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Committee Report: Insurance

By Melvin A. Warshaw

Life Insurance Planning After the 2010 Tax Act

For some wealthy clients, there's a two-year golden opportunity to maximize enhanced funding strategies and leverage the death benefit. Don't miss out

The Dec. 17, 2010 enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act) added the concept of portability and dramatically increased the gift tax exemption to \$5 million per individual (\$10 million for married couples). (See "New Rates, New Exemptions, New Gifting Opportunities," by Douglas Moore and David A. Handler in the February 2011 issue of *Trusts & Estates*, p. 20.) For wealthy clients, the combination of the enlarged gift and generation-skipping transfer (GST) tax exemptions create exciting planning opportunities over the next two years. But what are the ramifications of the 2010 Tax Act on life insurance planning?

The life insurance needs of married couples with estates of less than \$10 million will most likely center on non-tax situations, such as funding a business buy-sell agreement, equalizing the estate among children, providing liquidity for second marriage situations or

providing for a special needs heir. The \$5 million estate tax exemption may simplify insurance ownership by reducing the complexity of planning and the need for trusts in some situations.

For very wealthy couples with estates of \$10 million or more, the reunification of the gift and estate tax exemption at \$5 million creates a potentially limited period of time to leverage the death benefits from life insurance. The ultra-wealthy will want to maximize the enhanced funding opportunities available in the next two years by making large completed gifts to irrevocable life insurance trusts (ILITs) that can leverage significant amounts of death benefit for the insured's family.

Reunification of the gift and estate tax exemptions at \$5 million makes outright gifts and larger gifts to ILITs easier to manage. Large gifts to pay premiums won't be subject to gift or GST tax. Major gifts of income-producing property can be transferred to ILITs benefitting younger generations with the income from the property used to fund premiums.

In large premium situations and for older clients, the enlarged gift tax exemption of \$5 million (\$10 million per couple) will eliminate a major hurdle previously faced by advisors of how to efficiently



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transfer money into an ILIT to fund premiums. Clients with illiquid estates can now more easily solve an estate liquidity problem by making a large gift of discounted assets to an ILIT to fund future premiums on policies that are vitally important to their overall estate plans.

New Interim Funding Paradigm

In the past, many advisors recommended that individuals first take advantage of the annual gift tax exclusion to the fullest extent possible, on an annual basis. For insureds funding ILITs, this meant that a trustee had to send timely annual *Crummey* notices to beneficiaries to grant them time-limited present interest withdrawal rights over trust property. It rarely made sense for a client to make a significant taxable gift instead of making annual exclusion gifts to ILITs.

The gift tax law this year and for 2012 now presents a possibly temporary change to the traditional ways in which clients have funded their ILITs. That's because the 2010 Tax Act increased the gift tax exemption to \$5 million for only 2011 and 2012, and there's a possible return to a lower gift tax exemption in 2013. Because of the sunset of the 2010 Tax Act provisions, advisors may encourage their wealthy clients who can afford to do so to make large gifts without incurring a tax, since the tax could reappear after 2012.¹

For example, the significantly enhanced gift tax exemption provides a combined \$10 million gift tax exemption for a husband and wife who never before made taxable gifts. If both spouses each exhausted their \$1 million gift tax exemptions before 2011, they now have an additional \$8 million of combined gift tax exemption available for at least two years.

The next two years present a golden opportunity for very wealthy individuals who need estate liquidity and seek financial security for their families. By carefully selecting both the product type and a favorable premium schedule, very wealthy individuals can lock up, in trust, for comparatively short dollars in the near-term, very significant amounts of life insurance death benefit that's guaranteed by the carriers. These individuals can leverage a large gift to an ILIT of, say \$5 million, and a portion of such gift can be used to pay life insurance premiums that will become a death benefit of perhaps five times the estimated lifetime premium payment amount, or roughly \$25 million.

Administration of ILITs that are funded with large gifts should be relatively easy because a large gift is "complete" upon receipt by the ILIT trustee. There's no need for the trustee to send out annual *Crummey* notices or engage in and monitor complicated split-dollar arrangements (through economic benefit reporting) or private premium loans (through loan interest reporting) after the policy is issued. (More on the future of split-dollar

arrangements and private premium loans later.)

Continued Use of Trusts

Despite the increased exemptions, there are many reasons why trusts will continue to be an important component in many, but not all, clients' estate plans. While ILITs are primarily used to avoid inclusion of a policy death benefit in an insured's gross estate, some of the same tax reasons why clients use trusts in their overall testamentary planning should also apply to their continued use of ILITs:

1. Absent further Congressional action, the benefits of the 2010 Tax Act will expire on Dec. 31, 2012, and the gift and estate tax exemptions will revert to only \$1 million (and the GST tax exemption will also be significantly reduced). Life insurance is a long-term asset that, when owned by an ILIT, can provide virtually certain leveraged estate liquidity in an era of current uncertainty over future transfer tax laws and uneven investment performance.
2. Use of a credit shelter or bypass trust provides an opportunity to shelter from estate tax, on the death of the surviving spouse, any appreciation of assets after the death of the first spouse. (For more information on this issue, see "Bypass the Bypass Trust?" by Deborah V. Dunn in the February 2011 issue of *Trusts & Estates*, p. 24.) So long as the estate tax isn't subsequently repealed, a surviving spouse can shield from the estate tax significant asset value appreciation

In certain states, use of a trust may save considerable state estate taxes at the death of the surviving spouse.

if the assets are held in trust after the first spouse's death.

3. The state estate tax exemption in states that now have separate estate or inheritance tax laws generally remains significantly lower than the \$5 million federal estate tax exemption. Due to the revenue shortfall of these states, it's unlikely they can afford to raise their state exemption to match the current federal exemption amount. Therefore, in these states, use of a trust may save considerable state estate taxes at the death of the surviving spouse.

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Trusts, including ILITs, continue to offer a number of non-tax benefits:

1. Trusts protect assets from claims of beneficiaries, including ex-spouses in some circumstances.
2. Trusts can provide asset and investment management expertise for a spouse and children. Professional management of assets and control of distributions may be desirable depending on a spouse's or child's age or if other circumstances warrant such professional management.
3. In a second marriage situation, trusts can provide

When life insurance is owned by an ILIT, there are no settlement costs or transaction fees.

for the second spouse while also protecting the inheritance of children from the first marriage. Often, life insurance held in an ILIT provides an easy way to ensure sufficient liquidity for a second spouse or children from the first marriage and can minimize disputes over other inherited assets.

4. Trusts avoid the cost and delay of probate. In the case of life insurance owned by an ILIT, there are no settlement costs or transaction fees and no re-titling delays incurred to reduce the asset to cash following the death of the insured.
5. Trusts allow the head of the family to retain indirect influence over a family's wealth long after that person is gone, such as in long-term trust situations extending over many generations. Wealth planners often advise very affluent insureds to establish fully discretionary long-term trusts that will benefit their currently unborn descendants. And some donors have turned to inserting beneficiary incentive language into the trust document or writing non-binding side letters addressed to the trustee to ensure that the future administration of the family wealth is compatible with the donor's intentions.
6. Some very wealthy individuals, while acknowledging the tax advantages to completing large gifts in 2011 and 2012, may be reluctant to part with \$5 million

or more of their assets. While married couples may be tempted to establish trusts for each other, advisors must carefully try to navigate around the "reciprocal trust" doctrine.²

Married couples may be better served by considering the use of a fully discretionary irrevocable trust that's designed to benefit younger family members. A donor spouse might specifically designate his non-donor spouse as a permissible beneficiary of such trust, provided that there's an independent trustee with discretion to make trust distributions. Assuming a solid marriage and no pre-arranged plan, use of the non-donor spouse as a possible indirect conduit in returning trust assets to the donor spouse in the event the family's fortunes decline, may be a sufficient safeguard for some reluctant married couples to move forward with bold gift planning in 2011 and 2012.

Side Funds

In the past, most insureds made gifts to their ILITs consisting of only enough cash to pay the current annual premium. But insureds now have a potentially time-limited (that is, two year) gift tax incentive to accelerate funding of their ILITs in amounts far in excess of the annual premium due. We may see that insureds are increasingly asking professionals with investment management expertise, such as national banks and trust companies, to serve as an ILIT trustee so insureds can be assured that excess gift proceeds are safely invested and will be available when needed for future premiums. Advisors will want to ensure that the ILIT is a grantor trust for income tax purposes, so the donor—not the ILIT—pays any tax on taxable investment income earned by the ILIT.

Moreover, frontloading large gifts to an ILIT but backloading premium payments by the ILIT to the carriers allow the trustee to hedge the insured's overall estate plan and future uncertainty of the transfer tax system. While carriers would generally prefer to receive large premiums sooner rather than later and life insurance agents are also financially incentivized to frontload premiums, the best interests (when measured by internal rate of return on total death benefit at life expectancy) of an insured purchasing a no lapse guarantee universal life (NLG UL) policy often calls for backloading (or optimizing) premium payments.

Modified Endowment Contracts

While insureds might accelerate funding of their ILITs over the next two years, ILIT trustees will need to consider the potential income tax consequences of likewise accelerating premium payments on a new policy.

Under income tax laws, a policy that's a modified

endowment contract (MEC) has potentially adverse income tax consequences during the insured's lifetime if the policyholder borrows or withdraws against the policy cash value.³ The federal tax law's definition of "life insurance" limits a policyholder's ability to pay certain high levels of premiums in the early years of a policy. If cumulative premium payments at any time during the first seven contract years exceed certain amounts specified in the Internal Revenue Code, the policy will become a MEC. While the tax treatment of the death benefit remains income tax-free, withdrawals and policy loans drawn against policy cash value during the insured's lifetime will generally be subject to less favorable income tax treatment than policies not categorized as MECs.

In enacting the MEC rules, Congress denied lifetime tax-free access to policy cash value if there are accelerated, front-loaded premium payments on the contract that make it look more like a traditional portfolio investment. Whether to structure a new life insurance contract as a MEC at inception depends on the insured's financial circumstances and potential need for lifetime access to the policy cash value in the future.

For most affluent insureds who may want to retain the flexibility of tax-free lifetime access to policy cash value, their advisors will want to ensure that the premium payments on a new policy are paid over at least 8 years (or such shorter periods as the carrier confirms) to avoid MEC status. Ultra-affluent insureds who have ample other personal financial assets to maintain their current lifestyle typically aren't worried about lifetime access to policy cash and can tolerate MEC status.

Product selection can also play a critical role in planning for lifetime access to policy cash value. For most affluent insureds who want tax-free lifetime access to policy cash value, purchase of either a current assumption universal life (UL) or variable universal life (VUL) policy with meaningful cash value accumulation may be appropriate. For very affluent insureds, purchase of an NLG UL policy, offering a long-term trade-off of reduced premiums for relatively low cash value, may be appropriate.

Split Dollar, Private Loans

In the past, large premium policies owned by ILITs were funded on an interim basis by relying on some combination of split-dollar arrangements (that is, any arrangement between the owner of a life insurance contract and a non-owner of the contract under which either party to the arrangement pays all or a portion of premiums, with one of the parties paying the premium entitled to recover all or any portion of those premiums and such recovery is to be made from or secured by the proceeds of the contract⁴), and/or premium loans advanced by the insured (or perhaps an employer). Since final regu-

lations were adopted in 2003, insureds have been able to leverage large gifts to ILITs while minimizing their annual tax reporting costs.

During 2011 and 2012, insureds will be able to finance large premium amounts through large, simple completed gifts to an ILIT. As a result, advisors to insureds who insist on simplicity can be expected to forego adopting new split-dollar arrangements and private loan programs in large premium situations

Split-dollar arrangements and private loan programs are complex interim funding strategies that insureds and their advisors may want to avoid in 2011 and 2012.

during the next two years. Large completed gifts to ILITs are far easier for insureds and ILIT trustees to manage.

Split-dollar arrangements and private loan programs are complex interim funding strategies for large trust-owned policies that require significant monitoring after the policies are issued. Among the reasons insureds and their advisors might want to avoid this complexity in 2011 and 2012 are:

- A well-conceived loan or split-dollar program is interim financing that requires early implementation of an exit strategy (such as a grantor retained annuity trust (GRAT) or sale) to eventually repay the premium advances.
- While annual economic benefit reporting costs are very attractive for younger and middle-aged individuals, especially for survivorship policies, following the death of the first co-insured, the annual economic benefit reporting costs can rise dramatically for the surviving spouse.
- If a non-guaranteed policy is in an "equity" position because cash value exceeds premiums paid when a split-dollar arrangement plan is terminated, under Notice 2002-8, the Internal Revenue Service takes the position that there will be income, gift and possibly GST tax consequences for the policyholder.

- Each premium advance is considered a separate loan under the final split-dollar loan regulations, and the insured's attorney needs to prepare a separate written loan agreement for each premium advance.
- Once low interest rate loans are in place, advisors must constantly monitor the interest rates on many of these loans prior to their maturity and consider refinancing such loans before maturity if interest rates begin to rise.

The \$5 million gift and GST tax exemptions provide a unique opportunity to complete the funding of a “dynasty trust” designated as an ILIT.

For insureds who can tolerate complexity, however, split-dollar arrangements or private loan programs offer the opportunity to leverage the gift and GST tax laws.

Of course, clients who previously undertook split-dollar arrangements or private loan programs may never have gotten around to implementing an exit strategy, or if they did implement it, the designated underlying asset may have failed to appreciate as envisioned. For these clients, there's now a two-year window during which to make a large gift to an ILIT and complete the exit strategy for the prior premium advances, thereby unwinding their split-dollar arrangements or private premium loans.

Dynasty Trusts

The \$5 million gift and GST tax exemptions available in 2011 and 2012 provide a unique, but possibly time-limited opportunity to complete the funding of a so-called “dynasty trust” designed as an ILIT. By leveraging large premium amounts into much larger death benefit amounts through the purchase of life insurance, a very wealthy insured can provide future liquidity and virtual financial certainty for younger generations.

Let's assume that a very affluent married couple, each spouse 65 years old, previously used up their respective \$1 million gift tax exemptions. Assume the couple is in good health and a major portion of their net worth is tied up in an illiquid family business or in real estate investments. The couple is prepared to contribute a total of \$5 million to a new dynasty trust (an ILIT) in 2011 and 2012. The ILIT trustee will hold any gift pro-

ceeds not needed to pay current-year premiums inside the trust in a “side fund” that's conservatively invested to ensure preservation of principal that can be earmarked for future premium payments.

How much survivorship death benefit will the \$5 million of premiums buy? What's the impact of product selection? What if the insureds are in excellent health and are eligible for preferred (or better) medical underwriting by the carrier? Let's take a look.

In designing survivorship policies to be held in a dynasty trust on the lives of very affluent insureds, cash value accumulation is often not a relevant consideration. The choice of product type often comes down to whether the co-insureds want the carrier guarantees found in an NLG UL product (now available, let's say, to about age 105 or lifetime). With NLG UL policies, the carrier bears all future investment and mortality risk following the issuance of the policy; however, there's no upside potential for increased death benefit and cash value accumulation. Diversification across top-rated carriers is a virtual necessity for a portfolio of ILIT-owned NLG UL policies. If the co-insureds want the flexibility of potential increased death benefit amounts and the ILIT trustee is willing to bear all investment risk as to how the carrier invests the premiums, a current assumption UL policy can be designed to project a \$1,000 cash value at age 105 or longer.

A portfolio of 4-pay non-MEC survivorship policies (held by an ILIT) calling for \$5 million of premiums (that is, policies for which a total of \$1.25 million is paid in each of the first 4 years) would produce different death benefits for the couple, depending on the product type and whether they're standard or preferred underwriting. (See “Survivorship Death Benefits,” page 5.)

While the 4-pay policies in “Survivorship Death Benefits” wouldn't be classified as MECs, for co-insureds looking to maximize death benefit—and assuming they have sufficient current personal cash and can tolerate MEC status—why not consider a “2-pay” policy (that is, \$2.5 million of premiums paid in the first two years: each of 2011 and 2012)? (See “Even Better,” page 5.)

For very wealthy insureds who want to retain the lifetime flexibility of tax-efficient access to policy cash value, the same \$5 million of premiums dedicated to a type of UL life insurance product will result in a substantial reduction in death benefit. The co-insureds could recoup the \$5 million of premiums paid beginning in policy year 7, but a standard underwriting would yield a death benefit of only \$16.2 million, while a preferred underwriting would yield a death benefit of \$18.6 million, well below the death benefit levels available in minimal cash value NLG UL or UL policies. (See “Trade-offs,” page 7.)

Use of Discounted Assets

Some affluent insureds who want to leverage valuation discounts in large gifts made to an ILIT in 2011 and 2012 may want to consider combining a gift of cash/marketable securities with the use of either a GRAT or sale to grantor trust strategy utilizing discountable assets. Some clients may be unwilling to commit \$5 million of cash to an ILIT that provides long-term benefits to family members. These clients might prefer combining in 2011 and 2012, say a \$2.5 million gift of cash/marketable securities with a GRAT or sale to the ILIT funded with discountable assets that are expected to generate \$2.5 million of cash in the future. The initial gift of cash/marketable securities might cover near-term premium payments, while the cash from successful liquidity events in which a GRAT or ILIT participates could cover premiums due, say five or 10 years from now. The 2010 Tax Act made no changes in the valuation discount rules previously in effect.

Ultra-wealthy insureds who wish to leverage both their gift and GST tax exemptions in 2011 and 2012, rather than make large completed gifts in trust of cash/marketable securities, may find that a sale to an ILIT (which is a grantor trust) in exchange for note transaction has more tax leverage opportunity than in the past. The increase in the GST tax exemption to \$5 million (\$10 million for married couples) enhances the viability of a sale to trust for note transaction by maximizing both the gift and GST tax-exempt funding

of a dynasty trust. GST tax exemption can be allocated up front to the initial gift to an ILIT, prior to sale, to ensure a zero inclusion ratio for such a large ILIT.

In the past, when the lifetime gift tax exemption was \$1 million, a common concern with a sale to trust for note transaction was how to get the initial gift into the ILIT without paying gift tax by exceeding \$1 million. The rule of thumb among advisors in pre-funding ILITs prior to a sale for note transaction is that the amount sold should be no more than 10 times the amount of the initial gift. The increase in the gift and GST tax exemptions to \$5 million (and up to \$10 million for married couples) for at least two years should allow for much larger initial gifts that can leverage much larger sale transactions. A \$10 million initial gift made in 2011 or 2012 should now support a \$100 million sale to ILIT for note transaction.

While the 2010 Tax Act didn't impose a 10-year minimum term for a GRAT (as was proposed earlier in 2010), a GRAT should continue to be an effective "estate freeze" strategy. Naming the ILIT as the remainder beneficiary of a GRAT program involving a series of rolling, 2-year GRATs may squeeze enough appreciation from a volatile publicly traded asset to fund a non-exempt ILIT. The ILIT, however, wouldn't be exempt from GST tax, unless the exemption was allocated to the ILIT after the GRAT term ended. [ii](#)

Survivorship Death Benefits

Product selection and the co-insureds' health impact payout

Assumes a 4-pay, non-modified endowment contract policy calling for \$5 million in premiums

If "Standard" Underwriting

Product Type	Death Benefit
Universal Life	\$19.3 million
No Lapse Guarantee	\$22.3 million

If "Preferred" Underwriting

Product Type	Death Benefit
Universal Life	\$25.1 million
No Lapse Guarantee	\$27.0 million

— Melvin A. Warsaw

Even Better

Co-insureds with enough cash and a tolerance for MEC policy status often get higher death benefits

Assumes a 2-pay, modified endowment contract policy calling for \$2.5 million in premiums

If "Standard" Underwriting

Product Type	Death Benefit
Universal Life	\$20.3 million
No Lapse Guarantee	\$23.1 million

If "Preferred" Underwriting

Product Type	Death Benefit
Universal Life	\$26.3 million
No Lapse Guarantee	\$28.1 million

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Endnotes

1. Individuals considering gifts in 2011 and 2012 should be made aware by their advisors that, because of the way federal estate tax liability is calculated, a portion of the benefit of sheltering lifetime transfers under the current \$5 million gift tax exemption, could be “recaptured.” If the estate tax exemption is reduced in 2013, concerned advisors suggest that the estate tax on the remaining portion of the estate may be higher than it would otherwise have been had the gifts in 2011 and 2012 not been made. Less concerned advisors take the position that taxable gifts aren’t part of the gross estate and, pursuant to the Form 706 instructions, they’re just part of the estate tax calculation procedure to tax an estate in the highest marginal bracket considering lifetime gifts. These less concerned advisors believe Congress didn’t intend a result in which there’s a clawback or recapture of additional estate tax. They contend that clawback or recapture is beyond the purpose of Internal Revenue Code Section 2001(b). For example, Jerome M. Hesch of Miami’s Carlton Fields stated his view in a Feb. 10, 2011 BNA webinar, that Congress would have to rewrite the law to get a clawback of gifts in excess of lifetime transfer credit lower than \$5 million. “It would probably be a political nightmare,” Hesch said. See “Tax Clawbacks a Myth, Practitioner Says,” *Tax Notes Today*, 2011 TNT 29-5 (released Feb. 11, 2011).

The current technical glitch may be fixed before 2013. Even if the glitch isn’t fixed in the next couple of years, in most circumstances it will still have made sense to have taken advantage of the increased gift tax exemption under the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

2. Advisors considering recommending that each spouse establish a trust for the other spouse must be very careful to avoid the “reciprocal trust” doctrine. In *United States v. Grace*, 395 U.S. 316 (1969), “A” created a trust for “B” and simultaneously “B” created a trust for “A.” The U.S. Supreme Court held that if two trusts have substantially identical terms and are interrelated, the trusts will be uncrossed and each person will be treated as the donor of the trust for his own benefit. In *Grace*, the trust terms were identical, the trusts were created at the same time and the trusts were of the same initial value. However, if the terms of the two trust aren’t substantially identical, the reciprocal trust doctrine doesn’t apply. *Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983). In *Levy*, one trust gave a broad inter vivos special power of appointment to the current beneficiary, and the other trust didn’t. In Private Letter Ruling 200426008, the Internal Revenue Service apparently accepted the distinction in trust terms in *Levy*. Advisors must focus on granting different powers to the beneficiaries of each trust, such as granting a lifetime or testamentary broad special or limited power of appointment or five-and-five withdrawal powers to the current beneficiary of one trust but not to the current beneficiary of the other trust. The donor of each trust might name different classes of remainder beneficiaries, fund each trust at different times and transfer materially different amounts to the trust benefitting the other person.

3. For a modified endowment contract (MEC), IRC Section 72(e)(10) makes IRC Section 72(e)(2)(B) applicable, so that the amount received from a policy loan or withdrawal is first treated as ordinary income on the contract to the extent it doesn’t exceed the untaxed gain in the policy at the time of distribution. That is, the amount received by the policyholder on a policy

Trade-offs

A cash accumulation type universal life product allows future tax-efficient access to policy value, but provides lower death benefits

Assumes insureds want to recoup \$5 million in premiums paid, beginning in policy year 7

If “Standard” Underwriting

Product Type	Death Benefit	Cash Value (Year 7)
Universal Life	\$16.2 million	\$5.2 million

If “Preferred” Underwriting

Product Type	Death Benefit	Cash Value (Year 7)
Universal Life	\$18.6 million	\$5.2 million

— Melvin A. Warshaw

loan or withdrawal is first includible in gross income to the extent of gain, and only after all gain has been taxed are distributions considered as coming from the cost basis. This last-in, first-out method of taxing applies to distributions from a MEC contract. In addition, a 10 percent penalty is applied to all distributions under a MEC policy that occur before the insured is age 59 1/2. On distributions in the form of loans and withdrawals under a non-MEC contract, however, IRC Section 72(e)(5)(E) provides a different tax treatment. The distributions received from a non-MEC contract are includible in gross income, but only after cumulative lifetime distributions exceed the cost basis. This is the first-in, first-out method.

4. Treasury Regulations Section 1.61-22.

5. An especially effective way to maximize the use of the generation-skipping transfer (GST) tax exemption is for an individual to create a so-called “dynasty trust” that’s intended to last for the maximum period permitted by law. Assuming normal life expectancies, in most states such a trust created by an individual could be expected to last nearly 100 years. A number of states now permit perpetual trust terms. During the existence of the trust, trust property is available for the donor’s descendants in the discretion of an independent trustee. There will be no gift, estate or GST tax imposed on the trust property during the term of the trust.