USING THE LIFETIME GIFT TAX EXEMPTION TO PREFUND IRREVOCABLE LIFE INSURANCE TRUSTS

OVERVIEW

The Tax Cuts and Jobs Act of 2017 ("The Act") doubled the gift, estate and generation-skipping transfer (GST) tax exemption to $10,000,000 per person, indexed for inflation using the Chained-CPI index:

- The exemption for 2019 is $11.4 million with a maximum 40% tax rate
- The gift, estate and GST tax exemption will continue to be indexed to inflation.
- The current exemptions provide married clients with the opportunity to shift the appreciation on up to $22.8 million ($11.4 million if single) away from their taxable estates.[1] These increased exemptions are scheduled to sunset and revert to what they were prior to enactment of The Act on January 1, 2026.
- This deadline creates urgency to make use of the increased exemption amount before it is lost, assuming Congress does not enact new legislation. To make use of this opportunity during one's lifetime, gifts in excess of the base (pre-2018) amount, to which the exemption will revert, must be made before 2026.
- The Act provides a planning opportunity for taxpayers with substantial net worth. In light of the Act, you should consider creating an Irrevocable Life Insurance Trust ("ILIT") and gifting assets to the ILIT to fully utilize your lifetime gift tax exemption and to provide liquidity for future life insurance premiums. Below is a brief summary of the ILIT concept and the potential benefits of this type of planning.

IRREVOCABLE LIFE INSURANCE TRUST

- **Estate and Income Tax Savings.** The life insurance proceeds payable to an ILIT should not be included in your estate for estate tax purposes. Because the earnings in the cash value are tax deferred, any income tax liability attributable to any portion of the ILIT for which you are treated as the owner for income tax purposes under the grantor trust rules (discussed below) may be reduced or minimized.
- **Management of Policy Proceeds.** An ILIT provides an excellent mechanism to professionally manage the insurance proceeds for the beneficiaries under the terms established by you at its formation. The ILIT can be drafted to benefit your spouse, children and/or other descendants.
- **Liquid Wealth to Beneficiaries – Offsets Estate Taxes or Accomplishes Other Wealth Transfer Goals.**
  - As your assets continue to appreciate in value, your potential estate tax liability will increase.
  - Estate taxes are generally due (in cash) nine months after the death.
  - Significant life insurance proceeds may be received by an ILIT income tax free and can be used to provide a source of liquid wealth to your estate and/or the beneficiaries thereof. This wealth can help provide funding to pay estate taxes at your death or replacement of other monies used for this purpose.
  - Death benefit proceeds are generally received income tax free by the ILIT under IRC § 101 as cash and can then be reinvested. Thus, it is the only asset that can effectively receive a "step-up" in basis after death when owned outside your taxable estate (generally to otherwise get a basis step-up, an asset's fair market value must be included in your taxable estate for federal estate tax purposes under IRC § 1014).
  - If not used for estate tax liquidity, the death benefit proceeds can be used for other estate planning goals, such as to offset income taxes on capital gains realized by the trust upon the future sale of other trust assets, provide cash to help with the transition of a family-owned business, replace the value of estate assets that were bequeathed to charity, achieve specific financial legacy goals for children or grandchildren, etc.

- **Coordinate with Revocable Trust.** The ILIT can be drafted with provisions to match or complement your Revocable Trust. The ILIT could also include language removing a spouse in the event of a divorce or legal separation.
- **Creditor Protection.** Assets owned by the ILIT, structured properly, can be protected from the claims of your creditors and those of your children and other descendants.

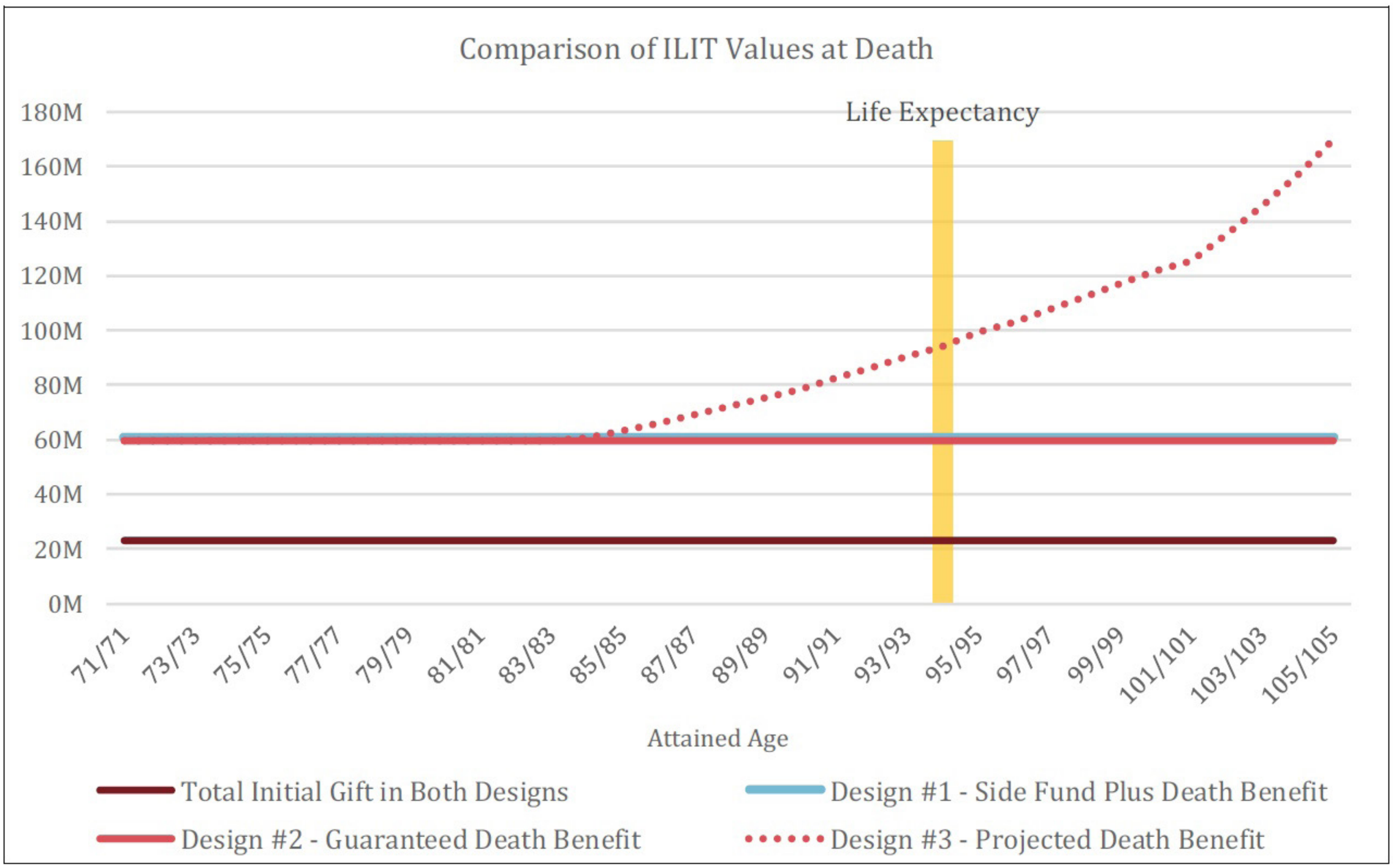
PREFUNDING THE ILIT

- **Single Premium Policy.** The increased transfer tax exemption may allow insureds to gift enough funds to purchase a large single-premium policy.
  - Single-premium life insurance allows a person to make one large payment to purchase a policy, eliminating the need for continual premium payments.
  - Making one large payment may allow the cash value of the policy to increase more rapidly over time, thus potentially resulting in net death benefit "force-ups", depending on the policy type and design.
  - Since more money is initially paid as premium to the policy, the earnings in the cash value of which are tax deferred, any income tax liability of the grantor attributable to the ILIT may be reduced.
  - One disadvantage of a single-premium life insurance policy is that the Internal Revenue Service could consider the policy to be a modified endowment contract ("MEC")[2] under IRC §§ 7702A and 72. MECs have a few tax disadvantages related to actual or deemed cash value disbursements prior to death but do not affect the taxation of the death benefit.
- **Recurring Premiums Policy.** The increased transfer tax exemption may also allow insureds to fund future premiums that might otherwise have required future loans to the ILIT.
  - Clients are limited to the amount they can gift to an ILIT to help fund an insurance program without triggering gift tax and may be limited even more so in the future if the current increased exemption amount sunsets after 2025 as scheduled.
  - To prevent triggering gift tax, individuals often loan funds to an ILIT to help pay policy premiums. These loans could result in numerous promissory notes being exchanged between the client and the ILIT, and as such, may result in additional administration expenses of the ILIT.
  - Prefunding an ILIT with several years worth of premiums could reduce the administrative burden and expense of creating and administering annual promissory notes. In addition, prefunding an ILIT may eliminate the hassle and expense of sending annual withdrawal notices to the beneficiaries of an ILIT to qualify gifts for the annual gift tax exemption.
  - Recurring premiums may also help prevent the policy from being considered a MEC if tax-advantaged access to cash value by the ILIT is important during the insured's lifetime.
- **Income Producing Assets.** You may also want to consider gifting income-producing assets to an ILIT.
  - You could gift marketable securities, or other income producing assets
  - Income from the assets could be used to pay future premiums.
  - Additionally, the income-producing assets could continue to grow free of estate and gift taxes.
- **Income Tax Considerations.** When determining whether to gift income-producing assets to an ILIT, you should consider the potential income tax consequences.
  - Many ILITs are structured as "grantor trusts," meaning the grantor of the ILIT is treated as the owner of some portion or all of the trust under IRC § 671 for income tax purposes only (as a result of the existence of any prescribed trust powers, rights or interests under IRC §§ 672-678) and, hence, must include in his or her taxable income all items of income, deduction and credit against the tax attributable to that portion of the ILIT for which he or she is treated as the owner.

    - ✓ The grantor may not have direct access to the assets of the ILIT to assist in paying the income tax attributable to the portion of the ILIT for which he or she is treated as the owner for this purpose.
    - ✓ In some situations this may be ideal as it could allow the continued depletion of the taxable estate (often referred to as the "tax burn" because it can reduce future estate tax liability) while allowing the assets in the ILIT, which are generally not subject to estate tax, to grow unencumbered by income tax and, therefore, to a greater extent. Pursuant to Revenue Ruling 2004-64, when a grantor pays income taxes attributable to that portion of the ILIT for which the he or she is treated as the owner, the grantor is not treated as having made a gift to the ILIT equal to the taxes paid.
    - ✓ In addition, structuring the ILIT as a grantor trust may provide future flexibility in its administration, e.g., allowing a sale of the policy to a new ILIT at a later date without income tax consequences.
  - › Thoughtful consideration should be given to the selection of which assets to gift as it pertains to the adjusted tax basis of the asset, it's potential for future growth, the ILIT's effective capital gain income tax rate relative to the grantor's estate tax rate, and the age of the taxpayer.
    - ✓ The ILIT will take a tax basis in the asset equal to the basis in the hands of the transferor immediately before the transfer ("carryover basis") under IRC § 1015.
    - ✓ Carryover basis will cause the ILIT to recognize taxable income upon the sale of any trust assets to the extent the amount realized exceeds its adjusted tax basis.
    - ✓ Because the tentative taxable estate includes the value of any taxable gifts made during life in calculating the tentative estate tax due under IRC § 2001 before the unified credit is applied under IRC § 2010, only the value of any appreciation occurring on the value of the gift following the date of the transfer will escape estate taxation.
    - ✓ Therefore, sufficient time must transpire, and appreciation occur, so that the estate tax savings on the post-gift growth exceed the income tax exposure on any future taxable gain on the gifted assets.
- **Example.** Below is a hypothetical example[3] showing how Prefunding an ILIT can work:
  - › Male and female, both age 70 and standard nonsmoker, joint life expectancy of 24 years.
  - › **Design 1** assumptions: $22.8 million cash gift to an ILIT invested in a side fund earning a hypothetical 4% pre-tax rate of yield per year and resulting annual income is used to pay annual life insurance premiums (conservative risk asset allocation in the side fund due to need to take annual withdrawals to pay premiums), death benefit is guaranteed for life, policy is Prudential PruLife SUL Protector (a survivorship universal life policy with a secondary guarantee and little to no cash value), grantor pays the income tax on the annual income at a 30% effective tax rate.
  - › **Design 2** assumptions: $22.8 million cash gift to an ILIT used to pay a single life insurance premium, death benefit is guaranteed for life, policy is Lincoln SVULONE (a survivorship variable universal life policy with a secondary guarantee and cash value growth potential), 8% gross rate of return (7.76% net) assumption for the underlying cash value (assumes a higher risk asset allocation in the policy's variable investment options due to the guaranteed death benefit and no need to take withdrawals to pay premiums), no grantor income tax liability since the cash value earnings are tax deferred.

› Hypothetical projected results:

			Design 1: Gift to Fund Level Annual Premium from Side Fund							Design 2: Gift to Fund Single Pay Premium			
1	2	3	4	5	6	7	8	9	10	11	12	13	14
Year	Ages	Gift to ILIT	Beginning Balance	Annual Premium	Income at a 4% Yield	Ending Balance	Guaranteed Death Benefit	Total ILIT Value at Death	Grantor Tax Liability at a 30% Effective Tax Rate	Annual Premium	Guaranteed Death Benefit	Projected Death Benefit 8% Return (7.76% Net)	Grantor Tax Liability at a 30% Effective Tax Rate
1	71/71	22,800,000	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	22,800,000	59,418,000	59,418,000	0
2	72/72	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
3	73/73	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
4	74/74	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
5	75/75	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
6	76/76	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
7	77/77	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
8	78/78	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
9	79/79	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
10	80/80	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
11	81/81	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
12	82/82	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
13	83/83	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	59,418,000	0
14	84/84	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	60,475,334	0
15	85/85	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	63,263,073	0
20	90/90	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	78,243,589	0
24	**94/94**	**0**	**22,800,000**	**876,923**	**876,923**	**22,800,000**	**37,864,000**	**60,664,000**	**263,077**	**0**	**59,418,000**	**94,185,551**	**0**
25	95/95	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	99,057,564	0
30	100/100	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	121,894,592	0
35	105/105	0	22,800,000	876,923	876,923	22,800,000	37,864,000	60,664,000	263,077	0	59,418,000	169,725,814	0



- Observations on the hypothetical results of these two designs:
  - ✓ The ILIT side fund principal plus the guaranteed death benefit with Design 1 is roughly same (slightly more) than the guaranteed death benefit with Design 2. That is, the ILIT values after the death of the insureds is comparable initially. Note, the side fund principal in Design 1 may fluctuate as may the income therefrom.
  - ✓ The policy in Design 1 has no accessible cash value but the ILIT has a side fund of investable assets from which it pays premiums and can make funds available to its beneficiaries during life or, in addition to the death benefit, after the death of the insureds. Note, if the side fund principal, or income therefrom, becomes insufficient to pay the required premiums, additional gifts may be needed to keep the policy in force.
  - ✓ The grantor's annual tax liability on the assumed ILIT income realized in Design 1 is roughly $263,000. Note, since the income of the ILIT's assets may fluctuate over time, so may the grantor's income tax liability.
  - ✓ The projected cash value of the policy in Design 2 eventually grows to a point that causes the projected death benefit to grow from corridor "forced-ups" in order to comply with the statutory life insurance tests in IRC § 7702, thus resulting in a greater long-term value to the ILIT after the death of the insureds. Note, accessing cash value through withdrawals and/or policy loans may impact the secondary guarantee of the death benefit.
  - ✓ Because the entire gift amount was paid into the life insurance policy, the earnings in the cash value of which are tax deferred, there may be no grantor income tax liability attributable to the ILIT since no taxable income was realized therein (assumes the policy stays in force until death).
- Click here for the insureds' joint life expectancy analysis.
- Click here for the full basic illustration from Lincoln.
- Click here for Prudential.

[1] *The actual amount will depend on the balance of a donor's lifetime gift tax exemption and generation-skipping transfer tax exemption.*

[2] *The Technical and Miscellaneous Revenue Act (TAMRA) that was signed into law November 10, 1988 alters the tax treatment of distributions from certain types of life insurance policies. The law applies to all policies issued or materially changed on or after June 21, 1988. If premiums paid on such a policy are in excess of the limits established by Congress, then the policy is classified as a Modified Endowment Contract (MEC). If there is a gain in the contract, the portion of the gain included in any distribution, including policy loans, will be reported as taxable income. If a distribution occurs prior to the insured attaining 59 ½, the taxable portion of the distribution may also be subject to a 10% tax penalty. A policy that, at issue is, or later becomes Modified Endowment Contract will always be subject to MEC tax treatment. This applies even if the policy is exchanged for a new contract that, standing alone, would not be a MEC. Tax-deferred growth in cash values and tax-free death benefits are still available under a MEC.*

[3] *This is a hypothetical example that is demonstrating a mathematical principle. It does not illustrate any investment products and does not show past or future performance of any specific investment. No information contained herein can be used or construed as tax or legal advice. Additional tax and legal considerations beyond those mentioned herein may apply. Accordingly, all taxpayers should seek guidance from qualified tax and legal professionals regarding any tax and legal matters pertaining to their individual situations.*

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Life insurance contains charges that are deducted from the cash value. If the policy is a non-MEC, withdrawals of cash value are income tax free up to cost basis and any policy loans are income tax free as long as the it stays in force until death. If the policy becomes a MEC, it is always a MEC and any withdrawals or loans (including interest accrual thereon) to the extent of gain are taxable as ordinary income plus a 10% penalty if the insured is under age 59½ (If the ILIT is not a grantor trust for income tax purposes with respect to the insured, then the 10% penalty may apply all years). MECs do not affect taxation of the death benefit proceeds. Guarantees are subject to the claims-paying ability of the issuing company.

All projected values herein are hypothetical and for illustrative purposes only. Actual results will vary and may be more or less favorable than what is shown. Illustrated life insurance values may be based on non-guaranteed elements (e.g. policy charges and crediting rates) and are a supplemental illustration, not valid unless preceded or accompanied by a basic illustration from the life insurance carrier. Please refer to carrier basic illustration for important details regarding guaranteed and non-guaranteed elements and other important policy information.

Variable life insurance is sold by prospectus. Please consider the investment objectives, risks, charges, expenses, and your need for death-benefit coverage carefully before investing. The prospectus, which contains this and other information about the variable life policy and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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LION STREET®

515 Congress Ave; 25th Floor
Austin, TX 78701
(512) 776-8400
www.lionstreet.com

