"Transfer Tax and Life Insurance Planning in 2011 – 2012"

By

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In addition to staving off the reversion to pre-2001 rates and exemptions, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010") made several enhancements to our transfer tax system. Part I of this article is a discussion to build a common understanding on what TRA 2010 does and does not address. Part II contains a more comprehensive examination of some of the many planning opportunities that exists, with a focus on planning with new or existing life insurance.

PART I
What TRA 2010 Does, and Doesn't, Address

I. Observations about Portability

A. A New Concept. Portability, or the ability for the first estate to transfer unused estate and gift tax exemptions to a surviving spouse, was introduced. We have not seen it before in our transfer tax system, and it has received a lot of publicity (who by now hasn't heard of DSUEA – deceased spousal unused exemption amount?). As may not be surprising, this first effort contains some bugs, yet portability could have major significance due to the increase in the gift and estate tax exemption to $5 million.

B. Limited Applicability; Limited Duration. Portability is available for estate and gift tax exemptions, but not the GST exemption. Also, like all of the transfer tax provisions of TRA 2010, portability expires after 2012. Interestingly, the Administration's 2012 Budget seeks to make portability permanent, but without further law, it evaporates at the end of 2012. Thus, many drafting attorneys are unwilling to rely on portability as the cornerstone feature in planning documents. There has been debate over the future of credit shelter trusts, but for the most part, practitioners are being cautious before eliminating them for most clients.

C. Must be Timely Filed Estate Tax Return and Election Made by Executor of Predeceased Spouse's Estate. The executor of the first spouse's estate must file an estate tax return on a timely basis and make an election on that return to permit the surviving spouse to receive the first-to-die's DSUEA. This is true even if there is no other cause to file a 706. In such cases, a determination will need to be made by the executor whether as a fiduciary to expend the effort and resources (that might otherwise flow to someone other than the surviving spouse) to prepare and file the return.

D. Only the Last Deceased Spouse's Unused Exemption Amounts Applies. Only the most recent deceased spouse's unused exemption can be used by the surviving spouse. Thus, remarriage introduces complications. For example, if H1's DSUEA passes to W, and W remarries and survives H2, H1's DSUEA is wasted - a good reason for W to consider making gifts during the second marriage to use H1's DSUEA.

E. Use or Lose Concept (To Eliminate Risks of a Subsequent Remarriage or Future Reduction in Gift/Estate Tax Exemption Amounts). As just noted, a surviving spouse of a decedent dying in 2011 or 2012 should consider using the deceased spouse's unused exemption with gifts, especially if the surviving spouse remarries or in case the surviving spouse passes in a year in which the exemptions are lower. Clawback is addressed below.

F. New Estate Plans May Increasingly Rely on Disclaimer Trusts. Due to the uncertainty of future estate tax laws, some lawyers are also employing disclaimer planning to maximize the tax savings in first marriage situations.

G. QTIP Trusts in Combination with Disclaimer (Family or Bypass) Trusts. If the surviving spouse is a beneficiary of the Family or Bypass Trust, consider a double disclaimer by the surviving spouse first from the QTIP Trust (of which the surviving spouse is the sole beneficiary) to the Family or Bypass Trust and a second disclaimer of the surviving spouse's interest in the Family or Bypass Trust, to take advantage of the enlarged exemption amounts.

H. Other Issues. There are other issues, including some inconsistencies between the statutory language and the Joint Committee Explanation of the act (especially, example 3), including privity. The issue here is easily framed by an example. H1's exemption to W, W remarries H2 and W passes, H2 cannot receive any of H1's DSUEA. The sub-issue is if W made gifts, could she use H1's exemption before her own? Apparently she could not, according to the Committee explanation.

I. Non-Tax Reasons Continue for the Use of Trusts. Removing future appreciation, asset protection, special needs planning, disability planning, planning for the investment management of assets, charitable planning and estate equalization among heirs are several non-tax reasons that even mass affluent clients will continue to rely on the use of trusts in their planning.

II. Reunification of the Gift and Estate Tax Exemption for Two Years Creates Many Immediate Planning Opportunities, Especially for Very Wealthy Clients

A. Clients May Be Very Interested in Sophisticated Estate Planning. Clients, especially those with very significant net worths, have an enormous (possibly temporary) opportunity to do transfer planning taking advantage of the $5 million gift and GST tax exemptions.

i. There is no assurance Congress will extend the $5 million exemptions beyond 2012.

ii. Future growth in value of assets will be removed from the donor's estate.

iii. TRA 2010 did not prohibit the traditional planning strategies currently in use, such as direct gifts, short term GRATs, sales to grantor trusts, or general valuation discount planning. NOTE: Just because TRA 2010 did not prohibit them, this doesn't mean Congress cannot pass tax legislation to do so. In fact, the Administration's 2012 Budget mentioned above also seeks to have imposed a minimum 10 year term on GRATs and prohibit valuation discounts on intra-family transfers.

iv. What may be possible to give, may be more than prudent. Even wealthier clients may feel more uncomfortable in making gifts fully using their exemptions.

B. "Clawback". If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift tax exemption amount, it is not clear how the estate tax calculation will be interpreted. In other words, if an individual makes a gift of the $5 million gift tax exemption amount, and later dies after the estate tax exemption has been reduced to a lower amount, will estate tax be payable on the "excess" amount? There is no clear answer, but many advisors believe there isn't an issue and if there might be, a technical corrections bill will resolve the situation. Further, staffers on the Joint Committee on Taxation indicate that was not intended, and also suggest that this will be clarified by future legislation.

Advisors should be aware of the possibility of the additional estate tax, but should not overemphasize the fear of it because in general the combined estate/gift tax would not be greater than if no gift were made in the first place.

- Even if the "clawback" applies, the estate will not pay more taxes as a result of making the gift than if the gift assets had been retained unless the gift assets were to decline in value or unless gift taxes are actually paid at higher rates than the estate tax rate.
- An issue that may be of concern arises if the gift was made to persons different from the residuary beneficiaries. In that case, the residuary beneficiaries may end up paying the additional estate tax with respect to assets that have passed to the donees.
- If the estate would otherwise pass to a surviving spouse or charity, the additional tax expands because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax hit. Even in that case, while there may be estate taxes payable at the first spouse's death, those same taxes would have been payable if the gift assets had been transferred to the gift donees at the first spouse's death.

The recapture/clawback estate issue discussed above can also arise in the context of gifts using the surviving spouse's "deceased spousal unused exemption amount." If the spouse later remarries and the subsequent spouse dies, with less exclusion, the spouse will not have as much DSUEA for estate tax purposes as when the gifts were made, so the exclusion amount for estate tax purposes will be less than for gift tax purposes when the gifts were made. This may result in additional estate taxes being due at the donor's death. The clawback issue in this context may be resolved differently than in the context of making gifts under a larger gift exemption than the estate exemption that exists at the donor's death.

III. Other Planning Techniques

A. Carried Interests and Business Buy-Sell Arrangements Under Chapter 14. TRA made no changes to any of the prior provisions in Chapter 14 that impacts carried interest planning and buy-sell agreements among other items.

B. GRATs. Ultimately, Congress made no change in the minimum term required for a new GRAT. While the 7520 rate has inched up in the past few months, short-term and rolling GRAT programs should remain popular.

C. CLATs. Similarly, the relatively low interest rates should be an incentive for charitably-minded donors to establish CLATs.

D. A Possible Twist on Intra-Family Loans. While in the past, many wealthy donors loaned significant amounts of money to heirs or grantor trusts for heirs to take advantage of the low AFR rates and the opportunity to arbitrage the expected investment return on the assets given away.

i. Now, lenders involved in a prior intra-family loan transaction may want to consider forgiving some part or all of the entire loan balance, treating the amount forgiven as a gift and relying on the increased gift / GST tax exemptions.

ii. What about a "net gift" arrangement under which the donee agrees to pay any gift tax from the loan forgiveness if the gift exceeds $5 million? (Reduces the effective gift tax rate to about 25.9%). A gift forgiving the unpaid loan balance should not be debt cancellation income to the donor even if the donee is not a grantor trust as to the lender/forgiver. However,

be careful that the net gift agreement won't give the IRS a resource to pay a tax liability for an insolvent estate should "clawback" in fact apply.

E. Sales to Grantor Trusts Compared to GRATs. Sales to grantor trusts have various advantages, especially that GST exemption can be allocated to the grantor trust at the outset so that all appreciation in trust is also forever GST exempt.

i. GST exemption cannot be allocated to a GRAT until the end of the retained annuity term.

ii. The leverage opportunities from a sale transaction have increased, since a $5 million pre-sale gift to a trust should support a $50 million sale (applying the generally accepted 10:1 debt to equity rule of thumb).

iii. The hurdle rate in a sale utilizing a mid-term AFR rate is lower than the 7520 rate required in a GRAT.

iv. Mortality is a consideration in a GRAT as the donor must be alive when the GRAT expires for such strategy to completely succeed, whereas a sale will completely succeed even if the seller dies shortly after the sale is completed (and assuming all the bona fides of the sale are adhered to).

F. Equalize Gifts Among Children and Grandchildren. It is now possible to use the additional gift exemption amount to equalize gifts among children or among grandchildren. For example, perhaps grandparents began annual exclusion trusts for grandchildren, but then more grandchildren are born after one grandparent has passed. The younger grandchildren thus may be receiving half of the gifts the older ones received when they were young. Consider doing a present value computation to determine how much more should be added to hopefully equalize the purchasing power at a future date.

Part II

Planning Opportunities, Especially with Life Insurance

I. Divergence of Planning Opportunities for Next Two Years Depending on Client Net Worth

A. Mass Affluent Couples (Estates Below $10 Million). The $10 million combined estate tax exemption available for 2011 and 2012 to mass affluent couples will most likely cause them to focus their wealth transfer planning on non-tax considerations. From a life insurance perspective, they will focus on situations such as funding a buy-sell agreement, equalizing inheritances among children, providing liquidity at death to a second marriage situation or providing for a special needs child or grandchild.

B. Very Wealthy Couples (Combined Estates Well Above $10 Million). The reunification of the gift and estate tax exemption at $5 million – for at least two years – and the increase of the GST exemption to $5 million creates a potential time-limited window of opportunity to make large simple completed gifts to an irrevocable life insurance trust (“ILIT”).

II. New Interim Funding Paradigm for ILITS?

A. Prior Custom Was to Rely on Annual Exclusion Gifts and *Crummey* Notices to Fund Premiums Annually. In the past, most advisors recommended that every year individuals take advantage of the gift tax annual exclusion, to the fullest extent possible, to fund annual premiums due by ILITs. This meant that the ILIT trustee had to send timely annual *Crummey* notices to beneficiaries to grant them time-limited withdrawal rights over trust property. It rarely made sense to pass up annual exclusion gifts to make a significant taxable gift to an ILIT because of the $1 million lifetime gift tax exclusion.

B. Temporary 2-Year Change in Funding Approach for ILITs? There may be a temporary shift in the preferred funding paradigm for ILITs, especially for large ILIT-owned life insurance premiums due on significant trust-owned portfolios. Due to the sunsetting of the TRA 2010 provisions after 2012 – and a possible return to the 2001 gift tax exemption amount of $1 million in 2013 – advisors may want to encourage wealthy clients to explore funding options for large ILIT-owned policies to consider making large front-loaded taxable gifts to their ILITs (assuming they can afford to do so).

C. Large Gifts to ILIT are Simple. Once the ILIT trustee accepts a large taxable gift made by the insured to the trust, the gift is complete. There is no need to send out *Crummey* notices. Non-professionals might assume the role of ILIT trustee if they could administer an ILIT without the need to annually send out *Crummey* notices. There would be no need for an ILIT trustee to engage in or monitor complicated split-dollar agreements or private premium loans to the ILIT.

III. Continued Use of Trusts

Despite the increased transfer tax exemptions, there are many reasons why trusts will continue to be important to a client's estate plan.

A. <u>Some Tax Reasons to Continue to Use ILITs and Other Trusts</u>.

i. Absent further Congressional action, the benefits of TRA 2010 expire after 2012. Life insurance is a long-term asset that, if owned by an ILIT, can provide virtually certain estate liquidity in an era of tax uncertainty.

ii. Use of a traditional credit shelter or bypass trust provides an opportunity to continue to shelter from estate tax at the surviving spouse's death any estate tax on the appreciation in value of assets after the death of the first spouse.

iii. The state estate tax exemption in states that now have separate state estate tax or inheritance tax laws generally remain significantly lower than the current $5 million federal estate tax exemption. It is unlikely that these states can afford to increase their state exemptions to match the increased federal estate tax exemption. In these states, use of a trust may save considerable state estate taxes at the surviving spouse's death.

B. <u>Some Non-Tax Reasons to Continue to Use ILITs and Other Trusts</u>

i. Trusts can protect assets from claims of beneficiaries (possibly ex-spouses).

ii. Trusts can provide asset and investment management expertise for a spouse and children through professional expertise.

iii. In second marriage situations, trusts can provide for the second spouse while also protecting the inheritance of children of the first marriage.

iv. Trusts can avoid the cost and delay of probate. In the case of life insurance owned by an ILIT, there are no settlement costs or transaction or retitling delays incurred to reduce the asset to cash following the death of the insured.

v. Trusts allow the senior generation to retain indirect influence over their descendant's wealth long after the matriarch or patriarch is gone. Wealth advisors often encourage very affluent individuals to establish fully discretionary trusts, utilizing an independent trustee that will benefit currently unborn descendants. Some donors striving for future flexibility in administering these trusts have inserted beneficiary incentive language into the trust document itself or periodically write non-binding side letters to the trustee to ensure the trust is administered consistent with the donor's intent.

C. <u>Hedging The Gift Tax Laws: Rainy Day Funds?</u>

i. For mass affluent couples unsure of whether they will ever need access to large gift proceeds in the future, there are several techniques available. A donor might consider establishing a "rainy day" fund with a large taxable gift made in 2011 or 2012 and name the non-donor spouse as a permissible beneficiary. If the trust's distribution powers are limited to an "ascertainable standard," the non-donor spouse could be the trustee. Some have suggested that each spouse contribute assets to new trusts that benefit the other spouse initially. These trusts must not be considered to be "reciprocal trusts" (i.e., the terms of each trust must be materially different). Another approach is for a donor to establish a trust in a state that has adopted a self-settled spendthrift statute, naming him or herself as a permissible beneficiary with an independent trustee. So long as creditors of the donor cannot reach the trust assets, the gift to the trust should be considered to be complete for gift tax purposes.

ii. For very wealthy couples, there is presumably less financial need to design a rainy day fund which the non-donor spouse might access during his or her lifetime. Nevertheless, even very wealthy individuals establish a trust that allows a trust protector to add the non-donor spouse as a permissible beneficiary if the family's financial fortunes decline in the future. So long as there is no pre-arranged plan and there is a longstanding durable marriage, the non-donor spouse could be a conduit in indirectly returning trust assets to the donor spouse.

IV. Side Funds

A. Front-loading Gifts to ILITs and Back-loading Premium Payments Due Carriers. An individual can put in place today a large portfolio of permanent ILIT-owned life insurance and hedge whether to continue to fund the program in the future. The insured could make a simple large taxable gift to the ILIT in 2011 or 2012 but backload or optimize premium payments on certain types of products (such as no lapse guaranteed universal life ("NLG UL" policies)). Until significant premiums are due many years after the large gifts are made to the ILIT, the ILIT trustee can conservatively invest the excess gift proceeds for future use by the family. If the insured decides in the future not to continue the life insurance program, or decides to downsize the extent of coverage due to the ultimate success of other well-known estate freeze strategies, the excess gift proceeds and investment income can be redeployed for non-insurance needs.

B. Back-loading of Premiums Produces Superior IRRS and Reduces NPV Costs of Coverage. While carriers prefer receiving more premiums earlier and most insurance products reward agents for maximizing first year premiums, the best interests of most insureds are to back-load beyond life expectancy significant premium outlays. (Note that back-loading, optimizing or stepped increases in premiums can only be used with a universal life or variable universal life type of product, not with a whole life policy). When measured by internal rate of return ("IRR") and net present value ("NPV"), the back-loading of premiums can often lock up the maximum amount of current coverage for the smallest current outlay.

V. Modified Endowment Contracts (MECs)

A. The Dilemma. While insureds should consider accelerating funding of their ILITs in the next couple of years, they must also consider the potential adverse income tax consequences of likewise accelerating premium payments on a new policy.

B. Limits on Lifetime Tax-Free Withdrawal against Policy Basis or Policy Loan Distributions If Policy Is Considered a MEC on Issuance. The federal tax law defines life insurance for tax purposes. This definition limits a policyholder's ability to accelerate funding of the policy. If cumulative premiums paid during the policy's first seven years are too large in relation to the death benefit the policy will be categorized as a MEC. If a policy is labeled a MEC, all lifetime amounts received from a policy loan or withdrawal are first treated as ordinary income to the extent the distribution does not exceed the gain on the policy at the time of such distribution. In effect, a MEC is taxed under the "last in, first out" method. A non-MEC policy continues to be taxed under the "first in, first out" method applicable to a traditional level-funded life insurance policy, with the result that the first dollars distributed during the insured's life will be tax free.

C. MEC Status Has No Adverse Income Tax Consequences for Death Benefit. Even if a policy is categorized as a MEC, the death benefit – like a non-MEC – will not be subject to income tax (so long as the "transfer of value" rules were not violated during the insured's lifetime).

D. Product and Client Profile Can Impact MEC Risk Tolerance. In the case of most NLG UL policies, there is very little practical opportunity to receive a lifetime distribution of a policy loan or withdrawal against policy cash value because such action would likely seriously jeopardize the continued viability of the policy. Moreover, very wealthy clients with no need for lifetime access to policy cash value can tolerate MEC status because they will never request a lifetime distribution from the policy cash value.

VI. The Future of Split Dollar Arrangements and Private Loans

A. Split Dollar Arrangements and Private Loan Programs Are Complex Interim Funding Strategies, but Offer Unparalleled Transfer Tax Leverage Opportunities. Previously, large premium policies owned by an ILIT were funded on an interim basis by relying on some combination of a split dollar arrangement and/or private loan program funded by the insured. As noted above, during 2011 and 2012, insureds will be able to fund large premium amounts through large, simple taxable gifts to an ILIT.

B. Reasons to Discontinue Split Dollar and Private Loans.

i. Both techniques require early implementation of an exit strategy because both are “interim” funding approaches, so GRATs and sales to grantor trusts must be undertaken early on by the insured to eventually unwind these large premium advances.

ii. Following the death of the first insured in a second to die survivorship policy, the annual economic benefit cost of reporting for the surviving spouse will rise dramatically.

iii. If a non-guaranteed policy is in an “equity” position (because policy cash value exceeds premiums paid) when a split dollar arrangement is terminated during the insured’s life, under IR Notice 2002-8 the IRS can be expected to assert that there will be current income, gift and possibly GST tax consequences for the policyholder.

iv. Each premium advance is considered a separate loan under the final split dollar loan rules, and a separate written loan agreement should be executed for each premium advance each year.

v. Once low interest rates are in place by relying on historically low AFR rates for the months the loans were made, advisors must constantly monitor the interest rates on these loans prior to their maturity. Advisors will want to consider refinancing such split dollar loans before maturity if interest rates do decline.

C. Large Gift to ILIT to Unwind Spilt Dollar or Large Gift Forgiving Loan Balance. Some donors may decide to capitalize on the current $5 million gift and GST tax exemptions by unwinding their current split dollar or loan programs. In unwinding a loan program, the donor might simply cancel the outstanding loans of the ILIT by applying some portion of his or her $5 million exemption with no out-of-pocket exchange of money. In unwinding a split dollar arrangement, the same result should be obtained.

D. Reasons to Continue Split Dollar Arrangements and Private Loan Programs. The major reason to tolerate the administrative complexity associated with a split dollar arrangement or private loan program is the enormous tax leverage available to a donor-insured. The current measure of the gift for both gift and GST tax reporting purposes is either the annual economic benefit cost, using either the IRS Table 2001 rates or possibly a carrier's slower term rates if available, or the annual interest on all outstanding loans.

i. For survivorship policies where both insureds are alive, the annual economic benefit costs used to measure the gift are initially relatively nominal but these costs do rise as the insureds grow older. At some point, when the insureds are in their 70s and 80s, it may be preferable to convert a loan program to minimize current tax reporting costs. (This is known as "switch dollar").

ii. In dynasty trusts designed to benefit multiple generations, the ability to leverage both gift and GST tax reporting cost of coverage at a fraction of the overall annual premium outlay provides additional incentive to adopt a split dollar arrangement or private loan program.

VII. Dynasty Trusts and Leveraging the Death Benefit.

A. Combining a Large Gift with Maximizing the Death Benefit. A married couple that is committed to taking advantage of the two-year window in the transfer tax laws by making a large gift to an ILIT in 2011 and 2012 may be able to leverage say, $1 million of premium payments into perhaps $5 million of death benefit (assumes co-insureds ages 65/65 in good health). For very healthy insureds who qualify for preferred underwriting, they may be able to obtain even larger amounts of death benefit.

B. Tradeoff is Policy Cash Value. For married couples wishing to maximize the estate liquidity (death benefit) amount they should seriously consider purchasing NLG UL products held by a long-term dynasty trust. In this circumstance, the insureds must forego lifetime access to policy cash value. Another type of product that may be beneficial in maximizing death benefit is current assumption UL with an underlying guarantee to a prescribed age of say 90 or 95. For clients who insist upon having lifetime access to policy cash value during their retirement, the trade-off is a reduced death benefit. A cash accumulation type of universal life policy would be appropriate, but in order to build up cash value in the policy by the 10th policy year, the amount of pure death benefit coverage must be reduced.

VIII. Discounted Assets

A. A Combination of Discounted Assets and Cash Can Be Used to Fund an ILIT. Some very affluent insureds wish to maximize the leverage available from a valuation discounted gift made to an ILIT. For these clients, they might consider combining a gift of cash/marketable securities with a gift of discounted assets to the ILIT. The cash contributed to the ILIT could be earmarked for premiums due in the near-term. So long as the discounted asset participates in a successful interim liquidity event, the ILIT would be able to use such sale proceeds to cover significant long-term premiums.

B. Large Sales to a Grantor Trust in Vogue? In the past when the lifetime gift tax exemption was $1 million, a common concern with a sale to grantor trust transaction was how to get the initial gift into the ILIT without paying gift tax. The rule of thumb among commentators in pre-funding trusts prior to a sale for note transaction has been that the amount sold should be no more than 10 times the amount of the initial gift. The increase in the gift and GST exemptions to $5 million for at least two years should allow for much larger initial gifts and, therefore, much larger sale transactions. A $10 million initial gift by a married couple made in 2011 or 2012 should now support a $100 million sale for note transaction.

C. GRATs May Remain Popular. While the TRA 2010 did not impose a 10-year minimum term for GRATs (as proposed earlier in the year), a GRAT remains a popular and effective “estate freeze” in certain circumstances. Naming an ILIT as remainder beneficiary of a GRAT program involving a series of rolling, 2-year GRATs may squeeze enough appreciation and eventual liquidity from a single volatile publically traded asset to fund future premiums. The remainder trust (ILIT) will generally be a non-exempt trust for GST tax purposes.