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Creating Tax Mitigation, Diversification, and Leverage in Grantor Trusts with Life Insurance

Leverage
Flexibility
Liquidity

Vernon W. Holleman, III, CLU, Principal, BCG Holleman
Contributions by Eric J. Hieber, Principal, BCG Companies

Rationale for Planning

After solid return years in the stock market in both 2013 and 2014, along with two filed tax returns where Grantors viewed the actual taxes – not just an estimated number – that they sent to the IRS, as well as a re-hydration period following the mad dash that occurred at the end of 2012 – Grantors are now ready to focus on how to reduce the taxes they are personally paying in their Grantor Trusts, even if 2015 yielded modest or negative returns. The re-hydration period also included a settling of Trust assets by swap for those Trusts where Grantor made gifts of certain assets at the end of 2012 and traded them for other assets since that time.

Although not a surprise to most, due to good estate counsel, the tax amounts paid were significant, especially for those who maximized the gift ceiling. The taxes paid in 2014 and 2015 have the attention of Grantors. Although not unreasonable in theory, the argument that taxes paid by Grantors are an additional estate planning benefit because they get dollars out of the taxable estate is, in fact, a rationalization for the uncreative planner. Simply put, Grantors deserve exposure to tax mitigation alternatives. Advisors and planners need to be pro-active in helping clients explore opportunities for tax reduction and other goal achieving planning benefits, such as increasing their charitable giving. Diversifying Grantor Trust assets with life insurance is one such strategy.

Life Insurance Use in Grantor Trusts - Overview

Assuming the prior establishment of a so called “2012 Grantor Trust” (Grantor Trusts created and funded with Gifts in 2012 with the idea that the law might have changed in 2013, but be grandfathered for those completed prior to the end of 2012) – the acquisition of life insurance in the Trust is simply a matter of re-allocating a portion of the assets from the current Trust into a life insurance policy, or policies, where the Grantor(s) is the insured person(s). In other words, taking money from one Trust pocket and putting it into another Trust pocket. There are no gifts to be made; no annual Crummey letters to write as in a typical ILIT (Irrevocable Life Insurance Trust); and no Split Dollar or other borrowing complexity. Simply put, this is a straight forward planning idea using a seasoned, flexible, and transparent financial product – life insurance.

Primary Planning Reasons

The primary reasons for considering life insurance as an asset class inside a Grantor Trust are the product's core tax benefits: the tax-deferred growth of the cash value inside the policy and the tax-free receipt of the death benefits. Given that the Grantor Trust assets are already out of the Grantor's estate, via the gifts having been made, the death benefits received by the Trust would, by law and contract, be income and estate tax-free, hence the "leverage" of the gift. Further, the life insurance will, in most cases, have a cash value, or equity, portion that can easily (depending on product selection) be both re-allocated as markets change, and, if needed, exited if the Grantor Trust (Trustee) believes the insurance is no longer beneficial, cash is needed, or if Trust beneficiaries behavior warrants a reduction in the total gift at death, i.e. to de-leverage through a surrender of the policy.

As a diversification tool, life insurance expands an already made gift and mitigates ongoing taxes for the Grantor, while providing additional protection, or a cushion, if the Grantor dies when valuation of the Trust assets (whether stocks, bonds, real estate, or other) are low, and provides pure cash, as distinguished from "liquid" assets which are not necessarily easily turned to cash, when needed most. Never is cash unwelcome at the time of an estate settlement. Further, the depth and breadth of today's products' sub-account options (funds inside the life insurance that look and act like mutual funds) in today's variable universal life insurance (whether registered or private placement) products give Trustees a wide range of alternatives to invest. The assets (cash value) in the life insurance can be widely diversified and frequently, with only limited restrictions, be re-allocated or changed.

Two Planning Stages

Exploring life insurance as an asset to own inside Grantor Trusts takes two primary stages. The first is to help the Grantor understand the planning enhancements, i.e., taxation reduction and increased charitable giving aspects of using life insurance. If these attributes are appealing, the second stage is determining that the planning benefits justify the cost of the life insurance protection, i.e. the design and economic analysis of the insurance product(s). Although the insurance product design aspect of the second stage is led by the insurance advisory firm involved - specific design and product selection of the life insurance should be done with input from the other advisory members too. How much life insurance and what kind of policy, as well as the life insurance funding and policy design strategies to consider, such as how long to pay premiums are all decisions that unfold during this stage.

Underwriting Drives Feasibility, Pricing, and the Economics

Good health is commonly assumed at the front end of any analysis performed on the economic viability of using life insurance. However, it is ultimately important and necessary to actually qualify for the insurance by a carrier(s) underwriter. The health and lifestyle, including travel or risky avocations, of the Grantor(s) are significant and real factors in the policy pricing. Health ratings vary from carrier to carrier, so exploring with multiple life insurance carriers is ideal. Prior to needing to complete an insurance

physical – an exam performed by a third party that commonly requires blood work, among other requirements – a Grantor can submit to "preliminary" underwriting exploration by allowing carriers to review his/her medical records and seek tentative ratings/decisions.

Advisory Team Teamwork is Critical

A Grantor, or family, is best served in the consideration of a *life insurance acquisition* when their advisory team is, in fact, working as a team – truly collaborating.

Traditionally, life insurance advisors have focused their analysis and sales efforts on the end user – the insured, who often made decisions alone, or with a modest level of outside counsel. This is no longer the case in today's market. Grantors capable of making gifts in excess of $10mm rely on several trusted advisors to consider any financial and estate planning decisions. Therefore, a team (or committee) approach is common practice today when examining if life insurance makes economic and planning sense as an asset in a Grantor Trust. Each discipline (estate law, tax planning, wealth / asset planning, and life insurance planning) all bring knowledge and focus to the decision making process that is essential for making the most well informed conclusions about the value of life insurance in a specific Grantor's Trust. When truly thinking out loud together and creating give and take dialogue about the Grantor's planning, the team can not only maximize the various estate planning goals, but create appropriate expectation management for the client, as well as a clear path to the planning's end in mind and steps (and timing) necessary to achieve it.

Planning Step One – Identifying Planning Goals

As tremendous a financial tool as life insurance can be, the great challenge with life insurance, as it has always been, is that it deals with death. This can make keeping an open mind on the merits of life insurance as an asset a challenge. This hurdle can be compounded by the old beliefs that life insurance is expensive, a bad investment, or not attainable due to imperfect health. Helping Grantors work through these mental blocks is real challenge and not for the faint of heart. The first step is like that of Stephen Covey's *The 7 Habits of Highly Effective People* book: begin with the end in mind. In other words, all the tax savings in the world are useless if the planning is not helping the Grantor achieve something meaningful to them. They must see what the insurance will do for them and their family. This is a critical place to begin for the Advisor Team. They need to identify planning objectives or emotional triggers early.

Below are some high level planning reasons for life insurance in a Grantor Trust.

Life Insurance Reduces Income Taxes – being paid out of pocket by the Grantor on the growth of the grantor trust asset gains

Life insurance provides planning alternatives that are simply not there without it, given its tax advantages and liquidity features. A Grantor may be triggered by taxation and not wanting the government to get any more than necessary.

Life Insurance Increases the Gifts - to the Grantor Trust beneficiaries

Grantor Trusts commonly transfer at the Grantor(s) death. With life insurance, the total amount transferred is higher than without, given the nature of the death benefits. Properly structured, the death benefits can grow over the Grantor's life to keep up with inflation.

Life Insurance allows a Grantor to Increase their Charitable Giving Impact / Philanthropic Legacy – both today and at death

Although some Grantors like the idea of leaving children and heirs as much of their wealth as possible, many want to leave a specific amount, or cap the amount they leave directly. Too much, they feel, is a disincentive to work or participate fully in life. By enhancing the Grantor Trust gifts, life insurance can help Grantors achieve the specific, or ideal, amount they want Trust beneficiaries to inherit. This will allow them to then leave other assets to their Foundation, or other charitable organizations, knowing they have done for their children what they want them to have.

Life Insurance can Help "Equalize" an heir not Inheriting a Specific Asset - such as real estate or a family business.

Grantors with diverse holdings and a number of children may like the idea of using life insurance as a tool to attempt to equalize their estate planning by providing cash to one heir, where another will receive a specific asset such as art, a business, or real estate, such as a house. This can work in a Grantor Trust, or outside it, but it is common way for life insurance to play a role in family estate and business planning.

Life Insurance Provides Cash (vs. Liquidity) at Death - for enhanced estate and / or business succession purposes

Many Grantor Trusts were created and funded with non-liquid assets, such as a private business interest or real estate. Even though those assets are out of the Grantor's estate, cash at the death of the Grantor(s) can come in handy for settling the estate. Further, a lot of assets placed in Grantor Trusts in 2012 have since been swapped out for other assets. Examining life insurance's liquidity features could play a role is simply good due diligence. A "liquid" asset is not necessarily

as easy to liquidate and is not the same as cash. Life insurance can provide guarantee liquidity.

***Key Example Questions for the Collaborating Team to Ask and Consider*:**

- Where is the cash to pay the Grantor Trust taxes coming from?
  - Is that the best use of that capital?
  - Is it a challenge to raise that cash?
  - How much does it bother the Grantor to be paying the taxes generated by gifts already made?

- Is the Grantor concerned their children will inherit too much?
  - Does the Grantor have an idea (specific or vague) of what they want to leave to their children (in a dollar amount or percentage of estate)?
  - Are they going to treat each child, or heir, the same?

- How Philanthropic is the Grantor(s)?
  - Is there a passion for certain charitable or educational organization?
  - Do they have a foundation?
  - If a foundation, will it receive all the Grantor's bequests or are there other charities he/ she/ they want to benefit outside the scope of the foundation?

Planning Step 2 – Economic Analysis of Grantor Trust Gifting

There are, of course, many reasons for executing estate planning ideas beyond the tax savings that they may provide. However, reducing, or eliminating, taxes is often a motivating factor for implementing estate planning strategies. Estate tax savings is commonly the primary reason for the creation of a Grantor Trust where high amounts of lifetime exclusion gifts are made. This section is meant to demonstrate the economics of such planning.

<u>To Gift, or Not to Gift? – *That* is the question</u>

Lifetime Gifting Limitations

Estate taxes can have a significant impact on the amount of assets passed to future generations. Under current estate tax law for 2016, an individual can gift $5,450,000 at any time during their life or at death and a married couple can gift $10,900,000, with no estate or gift taxes. Estate assets in excess of this lifetime exclusion are taxed at an effective rate of 40%.

Gift Today or at Death?

The larger the estate, the more value is eroded as a result of estate taxes. If the lifetime exclusion is transferred at death, the ultimate value transferred is $10,900,000 increased based on inflation. Assuming a 3% rate of inflation, the lifetime exclusion will increase to over $19,000,000 in 20 years. If a gift of the maximum $10,900,000 is made to a trust today and the gifted assets grow at 4% annually (100 basis points more than inflation), the gifted assets that pass free of estate taxes increases to over $23,000,000. This is a notable increase over the strategy to wait until death to use the lifetime exclusion gift limit.

Therefore, there is ***real value in making gifts today***, in particular to get the future growth of gifted assets out of the Grantor's estate. This is particularly true given the uncertainty of the growth of the lifetime exclusion gift amount. It is indexed for inflation using a CPI (consumer price index) annual inflation calculation, but increases will certainly vary over time as they have since 2012.

The Current Income Tax Environment

With effective tax rates at the levels noted in the chart below, Grantors are focused on the impact of income taxes.

Top Federal Income Tax Rate	39.6%
Short-Term Capital Gain Tax Rate	43.4%
Long-Term Capital Gain Tax Rate	23.8%

Tax Treatment of Life Insurance

Life insurance provides features that make it an attractive planning tool for gifting purposes. Three key features are highlighted in the table below:

- Policy cash values grow tax-deferred
- Cash values may be withdrawn or borrowed with no income taxes
- Death benefits are received income tax free

Like other assets, as long as the life insurance is not cancelled, the cash value growth is not taxed. However, if the policy is cancelled or withdrawals are taken in excess of the policy basis, policy gains would be taxable as ordinary income. Understanding this is important, as is the long-term service of any permanent life insurance product.

The most unique feature of life insurance is that death benefits are not taxed when they are paid.

Income tax on death benefit proceeds	0.0%
Tax on accrued policy cash values *	0.0%

* Assumes no policy distributions in excess of the policy cost basis

The Lifetime Exclusion - Three Main Alternatives

Under the current estate and gift tax laws, Grantors have three primary options when considering how to use the lifetime exclusions:

- Retain the exclusion amount, i.e. do nothing and wait until death to transfer assets
- Gift the lifetime exclusion now and invest in a diversified investment portfolio
- Gift the lifetime exclusion now and invest in a diversified investment strategy, which includes life insurance in the asset allocation strategy

Life Insurance Policy Design and Funding

Today's life insurance product alternatives are significant in both scope and depth and any discussion of exploring policy alternatives inside a Grantor Trust needs to include a wide variety of policy types and funding options for consideration and comparison. Further, multiple carriers' products should be compared to seek best performance. Other design and funding considerations include:

- Flexible or Rigid Premium Policy – whole life or universal / variable universal life
- Registered or Private Placement product
- Investment or Sub-Account Selection
- Premium payments – single pay, seven year, or lifetime
    - Modified Endowment (MEC) implementation
- Carrier Financial Strength, Ratings, and Leadership Stability
- Insurance Advisory Firm market positioning and long-term servicing capability

It is the job of the insurance advisor to educate the Grantor and the advisory team on these options and the implications of each, as well as the inherit risks and rewards associated with policy design and funding choices.

Economic Analysis of Gifting Today - Case Example

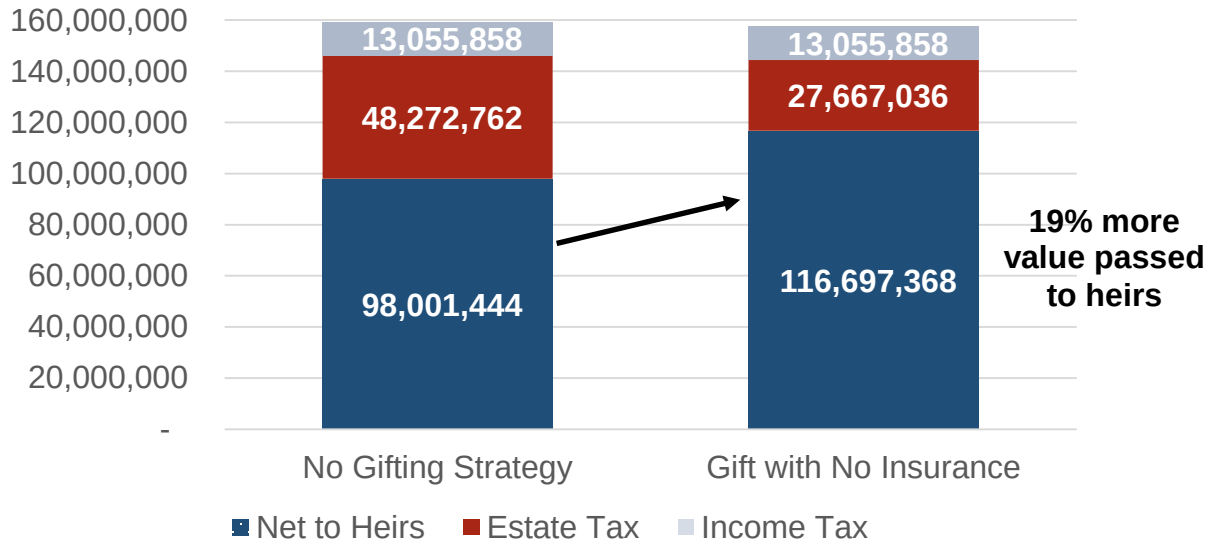
To demonstrate the economics of the gifting today, with and without life insurance, the following has been assumed:

- A husband and wife couple, both age 60, in “preferred” health and both non-smokers who are looking to acquire a second-to-die (survivorship) life insurance policy.
- 6% Total Annual Investment Return (net of investment management fees)
- 2% from dividends
- 4% from capital gain appreciation
- 25% annual portfolio turnover
- 43.4% effective short-term capital gain tax rate
- 23.8% effective long-term capital gain tax rate
- 23.8% qualified dividend tax rate
- 3% Inflation

<u>Gifting Lifetime Exclusion to a Grantor Trust, with No Life Insurance</u>

Making a gift today passes the current lifetime exclusion amount, as well as all future growth in excess of inflation, to Grantor Trust beneficiaries and those future generations. To illustrate the impact this strategy can have on an estate, this example assumes a lump-sum gift of $10,860,000 (2015 limit amount) to an irrevocable Grantor Trust. The gift results in a lower estate tax because the taxable estate is reduced and the net estate passed to the heirs increases. In year 30, the net to heirs has increased from $98 million to $117 million, an increase of 19% versus holding onto the $10,860,000 until death.

The primary benefit of this strategy is the reduction in the estate tax due. This is illustrated in the following chart comparing values in 30 years.

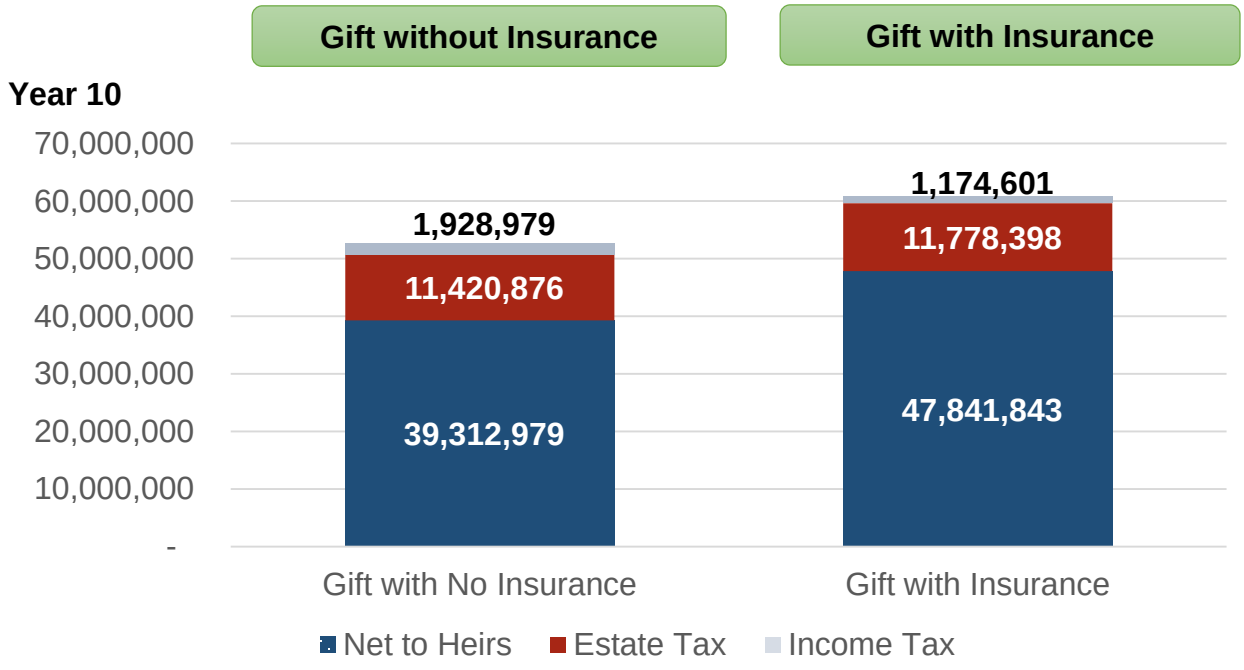


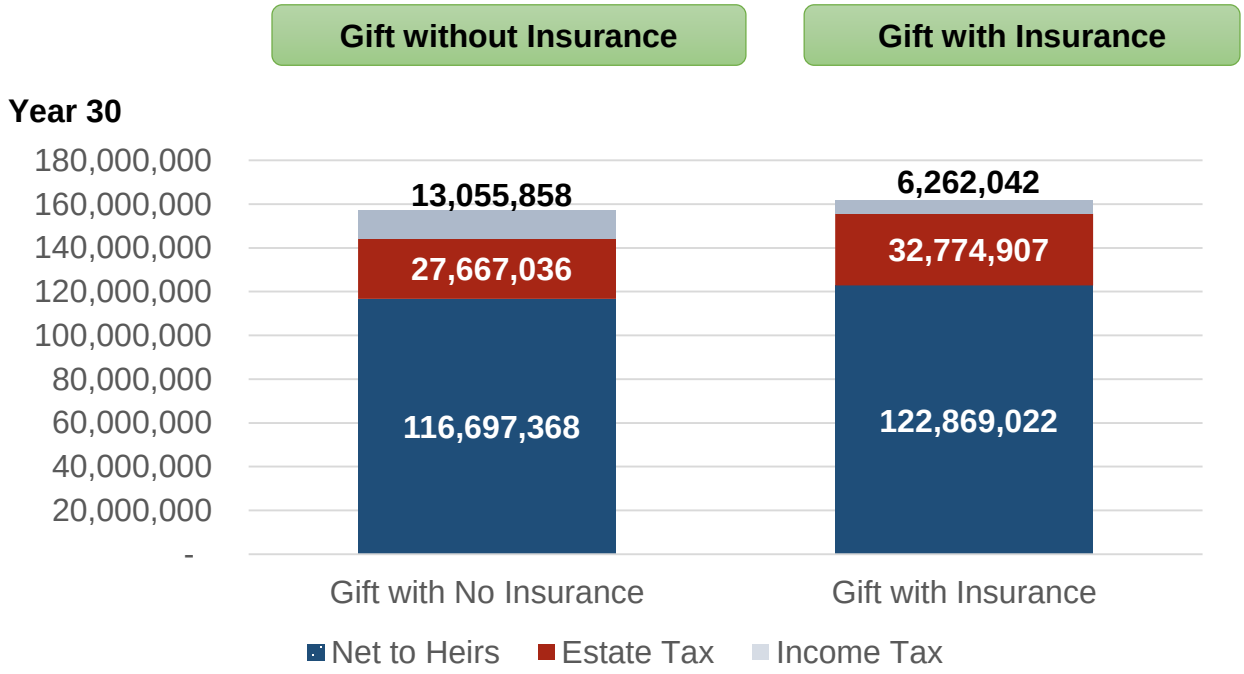
Gifting Lifetime Exclusion to a Grantor Trust, with Life Insurance

Life insurance may be used in the asset allocation of the Grantor Trust mix to further leverage the lifetime exclusive gifts by providing both tax-deferred growth of the assets in the policy and income-tax free death benefits to the Trust at the death of the insured(s).

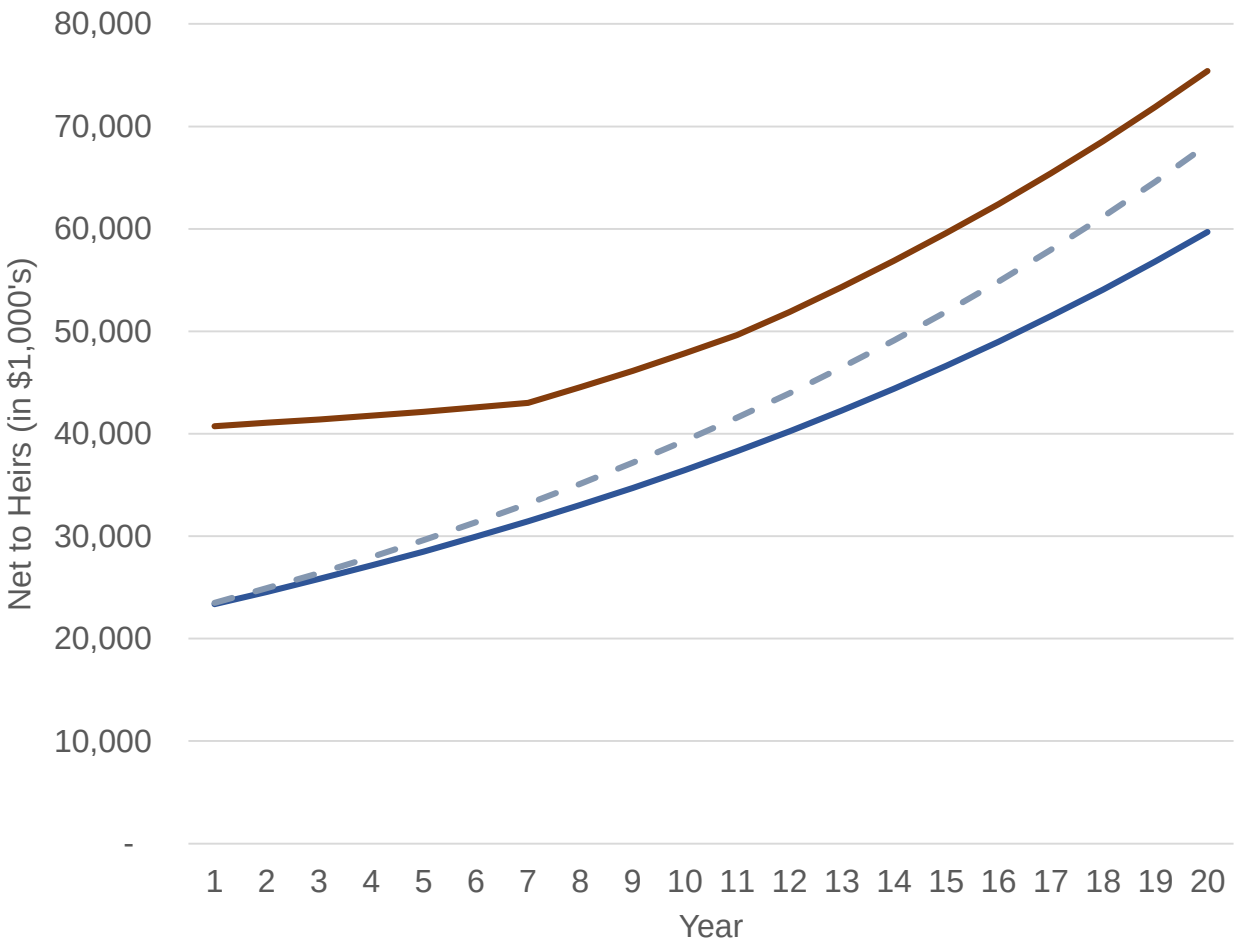
In the scenario above, if the client diversifies the gifted assets into a combination of both taxable investments and life insurance, income taxes can be reduced and more assets can pass to future generations. This also creates the potential flexibility to leave more to the charitable interests, given more has been left for children.

The charts below demonstrate the advantage of diversifying the Grantor Trust with life insurance versus without. The charts assume a Grantor gifts the 2015 maximum of $10,860,000 and then allocates $1,000,000 per year for seven years (dollar cost averaging into the policy) to a Variable Universal Life or Indexed Universal Life (IUL) insurance policy with an initial death benefit of $18,298,713 and assuming a 6.0% rate of return and current policy expenses.


Gift without Insurance
Gift with Insurance
Year 10
70,000,000
60,000,000
50,000,000
40,000,000
30,000,000
20,000,000
10,000,000
-
1,928,979
11,420,876
39,312,979
1,174,601
11,778,398
47,841,843
Gift with No Insurance
Gift with Insurance
Net to Heirs
Estate Tax
Income Tax


Gift without Insurance
Gift with Insurance
Year 30
180,000,000
160,000,000
140,000,000
120,000,000
100,000,000
80,000,000
60,000,000
40,000,000
20,000,000
-
13,055,858
27,667,036
116,697,368
6,262,042
32,774,907
122,869,022
Gift with No Insurance
Gift with Insurance
Net to Heirs
Estate Tax
Income Tax

Utilizing life insurance in Grantor Trust planning, as the following graph illustrates, can allow for the net amount passed to heirs in scenario discussed to be higher, thus reducing taxes paid and increasing planning flexibility.



Summary and Conclusion

There are many strategies available to families to help them reduce their estate tax liability or to fund for the liability efficiently. Paramount to any effective estate planning is the clear understanding of a Grantor's driving goals and vision for their wealth and its influence. Goals are often most clearly crystalized when a team of the Grantor's key advisors collaborates well, compare notes, and confirm these goals with the Grantor. All planning strategies need to be explored with these end goals in mind and then presented and discussed with the Grantor.

Gifting of the lifetime exclusion amount today is a viable option to consider for estate planning as it can yield considerable more wealth transferred to heirs versus waiting until death. Further enhancing this strategy by diversifying the Trust assets with life insurance can be meaningful to the diversification and protection of the Trust. This gives the Grantor more planning options and flexibility than they have without the life insurance. Unlike years past when life insurance was inflexible, costly, and offered only modest yields, today's life products offer very broad investment alternatives. Life insurance costs are the lowest in history due to extended mortality – people are living longer – and offer high cash values even early in the life of the policy. These reasons, among others, warrant serious consideration of the economics of using life insurance in Grantor Trusts.