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Transfer Your Wealth with an Irrevocable Life Insurance Trust

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An Irrevocable Life Insurance Trust (ILIT) is a relatively simple estate planning tool which can be utilized to transfer wealth to family members. If careful tax planning steps are followed, as described below, the use of an ILIT may reduce estate and gift tax costs.

Who should consider an ILIT?

An ILIT should be considered by individuals and their spouses whose combined estate is expected to exceed their combined estate tax applicable exclusion amounts ($2,000,000 per individual in 2008, $3,500,000 per individual in 2009). By setting up an ILIT, the insured can plan for the transfer of additional wealth to children and the next generation of beneficiaries, while adding liquidity to their estate.

What is an irrevocable life insurance trust designed to achieve?

ILITs are separate legal entities designed to own life insurance policies on the life of the insured that maintains the value of the policy outside of the insured's estate. Upon the insured's death, the value of the death benefit is then passed to the ILIT and is generally not subject to the insured's estate taxes.

There are two methods to establish an ILIT: by transferring an already existing insurance policy to the ILIT or by setting up the trust prior to buying an insurance policy.

Transferring an existing life insurance policy to the ILIT

An existing life insurance policy may be transferred to the trust. The value of the life insurance policy at its initial transfer date is considered a "gift" for federal gift tax purposes as well as any future premium payments made by the insured to the trust. To avoid the payment of gift tax, the trust agreement can provide the beneficiaries with Crummey withdrawal powers (named after the case Crummey v. Commissioner) or the insured can utilize all or part of their lifetime applicable exclusion amount ($1,000,000). Crummey withdrawal powers give a beneficiary the right to withdraw a certain amount from the trust (usually limited to the annual exclusion amount) each year that a transfer is made to the trust. Providing Crummey withdrawal powers to the trust beneficiaries qualifies for the gift tax annual exclusions (currently $12,000 for individuals, $24,000 for spouses). The trust agreement can grant Crummey withdrawal powers to numerous beneficiaries, therefore absorbing a large amount, or all, of the taxable gift. To the extent the premiums exceed the annual exclusion amount; the insured can utilize any remaining lifetime applicable exclusion amount.

To notify the beneficiaries of their withdrawal rights, the trustee should send a letter to the trust's beneficiaries, called a "Crummey Letter." If the time elapses and the money remains in place, the ILIT trustee is free to use the funds to pay for the life insurance premium.

If the life insurance policy is transferred to the trust, it is important that the insured not retain any "incidents of ownership" at the time of death or relinquish their rights in the policy within three years of his or her death. Incidents of ownership are defined as interests or rights that an individual maintains in an asset. A few examples are the ability to change the beneficiaries of the policy, transfer ownership of the policy, or use the value of the policy as collateral for a loan. If it is determined that the insured retained incidents of ownership at the time of death or relinquished their rights within three years of death, the death benefit of the policy will be included in the insured's estate. Therefore, if the insured holds 'incidents of ownership' at the time of the policy's transfer to the trust, the insured should relinquish these rights immediately.

Furthermore, the insured must be careful that the insurance policy is payable to the trust and not the insured's estate, and that the payout is not available for payment of taxes, debts, or other charges enforceable against the estate. These additional items will cause the value of the death benefits to be included in the insured's estate.

Setting up the ILIT prior to purchasing life insurance

It is beneficial to set up the trust prior to purchasing the life insurance policy to avoid the possibility that the death benefit proceeds may become part of the insured's taxable estate. The trust should buy and maintain ownership of the life insurance policy. If policies are purchased directly by the ILIT, the insured will never own incidents of ownership in the policy and the policy will not be included in their estate. The individual whose life is covered by the insurance policy should not serve as trustee of the ILIT. Similar to the situation described earlier, when the policy is transferred to the trust, the annual life insurance premiums can be funded each year by the insured if he or she gifts the amount of the premium to the trust. If the premiums exceed the annual excludable gift tax exclusion amount, the excess amount will be utilized as part of the insured's lifetime gift tax exemption amount.

In summary

Irrevocable life insurance trusts (ILITs) are valuable vehicles used to transfer wealth to family members at a reduced estate and gift tax cost. For further information on this topic, please contact a PricewaterhouseCoopers professional advisor.

“Money Doesn’t Grow on Trees!”
Children and Money

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Raising financially responsible children is a process that most parents struggle with and takes place over an extended period of time. In addition to understanding basic budgeting, it also includes educating your children about your family’s personal values, wealth, and what is involved in managing that wealth. Financial professionals do not always agree as to when, or how, to introduce financial concepts to children, but what most financial professionals do agree on is the general principle that instilling disciplines early on about financial values will help to promote your family’s financial well-being.

Start early with teaching your children the fundamentals of financial discipline. Educating children about handling money should focus on 5 key concepts of: earning, spending, saving, borrowing, and sharing.

1. Earning, or receiving money, is important to teach work standards and habits. It begins to address the relationship of money (time, skills, and energy) and the value of financial independence.

2. Spending provides opportunity to: experience the differences between wants and needs, compare alternatives, and make responsible decisions.

3. Saving supports planning and delayed gratification. It illustrates the “pay yourself first” concept and saving as a way to work towards what you want.

4. Understanding borrowing is an important lesson for children, as it will teach them that borrowed money needs to be paid back - that there is a cost to it.

5. Sharing provides the opportunity to help others. Sharing can include time, energy, or skills in addition to money.

Some suggestions for early learning opportunities include:

Early Years (to age 6):

- Get a piggy bank! Though children cannot comprehend the value of money, they can feel the weight!
- Afford children the opportunity to choose between purchasing two or three items and limit their choices.

Early School Age to Preteen (6–12):

- Start a modest allowance for doing basic household chores.
- Encourage them to seek small employment opportunities when they are able such as garden work or child care.
- Encourage long term savings and consider matching any money they save for over a year.
- Lend money when needed but never more than they can repay. Hold them to the loan agreement; do not end up forgiving the loan.
- Introduce philanthropy by sharing with a friend or contributing to charitable organizations.

Teenagers (13–18):

- Encourage them to earn and save for long-range goals important to them. Consider matching the amount that they save.
- Learn about the purposes, services, and charges of banks, credit unions, and other financial institutions.
- Discuss the use of credit cards and the costs of credit.
- Allow children to have discretionary money so they can make decisions and learn from mistakes.
- Continue philanthropy efforts focusing on the value of contributions and how actions can affect change.

College Age (18 and over):

- Collaborate and stick to a college spending budget.
- Insist on summer employment and fund their Roth IRA. If your child has earned income through self employment or W-2 wages, they can establish a Roth IRA for the amount they earned, up to $5,000 in 2008 ($4,000 for 2007), subject to certain income limits which start at $101,000 of modified adjusted gross income for single individuals. As with all IRAs you have until April 15 of the following year to put the money into the account. Parents or grandparents can give children some or all of the IRA funding money as gifts, allowing the children to keep and or spend what they make.
- Continue to encourage philanthropy actions and fundraising.

Today, college students are barraged with credit card offers well before they graduate from college. Consequently the concept that "money doesn't grow on trees" may be hard for them to grasp. In fact, some children who've grown up using checks and credit cards may conceptually have a difficult time understanding the notion of finite resources. As a result, many young people start out their careers under a huge pile of education and credit card debt that they could easily fall into a cycle of "borrowing from Peter to pay Paul." A survey of college graduates from 2000 to 2006 by Experience, Inc. found that 58% of those polled had moved home after school and that 32% stayed more than a year.

Times have changed and a great deal has been written about the issues faced by Generation X, Generation Y, and Millenials, many of which are financial in nature. Current headlines (e.g., volatile markets, expanding global competition, massive debt levels, etc.) all contribute to a "fear factor" for future generations and given the recent subprime debt crisis, we've seen the end of easy credit for the time being. Young people are going to have to be diligent about saving for a down payment if they want to buy a house.

Now more than ever, while time is on their side, one of the best gifts that you can give children is to teach them the fundamentals of financial discipline. You can "bet your bottom dollar" that it's a good investment and will help to establish that they'll have more than "two pennies to rub together" in the long run.

An Informational Primer on Exchange-Traded Funds

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The popularity of the investment vehicle known as the "Exchange-Traded Fund" (ETF) has grown enormously over the last five years. The ETF has several interesting characteristics that many investors have come to understand and appreciate. The discussion below attempts to highlight some of those characteristics and offers some portfolio applications with the hope that you will discover how ETFs may help you achieve your investment goals.

The Basics

Exchange-traded funds made their debut in the United States in 1992. They, like many other investment products, had humble beginnings but have grown like wildfire in recent years due to the flexibility they can offer. There were less than 100 ETFs on the market at the turn of the century whereas there are over 600 today, with 290 begun last year alone.

ETFs are essentially investment portfolios, similar to index funds, which trade like stocks on an exchange. An owner of an ETF share has legal right of ownership over a portion of a basket of securities. Authorized participants, who are generally large financial institutions with contractual agreements with the fund, can exchange "in-kind" their ETF shares for a representative basket of the underlying securities or visa versa creating ETF market liquidity.

Advantages & Disadvantages

Diversification—Similar to mutual funds, ETFs provide investors with instant diversification over numerous security positions. As the number of available ETFs grow, certain specialty ETFs are providing access to: large and small capitalization companies, real estate, international and emerging markets, bonds, gold, and other commodities. There are also leveraged ETFs, sector and industry specific ETFs, and ETFs that short particular indices.

Cost—ETFs maintain a relatively low ownership cost with expense ratios as low as 0.07% of assets and 0.52% on average, compared to the average mutual fund expense ratio of 1.34% (0.65% for index mutual funds). These ultra-low expense ratios are attractive for most; however, upon acquisition and disposition of ETF positions, unlike most open-end mutual funds, the investor must pay brokerage commissions. Thus the use of dollar-cost averaging in small dollar amounts may become more costly than the expense ratio differential when compared to mutual funds.

Tax—Compared to typical open-end mutual funds, ETFs are more tax efficient due to minimal trading and the "in-kind" redemption feature, which also helps ETF shares trade near their net asset value. Like most passively managed mutual funds, many ETFs only trade when the index they track rebalances or there is a reconstitution. By minimizing trading activity, there are fewer transaction costs and less potential tax liabilities created. The "in-kind" redemption feature allows the ETF to manage its taxable positions by exchanging out of securities with the lowest cost basis thus saving the ETF shareholders a large year-end tax liability. Capital gains upon the sale of ETF shares, interest, and dividends are still present but investors have more control over recognition for tax purposes.

Trading—ETFs trade similarly to stocks, on an intraday basis, unlike open-end mutual fund shares that are issued or redeemed based on end-of-day valuations. This also means that investors are capable of entering or existing this position with the use of market, limit, stop-loss, or trailing-stop orders. Investors can also short sell and write or purchase option contracts on many ETF shares.

Management—ETFs are mainly built to track a particular index or basket of securities, known as an index strategy or passive management. Indices are created by determining a universe for security selection, the construction methodology, and the objectives. These factors are vitally important to understand in evaluating the selection of ETFs for investors.

Portfolio Applications

Although there is significant debate over active portfolio management versus passive management; many agree that maintaining low expenses (management and tax) and proper asset allocation will help generate better long-term total returns. Thus, the use of ETFs assists investors in developing the proper asset allocation by allowing them to achieve diverse market exposure.

One commonly used investment technique using ETFs is known as the “core and satellite” strategy. This portfolio strategy attempts to track the broad market with the majority of assets—the core. With the remainder of portfolio assets, the investor attempts to increase total portfolio value through the use of more aggressive positions in sectors/industries that are expected to outperform—the satellites.

Because ETFs have tax-efficient characteristics, they provide investors with more tools during the asset location analysis. Asset location consists of determining where an investor holds what assets—either inside a tax deferred vehicle, such as a retirement account, or in a taxable brokerage account. Therefore, investors can hold ETFs in their taxable accounts to benefit from their tax efficient nature and utilize them for tax loss harvesting purposes. For example, to capture the capital loss for tax purposes a losing stock can be sold and, to maintain comparable market exposure, the investor can replace that stock with an ETF that has similar investment characteristics.

ETFs have become very popular for hedging and risk management purposes. For example, many corporate executives accumulate substantial positions in their own company’s stock, subjecting themselves to increased exposure to company specific risks. There may be legal restrictions and/or personal ethics issues that prevent these executives from selling or short selling their own company stock. However, the executive is able to help reduce his concentrated stock risk by short selling an ETF with concentrated holdings in the same industry as the executive’s company stock. The desired portfolio effect of this strategy would be to gain on the ETF that was sold short when the executive’s company stock is losing value.

For investors seeking current income, there are numerous bond ETFs that invest in high-quality corporate bonds, high-yield corporate bonds, and treasuries. There are also ETFs designed to maximize dividend income or to purchase stocks with a strong history of raising its dividend payout. This ETF strategy allows investors to gain access to strong dividend paying companies without the necessary research involved in evaluating each company’s specific circumstances.

As you can see, there are many simple, yet effective ways to build investment portfolios with the use of exchange-traded funds. By utilizing these investment vehicles, it can be beneficial helping to build wealth in a low-cost and diversified manner.

The Check's in the Mail!

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Starting in May 2008 the Treasury will begin sending economic stimulus payments to more than 130 million individuals. The IRS will use the 2007 tax returns to determine peoples' eligibility for the payment, and to calculate the amount of the payment.

For most people the payment will equal the amount of tax liability on the return, with a maximum amount of $600 for individuals ($1,200 for taxpayers that file a joint return) and a minimum of $300 for individuals ($600 for joint filers).

People with no tax liability may qualify for a minimum payment of $300 ($600 for joint filers) if their tax return reflects $3,000 or more in "qualifying income," defined to include earned income such as wages, net self-employment income, Social Security benefits, certain Railroad Retirement and certain veterans benefits.

An additional $300 will be paid for each qualifying child (to qualify a child must have a valid Social Security number and be eligible under the Child Tax Credit).

Eligibility for the payment is subject to maximum income limits, and payment amounts will be reduced by 5% of the amount of income in excess of $75,000 ($150,000 for joint filers).

Low income workers or Social Security recipients who don't have a regular filing requirement must file a 2007 return in order to notify the IRS of their qualifying income.

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