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

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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 may have included a swap of Trust assets in cases where Grantor made gifts at the end of 2012 and

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traded the gifted assets for other assets since that time.¹

The taxes paid in 2014 and 2015 have the attention of Grantors. While the argument that taxes paid by Grantors are an additional estate planning benefit because they get dollars out of the taxable estate without imposition of a transfer tax or additional use of exemption amount has merit, 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. 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 during the rush to implement planning before the estate and gift tax law changed), the acquisition of life insurance in a 2012 Grantor 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 irrevocable life insurance trust, and no Split Dollar or other bor-

¹ Exercise of a “swap” power, or “power of substitution,” by the grantor is not a taxable event for income tax purposes because the grantor is deemed to own both the assets reacquired from the trust and the assets transferred to the trust, both before and after the exchange. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

rowing 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 a properly structured Grantor Trust's assets are already out of the Grantor's estate, the death benefits received by the trust would, by law and contract, be income and estate tax-free,² 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, distributed if the Grantor Trust's trustee believes the insurance is no longer beneficial, cash is needed, or if trust beneficiaries' behavior warrants a reduction in the total bequest 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 into 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

² See §101 and §2042. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

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 client's other estate planning advisors. How much life insurance and what kind of policy, as well as the premium 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 applying the standards set by the carrier's underwriter. The health and lifestyle, including travel or risky avocations, of the insured(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 by allowing carriers to review his/her medical records and to arrive at 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 \$10 million 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) brings essential knowledge and focus to the decision-making process. When truly thinking together about the Grantor's planning, the team can not only maximize the various estate planning goals, but also create appropriate expectation management for the client, as well as provide a clear path to the plan-

ning'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. For some clients, this can make keeping an open mind on the merits of life insurance as an asset a challenge. This hurdle can be further 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 a real challenge and not for the faint of heart. The first step is like that of Stephen Covey's book, *The 7 Habits of Highly Effective People*: 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 Advisory 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 and Estate Taxes — being paid out of pocket by the Grantor on the growth of the Grantor Trust asset gains:³

Life insurance provides planning alternatives that are simply not available with other investments, given its tax advantages and liquidity features. A Grantor may be motivated by minimizing taxes, i.e., not wanting the government to get more taxes than absolutely necessary.

Life Insurance Increases Gifts — to Grantor Trust beneficiaries:

Grantor Trusts sometimes, depending on their terms, transfer their assets 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.

³ Qualification as "life insurance" within the meaning of the Internal Revenue Code entitles U.S. taxpayers that hold life insurance contracts to certain well-known benefits under the §72(e) and §101(a). These include deferral of income taxation on the "inside buildup" on a life insurance contract (other than a modified endowment contract, or MEC), and, absent a "transfer-for-value," exclusion of the proceeds of the policy from gross income (and, if properly structured, from the insured's gross estate) upon death.

Life Insurance Allows a Grantor to Increase 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 a Grantor to then leave other assets to his or her private foundation or other charitable organizations, knowing they have otherwise provided for children.

Life Insurance Can Help "Equalize" an Heir Who Does Not Inherit 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 also works outside of a Grantor Trust, but it is a 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 private business interests or real estate. Even though assets in a Grantor Trust are (usually) out of the Grantor's estate for federal estate tax purposes, cash at the death of the Grantor(s) can come in handy for paying estate taxes due on the non-liquid assets. Examining how life insurance's liquidity features could play a role in the administration of the Grantor's estate is simply good due diligence. A "liquid" asset is not necessarily equivalent to cash. Life insurance can provide guaranteed liquidity.

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

- Where is the cash to pay income taxes on the Grantor Trust income coming from?
- Is that the best use of that capital?
- Is it a challenge to raise that cash?

- 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 he/she wants to leave to children (in a dollar amount or percentage of estate)?
 - Does the Grantor intend to treat each child, or heir, the same?
- How Philanthropic is the Grantor(s)?
 - Is there a passion for certain charitable or educational organization?
 - Does he/she have a private foundation?
 - If he/she has a private foundation, will it receive all the Grantor's charitable bequests or are there other charities he/she wants to benefit outside the scope of the foundation?

PLANNING STEP 2 — ECONOMIC ANALYSIS OF GRANTOR TRUST GIFTING

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

To Gift, or Not to Gift? — That is the Question

Gift Limitations

Estate taxes can have a significant impact on the amount of assets passed to future generations. In 2016, an individual can transfer \$5,450,000 (\$10,900,000) at any time during life or at death, with no estate or gift taxes. Estate assets (or lifetime gifts) in excess of this exemption amount are taxed at 40%.

Gift Today or at Death?

The larger the estate, the more value is eroded as a result of estate taxes. If the exemption amount is transferred at death, the ultimate value transferred at the death of the surviving spouse will be \$10,900,000, adjusted (increased) by inflation. Assuming a 3% rate of inflation, the exemption amount for a married couple 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 in 20 years to over \$23,000,000. This is a notable increase over the strategy to wait until death to use the decedent's exemption amount.

Therefore, there is real value in making gifts today, in particular to get future growth of gifted assets out of the Grantor's estate.⁴ This is particularly true given the uncertainty of the growth of the exemption amount. The exemption amount 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

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.

⁴ However, taxable assets that are gifted during life will not receive a basis step-up to fair market value on death. Therefore, the decedent's heirs may have to pay an income tax on those assets that could, in some high-tax jurisdictions, equal or exceed the estate tax otherwise payable. This tax, as noted below, may be avoided through the use of life insurance as a funding asset.

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

The Exemption Amount — Three Main Alternatives

Under the current estate and gift tax laws, a Grantor has three primary options when considering how to use his/her exemption amount:

- Retain the exemption amount, i.e., do nothing and wait until death to transfer assets
- Gift the exemption amount now and invest in a diversified investment portfolio
- Gift the exemption amount 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 the 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 inherent 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:

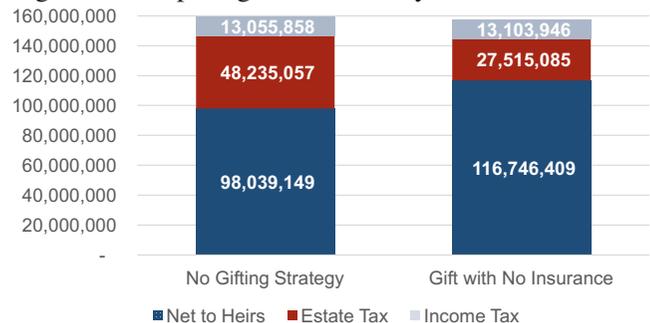
* Assumes no policy distributions in excess of the policy cost basis

- A couple, both age 60 in “preferred” health and both non-smokers, 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

Gift of Exemption Amount to a Grantor Trust, with No Life Insurance

Making a gift today passes the current exemption amount, as well as all future growth in excess of inflation, to Grantor Trust beneficiaries and possibly 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 burden because the taxable estate is reduced and the net estate passed to the heirs increases. In year 30, the net to heirs increases 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.



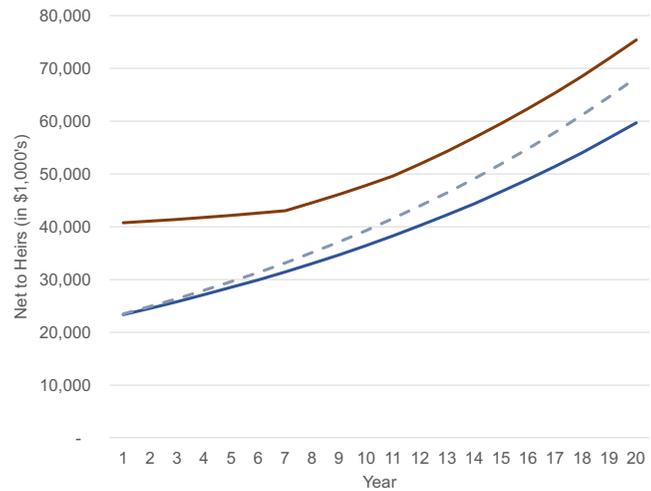
Gift of Exemption Amount to a Grantor Trust, with Life Insurance

Life insurance may be used in the asset allocation of the Grantor Trust to further leverage the gift of the exemption amount 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 trustee diversifies the Grantor Trust 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 charitable interests, given that more has been left to children.

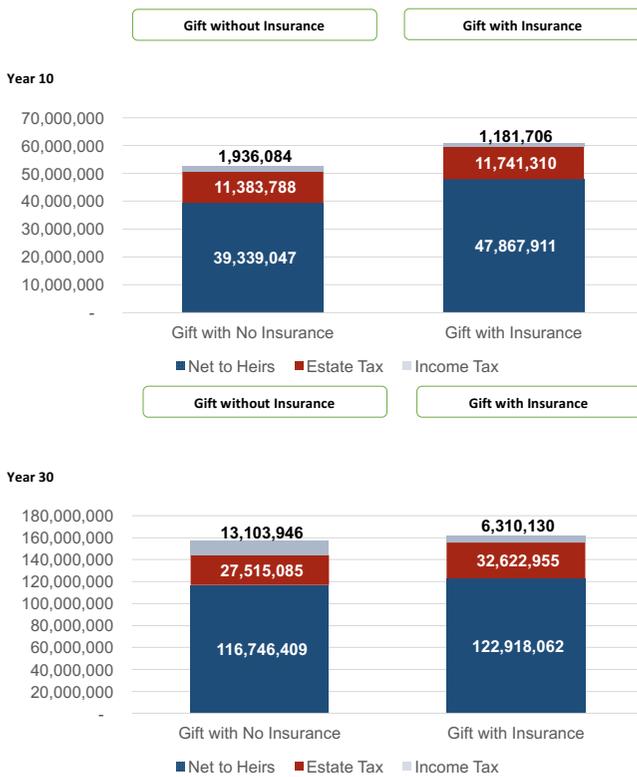
The charts below demonstrate the advantage of diversifying the Grantor Trust with life insurance versus without. The charts assume a Grantor gifts the 2015 maximum of \$10,860,000 and then allocates \$1,000,000 per year for seven years (dollar cost averaging into the policy) to a Variable Universal Life 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.



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. Critical to any effective estate planning is a clear understanding of a Grantor's goals and vision for his/her wealth and its influence. Goals are often most clearly crystallized when a team of the Grantor's key advisors collaborate 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.

Gift of the exemption amount today is a viable option to consider for estate planning as it can yield considerably 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.



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