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Planning With Life Insurance in Uncertain Times

A holistic approach can help clients move forward.

[Robert W. Finnegan](#) | Mar 22, 2018

With the passage of the Tax Cuts and Jobs Act of 2017 (the Act) and the doubling of the gift, estate and generation-skipping transfer (GST) tax exemptions, only the smallest percentage of clients are now subject to the estate tax. However, clients face an unstable planning environment that likely represents the new normal. As we move into the future, income, gift, estate and GST taxes can be expected to seesaw back and forth as the political party in control of our federal government changes. Fortunately, we're in the Golden Age of estate planning,

and the full range of wealth transfer planning strategies and favorable factors remain unaffected by the Act.¹

Although generally, ultra-wealthy clients continue to plan, the Act created a substantial group of high-net-worth (HNW) clients who don't currently have an estate tax. One of the unintended consequences of the higher exemptions is that many of these clients feel that they can defer planning. The easy answer is that the changes are temporary, sunseting at midnight on Dec. 31, 2025. For many clients, however, that alone isn't a compelling reason to plan, and we need to retool our message.

Toward that end, let's consider a holistic approach to planning that first and foremost focuses on the clients' financial security and then on beneficiaries. In the process, this approach identifies and addresses all the threats to wealth—not just taxes. I'll then focus on the role of life insurance as a wealth transfer and income tax planning vehicle, illustrate the substantial cost of delaying planning and discuss the lifetime benefits life insurance can provide to help ensure the clients' financial security. Three themes will emerge: client access and control, wealth transfer and income tax planning.

Threats to Wealth

Estate planning isn't solely or even primarily about taxes; it's about minimizing or eliminating the full range of threats to wealth to ensure the financial security of the client and his family. Today, the tools are available to create the perfect hedge that addresses all threats to wealth.

Perhaps the most basic premise of estate planning is to first ensure the client's financial security. "What Are the Threats to Wealth?" p. 55, intentionally separates the threats to the clients from those affecting beneficiaries and places threats to the clients first. By first answering the client's question, "What's in it for me?" our planning becomes client-centric rather than beneficiary-centric. Consider some of the ways to address the threats to wealth:²

What Are the Threats to Wealth?

Clients and beneficiaries each have their own issues that estate planning can address; focus on clients' threats first

Clients	Beneficiaries
1. Loss of access to trust assets	1. Spendthrift
2. Loss of control and planning flexibility	2. Divorce/creditors/predators
3. Creditors	3. Destructive family dynamics
4. Living too long	4. Income, gift, estate and generation-skipping transfer taxes
5. Dying too soon	5. Dilution due to a growing family
6. Income and estate taxes	6. Senior generation delaying planning

— Robert W. Finnegan

1. Dual spousal lifetime access trusts (SLATs), donor asset protection trusts, self-settled trusts and beneficiary defective inheritor trusts (BDITs) all provide clients with access to trust assets and earnings. An arm's-length loan by the trustee to the grantor provides further access to trust assets, creates a debt against the estate and, via loan interest at market rates, moves additional wealth to the trust.
2. In effect, the irrevocable trust is no longer written in stone. The grantor retains a great deal of control through decanting statutes, trust-to-trust transfer powers, trustee removal and replacement powers,³ the use of trust protectors and non-judicial settlements. With respect to dual SLATs, the non-grantor spouse can be a co-trustee along with an independent trustee.
3. Dual SLATs, BDITs and self-settled trusts move assets beyond the reach of creditors, provided assets are transferred far enough in advance (that is, so that trust funding isn't a fraudulent transfer) and, in many states, life insurance cash values are creditor protected.
4. Income and appreciation from trust assets are available to support the grantor and/or the grantor's spouse throughout a long life. Life insurance on the grantor of each dual SLAT protects the surviving spouse against the loss of access to assets on a spouse's death.⁴
5. Life insurance, discussed in greater detail below, continues to be a powerful planning tool that can protect against premature death.

6. For many clients, estate planning will now emphasize income tax planning.⁵ Life insurance provides wealth transfer and income tax planning benefits to the client, the client's spouse and beneficiaries. Private financing uses an intra-family loan to fund life insurance, preserving exemption for income tax planning. Transferring interests in a flow-through entity such as a limited liability company, family limited partnership or S corporation to a trust, in which the clients retain control of the entity, continues to address many of the clients' threats to wealth.⁶

Trust planning continues to provide the full range of benefits and protections for beneficiaries including the tax-efficient transfer of wealth, especially when coupled with favorable low valuations and split-dollar funding of life insurance. Trust ownership of assets provides spendthrift trust provisions, divorce/creditor/predator protection, avoids spoiling beneficiaries with too much too soon and protects beneficiaries from anti-social behaviors.⁷ Professional trust management and engaging professional counselors can mitigate destructive family dynamics. Swap powers allow the exchange of the trust's low basis assets for high basis assets (cash) so that the estate will receive a stepped-up cost basis on the death of the grantor, which benefits the beneficiaries as well as the surviving spouse. Life insurance provides income tax-free death benefits.

Dual SLATs

Today, income tax-free death proceeds, favorable lifetime access to cash values and irrevocable trust ownership make life insurance even more essential as a key component of a balanced estate plan.

Focusing on "what's in it for the clients," dual SLATs, in which each spouse creates a trust for the benefit of the non-grantor spouse, children and future beneficiaries, are becoming much more prevalent in the increased exemption environment because they remove appreciation of gifted assets from the estate, provide access via the grantor's spouse and may provide creditor protection.⁸ In their simplest form, dual SLATs merely consist of two irrevocable life insurance trusts in which the only asset is the policy insuring the grantor funded with annual exclusions and/or lifetime exemptions.

In addition to transferring wealth in an income tax-efficient manner for the benefit of children and future generations, this strategy provides the clients with substantial lifetime benefits. The independent trustee may make distributions to the non-grantor spouse from tax-free withdrawals of policy cash values⁹ or, if the policy has a long-term care rider, from qualified long-term care benefits.¹⁰ The income tax-free death proceeds can be used to support the surviving spouse and other beneficiaries as well as provide for actual or potential future taxes. Because

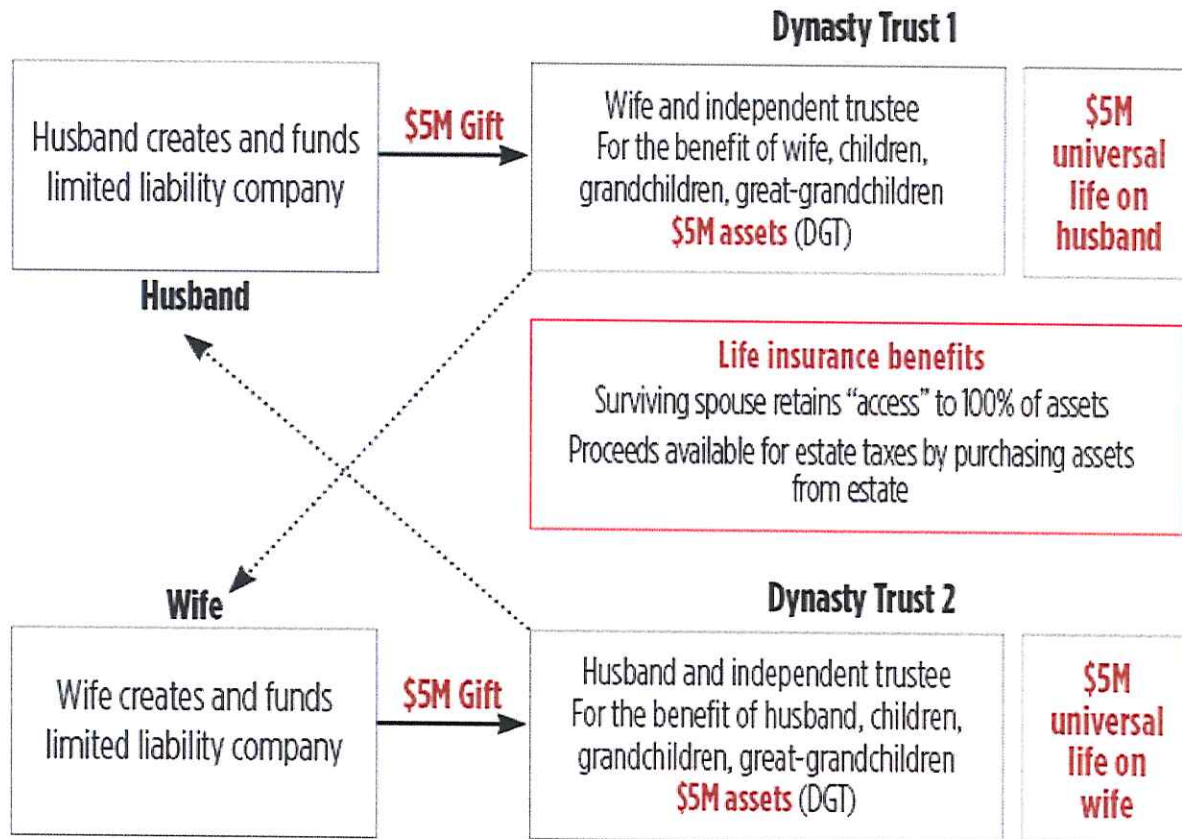
the only gifts to the trust are those to pay premiums, clients retain full control of nearly all of their assets, and exemptions are preserved for stepped-up basis planning—to the benefit of the surviving spouse as well as future generations.

With many dual SLATs, each spouse will make a substantial current gift. As long as both spouses are alive, the spouses retain access to 100 percent of the transferred assets but, following the first death, the surviving spouse only has access to 50 percent of the funds. Individual life insurance on the grantor of each trust can be used to replace the assets no longer accessible to the surviving spouse.

Example: Husband and Wife each gift \$5 million of assets to a trust of which the non-grantor spouse is a beneficiary. Each trust also purchases \$5 million of permanent life insurance protection on the grantor. If Husband dies, Wife no longer has access to assets in her own trust. However, life insurance proceeds insuring Husband are paid into Husband's trust and are available to support Wife. Although two \$5 million life insurance policies are roughly 50 percent to 60 percent more expensive than \$10 million of survivorship, the additional cost may be justified by the fact that the insurance benefits Husband and Wife directly and ensures their financial security, whereas survivorship life is strictly for the benefit of children and future generations. See "Dual SLATs With Single Life Insurance," this page.

Dual SLATs With Single Life Insurance

How to set this up



Note: Must take steps to ensure Dynasty Trusts 1 and 2 aren't reciprocal.

DGT denotes defective grantor trust

— Robert W. Finnegan

As an alternative, at the time that the dual SLATs are created, clients establish a third irrevocable trust that's authorized to purchase survivorship life insurance. That trust is a permissible beneficiary of each SLAT, adding tremendous flexibility to the plan. The grantors may make gifts directly to this third trust, or each SLAT may make distributions to the trust to pay one-half of each annual premium on the survivorship policy. Once a spouse dies, the trust of which the survivor is the grantor can distribute the full premium to the survivorship trust, freeing up cash flow in the decedent's trust to support the surviving spouse.

As another alternative, each SLAT can purchase term insurance on the grantor to augment the survivorship policy in the third trust. Term insurance is convertible without evidence of insurability, typically to the insured's age 70. Term insurance protects the clients during their prime earning years and protects each grantor's insurability. Later on, the clients can extend the term coverage by converting all or a portion of it to permanent insurance. Some carriers allow very favorable conversion of the single life term insurance to survivorship so that, at the time of conversion, it may be advisable for each trustee to distribute the term policy to the survivorship trust in which the two term policies would be converted into survivorship life.

Private Financing

Private financing¹¹ is an attractive strategy to fund dynasty trust-owned life insurance policies that protect against repeat estate taxation. Private financing consists of a large up-front split-dollar term loan that locks in the current applicable federal rate (AFR). The loan plus earnings are sufficient to pay each premium and repay the loan at the end of the term. As a loan regime split-dollar plan, it must be designed and administered to comply with Treasury Regulations Section 1.7872-15. The regulation allows the use of accrued interest based on the appropriate AFR at inception—a tremendous advantage when loan rates are low. The clients are merely giving up the asset growth in excess of the AFR interest.

Life insurance proceeds are received by the dynasty trust income, gift, estate and GST tax free and, because private financing is a loan and not a gift, it preserves exemptions for income tax or other planning. The plan can be designed so that the client is fully secured by the loan proceeds and the policy cash surrender values (except perhaps the early years). As a result, clients can feel more comfortable entering into the transaction because the plan can be unwound by the trustee and the clients repaid. The plan moves wealth to a dynasty trust without income, gift, estate or GST taxes. Finally, the strategy is relatively simple—most clients understand a loan and the trust investing those loaned assets to pay premiums and repay the loan.

Dilution Due to a Growing Family

One of the threats to wealth that's frequently overlooked is the dilution of the estate due to a growing family. For example, if clients had three children, and each child had three children (nine grandchildren total), \$100 million can, after a mere two generations, become \$5.6 million per heir.¹²

Even if the clients' estate isn't subject to estate taxes, by the time the wealth reaches grandchildren, it will have been diluted substantially. For example, with

three children and nine grandchildren (three per child), a \$10 million estate will be divided \$1.1 million per grandchild. With uneven distributions of grandchildren and the common use of per stirpes allocations, the result can be skewed even more unfairly. Life insurance can be used as a wealth creation vehicle to mitigate this estate dilution and unfair allocations, for example, with a \$10 million life insurance policy held in a pot trust for the benefit of all descendants.

Plan Today?

We're in the Golden Age of estate planning. Why would a client elect to defer planning in the most opportune wealth transfer environment we've ever seen? Absent compelling reasons, such as a serious medical condition, few clients really want to plan—there are always more important things to do. Many clients may be reluctant to transfer substantial wealth due to their concern over their personal financial security. They may feel that the Act's changes will become permanent or that their children already have enough. Finally, estate planning forces a client to face many uncomfortable issues including his own and his loved ones' mortality and often complex and emotionally charged family dynamics.

Whatever their reasons, clients need to understand the risks involved. Delaying planning not only extends the exposure of a portion of clients' assets to creditors (for example, with respect to the assets gifted to dual SLATs), but also, it has substantial costs in terms of the amount of wealth transferred. These costs are best illustrated with an example that first demonstrates the benefits of planning today and then the cost of delaying planning.

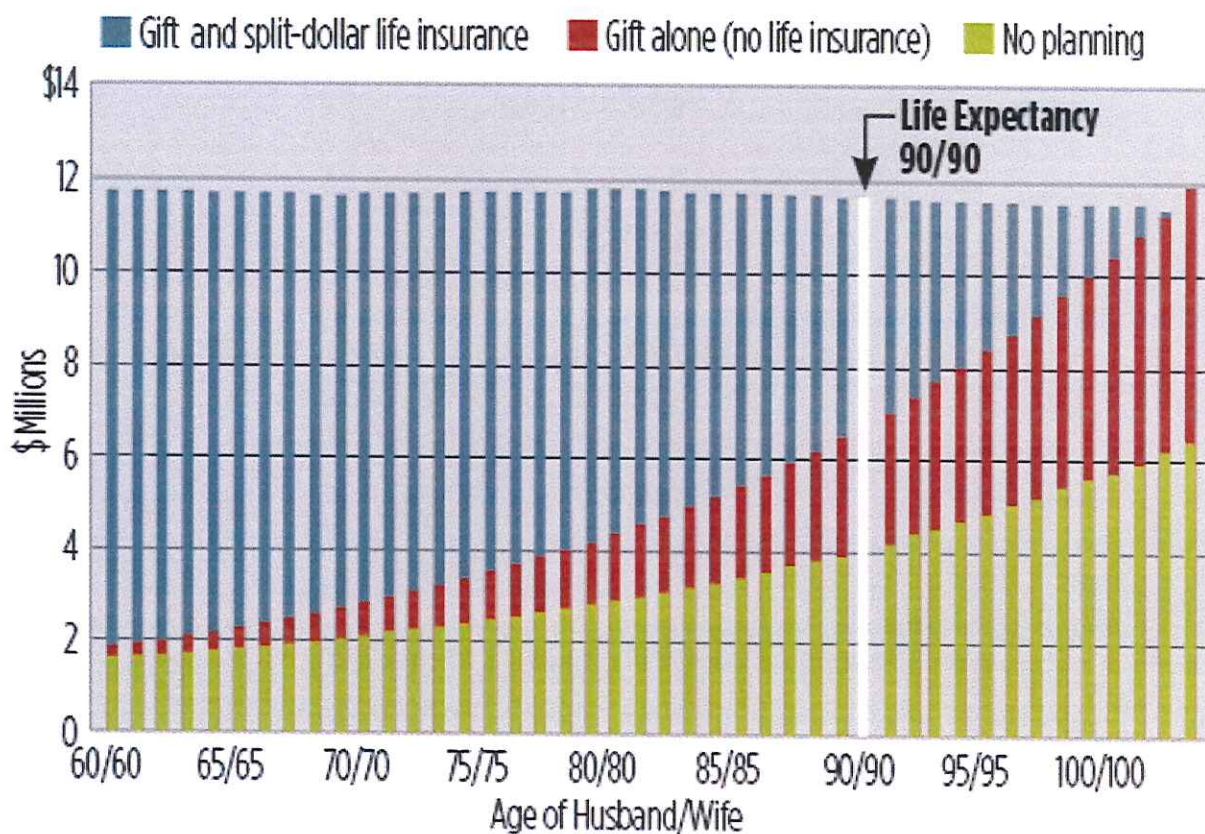
Example: Assume Husband and Wife, each age 60 and in excellent health, are considering a combined gift of \$1.75 million to a dynasty trust for the benefit of children and future generations only. The \$1.75 million of assets are assumed to grow at 5 percent pre-tax and 4 percent after tax and support \$10 million of permanent survivorship universal life coverage funded with a private split-dollar plan.¹³

"Plan Today," this page, compares the net to family if the second death occurs in any given year for three scenarios:¹⁴

1. No planning (the baseline). The \$1.75 million of assets are simply retained in the taxable estate.
2. The \$1.75 million of assets are gifted to a dynasty trust today, no life insurance.
3. The \$1.75 million of assets are gifted to a dynasty trust today, and \$10 million of survivorship life insurance is funded with an economic benefit regime split-dollar plan.

Plan Today

A comparison of three scenarios



— Robert W. Finnegan

The following observations can be made regarding “Plan Today”:

1. The green bars illustrate the net to family with no planning. The \$1.75 million of assets grow at 4 percent after-tax and, on the second death in any given year, are subject to a 40 percent estate tax.
2. The red bars represent the improvement over Scenario 1 (“No planning”) if the assets were gifted today without life insurance. It’s important to note that this planning takes time to move substantial wealth.
3. The blue bars illustrate the improvement based on the \$1.75 million gift using cash flow to fund survivorship life insurance. It’s important to note that if one of the clients lives to age 103, he would have been better off without the life insurance (the “crossover year”). Because we don’t know when deaths will occur,

this suggests a balance of Scenarios 2 and 3—the gift without life insurance protects against living too long, while the gift with life insurance protects against dying too soon. Many clients object to the expense of life insurance, but as the model demonstrates, it does in fact add value in all years.

“Net to Family,” p. 59, compares the wealth transferred at joint life expectancy of 90/90 (Year 31) for Scenarios 1, 2 and 3.

Net to Family

Wealth transferred at joint life expectancy

Wealth Transferred in . . .			
Planning Scenarios	Dynasty Trust	Estate (net after estate tax)	Total
1. No planning	\$1.75	\$2.26	\$4.01
2. Gift (no life insurance)	\$7.94	(\$1.22)	\$6.72
3. Gift and split dollar	\$13.65	(\$2.00)	\$11.65
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Change at life expectancy Scenario 3 to Scenario 1	\$11.90	(\$4.26)	\$7.64

All figures are in \$ millions

— Robert W. Finnegan

Regarding “Net to Family,” compared to Scenario 1, Scenario 3 transfers: (1) \$13.65 million to a dynasty trust (\$11.90 million more), and (2) \$4.26 million less via the estate¹⁵—true wealth shifting at work! The bottom line: There’s more for the family, less paid in taxes.

Next, assume that the clients delay planning for 10 years.¹⁶ “Cost of Delay,” this page, compares the wealth transferred at life expectancy (Age 90/90) for Scenario 3 if the \$1.75 million gift (with life insurance) was made today versus in 10 years. The cost of delay can vary widely depending on the health of the clients at that time.

Cost of Delay

How health can affect wealth transferred

	Alive	Rating(s)	Dynasty Trust	From Estate	Total	Less in Trust	Life Insurance Supported By \$1.75 gift	
Plan Today	M60/F60	Preferred NT	\$13.65	(\$2.00)	\$11.65	N/A	\$10.00	Plan Today
Plan In 10 Years	M70/F70	Preferred NT	\$3.56	\$0.35	\$8.91	(\$5.09)	\$6.60	Both Alive
	M70/F70	Standard NT	\$6.90	\$0.32	\$7.22	(\$6.75)	\$4.93	
	M70/F70	Table B (150%)	\$5.84	\$0.30	\$6.14	(\$7.81)	\$3.86	One Alive
	F70	Standard NT	\$5.22	\$0.40	\$5.62	(\$8.43)	\$3.28	
	M70	Standard NT	\$4.53	\$0.36	\$4.89	(\$9.12)	\$2.57	

Notes:

1. Assumes same products available in 10 years
2. Death benefit reflects private split-dollar scenarios
3. Principal preserved in all examples (such as cash flow funds coverage)
4. All figures are in \$ millions
5. "M" denotes male; "F" denotes female; "NT" denotes non-tobacco smoker

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Assuming a \$1.75 million gift in 10 years, “Cost of Delay” summarizes how the clients’ health can affect the wealth transferred:

1. The \$1.75 million gift supports \$3.4 million to \$7.43 million less life insurance.
2. There’s \$5.09 million to \$9.12 million less in a dynasty trust.
3. In all alternatives, the children receive about \$2.3 million to \$2.4 million more via the estate than in the Plan Today scenario because: (1) there are 10 years less of tax burn, and (2) in the delay planning scenarios, the growth of \$1.75 million over 10 years remains in the estate.¹⁷

From another perspective, the amount of the gift that would be required to support the full \$10 million of life insurance coverage if planning in 10 years depending on the health of the clients at that time varies from \$2.65 million if both clients are still preferred risks to over \$6 million if only the husband is still alive and a standard risk.

Keep Existing Life Insurance?

In many cases, clients will be considering whether to maintain existing life insurance coverage. It's essential not to make a rash decision without considering the long-term need for insurance and the many benefits it can continue to provide. Factors to consider include: the age and health of the insured, the availability and cost of replacement coverage, the lifestyle needs of clients, the estimated future value of the estate, the possible reduction of exemptions and the type of policy. If it's decided that coverage is no longer needed, there are many options besides surrendering the policy for its cash surrender value, including reducing the policy death benefit, selling the policy on the secondary market or using policy cash values to fund an annuity.¹⁸

Holistic Approach

Planning isn't just or even primarily about taxes, it's about protecting family security from all threats to wealth. Many HNW clients will elect to delay estate planning at their own and their families' peril. A holistic approach that first protects the clients' financial security, identifies and addresses all threats to wealth and provides optimal wealth transfer and income tax planning for clients and heirs can help clients make the decision to move forward with planning today.

Endnotes

1. Extremely low Internal Revenue Code Section 7520 and applicable federal rates, favorable valuation opportunities, dynasty trusts that are defective grantor trusts, extremely high and indexed gift, estate and generation-skipping transfer tax exemptions, even following sunset and favorable split-dollar rules and excellent life insurance products including fully guaranteed coverage remain after the Tax Cuts and Jobs Act of 2017.
2. This discussion is intended as a survey of available strategies, not as an exhaustive treatment.
3. Through removal and replacement powers, provided the appointed trustee is a non-adverse party who isn't related or subordinate under IRC Section 672(c).
4. Insurance can also protect against disability and long-term care needs.
5. For example, see Ed Morrow, "The Optimal Basis Increase Trust" (Jan. 24, 2018), promoted by LISI.
6. Five of the six client threats to wealth are addressed by planning with entities: (1) salaries or management fees provide access to income; (2) control of entity assets through voting shares, managing membership interests or general partnership interests; (3) strong creditor protection; (4) based on the growth and cash flow of the entity assets, protection against dying too soon; and (5) lower valuations result in more efficient wealth transfer, and lower income taxes may result under the new IRC Section 199A.

7. Antisocial behaviors include substance abuse, involvement in a cult or simply running with the “wrong crowd.”
8. Care must be taken to avoid reciprocal trusts. These trusts are especially powerful when executed as a dynasty trust in a state with favorable rule against perpetuities, decanting, self-settled trust and creditor protection statutes. See state rankings charts published by The Oshins Law Firm at www.oshins.com/state-rankings-charts.
9. Partial surrenders of cash values up to basis and policy loans are tax free provided the policy isn't a modified endowment contract.
10. Many policies provide long-term riders that must be underwritten and purchased at the time of issuance of the policy.
11. For a more complete discussion of private financing and loan regime split dollar, see Robert W. Finnegan, “Understand Split Dollar and Generational Split Dollar Plans,” *Estate Planning Magazine* (August 2017).
12. The example assumes that clients have a \$100 million estate, \$10 million of exemption available at each generation, 40 percent estate taxes, assets are left to children and growth of the estate net of lifestyle needs and charitable gifts equals inflation. In fact, inflation could erode assets further.
13. The life insurance is funded with economic benefit regime split dollar. The first death is assumed to take place in the 21st year, at which time the 1-year term cost increases to reflect the single life term cost. The 5 percent pre-tax cash flow net of the 1-year term cost is invested in a side fund. A portion of the side fund is used to roll out the split-dollar plan, so that the \$1.75 million of principal is preserved.
14. For the three scenarios, the model tracks the effect on the grantor (the estate) as well as the dynasty trust.
15. The negative \$2 million from the estate in Scenario 3 is due to: (1) the tax burn, (2) the premium burn from the split-dollar plan, and (3) the lost use of those funds (Scenarios 1 and 2 compounded at 4 percent after tax).
16. The example assumes that the increased exemption sunsets at the end of 2025 (nearly eight years), and it takes the client another two years to implement planning.
17. In 10 years, \$1.75 million at 4 percent after tax grows to \$2,590,427, less the \$1.75 million gift leaving \$840,427 in the estate.
18. Possibly with a long-term care rider potentially converting some of the taxable policy.