



# Estate Planning

The Incentive ILIT

*Managing Wealth For Generations*



### Life Insurance Provides Cash.

For many years life insurance has been an important tool in estate planning. Well-to-do people often use life insurance to provide the cash their estates need to pay off debts and to pay federal estate taxes. They seldom own the life insurance policies themselves. Their legal and tax advisors generally suggest that they create an irrevocable life insurance trust to own the policy and receive the income tax free death benefits. Over the years these trusts have become known as ILITs. Owning the policy in an ILIT keeps the death benefits from being added to their estate and increasing their estate taxes. The ILIT trustee makes the death benefits available to the estate to pay debts and taxes by making loans to the estate or purchasing estate assets.

### Will My Family Be Spoiled?

Many well-to-do parents and grandparents have mixed feelings about their estate planning. They've worked hard to become financially independent and they don't want their money decimated by taxes or stolen away by creditors. They want to preserve and pass on the fruits of their hard work to their families. And yet they are concerned that the money they pass on to their children and grandchildren may do more harm than good. They fear that the inheritance they pass along may "spoil" some children and grandchildren by making life too easy for them. They wonder: "Should I go to the trouble and expense of preserving the value of my estate if the extra money will make them lazy?" The last thing they want is to be responsible for turning younger family members into lazy, spoiled brats.



### Give Them Incentives.

Parents and grandparents are right to be concerned about the potential negative consequences an inheritance can have on younger family members. Fortunately, an inheritance can be structured so that it acts as a positive incentive rather than a negative one. Parents and grandparents can structure an inheritance so it isn't automatic. Instead, part or all of what is passed on can be conditioned on positive action or good behavior. In other words, part of an inheritance can be held in reserve and only given to younger family members after they've "earned" it.

A parent/grandparent can draft an ILIT so that it promotes behavior or values that are important in leading a valuable, productive life. Distributions from the trust can be used to reward a beneficiary for positive action. In this way a parent/grandparent can guide children, grandchildren and other trust beneficiaries toward behaviors and actions that will improve their lives.

Trusts with these conditional distribution provisions are sometimes called "incentive trusts" or "values trusts." Any trust for younger family members can have these provisions. When an ILIT is drafted with these provisions, it is called an "Incentive ILIT." Incentive ILITs are attractive to people who want to use life insurance death benefits to encourage and reward specific life choices by children and grandchildren. They can also be used to discourage and punish other life choices.

## The Beneficiaries Make The Choices.

Conditional distribution provisions allow the trust beneficiaries to make choices. Parents and grandparents can't force a child or grandchild to live in a certain way or to have certain values. Children and grandchildren decide for themselves. Beneficiaries who choose to meet the performance standards in an Incentive ILIT will be rewarded with distributions. Those that choose not to meet those standards will not lose anything. They just won't be rewarded with a distribution. Instead, those funds will remain in the trust.

## Positive Incentives.

There are many ways an Incentive ILIT can be designed to promote positive life choices. The values and behaviors it can promote are limited only by the objectives and creativity of the parent/grandparent and the attorney who drafts the trust. Incentives like these are commonly found in Incentive ILITs:

***The Earnings Incentive*** — A grantor may not want beneficiaries to rely on the ILIT for all his/her income. They may want the beneficiaries to be out in the working world, earning their own way. The ILIT can be drafted so that a percentage of the beneficiary's earned income qualifies for a matching distribution from the trust. This can be a dollar-for-dollar match or a percentage match with a maximum ceiling.

***The Public Service Incentive*** — Jobs in non-profit organizations and government often pay less than jobs in the private sector. A grantor may believe it is important for a beneficiary to consider public service-oriented employment. The ILIT can make up for the lower salary a beneficiary will earn in a non-profit or government job. The ILIT can empower the trustee to make distributions to supplement the lower salaries of beneficiaries who choose these careers.

***The Achievement Bonus*** — Grantors can give beneficiaries incentives to achieve specific goals by directing the trustee to make a distribution when a milestone is reached. Such milestones can include: graduation from college or graduate school, earning a professional license, buying a home, publishing an article, writing a book, winning an industry award, etc.

***The Venture Capital Fund*** — Grantors may want to encourage beneficiaries to start their own businesses. If so, the trustee can be directed to make a distribution to supplement funds a beneficiary raises to start his/her own business. This could be a matching distribution with a ceiling or a fixed amount.

***The Happy Marriage Incentive*** — Grantors may want to encourage beneficiaries to marry and stay married. If so, the ILIT can make a distribution after a marriage ceremony or upon specified anniversaries (e.g. 5th, 10th, 15th, 25th, 30th anniversaries).

***The Grandchild Incentive*** — Some grantors may want grandchildren or great grandchildren. To give children a financial incentive to produce new family members, the ILIT can direct the trustee to make a single payment or a series of payments to children who have children of their own.

***The Elected Office Incentive*** — A grantor may believe a beneficiary can benefit from pursuing election to a public office. If so, the ILIT can have a provision that makes a distribution to a beneficiary who runs for election to a national, state, county or local office. This distribution could be used to pay campaign expenses or to compensate the beneficiary for time spent in organizing and running the campaign.

***The Family Reunion Fund*** — Some parents and grandparents may believe it is important for family members to get together on a regular basis. If so, the ILIT can direct the trustee to make distributions to pay the expenses family members incur in organizing private family gatherings at regular intervals.

Incentive ILITs can be designed to promote almost any behavior that parents and grandparents wish to encourage. It all comes down to two choices: (1) the choice of the older family members to make part of the transfer of his/her wealth contingent on meeting certain goals or standards and (2) the choice of a beneficiary to take advantage of the opportunity.

### **Negative Incentives.**

Parents and grandparents may also include provisions in their ILITs that can result in the loss of benefits. There are two general reasons why the ILIT's trustee might be given the power to withhold benefits. First, the grantor may wish to discourage certain behaviors and lifestyle choices the grantor believes are negative or offensive. Second, the grantor may not want a beneficiary to have the opportunity to use Incentive ILIT distributions to finance damaging, dangerous or illegal behaviors. Negative incentives could be used to halt, reduce or delay distributions to an offending beneficiary. Examples of negative behaviors that could result in the reduction, postponement or even loss of distributions include:

- † Conviction of a crime
- † Spousal or child abuse
- † Gambling addiction
- † Substance abuse
- † Professional ethical complaints
- † Divorce
- † Birth of an illegitimate child

Negative incentives that are included in an Incentive ILIT will reflect the concerns and values of the grantor. Just as positive incentives act as a "carrot" to guide beneficiaries toward positive life choices, negative incentives can act as a "stick" to direct them away from damaging life choices.

### **Grandchildren As Beneficiaries.**

It is common for Incentive ILITs to continue for many years. Some states will permit ILITs to continue far into the future to pay benefits to children, grandchildren, great grandchildren and additional future generations. ILITs that last this long are known as "Dynasty Trusts." If the ILIT is likely to pay benefits to grandchildren and even younger family members, the generation skipping transfer (GST) tax can be a concern. The GST tax is a tax that tries to discourage families from avoiding federal estate taxes by transferring funds to "skip over" one or more generations. Fortunately, every person has a generation skipping tax exemption (\$1,500,000 in 2004 and 2005). This exemption can be allocated to contributions to an Incentive ILIT so that distributions that come out of it in the future can avoid the GST tax. You will want to discuss the GST tax with your tax advisors.



### **The Incentive ILIT.**

An Incentive ILIT can be a valuable and versatile estate planning tool. It can use life insurance to provide the cash your estate will need to settle debts and pay estate tax obligations. It can also provide strong incentives to your children, grandchildren and other loved ones to lead happy, productive lives. Its distribution provisions can give them incentives to be successful, high-achieving members of society. An Incentive ILIT can add a unique, positive dimension to your estate plan and provide lifestyle guidance to younger family members for generations to come.

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