# Estate Planning for the Long Term in All Times

Timothy C. McFarland, JD

**Timothy C. McFarland, J.D.,** is an assistant vice president and associate counsel in the advanced markets group of John Hancock in Boston. Prior to joining John Hancock, McFarland had a private practice, concentrating on estate planning for moderate- and high-net-worth individuals, including planning for interests in real estate and closely held businesses, life insurance planning, planning for the disposition of large retirement plan assets and charitable planning. McFarland is a member of the Order of the Coif and the Massachusetts Bar Association.

*John Hancock Life Insurance Co.*
*Advanced Markets*
*197 Clarendon St. C-07-01*
*Boston, MA 02116*
*Phone: 716.572.4473*
*E-mail: tmcfarland@jhancock.com*

**I/R Code: 2500.00**
**Cassette: A0549**
**CD: C0549**

The twenty-first century opened with great promise and great expectations. But very quickly a confluence of events heralded uncertain times. For those of us involved in estate planning, we watched as clients froze like proverbial deer caught in headlights. Fortunately, as time has passed, many clients have begun to plan again. This is due in no small measure to the tenaciousness of financial planners. Financial planners who have been able to get their clients to "move" understand one simple but critical idea—estate planning in uncertain times remains planning for all times. Planning for uncertain times requires only that we become more creative and more flexible. We simply need to look at clients' assets and our planning tools in new ways. Rather than shrinking from uncertainty, we can and must help our clients face the future. It is an exciting time to be a planner! Let's begin.

## How Did We Get Here and Where Do We Go from Here?

In early 2000, the stock market dropped. Later in the year it became clear that an economic slow down had begun. In 2001, President Bush's tax act gave us estate tax uncertainty. Projected budget surpluses were quickly wiped out and replaced by historic budget deficits. Then September 11 happened. The War on Terror began in Afghanistan and the war in Iraq. During this same period, the credit markets entered a period of low interest rates not seen since the pre-Vietnam era. In addition, the IRS began its attack on a treasured insurance planning concept—split dollar. There was much wringing of hands and gnashing of teeth. But then planners began to ask several questions: what has changed; where do we need to be; and how do we get there?

What has changed? When thoughtful planners asked this question the answer quickly came to view. Nothing essential has changed.

Where do we need to be? When thoughtful planners asked this question the answer was the same. Nothing essential has changed. Financial planning remains the same: the creation of wealth, the conservation of wealth,

# Estate Planning for the Long Term in All Times *(continued)*

and the distribution of wealth. Clients still need to protect family members. Protecting spouses and providing for children remains paramount. Leaving a legacy and being remembered is still important. Maintaining control and a sense of independence is ever-present. And, of course, minimizing taxes is always on the minds of clients. But, the old adage remains true: "The tax tail should never wag the planning dog."

How do we get there? When thoughtful planners asked this question the answer changed, but only slightly. The key is to remain flexible and creative. Flexibility and creativity have always been the pillars of a good planning strategy. In uncertain times, planners focus on the foundation. Well thought out plans, well defined exit strategies and well drafted documents will secure the foundation. But this is not enough. Just as a magnificent building requires the skills of expert craftsmen, today's estate plans require the cooperation and coordination of a professional team of advisors. The quarterback of this team must decide if the plan will work, if it is the best strategy available, and if it will be the best strategy in the future. Creative plans that are built with flexibility in mind will stand the test of time and work for all time.

**Six Planning Ideas for Uncertain Times and All Times**

We will review six planning ideas that can help to maximize a client's planning objectives while minimizing taxes. They are:

1. Flexible ILIT Planning
2. Paying Life Insurance Premiums with Tax Disadvantaged Assets—"The MAXs"
3. Paying Life Insurance Premiums with Tax Advantaged Assets
4. Third Party Premium Financing
5. Leveraging Family Money to Pay Life Insurance Premiums
6. Deferred Gifting Plans as Exit Strategies.

Each of these ideas works on the same principle-- flexible and creative use of assets and planning tools.

**Flexible ILIT Planning**

An irrevocable life insurance trust (an "ILIT") as its name suggests is irrevocable. An irrevocable trust means that the trust cannot be altered, amended or revoked by the grantor (the creator of the trust). An ILIT must be irrevocable to be effective for federal estate, gift, and generation-skipping transfer ("GST") tax purposes. However, IRREVOCABLE does not mean INFLEXIBLE. A well drafted ILIT can be a very flexible document over time. But it must be drafted flexibly upfront. Too many times, ILITs are drafted only to meet a specific need at a specific time. There is nothing per se wrong with drafting an ILIT for a specific need or a specific family situation. After all, if drafted competently, the ILIT will meet the need and situation. The problem is that the ILIT becomes time bound. It is inflexible. It cannot adapt to changing needs and changing family situations. And needs and family situations do change.

If drafted flexibly, an ILIT can hold assets other than life insurance. It can be effective for estate, gift and GST tax purposes but ignored for income tax purposes. It can maximize the use of federal gift-tax annual exclusions, gift-splitting, and generation-skipping exclusions. It can provide liquidity for estate taxes. It can be "blown-up" if estate taxes are permanently repealed. It can provide income and estate tax free resources for surviving spouses and children. It can protect children against creditors and themselves. It can provide a family bank for many future generations. Or, it can remain a source of cash for the grantor and his spouse, albeit through the spouse. The key is in the drafting[1].

Perhaps the most flexible ILIT is "The Cristofani Survivorship Spousal Access Dynasty Trust". This is not an actual type of trust; it is simply an ILIT with multiple flexible provisions incorporated into a single document.

Why Cristofani? Rather than limiting Crummey withdrawal rights to children, this trust provides all issue (lineal descendants of the grantor) with Crummey rights.[2] Even if there are no grandchildren today, there likely will be grandchildren tomorrow. Granting powers to issue rather than limiting powers to children maximizes the

# Estate Planning for the Long Term in All Times *(continued)*

number of available annual exclusions today and permits the number to increase as the class increases. This is especially important in this time of estate tax uncertainty. With decreasing gift tax rates, the lifetime gift tax exemption set at $1,000,000 per person, and permanent estate tax repeal still a possibility, paying gift taxes is unpalatable. Cristofani Crummey powers, together with spousal gift-splitting, can maximize the amount of tax-free gifting to fund insurance premium dollars.

Why Survivorship? Although there is the possibility of permanent estate tax repeal, the more likely scenario will be some form of reform. With reform, marital deduction planning will remain an important factor in estate planning. Thus, survivorship insurance, with its lower COIs, remains the preferred choice of insurance for estate tax liquidity.

Why Spousal Access? A spousal access provision permits the non-grantor spouse to have access to policy values as a beneficiary of the ILIT with no estate tax inclusion in either spouse's estate. See PLRs 9602010 and 9748029. What this means is that the marital unit can have access to cash surrender values if necessary. The ILIT can have a provision that gives an independent trustee (a trusted friend or advisor of the grantor) the power to pay any and all income and principal to any one or more of the beneficiary spouse and issue in such amounts and manner, as the trustee deems expedient. Such a power will also permit the trustee to "blow up" the ILIT if the estate tax is permanently repealed[3]. (Although, the trustee need not do so if there are sufficient non-tax reasons to maintain the insurance in the trust.) If the estate tax is permanently repealed, the trustee can exercise his absolute discretion to distribute the policy to the spouse. The beneficiary spouse could then surrender the policy and would have the net cash surrender value at her disposal. With the policy distributed out of the trust, the trustee would then simply terminate the trust for want of assets. Obviously, if the estate tax is not repealed the trust would continue as planned.[4]

CAVEAT: In a community property state, such as California, it is imperative that the grantor spouse use separate property to fund the trust. Otherwise, the beneficiary spouse will be deemed to have contributed one-half of each gift. The beneficiary spouse's beneficial interest in the trust would then be considered a retained interest under Section 2036 of the Code resulting in estate tax inclusion of a part or all of the trust proceeds in her estate. If there is no separate community property, a separate property agreement should be used to create separate property. If possible, consider separating other property as well in the beneficiary spouse's name to equalize the effect of the agreement. Also, basis considerations need to be taken into consideration. Any such agreement must be in force BEFORE any gifts to the trust are made. And, create a notation in your tickler system to remind yourself to review the plan each year with the clients to make sure the separate property, and not the joint checking account, is used to make gifts of the premium dollars.

Why a Dynasty Trust? The answer here is why not. Unless available GST tax exemption will be used elsewhere, why not draft the ILIT as a dynasty trust. Too many ILITs are drafted to simply avoid the estate tax. Once both spouses have died, the assets are distributed to the children. While this may be perfectly acceptable (and desirable from the children's viewpoint) it is less than ideal. The vagaries of life make mandatory distributions suspect. A child may appear fine today, but may be hiding a drug, alcohol, or gambling problem. A child may appear happily married today, but be facing an ugly divorce tomorrow. A child may be healthy today, but become permanently disabled in the future. Or, parents may decide that it is unwise to give too much money too soon to children, if ever. If any of these events or decisions is made after the trust is drafted, it will be too late.[5]

Keeping assets in the ILIT for an indefinite period of time can protect beneficiaries against themselves. If it makes sense to distribute assets to children (or grandchildren) an independent trustee can be given the discretion to do so. If a decision is made to withhold distribution, the trustee can be instructed to revisit that decision over some interval of time. Mandating a distribution prevents a second, future look.

# Estate Planning for the Long Term in All Times *(continued)*

In addition, children may become wealthy in their own right. In such a case, passing assets outright will only exacerbate their estate tax problems.

Dynasty trust provisions can alleviate these concerns and create the potential for a family bank of unlimited duration. Life insurance proceeds received estate and income tax free can be significantly leveraged over the approximately one hundred (100) years that a dynasty trust can last in a rule against perpetuities state. A thousand (1000) years in a non-perpetuities state is almost unfathomable! Of course distributions will deplete the trust and thereby reduce leverage, but life insurance on trust beneficiaries, if permitted under applicable state law or the trust document, can replenish the trust assets. The leverage in terms of premium dollars and annual exclusions can be truly phenomenal.

The bottom line is that good planning requires anticipating future needs and planning for them today. Flexible ILITs are the essential tool for planning.

**Paying Life Insurance Premiums with Tax Disadvantaged Assets— "The MAXs"**

Many clients have assets that are excellent choices for the creation or conservation stages of financial planning. However, as the clients move to the conservation or distribution stages, these assets become unneeded or undesirable because of market performance or orientation, because the clients' other assets are sufficient to meet current and future needs, or because these assets are tax disadvantaged assets. The challenge here is to leverage these assets for the clients or their heirs. Four planning concepts (called the "MAXs") have been developed to meet this challenge. They are Income Maximization, Annuity Maximization, Qualified Plan Maximization, and Municipal Bond Maximization. They are generally listed in this order because they represent a planning spectrum. Income Maximization serves a dual purpose: increasing a client's cash flow and (if necessary or desirable) saving estate taxes. Annuity Maximization and Qualified Plan Maximization are designed to reduce the double whammy of estate taxes and income taxes in the form of income in respect of decedent (IRD) on deferred annuities and qualified plan assets (including IRAs). Municipal Bond Maximization represents the other end of the spectrum, where estate tax savings (usually there is no concern about IRD) is the key, and the potential for more cash flow is secondary.

Income Maximization. Here the client has a low income yielding investment. Generally, the desire is to increase yield for the benefit of the client. A secondary consideration may be estate taxes. For example, the client may have a low yield bond. The client wants more income but desires security. Selling the bond and investing in a single premium immediate annuity (a "SPIA") may be the perfect answer. The annual SPIA payment will likely be much higher than the annual bond interest. In addition, with the exclusion ratio, much of the SPIA payment, at least through life expectancy, should be income tax free.

But what if the client desired to leave the asset to her children? With a SPIA, once the client dies, there will be no further payments to heirs (absent a term certain). However, it may be possible to purchase the SPIA, increase the client's income, and use any excess SPIA income to purchase insurance to replace all or a portion of the asset.

Annuity Maximization and Qualified Plan Maximization. Deferred annuities and qualified plan assets are tax-advantaged savings tools for retirement. However, if a client dies owning a deferred annuity or qualified plan asset, there is a potential double tax in the form of the estate tax and income tax on IRD. The net result is that the amount passing to the heirs may be as little as twenty-five (25) cents on the dollar, rather than the entire account balance. For example, after estate and IRD taxes a $1,000,000 deferred annuity or IRA balance may only yield the heirs $250,000.

Annuity Maximization and Qualified Plan Maximization involves taking distributions[6] from or annuitizing the contract or plan. The clients can take the net distributions and give them to an ILIT, which will purchase life insurance on the clients. The estate tax and income tax

# Estate Planning for the Long Term in All Times *(continued)*

free death benefit to the heirs outweighs the current imposition of income tax.

Some planners argue that Annuity Maximization and Qualified Plan Maximization are unnecessary given the ability to stretch distributions. However, while a stretch may outperform a MAX strategy in the long run, the author questions whether beneficiaries will ever opt to stretch, given the demands of college education and mortgage payments. While it is also true that some commercial deferred annuity contracts permit the client to choose the stretch as a payment option, the author suggests that careful consideration be given to such a decision, especially if it must be made irrevocably.

Municipal Bond Maximization. The play is essentially the same as with Annuity Maximization and Qualified Plan Maximization, except there is generally no IRD issue.

In sum, the MAXs reposition assets in a way that leverages the value for the benefit of the clients or their heirs. From a planning perspective, the MAXs turn ugly ducklings into swans.

**Paying Life Insurance Premiums with Tax Advantaged Assets**

Some assets have been or can be positioned such that they become tax-favored planning assets. These assets are ideal sources to pay insurance premiums, because gift tax issues can be eliminated or minimized. In addition, the positioning of such assets permits clients to achieve other non-tax goals such as control and protecting beneficiaries from the vagaries of life.

Using Family Limited Partnerships with an ILIT. Many attorneys and CPAs advise clients to set up family limited partnerships ("FLPs") or limited liability companies ("LLCs") to accomplish estate freezes with gift tax discounting. This is fundamental and excellent advanced planning.[7] However, where many advisors go wrong, in the author's view, is by giving such assets directly to children or grandchildren. As noted above in the discussion of flexible ILITs, there really is no reason to make substantial outright gifts of assets. A flexible ILIT is a much better vehicle to effect gifting strategies.

Appreciating assets with good cash flows are excellent FLP candidates. But take the planning one step further. Suppose the grantor gives the FLP interests to an ILIT. All cash flow with respect to the ILIT's interest in the FLP will flow to the ILIT when distributed by the FLP. This cash flow can be used to pay premiums on an insurance policy on the lives of the grantor and his spouse. Because the cash flow "belongs" to the ILIT, no further gifts are required to pay insurance premiums. In addition, if the ILIT is structured to be defective for federal income tax purposes, the grantor will pay all income taxes with respect to the ILIT's share of FLP income. This means that the gross cash flow to the ILIT is available to pay premiums and that the grantor's estate is depleted at income tax rates rather than estate tax rates. Moreover, if the grantor's spouse is named as a discretionary beneficiary of the ILIT, distributions can be made to the spouse in the discretion of an independent trustee. The spouse can use such distributions to offset income taxes (if the spouses file a joint return) or for living expenses.[8]

Consider Johnny and Peggy Walker. Johnny and Peggy are each age 60 and in excellent health. They have two children. They are successful real estate investors and have a gross estate of approximately $15,000,000. Their attorney suggests that they set up an FLP funded with cash and a piece of property worth approximately $3,000,000. With a modest 33% discount Johnny and Peggy can move the value of the property to their children without gift taxes by using up their combined $2,000,000 life time gift exclusions. The net result will be an "estate freeze" with respect to the property.

However, Johnny and Peggy need $10,000,000 of survivorship insurance for estate liquidity. The insurance planner suggests that the insurance plan piggy back off the attorney's plan. He suggests that rather than giving the FLP interests to the children outright, Johnny and Peggy give the interests to a defective ILIT (with spousal access provisions). The property generates $170,000 of net rental income annually. For simplicity, assume that the ILIT's share of FLP distributions equals the net rent roll. Thus, the ILIT will receive $170,000 annually with no further gifts from the Walkers.

# Estate Planning for the Long Term in All Times *(continued)*

The ILIT trustee will use $100,000 to purchase a survivorship universal life policy with a guaranteed death benefit of approximately $10,670,000. The ILIT trustee may (but need not) distribute the remaining $70,000 to Peggy. If Peggy so chooses, she can use any such distributions to pay income taxes or living expenses. In the alternative, the ILIT trustee can side fund the excess income or purchase additional insurance.

By suggesting that the FLP gifts be made to the ILIT, the insurance planner found a creative and flexible solution to the Walkers' planning needs.

Leveraging the Credit Shelter Trust. Marital deduction and credit shelter planning are the cornerstones of basic estate tax planning. Upon the death of the first spouse, the deceased spouse's assets are separated into two pots—the marital deduction amount and the credit shelter amount. The marital deduction amount is designed to postpone taxes until the surviving spouse's death. The credit shelter amount is equal to the deceased spouse's "unified credit"[9]. This amount is set aside in the Credit Shelter Trust (also known as the CST, the By-pass Trust, the B Trust, or the Family Trust). By setting aside the deceased spouse's unified credit amount in a separate trust, it is not "wasted"; the assets will not be included in the surviving spouse's estate as a marital deduction item.

The unlimited marital deduction led to the introduction of survivorship or second-to-die insurance. Insuring two lives is "cheaper" than insuring a single life. Thus, because estate taxes are delayed until the second death, it makes economic sense to purchase a policy that will only pay off on the surviving spouse's death.

Martial deduction and credit shelter trust planning coupled with survivorship insurance is a rock solid plan. However, a plan is only good if it is fully implemented. Clients do not always purchase the "right" amount of survivorship insurance. Or, situations change and the amount previously purchased is no longer sufficient. All too often, unfortunately, one spouse dies before additional survivorship insurance can be purchased.

The need for more insurance is still present, but now the premium cost is higher. Moreover, the surviving spouse may not be able to shelter the premium cost with gift tax exemptions. The only apparent solutions are to not purchase adequate insurance or pay gift taxes. Neither is palatable. Fortunately there may be another option.

Often times, the deceased spouse's CST is unused. The surviving spouse does not need the asset, so it may not be actively managed. Indeed, it may be neglected. However, its very nature makes it an ideal asset to leverage with life insurance. By definition, the CST is out of the surviving spouse's estate. Thus, using it to pay insurance premiums requires no gifting by the surviving spouse. Also, the CST may be fully or partially GST exempt because the deceased spouse's remaining GST exemption likely will have been applied to it.

Consider Anna Bronson. She is a widow age 65. Her late husband David's CST is currently worth $1,000,000. Anna has two children and needs more life insurance for estate liquidity. However, she has limited gifting ability. Her insurance planner has suggested having the CST purchase insurance on her life.

The planner has determined that the CST (with an assumed net growth rate of 6%) can pay premiums of $65,070 until Anna reaches age 100.[10] This amount will purchase a universal life policy with a guaranteed death benefit of approximately $3,800,000. If Anna lives to life expectancy (assumed to be age 83) Anna's heirs will receive approximately $4,500,000 (the death benefit plus the remaining CST fund). If the CST were simply invested at 6%, the heirs would receive approximately $2,800,000. Thus, by leveraging the CST, Anna's heirs net an additional $1,700,000 of liquidity free of estate and income taxes.

Before purchasing a policy inside a CST, it is important for the surviving spouse's tax advisor to determine whether the CST can hold insurance and whether the insurance will be includible in the surviving spouse's estate. To avoid incidents of ownership, the surviving spouse should not be a trustee or should resign as trustee before the insurance is put in force. In addition, there are certain rights or powers the surviving spouse may have in the CST that may cause the death proceeds to be includible in her estate.

# Estate Planning for the Long Term in All Times *(continued)*

Mandatory income rights, withdrawal rights, and limited powers of appointment may militate against owning the insurance inside the CST. If so, does this mean the CST assets cannot be leveraged? The answer is no.

It may be possible to have the CST lend money (at applicable federal rates) to a new ILIT set up by the surviving spouse. The surviving spouse can then make gifts to the ILIT to pay interest on the loan. Upon the surviving spouse's death, the ILIT can use the death proceeds to pay back the loan. If the ILIT and CST have identical terms, it will not matter in what pot the death proceeds land.[11]

Consider Mary Kerrigan. She is age 72 and in excellent health. Her husband's CST has $1,000,000 of assets. She needs more insurance for estate liquidity. She has four Crummey beneficiaries. Her advisors considered purchasing insurance in the CST, but advised against it because of unfavorable provisions in the CST instrument. Instead, they advised having the CST lend money to a new ILIT to be established by Mary. In addition, Mary will make annual gifts of $44,000 to the ILIT. The ILIT trustee will use the loans and gifts to pay premiums and interest on the loans. Any excess gifts not needed to pay current interest will be side funded in ILIT.

The advisors determined that the maximum amount that the CST should lend each year is $80,500.[12] The advisors assumed an average interest rate on the loans of 5%.[13] The ILIT trustee will use the premium loans to purchase a universal life contract with a guaranteed death benefit of approximately $3,200,000. If Mary lives to life expectancy (assumed to be age 83) Anna's heirs will receive approximately $4,275,000 (the death benefit plus the remaining CST fund plus the ILIT side fund). Thus, by leveraging the CST, Anna's heirs net $2,200,000 more liquidity free of estate and income taxes than if Anna had done nothing and approximately $600,000 more than if she had used only her $44,000 annual exclusions to purchase insurance.

### Third Party Premium Financing

A detailed discussion of third party financing of insurance (or premium financing as it is more commonly called) is beyond the scope of this article. However, it is important to mention it as a strategy to pay premiums for the right clients in these uncertain times. Premium financing is not free insurance. Only clients who understand interest rate risk and arbitrage should use this strategy. In addition, clients should have the wherewithal to pay premiums but choose not to for one of several reasons: they have a short term liquidity need, interest rate arbitrage, or they believe estate taxes are likely to be repealed and want to leverage dollars to pay insurance premiums in the interim. Premium financing should not be considered without an exit strategy. Clients under age 80 should have a strategy in place to exit the loan. Otherwise, interest rate risk becomes a significant factor. Despite these caveats, clients may want to consider premium financing for estate liquidity needs, gift tax leverage, business insurance needs (particularly where short term cash flow issues would otherwise preclude the purchase of permanent insurance), split dollar rollout, and 1035 exchanges with heavily loaned policies.

### Leveraging Family Money to Pay Life Insurance Premiums

As mentioned above, with estate tax repeal/reform uncertain, it is generally inadvisable to pay gift taxes. However, many clients have insurance needs with premiums that exceed current gifting ability. In the past, clients would have turned to split dollar. However, with the final split dollar regulations many advisors are uncomfortable suggesting traditional split dollar plans. Many clients consider premium financing but balk at the interest rate risk and the recourse nature of the loan. Also, many clients find the collateral requirements of such loans unpalatable. After rejecting split dollar and premium financing, the clients still have an insurance need. Enter self-financing.

Self-financing is nothing more than a private loan between a grantor and his ILIT. Although loans between family members or family entities are suspect, self-financing will be respected if the arrangement is treated as a true loan. See Miller v. Commr., T.C.M. 1996-3. In addition, if adequate interest is charged, the arrangement will not

# Estate Planning for the Long Term in All Times *(continued)*

be subject to the onerous loan requirements of the new split dollar regulations. To have adequate stated interest, the loan must require interest to be charged at the appropriate applicable federal rate[14]. With a loan transaction, the grantor has not made any gifts to the trust. Thus, the grantor's limited gifting ability is overcome.

It is essential that the ILIT be defective for income tax purposes. With a defective ILIT, the loan transaction is ignored for federal income tax purposes. See Rev. Rul. 85-13 (a taxpayer cannot enter into a taxable transaction with himself). Thus, the interest payments are ignored for income tax purposes (and if interest is capitalized any OID will also be ignored). In addition, the loan repayment will be ignored. The grantor does pay income taxes on the earnings in the ILIT. However, as mentioned above, this results in a depletion of the grantor's estate at income tax rates rather than gift or estate tax rates.

Self-financing is ideal for any wealthy client whether young or old. Essentially the only requirement is that the client be able to part with the loan funds. As with premium financing, clients should have an exit strategy to insure that the desired leverage is realized.

Self-financing can take myriad forms. However, in general, self-financing falls into three categories: a lump sum arrangement, an annual loan arrangement, and a sinking fund arrangement.

Lump sum financing. With a lump sum loan, the grantor lends the ILIT upfront a lump sum of cash. The cash is then invested inside the ILIT. From the investment returns, the ILIT trustee will pay interest to the grantor and premiums for the loan term. At the end of the loan term, the principal amount of the loan is repaid from the ILIT to the grantor. In the alternative, interest can be capitalized during the loan period. In that case, the ILIT trustee will use only a portion of the investment returns to fund the premium and will side fund the balance. At the end of the loan term, the ILIT will use the investment fund to repay the grantor the capitalized interest and principal amount of the loan.

In each case, the ILIT purchases a guaranteed universal life contract (either single life or survivorship) on a short pay basis. The premium stream generally is set equal to the loan term. As a result, at the end of the loan term, the loan is repaid and the ILIT is left with a guaranteed death benefit with no further premiums due.

Lump sum financing is ideal for younger clients and clients who are only willing to be tied to the loan arrangement for a relatively short period of time.

With lump sum financing, the interest rate is locked for the duration of the loan. In addition, the total amount of premium needed is fixed. The only variable is what rate of return the ILIT will earn on the invested funds. On the downside, lump sum financing generally requires a large amount of idle cash. Many clients do not have sufficient idle cash to make lump sum financing an option. If such is the case, annual loan financing should be considered.[15]

CAVEAT: Some planners believe that the grantor can lend assets to the ILIT, much like your neighbor can lend you a cup of sugar. However, it is the author's view that only cash can be lent. Attempting to "lend" assets may cause the IRS to argue that the loan arrangement is a failed attempt to set up a GRAT. As a failed GRAT arrangement, the entire amount lent would be subject to gift taxes at the outset.

Annual loan financing. With annual loan financing, the grantor annually lends the ILIT an amount equal to the annual premium. Interest can be paid currently (with other trust assets or gifts from the grantor) or capitalized. The loan principal (or loan principal and capitalized interest) is repaid at the grantor's death.

In each case, the ILIT purchases a guaranteed universal life contract (either single life or survivorship) on a full-pay basis. However, because the loan will not be repaid until death, the value of the note will be included in the grantor's estate for federal estate tax purposes.[16] If interest is capitalized, an ever-increasing amount will be subject to estate taxes. This means that the death benefit leverage may decline as the grantor's age increases. To cover this "loss" a return of premium rider and/or a cost of money factor may be added to the policy. Return of premium riders and cost of money riders are expensive. Thus, the planner must account for this added cost.

# Estate Planning for the Long Term in All Times *(continued)*

In addition, the parties cannot lock the interest on an annual loan arrangement. All that can be done is to lock each year's interest rate. Thus, there will be an "average" interest rate over the entire arrangement. The parties must estimate what this rate will be. Due to this interest rate uncertainty, annual loan financing is generally only appropriate for very old clients or arrangements where an exit strategy will be used.

Sinking fund financing. A sinking fund arrangement is a hybrid of the lump sum and annual loan methods. The grantor lends the ILIT a lump sum upfront (thus locking the interest rate for the life of the loan). The ILIT trustee invests the lump sum amount and uses it as a sinking fund from which to draw down annual premium payments. The sinking fund allows the grantor to lock his costs upfront. With a return of premium rider and a cost of money rider and given today's low long term AFRs, the policy can "cover" the estate taxes on the loan if interest is capitalized (at least out to age 100). As with the lump sum loan method, the only variable is the rate of return on ILITs investments. Thus, the sinking fund is ideal for clients who are older but may live beyond life expectancy.

To see how self-financing works, consider Mr. and Mrs. Jackson. They are both age 70 and in excellent health. They have limited gifting ability, but need an additional $10,000,000 of survivorship insurance for estate liquidity purposes.

Under a lump sum arrangement, Mr. Jackson would need to lend approximately $9,700,000 to a defective ILIT for a term of 9 years. Interest can be capitalized at the mid-term AFR. The ILIT can invest the loan proceeds at 7% in a side fund. From the ILIT earnings each year, the ILIT will pay a 9-pay premium on a survivorship universal life contract with a guaranteed death benefit of $10,000,000. At the end of the loan term, the loan will have grown to approximately $13,700,000. However, the ILIT side fund should equal or exceed that amount. The ILIT trustee can use the ILIT side fund to repay the loan and have a fully paid policy.

Mr. Jackson does not have $9,700,000 of cash available. So he considers an annual loan strategy. With a 50% return of premium rider and a 5% cost of money rider, the full-pay premium is approximately $208,000. With an assumed average interest rate of 5% and interest capitalization, the annual loan approach will net $10,000,000 of liquidity after the loan is paid off. However, if interest rates average higher than 5%, the plan will not be able to maintain $10,000,000 of net liquidity due to compounding of interest on the loan.

Mr. Jackson, does not like the interest rate risk. Thus, he considers a sinking fund approach. In order to cover the $208,000 premium, Mr. Jackson will need to lend the ILIT approximately $2,800,000 upfront. Interest will be capitalized at 5% as before, but now that rate is locked. In addition, Mr. Jackson is comfortable that the ILIT can maintain a 7% average rate of return. Under these assumptions, the plan will net $10,000,000 of liquidity in all years out to age 100.

**Deferred Gifting Plans as Exit Strategies**

As mentioned above, flexible and creative plans require a renewed focus on exit strategies. In this time of estate tax uncertainty, deferred gifting strategies that yield a zero gift tax cost are ideal exit strategies. Two especially noteworthy deferred gifting strategies that are ideal candidates are zeroed-out grantor retained annuity trusts (so-called "zeroed-out GRATs" or "Walton GRATs") and zeroed-out charitable lead annuity trusts ("zeroed-out CLATs"). Both zeroed-out GRATs and CLATs as exit strategies take advantage of the current low interest rate environment to leverage assets with solid growth potential and cash flow as sources of loan repayment dollars[17]. Use in this way is admittedly contrarian, but is necessitated by the need to fund premium dollars without incurring gift taxes. Of the two strategies, zeroed-out GRATs are generally the preferred tool[18]. This is due to the fact that CLATs are complex animals and require a true donative intent. Absent a present donative intent, CLATs simply aren't worth the trouble.

Consider a situation in which a client has considered and rejected premium financing, lump sum self-financing, annual loan self-financing, and sinking fund self-financing. The client agrees that he needs additional insurance

# Estate Planning for the Long Term in All Times *(continued)*

coverage and realizes the gift tax issues. However, he simply isn't willing to give away his assets without getting something in return. Here is where the zeroed-out GRAT as an exit strategy comes in to play.

The client can be advised to lend his ILIT the annual premium on a 8, 10, 12 or 15-pay basis. Interest will be capitalized at some conservative average interest rate. The client will also create a zeroed-out GRAT (with a term equal to the premium payment period). He will fund this GRAT with an appreciating asset with good cash flow. Each year the GRAT will provide him with an annuity. The annuity may or may not be the source of the premium loans; that decision is left to the client. The annuity must be paid no matter how the GRAT asset performs. At the end of the GRAT term, the GRAT remainder will flow, not to his children as would normally be the case, but instead to his defective ILIT. The ILIT trustee can then use the GRAT remainder asset(s) to repay the loan. The grantor has had an annuity stream over the GRAT term and has all or part of the value of the asset at his disposal at the end of the GRAT term.

Married couples, particularly younger couples, may want to consider private non-equity collateral assignment split dollar in place of a self-financing arrangement, with a zeroed-out GRAT as the exit strategy. The economic benefit costs generally will be much less than current interest charges, and thus the size of the GRAT can be significantly less. For example, a 60-year old couple in good health can fund a $10,000,000 guaranteed universal life policy on a private split dollar basis for ten years for as little as $642 in first-year economic benefit costs and $2832 in year 10[19].

## Conclusion

Planning is a process. Goals and needs will change. Life situations will change. Clients need creative and flexible plans that anticipate the vagaries of life. Always remember to stay flexible and be creative.

## (Footnotes)

[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and state tax laws (including the GST tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[2] Lineal descendants of the grantor should be permissible *Crummey* beneficiaries. *See Estate of Cristofani v. Commr.*, 97 T.C. 74 (1991); *Estate of Kohlsaat v. Commr.*, T.C. Memo. 1997-212; *Estate of Holland v. Commr.*, T.C. Memo. 1997-302. Note, however, that the IRS is critical of *Cristofani*-type *Crummey* provisions. Apparently the IRS believes that only current income beneficiaries or beneficiaries with vested remainder interests should be permissible *Crummey* power holders. The IRS views powers given to contingent beneficiaries as illusory. See A.O.D. 1996-010, 1996-29 I.R.B. (acquiescence in result only by IRS in *Cristofani*). The author believes the IRS is simply wrong. Nevertheless, consider making all descendants or issue current permissible recipients of income and principal during the life of the insured(s). In addition, to minimize the risk of IRS disallowance of *Crummey* powers avoid "naked" or "bare" powers. Do not give the Queen of England and her issue *Crummey* powers. Stick to descendants, or if none, to collateral heirs (*i.e.*, nieces and nephews and their issue).

[3] It is important to note that there cannot and should not be a prearranged plan or agreement between the grantor spouse and the trustee that the trust will be terminated in favor of the beneficiary spouse upon repeal or upon demand of the grantor spouse. See I.R.C. §2036 and Treas. Reg. §20.2036-1(a) ("An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred").

[4] The beneficiary spouse can split gifts even though she is a beneficiary of the trust without causing the ILIT assets to be included in her estate for estate tax purposes. The gift-splitting rule only applies for gift tax purposes. *See* I.R.C. §2513. The grantor is treated as the true transferor for estate purposes. *See* Rev. Rul. 74-556, 1974-2 C.B. 300. Keep in mind that with gift-splitting each spouse is deemed to be a transferor with respect to one-half of all gifts for federal GST tax purposes. *See* I.R.C. §2652(a)(2). Thus, if gift-splitting is used, each spouse must apply a portion of his or her GST tax exemption to shelter the gifts from the GST tax.

[5] It may be possible to transfer assets of the trust to a newly drafted trust or to sell assets from one trust to another trust, but each of these "rescue" plans has costs and limitations. It is much more preferable to draft flexibly upfront (even to the extent of anticipating a transfer to a newly drafted trust in the future).

[6] Clients who are under age 59 ½ must consider the 10% penalty on premature withdrawals and the exceptions thereto.

[7] Despite all the fuss over family limited partnerships, if designed and used properly they remain a vital and basic tool of advanced estate planning.

# Estate Planning for the Long Term in All Times

[8] There can be no prearranged plan to distribute cash flow to the beneficiary spouse to pay income taxes. If such a plan is deemed to exist, the assets of the ILIT may be includible in the grantor spouse's estate for estate tax purposes. *See* footnote 3 above. Some tax advisors may not be comfortable having a spouse as a beneficiary in such a case.

[9] The unified credit under the estate tax is now called the "applicable credit amount". For simplicity, the author will use its more familiar, if not technically correct, name.

[10] The planner solved for a sinking fund amount that would exhaust the fund under the growth assumptions at age 100, because at age 100 all premiums cease and the death benefit will be paid no matter when Anna dies. If the fund were to be depleted before then, the policy might lapse, with disastrous results.

[11] Indeed, it may be possible to do limited post mortem planning (by leveraging premium loans) to move assets away from or tie up assets for a CST beneficiary.

[12] This amount will insure that out to age 100 the total interest (at the assumed interest rate) will not exceed Mary's ability to make tax free gifts.

[13] Each premium loan will have a fixed interest rate until Mary's death. However, each year the interest rate will be set to the appropriate applicable federal rate (AFR) for the month in which the premium is paid. Thus, actual interest rates may be higher or lower than the assumed average rate of 5%. *See* I.R.C. §7872 and the regulations thereunder.

[14]The IRS publishes these rates monthly. Interest must be charged. It need not be paid currently. Thus, interest can be capitalized. A self-financed loan with capitalized interest is akin to a zero coupon bond. Like a zero coupon bond, a self-financed loan is taxed under the original issue discount (OID) rules of the Internal Revenue Code.

[15] In the alternative, clients may want to consider a sale of assets to the ILIT. Most practitioners agree that a gift of "seed" money is necessary to make the sale effective for tax purposes. The rule of thumb is 10% of the value of the assets sold. The seed gift would need to be covered by available unified credit or annual gift tax exclusions. If neither is available a sale may not be an option. For the sale to be ignored for income tax purposes, the ILIT must be defective for income tax purposes.

[16] The value of the note may be discounted due to lack of marketability. However, for this discussion it is assumed that the note will be returned at face value.

[17] To be effective as an exit strategy, the grantor must outlive the zeroed-out GRAT term. If the grantor's life expectancy is too short, a zeroed-out GRAT may not work. In such a case, the planner may want to consider a sale of assets to a defective ILIT. *See* footnote 15 above.

[18] Keep in mind that if a zeroed-out GRAT will be used as the exit strategy, the ILIT should not be used for dynasty trust planning. This is so because under the estate tax inclusion period ("ETIP") rules of the Code, GST exemption cannot be allocated to the zeroed-out GRAT until the GRAT term expires. *See* I.R.C. §2642(f). Allocation after the ETIP period ends is not practicable or desirable, because such an allocation likely will not be able to fully exempt the ILIT from future GST tax.

[19] Economic benefit rates were determined by running IRS Table 2001 through the so-called Greenberg-to-Greenberg formula for determining survivorship economic benefit rates.