

Walls Around Wealth – Protecting Legacies from Predators

By Nerre Shuriah



Estate planning isn't just about lowering, or providing liquidity for, transfer tax liability. A greater part of the process involves setting up the transfer of wealth to preserve as much of a client's assets as possible for the next generation and to ensure that those assets are protected from predators of wealth. So many inheritance transfers fail to traverse more than two generations. While some of that lost wealth is due to taxes and lack of/or poor planning, more of it is lost to other predators of wealth.

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What exactly are predators of wealth? In addition to the government seeking its fair share through tax revenues, predators of wealth also include bitter ex-spouses, acrimonious in-laws, unscrupulous lawsuit plaintiffs, opportunistic creditors and, at times, the beneficiaries themselves – due to financial illiteracy, overspending and general mismanagement, as well as personal issues such as substance abuse, lack of direction or ambition and mental illness.

A client's offspring may seem rational and well-adjusted during the planning process. In fact, they are most likely to appear harmonious while their parents – the main benefactors and buffers of conflict – are still alive. But who can predict what will happen in the future? Bankruptcy,

divorce and failed businesses do not just happen to bad, evil people. Unlucky and catastrophic events affect everyone, regardless of inherent character, and can befall any of us at any time. The well-thought-out estate plan will use all the strategies and techniques available to prevent those predators from getting at transferred wealth. This article details a selection of such techniques, the collective use of which we like to refer to as putting up walls around wealth.

Start with an ILIT

An important point to note at the beginning is that the basic foundation of any family estate plan is an irrevocable life insurance trust (ILIT). Whether it is a Dynasty Trust, Spousal Support Trust or a blended family situation, a good plan design usually includes a variation of an ILIT. What are some

of the advantages of the ILIT? Generally, annual exclusion gifts or the lifetime exemption are used to minimize gift taxes when making annual gifts of premium, so gifting is made in a tax-efficient way. Death benefits payable to the trust are generally excluded from decedent's estate and are not subject to federal income taxes. The trustee can loan funds to or buy assets from the estate with policy proceeds to provide the estate with cash to pay estate taxes. Life insurance is a leverage tool in that it magnifies the value of the gifts made to the trust to increase the wealth passed to beneficiaries. Lastly, assets held in trust are creditor-protected for the beneficiaries.

Include Flexibility with Spousal Support Provisions

Life insurance can play a key role in helping a client accumulate and transfer wealth. Nevertheless, a client generally can't alternately retain access to the cash value of a policy and remove the death benefit from his or her taxable estate. Access to cash value creates an incident of ownership that draws the death benefit back into the client's taxable estate upon his or her passing. This lack of accessibility can be a deterrent to some clients in setting up an ILIT. Younger clients, in particular, may feel wary of what the future may bring and be unwilling to give up total control and use of assets that may be needed in the future. To build flexibility into their plan without adverse tax consequences, clients may consider using a Spousal Support Trust to own the life insurance policy.

A Spousal Support Trust is an ILIT created by one spouse – the grantor spouse – for the benefit of the other spouse – the uninsured spouse. To fund the trust, the grantor spouse makes cash gifts from his or her separate property to the trust. In some situations, an agreement between spouses may be necessary to create separate property. The trustee then uses the cash gifts to purchase a fixed or variable universal life insurance policy on the life of the grantor spouse. The life insurance policy is usually the only trust asset.

The beneficiaries of the trust are the uninsured spouse and the children. During the lifetime of the grantor spouse, the trustee may make distributions to the uninsured spouse and/or the children for their health, education, maintenance and support – also called ascertainable standards. Since the life insurance policy is the only trust asset, the trustee can access the policy's cash value through loans or withdrawals to make distributions.¹ Upon the death of the grantor spouse, the policy's death benefits are paid to the trust and, according to the terms of the Spousal Support Trust, the assets are distributed and/or held in trust for the benefit of the surviving spouse and children.

¹Loans and withdrawals will affect the cash value of the policy and could affect the death benefit. Amounts received on withdrawals and surrenders may be subject to federal income taxes and/or company-imposed surrender penalties.

Spousal support trusts offer many benefits, the most important of which is flexibility. When an ILIT is created, the trust's assets are no longer accessible to the grantor or the grantor's spouse. The trust provisions permitting spousal access help to answer the "what if" questions often posed by clients, such as, "What if my family situation changes or my spouse/children need distributions before my death?" If any change in circumstances occurs with regard to the grantor's loved ones, they can access the trust's assets. If properly structured, the death benefit will escape federal estate taxation in the grantor's, surviving spouse's and children's estates.

What happens if estate taxes are actually permanently repealed? Keeping the life insurance policy in the trust may be the best course of action. The trust can still provide cash distributions to the grantor's loved ones, as well as offer protection from creditors of the beneficiaries, beneficiary divorce settlements and imprudent spending or investments by the beneficiaries. The trustee may decide to keep the life insurance policy and use the death benefit to increase the amount of wealth that can ultimately be passed to the children.

Positively Influence the Behavior of Beneficiaries

Parents who have considerable wealth are often faced with two concerns that conflict with each other when it comes to leaving bequests to their children. One is that their children are not going to live as well as they, the parents, do. The second concern is that the wealth they leave their children will spoil them and engender a lack of motivation, resulting in a poor work ethic and irresponsibility.

An incentive trust is an ILIT that contains provision for distributions to beneficiaries based on conditions referred to as "incentive provisions." These incentive provisions encourage certain positive behaviors in beneficiaries that reflect the grantor's values and encourage beneficiaries to be productive members of society.

Incentive trusts are an excellent way to combat the loss of ambition that providing a lump sum inheritance can cause. Typical incentive provisions would support such behaviors as continuing formal education, starting a family, purchasing a home, starting a business, maintaining a job through salary-matching or supplementing low wages earned in a public interest career.

Protect the Wealth for Successive Generations

There's an old adage that accurately describes a typical family phenomenon – "short sleeves to short sleeves in three generations." It means that usually the first generation creates wealth through hard work and ingenuity; the second generation inherits the wealth and loses it; and the third generation is once again a part of the working masses. Through some forethought and

planning, the wealth that a family has worked so hard to create can be protected from creditors and transferred to many succeeding generations and continue to benefit the family line indefinitely. A Dynasty Trust can be created with its location (situs) in a jurisdiction that has either repealed the rule against perpetuities (RAP) or has extended it for a period of time beyond 100 years. Having a trust's situs in such a state would allow the trust to continue to exist with no discernable end date.

A Dynasty Trust can be a successful way to transfer significant assets to multiple generations, going a step beyond a standard ILIT. The Dynasty Trust can extend over several generations by taking advantage of the generation-skipping transfer tax exemption. A Dynasty Trust is often structured so that the trustee is given broad discretion in making distributions, and can exercise great flexibility in meeting the needs of the beneficiaries. The trustee will often be given authority to make distributions of funds for the health, education, maintenance, and support of the beneficiaries, but the trust often doesn't include provisions for mandatory distributions of principal, thereby ensuring the continuance of the trust through several generations. Allocating generation-skipping transfer (GST) tax exemptions to gifts made to the trust also leverages the amount available to be passed to grandchildren GST tax-free.

Avoid Trust Income Taxation

Attorneys will often design Dynasty Trusts to be of a type called "intentionally defective grantor trusts." The trust is intentionally defective because the grantor has retained one or more certain ownership rights in the trust. This type of irrevocable trust is considered a separate entity for gift and estate tax purposes. Thus, assets in the trust will still be excluded from the grantor's estate for estate tax purposes. However, due to the retained ownership rights, the grantor and the trust are considered the same entity for income tax purposes. As a result, the grantor is taxed on any trust income and the trust avoids trust income tax liability. If the grantor pays any trust income tax liability, the trust retains more of its assets and the trust value can increase faster. It also saves money as the graduated tax rate schedule for a trust is far more condensed and quickly reaches the top 35 percent tax rate at \$11,150 of income, as compared to \$372,950 for single individuals. Drafting a grantor trust also allows for more flexibility in dealing with the trust assets. For instance, since the trust is not a separate entity for income tax purposes, a sale of assets to the trust – such as a life insurance policy – will not be a tax recognition event for the grantor or the grantor trust.

Prevent Conflicts Among Blended Family Members

The make-up of the American family isn't what it used to be. Many people have been divorced and remarried and have children from more than one relationship. When one or both parties in a relationship bring children from a prior relationship, that is called a "blended family."

The planning concerns of blended families differ from those of traditional nuclear families. In addition to alimony, divorce decrees and child support arrangements, estate planning also must take into account a new spouse and children with the current spouse, as well as children from a prior relationship. Those different parties often have conflicting concerns. For instance, if a new spouse is significantly younger, she or he may have the same life expectancy as children from the first relationship. In the traditional estate planning format of leaving everything to the spouse, the children from the first relationship will have to wait until the current spouse's death to receive an inheritance. With statistically similar life expectancies, the children from the first relationship will be effectively disinherited.

However, with prior planning, all parties can be provided for and the possibility of conflicts can be reduced. Working with his or her financial advisor and estate planning attorney, the grantor sets up an ILIT funded with a life insurance policy and names his or her children from a prior relationship as the beneficiaries. The grantor completes a will and/or trust and bequests the estate to his or her current spouse and children that they share. In this way, the children from the prior relationship receive their inheritance at death without having to wait for the passing of the surviving spouse and, as a result, are likely to have more goodwill towards the grantor's second family.

Remember Not All Couples Are Legally Married

According to 2000 census reports, the number of households consisting of unmarried couples has increased 72% in the last two decades—surging from 3.2 million to 5.5 million. Not surprisingly, more and more unmarried couples are interested in pursuing a joint cohesive estate plan. Without the benefit of the legal rights that marriage bestows, estate planning for unwed couples is not only critical but complex. Unmarried couples face unique tax burdens and estate allocation issues that can only be avoided with proper planning.

Although each person (except a non-resident alien) is able to transfer up to \$3.5 million at death without incurring estate tax, married partners may transfer unlimited amounts of property to each other without being subject to estate tax until the survivor's death. Thus, for a couple where each has a net worth of \$5 million (or \$10 million in total), at the first death of the married couple, there would be no estate tax due. At the first death of the unmarried couple, there would be an approximate estate tax of \$675,000 (\$5 million – \$3.5 million exemption x 45% estate tax rate).

Unmarried couples may circumvent this disadvantage by purchasing life insurance. By purchasing a policy held by a surviving partner or in an ILIT, liquidity is made available to cover the estate taxes

due at the first death. In addition, an ILIT is a private document and only the beneficiaries may see the provisions that specifically pertain to their distributions, thereby reducing chances of a contest or disharmony among remaining family members and the surviving partner.

There Are More, But In The Interest of Space...

There are numerous estate planning techniques available to help clients lessen the risk that the inheritance they leave for loved ones will be eroded by predators. This article has covered a few. Contact our Advanced Marketing Department to talk about any of these strategies in more depth or discuss other strategies that help put a wall around the client's wealth.

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