A “One of a Kind” Opportunity is Closing:
Leveraging Large Taxable Gifts in 2010 with Life Insurance

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Advisors are well aware that the clock is ticking down on the historic lifetime wealth transfer opportunities available for their most affluent clients in the remaining days of 2010. Only a few months remain for advisors to go on the offensive so their wealthiest clients maximize this “one of a kind” wealth transfer planning opportunity available in 2010. By leveraging life insurance into the planning, advisors can create momentum and allow their clients to minimize their major short-term risk from a large taxable gift while also providing long-term investment certainty for the client’s family.

Consider the following:

- Taxable gifts are almost always more efficient than bequests at death (because they are tax “exclusive”), but for 2010 there is added incentive to give away assets.
- The current 35% top federal gift tax rate for 2010 is the lowest since 1934.

- The one year repeal of the generation-skipping transfer (GST) tax for 2010 presumably will remain in place through the end of the year.
- The likelihood of Congress enacting transfer tax legislation that is “retroactive” to January 1, 2010 now appears remote.

Come January 1, 2011, this highly favorable tax environment will be gone, replaced by a set of onerous transfer tax rates that are even higher than those that applied for 2009; under current law, in 2011 there will be a 55% top gift tax rate and a 55% top GST tax rate with perhaps only a $1,340,000 exemption amount.

Now that “retroactive” legislative action seems highly doubtful, a simple gift may be appropriate. For those advisors still concerned about “retroactive” legislation, it may be appropriate for their clients to use a formula (defined value gift) clause that has the effect of adjusting values based on “retroactive” law changes. Thinking ahead, sophisticated advisors also need to remember that in 2011, the broad “had never been enacted” sunset rule contained in Section 901(b) of the 2001 tax act may be interpreted to mean that Chapter 13 (concerning GST tax law) did apply to a direct skip made in 2010 – not to impose a GST tax in 2010 – but for all other GST tax purposes.

Some believe the current Congress will try to make one final attempt to tackle the question of estate and transfer taxes after the mid-term election in early November. Most believe that Congress will return the estate tax to its 2009 level – a $3,500,000 exemption and a top rate of 45% - at least for a couple of years. Heirs of those who die in 2010 may also get the choice of using either the current 2010 rules or the 2009 rules. Most commentators and even Senator Baucus (Chairman, Senate Finance Committee) have stated that the odds of retroactivity appear remote. To be safe, advisors should now begin a serious dialogue with their wealthy clients about making a large taxable gift in 2010, and then consider waiting on Congress before finally executing on this strategy in late December 2010.

For older unmarried patriarchs or matriarchs unable to implement marital deduction planning because of their current marital status, there may be even greater urgency to seriously consider making a large taxable gift in 2010. Perhaps a widow or widower is prepared to relinquish or dispose of ownership of a portion of a marital deduction (e.g., QTIP?) trust inherited from a predeceased spouse?

Advisors and their wealthy clients will miss a golden opportunity if they fail to strongly consider undertaking a large taxable gift program in 2010, even if it results in payment of significant gift tax come April 2011. Adding life insurance can safeguard the success of the transaction.

Taxable Gifts in 2010

Under current law, the maximum tax rate on taxable gifts made in 2010 is 35%. As the likelihood of retroactively diminishes, there is increasing likelihood that a 35% top gift tax rate will ultimately apply to gifts made in 2010 either outright to or in trust for descendents. The gift tax rate for 2010 is now hovering at a 75 year low point. The current 2010 federal gift tax rate of 35% is a 10% reduction from 2009 and is a 20% reduction from the anticipated 2011 rate (absent Congressional action). Clients who have already used their $1,000,000 lifetime gift tax exclusion amount and who intend to eventually transfer significant additional wealth to younger family members have a strong incentive to do so in 2010.

Generation Skipping Transfers in 2010

Under current law, the GST tax is suspended in 2010. This presents a unique opportunity for wealthy clients with the financial ability and desire to make significant lifetime transfers to grandchildren and younger generations that will never be subject to GST tax. In past years, the GST tax has been expensive and difficult to plan around. During the balance of 2010, a transfer to grandchildren and younger generations will be taxed the same way as gifts to children. However, since the GST tax system re-emerges in 2011 and thereafter, the best way to make a gift to grandchildren and younger generations in 2010 is probably outright and not in trust. An outright gift to grandchildren and younger generations raises some non-tax considerations on how to subsequently control or restrict their future access to assets received by them in 2010.

If 2010 gifts for grandchildren and younger generations are made in trust, distributions from that trust in 2011 and in subsequent years may be taxable distributions or taxable terminations subject at that time to GST tax. Moreover, these taxable distributions would be taxed more harshly. The GST tax on a taxable distribution from a trust is “tax inclusive” (the GST tax is applied to the total amount transferred, including the GST tax itself). Any GST tax paid on a direct skip transfer to a grandchild is “tax exclusive” (any GST tax is applied to the amount actually received by the grandchild).

Transfers to custodianships for grandchildren are subject to the same considerations because the GST regulations treat custodianships as trust equivalents.

Outright gifts of FLP or LLC interests directly to grandchildren can provide management control and restrictions on access to the underlying entity assets. If necessary, it should be relatively easy for a patriarch or matriarch to quickly form a new FLP or LLC (perhaps with their children), contribute assets to the entity and then make a gift of a very significant FLP or LLC interest to his or her grandchildren. Since no valuation discount would be sought on this large taxable gift, step transaction concerns recently raised by the Tax Court in *Pierre v. Commissioner*, T.C. Memo 2010-106 (known as Pierre “II”) and previously considered in *Holman v. Commissioner*, 130 T.C. 170 (2008), *aff’d* ___F.3d___(8th Cir., April 17, 2010), should not be present. A new FLP or LLC can be quickly organized and capitalized and then immediately thereafter a grandparent can make a large taxable gift of FLP or LLC interests outright to grandchildren. Waiting until December 31, 2010 does heighten the risk that an older donor might unexpectedly die before both making the gift and locking in its success by having the FLP or LLC purchase life insurance on his or her life.

The donor of a large gift made in 2010 to grandchildren and younger generations should also consider filing a Form 709 (gift tax return) for 2010 electing out of automatic allocation of GST tax. This will prevent the automatic allocation rule under pre-2001 law from applying to any direct skips made in 2010 once the GST tax returns for 2011 and beyond.

Net Gifts? Financed Net Gifts? How to Add Efficiency (and Minimal Complexity)

A “net gift” is a gift in which the donor and donee agree that the donee will pay the gift tax. For a large taxable gift, the amount of the taxable gift is equal to the amount of the property transferred *less* the amount of gift tax the donee will have to pay. Rev. Rul. 75-52, 1975-1 C.B. 310.

Use of a net gift can be compelling. In 2010, use of a net gift arrangement will decrease the effective top gift tax rate from 35% to about 26% on large taxable gifts on which gift tax must be paid.

Children and grandchildren may lack sufficient personal assets from which to pay the gift tax on behalf of their parent or grandparent. Likewise, a super affluent parent or grandparent prepared to shift significant wealth to children and grandchildren in 2010 may find it undesirable to have such large taxable gift reduced almost immediately by one quarter for the gift tax that must be paid.

In a financed “net” gift, when the gift tax on a large 2010 taxable gift comes due in April 2011, the patriarch or matriarch (donor) might lend the cash to the children and grandchildren to pay the net gift in exchange for a promissory note. By taking back a 9-year note pegged to the mid-term AFR rate, which was 1.94% per annum in September 2010, the patriarch or matriarch freezes asset growth in his or her gross estate. The advantage of a financed net gift is that the entire taxable gift proceeds can be fully deployed by the children and grandchildren, since it is not burdened by the need to deplete the gift amount in order to pay gift taxes due in April 2011.

If outright gifts rather than gifts in trust must be made in order to avoid future GST tax ramifications (such as taxable distributions), the donor may recognize capital gain on the amount by which the gift tax liability exceeds the donor’s adjusted basis in the assets transferred. If the gift instead is made by the donor to his or her grantor trust that benefits only children, there should be no capital gain recognized on such a net gift transfer, but the unique 2010 opportunity to permanently eliminate GST tax will have been wasted.

A trust for children or an LLC for children and grandchildren can deploy the additional gift proceeds to buy life insurance on the life of the patriarch or matriarch. Some portion or all of the gift proceeds can be invested in life insurance policies on the life of the patriarch or matriarch that offer predictable after-tax equivalent returns approaching 10% through life expectancy. The current cost of such capital deployment to the trust or LLC is only 1.94% annually. A portion of the leveraged death benefit can be used to repay the estate of the patriarch of matriarch for the loan made in connection with the gift tax paid by the LLC.

Major Drawback to Large Taxable Gifts and Paying a Gift Tax: The Three-Year Lookback Rule Causes Inclusion of Gift Tax Paid in Donor’s Gross Estate…But Life Insurance is a Short-Term Hedge.

Aside from the almost immediate payment of gift tax, the major risk for an older donor who pays gift tax on a large taxable gift in 2010 is if that donor dies within three years of making such gift. In such event, the gift tax paid on the gift must be included in the donor's gross estate. IRC Section 2035(b).

Clearly, use of life insurance as a short-term hedge can eliminate the primary risk of a large taxable gift that generates a payment of significant gift tax. Once the three-year lookback (estate inclusion) period has expired, a donor might want to reassess whether to continue with the life insurance program. In order to combine a three-year hedge with optionality if the donor survives the three years, the LLC might consider purchasing a UL policy with an "early cash value rider" that maximizes the amount of cash value available when the three-year period ends.

Leveraging a 2010 Large Taxable Gift with Life Insurance

On a long-term basis, dedicating some portion or all of the gift proceeds to the purchase of a diversified portfolio of life insurance on the life of the donor makes good investment sense. The life insurance policies could be owned by the LLC whose members are predominantly the donor's grandchildren and younger generations (with donor's children perhaps owning small management interests).

Once the gift proceeds are transferred to the LLC, the family's financial advisors need to design an investment program to safeguard and grow these assets. Most donors making large taxable gifts in 2010 want to ensure that the gift proceeds provide long-term financial security for their family.

Sophisticated investors recognize that the need for diversification of assets is vital. Wealthy patriarchs and matriarchs often have made their fortune by assuming outsized risks. Typically, they own a large, concentrated illiquid position in a private business, investment real estate or private equity investments which they would like to pass on to their heirs. The use of life insurance to offset the estate taxes imposed on these illiquid, hard to value but lucrative assets can be invaluable in preserving highly appreciating but illiquid core assets for subsequent generations of family members.

Here are some takeaways on why very affluent families often use the unique long-term features of life insurance as part of their wealth transfer planning:

- ***Predictable Value***. The asset's date of death value is known in advance with virtual certainty. Traditional investments lack such future certainty.
- ***Liquidity***. At the death of the donor, the asset is automatically paid in cash by the insurance company. Unlike traditional portfolio assets, conversion to cash is not reduced by commissions or management fees. Unlike illiquid assets, there are no transfer (legal) fees incurred and there is no time delay.
- ***Value Not Directly Linked to Market Performance***. In the case of a no lapse guarantee universal life (NLG UL) policy, the payment of the death benefit amount does not directly depend on financial market performance. This means that the asset value of life insurance at the death of the donor is quite stable, especially if a diversified portfolio of policies issued by many top-rated carriers is acquired and thereafter actively monitored. Active monitoring of the carriers' long-term financial

stability assures that their long-term promises to the policyholder will be met.

- ***Equity-like Returns/Bond-like Risk Due to Lack of Income Tax Friction***. The income-tax free return on invested premium dollars causes the after-tax equivalent internal rate of return (IRR) to be comparable or superior to most traditional equity investments at life expectancy. However, by implementing a diversified portfolio of NLG UL policies, there is a bond-like risk. The risk-reward tradeoff consideration for an investor in life insurance is more favorable than with traditional market-based investments. Unlike high yielding alternative investments whose performance can fluctuate widely year to year, life insurance provides a non-correlated asset whose performance is predictable, assuming it is actively monitored.
- ***Leverage***. Premiums paid for death benefit protection can provide significant leverage, as well as a competitive after-tax return on investment (IRR) through life expectancy when compared to traditional taxable investments over the same period.
- ***Avoids Estate Tax…Outcome Not Dependent on Future Investment Performance for Success of Transaction*****.** Ownership of the policy can be held by a trust (ILIT), FLP or LLC so that the death benefits will not be subject to federal estate taxes and perhaps GST tax. Unlike a sale to intentionally defective trust (IDGT) or GRAT transaction that are highly dependent on future investment

performance for their success in removing appreciation from the patriarch or matriarch's gross estate, a properly structured trust, FLP or LLC that owns a diversified and well-monitored portfolio of life insurance eliminates future investment performance as a consideration.

- ***Special State Government Oversight***. Unlike other investments which are either loosely regulated by the federal government or not regulated, all life insurance companies and their policies are regulated by state insurance commissioners. The carriers must satisfy specific capital reserve requirements set by their regulators, and invest a majority of their general account assets in a laddered portfolio of fixed income bonds and Treasury obligations. Should a problem occur, policyholders come before bondholders, stockholders and general creditors of the carrier (but the industry experience has been that the remaining carriers typically agree among themselves on how to assume the policies issued by a problematic carrier).
- ***Income Tax-Free Payment***. Policy death benefits (including the amount in excess of premiums paid) are generally received income tax free. IRC Section 101. Stock options, deferred compensation and large IRAs owned by decedent's present potential income in respect of a decedent issues for a family (income tax considerations in addition to estate tax considerations).

A Real World Example

Assume that in late 2010, a wealthy 75 year old widow (and non-smoker in relatively good health) decides to move forward with a very large taxable gift, to take advantage of the historic, soon to disappear, wealth transfer planning opportunity described to her by her estate planning advisor.

Assume the widow owns about $35M of assets in her own name and is the spousal beneficiary of a large $65M QTIP marital trust established at her husband's death. The independent trustee of the QTIP has absolute discretion to make distributions of principal of this trust to the widow during her life. The widow has fully utilized her $1,000,000 lifetime gift tax exemption in connection with prior wealth transfers primarily benefiting her children. The widow intends to eventually transfer the bulk of her wealth to her children and grandchildren but has long been concerned about the tax costs to do so. She has far more assets than she needs to maintain her current lifestyle.

In the coming days, the independent trustee of the QTIP will distribute $20M in assets outright to the widow. Before the end of 2010, the widow will give a) $10M to a fully discretionary trust for her children, and b) the other $10M will be transferred to a new LLC (to which relatively small contributions will also be made by the children in exchange for management interest in the LLC) and the widow will make a large gift of the (non-management) LLC interests to her grandchildren.

The widow agrees that it is preferable for the widow – not her children or grandchildren – to pay from her personal assets any gift tax due by undertaking a so-called financed “net gift” transaction. The gift tax due without a “net gift” would be $7M ($20M x 35% federal tax rate in 2010) if the widow is responsible for the payment of the gift tax. By entering into a “net gift” agreement with the donees, in which the donees are responsible to pay the gift tax, the widow would reduce the gift tax due to about $5,185,000. She would save about $1,815,000 in gift tax payments, and reduce the tax cost on these gifts to a roughly 26% effective gift tax rate. If loans to the donees are made now (to lock in the very low interest rates available today), the widow would take back two identical 9-year promissory notes of about $2,592,000 apiece, one from the trust and one from the group consisting of her grandchildren, each with interest payable annually at the prevailing mid-term AFR rate (1.94% per annum for September 2010).

The trustee of the trust for children will buy a $5M life insurance policy on the widow. The independent trustee decides to purchase a NLG UL policy, but has arranged to backload or to optimize premiums beyond the widow’s life expectancy. The trustee has experience administering trust-owned life insurance and has internal systems in place to assure timely payment of premiums on this type of product.

The following results occur:

Year	Insured’s Age	Net Annual Outlay	Net Death Benefit	Internal Rate of Return
2011	76	$116,127	$5M	4205%
2021	86	$116,127	$5M	21.71%
2026	91	$347,122	$5M	10.34%
2031	96	$347,122	$5M	3.07%

The family's advisors decide that due to the longer time horizon and for administrative peace of mind, the LLC should consider a one-time premium payment of $2,116,634 to purchase a $5M NLG UL policy on the widow's life.

The following results occur:

Year	Insured's Age	Net Annual Outlay	Net Death Benefit	Internal Rate of Return
2011	76	$2,116,634	$5M	136%
2021	86	0	$5M	8.13%
2031	96	0	$5M	4.18%

In considering available alternative policy design options, since a financed "net gift" agreement is contemplated the advisor and donor might consider adding an "ROP" (return of premium) rider if offered by the carrier. The extra premium paid by the policyholder (i.e., the LLC) can be viewed as an investment that will yield a known return at maturity of the policy. If offered, an ROP premium rider would work well in conjunction with a financed "net gift" because the donee(s) of a large taxable gift made in 2010 have a fixed obligation to repay the loan balance due the donor's estate when the donor dies. More wealth – in the form of additional net death benefit – would be available to the donor's grandchildren from the LLC when the donor dies and the loan must be repaid. Sometimes advisors and donors also consider utilizing the ROP rider merely to enhance the internal rate of return (IRR) performance on the policy.

In undertaking their due diligence, the family's advisors also explore the possibility of purchasing an "early cash value rider" to a UL policy – in lieu of a NLG UL policy for the LLC – in the event the family wishes to change course in three years once the widow has survived the three year lookback (estate inclusion) period.

Through this "early cash value rider," the widow and her advisors can implement a "wait and see" approach. Under a "wait and see" approach, the widow would purchase a one pay UL policy with "early cash value rider." The major advantage of such a policy is that once the three-year lookback (estate inclusion) period has expired, the widow might reassess whether or not to continue the life insurance program altogether.

In three years, the policy net cash surrender value would approximate the amount of the one time premium paid three years earlier. The policyholder (i.e., the LLC) would own an investment that produced no return over three years (and would suffer the loss of the time value of money).

The results that might occur are as follows:

Year	Insured's Age	Net Annual Outlay	Net Surrender Value	Net Death Benefit
2011	76	$2,116,634	$2,116,634	$5M
2013	78	0	$2,116,634	$5M
2021	86	0	$2,215,464	$5M

If the policy were surrendered in three years, there should be little or no income tax due since the amount realized would essentially equal the premiums paid. See Rev. Rul. 2009-13, IRB 2009-21, Situation One (May 26, 2009). A surrender of the policy on the life of a 78 year old would avoid the MEC premature distribution rules (because the insured is older than 59 ½). Moreover, there is no annual accretion in the cash value in excess of premiums paid, which should avoid adverse MEC tax treatment during the first few years following the issuance of the policy.

In lieu of surrendering the policy after the end of the three year lookback (estate inclusion) period, the policyholder might consider other options. If the health of the donor insured has deteriorated, and the policyholder wishes to maximize the cash proceeds received in three years, the policyholder and donor-insured might consider a life settlement (sale) of the policy. Based on past experience, a policyholder who paid roughly $2.1M to acquire a $5M UL policy with an early cash value rider might receive an offer to purchase the policy in excess of $3M. Of course, in any life settlement the advisor and insured must weigh the possibility of a near-term death of the insured and foregoing the $5M death benefit.

If the health of the donor-insured remains strong, and the family wishes to continue the use of life insurance as one type of investment class, the policyholder might consider exploring an IRC Section 1035 like kind exchange of the UL policy with early cash surrender value for a new NLG UL policy or some other type of product that takes advantage of the prevailing mortality tables used by the carriers.

Conclusion

Integrating the use of life insurance to lock in the potential significant transfer tax savings available from a large taxable gift made in 2010 assures a successful wealth transfer planning transaction. The biggest risk – that the donor dies within three years of making a large taxable gift on which significant tax is paid and that must be included in the donor’s gross estate – has been hedged by purchasing some life insurance.

Careful policy selection can provide either short-term optionality or predictable long-term investment returns. For those policyholders and insureds who want to reassess their options once the donor survives the three years lookback (estate inclusion) period, use of a UL policy with an “early cash value rider” preserves a variety of options: surrender the policy for the amount paid (and no tax consequences), settle (sell) the policy perhaps for an amount in excess of the cash value or exchange for a new policy that might provide access to favorable mortality tables.