to use annual gift tax exclusions and/or lifetime gift tax exemption.² The third-party lender will require collateral¹⁷ for the loan and will generally require part of the cash value and death benefit as security for the loan.¹⁸ In addition, the lender may require

outside collateral and a personal guarantee.¹⁹ At your death(s), part of the death benefit will be used to repay the lender. The remaining death benefit should pass to the ILIT free from estate tax³ and income tax.* With premium financing, you can purchase the life insurance you need and keep your investments intact. It is not, however, intended to be used to generate tax benefits. In almost all cases, interest paid on borrowed funds will not be deductible for income tax purposes.

CONSIDERATIONS:

- What third-party bank will be the lender of the premiums?
- What are the terms of loan?
- What loan interest will the third-party bank charge? Is this interest variable or fixed? What kind of collateral will the third-party bank require?
- Who will be the trustee of the ILIT?
- Who will help the trustee administer the ILIT?
- Will gift tax returns need to be filed when funding the ILIT with cash needed to pay loan interest?

* 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).

Wealth Equalization Using Life Insurance¹⁰

Often in a family, it can be difficult to equalize wealth among family members. While you want to benefit all your heirs, it may not be practical or equitable to distribute all assets equally. For example, if you have a family business in which some of your heirs are active and others are not, you will likely want the business to pass to those individuals who participate in the business. In such situations, life insurance can be an effective way to equalize the estate.

With the help of an attorney, you will establish an Irrevocable Life Insurance Trust (ILIT) to own and be a beneficiary of a policy on your life or the lives of you

and your spouse. You will gift cash to the ILIT in order for the trustee¹ to make premium payments. Those gifts may be gift tax-free depending on your ability to use annual exclusions and/or lifetime gift tax exemption.² You will choose who the beneficiaries of the trust will be and how much each beneficiary will receive. By doing so, you can choose to equalize your estate the way you want. At your death, the death benefit proceeds will pass free from estate tax³ and income tax* to the ILIT and the ILIT trustee will distribute the trust proceeds according to the terms of the ILIT.

CONSIDERATIONS:

- Who will be the beneficiaries of the ILIT?
- How much will each beneficiary receive from the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will be the trustee of the ILIT?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

Wealth Replacement Using Life Insurance¹⁰

If you are charitably-inclined, you may want to leave a part of your estate to your favorite charity. Charitable donations can be made during life or at death and can take many different forms. For example, you can make outright gifts to a charity or you can create a charitable remainder trust for the benefit of the charity. The downside of any charitable gift is that you are disinheriting the heirs who would have received those assets but for the charitable donation. One solution to this dilemma is to use a wealth replacement strategy using life insurance.

CONSIDERATIONS:

- Which charity or charities do you want to benefit?
- What asset will you donate to charity?
- Who will be the trustee of the ILIT?
- Who will be the beneficiaries of the ILIT?
- When will the beneficiaries receive the ILIT assets?
- Who will help the trustee administer the ILIT?
- How will the ILIT be funded?
- Will annual gift tax returns need to be filed when funding the ILIT?

With the help of an attorney, you establish an Irrevocable Life Insurance Trust (ILIT) to own and be the beneficiary of a life insurance policy on your life or the lives of you and your spouse. You decide the desired amount of death benefit that you want to provide for your heirs to replace the amount going to charity. You gift cash to the ILIT in order for the trustee¹ to make premium payments. The gifts may be gift tax-free depending on your ability to use annual exclusions and/or lifetime gift tax exemption.² At your death, the life insurance death benefit proceeds will be paid to the ILIT free from estate tax³ and income tax* and the ILIT trustee will distribute the death benefit proceeds to the trust beneficiaries replacing the assets that you have donated to your favorite charity. By doing so, you will benefit your favorite charity without disinheriting your heirs.

See relevant endnotes on page 30.

* 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).

ENDNOTES

- 1 The trustee appointed should not be the insured or the insured's insurance professional. An insurance professional who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.
- 2 Starting on January 1, 2011, the annual gift tax exclusion is \$13,000 per donee and is indexed for inflation. From January 1, 2011 to December 31, 2012, the lifetime gift tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); and, the maximum gift tax rate is 35%.
- 3 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.
- 4 The GST tax is a flat tax at the highest federal gift and estate tax rate that applies to transfers during lifetime or at death to skip persons (i.e., persons who are two or more generations younger than the transferor). This tax is assessed in addition to other transfer taxes, such as gift and estate taxes.
- 5 From January 1, 2011 to December 31, 2012, the federal estate and GST tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); the maximum estate and GST tax rate is 35%; and, the rules regarding step-up in basis for property transferred at death are reinstated.
- 6 From January 1, 2011 to December 31, 2012, the lifetime gift tax exemption amount is \$5,000,000 (indexed for inflation starting January 1, 2012); and, the maximum gift tax rate is 35%.
- 7 On June 15, 2010, the U.S. House of Representatives passed legislation (H.R. 5486) that would require any GRAT funded after the date of enactment of the bill to have a term of no less than 10 years. The U.S. Senate has not addressed the bill but, if it passed by the Senate, the minimum term of a GRAT would be 10 years.
- 8 The gift to the GRAT may be valued at zero or at an amount close to zero for gift tax purposes if the GRAT is structured as a "zeroed-out GRAT." With a zeroed-out GRAT, the retained annuity interest is structured high enough so that the gift tax value of the gift is close to zero.
- 9 IRC Section 2642(f) prohibits the allocation of GST tax exemption during the selected term of a GRAT.
- 10 As with all uses of life insurance, the amount of life insurance coverage asked for in conjunction with this concept may be limited by Pacific Life's financial underwriting guidelines. Financial underwriting is an assessment of whether the proposed death benefit is a reasonable replacement for the financial loss caused by the death of the insured.
- 11 In order for a life insurance policy to be considered valid, it must meet insurable interest rules in the state in which it is issued. Most states have enacted laws giving a charitable organization an insurable interest in a donor. Before creating a charitable plan using life insurance, consult your attorney regarding your state's insurable interest laws. Priv. Let. Rul. 9147040 (Aug. 20, 1991).
- 12 If the grantor/insured intends to make a charity the beneficiary of (all or a portion of) the life insurance death benefit proceeds, there must be an established history of giving to that charity. This history should be in an amount sufficient to justify the amount of life insurance designated to benefit the charity. Without this established history of charitable giving, it is best to designate other (non-life insurance) assets to the charity and use the life insurance policy as a means to benefit heirs and replace the value of the asset left to charity (i.e., wealth replacement).
- 13 Tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death; (3) withdrawals taken during the first 15 policy years do not occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC Secs. 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.
- 14 Distributions may be subject to surrender charges and, if made prior to age 59 ½ may be subject to a 10% penalty tax in addition to income tax.
- 15 Distributions from the annuity to purchase life insurance do not qualify for tax-free exchange treatment under IRC Sec. 1035. Distributions from the annuity to purchase life insurance will be considered a replacement of the annuity under state insurance laws. After considering your individual facts and circumstance, whether any particular replacement is in your best interest is a determination to be made by you, along with your independent tax and legal advisors.
- 16 Final Split Dollar Regulations (Treas. Reg. 1.61-22(d)3(ii)) reserve the issue of the cost of current life insurance protection for future guidance. Until such guidance is issued, Notice 2002-8 states that taxpayers may continue to use the insurance carrier's published one year term rates or the Table 2001 rates for arrangements entered into prior to January 28, 2002. For arrangements entered into after that date, taxpayers are generally limited to the Table 2001 rates.
- 17 By assigning the policy as collateral, the lender will gain certain rights over the policy's death benefit and cash values. Specifically, the assignment will grant the lender the right to surrender the policy, or make policy loans or withdrawals, in certain circumstances.
- 18 When a loan is used to purchase a variable life insurance policy, additional lending requirements under Regulation U (12 C.F.R. 220) and Regulation T (12 C.F.R. 221) must be met. Please contact your lender and/or your legal advisors for more information.
- 19 The personal guarantee of one loan may involve gift and estate tax considerations that need to be reviewed by the guarantor's private counsel.



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