

Life Insurance in Estate Planning

By Joel Kabaker

Alphabet Soup of Trusts and Other Instruments

Most professional estate planners are familiar with the trusts and other financial instruments used to protect assets and effect movement from one generation to another. That is not what we will explain again here. Instead, we will work with just three of the most useful instruments. There are a number of insurance-related techniques that, when used in conjunction with these three instruments, can effect a better result. We will show the circumstances, problems to watch for and opportunities on which to capitalize, where these techniques are best employed. We will work simple examples to show the logic and mechanism behind each. Few outside of experienced estate planning attorneys and specialty insurance professionals use these methods. Knowing how they work will increase your ability to provide the best possible client service.

Self-Canceling Installment Note

Estate planners use installment notes to spread the taxation on gains from the sale of highly appreciated assets over a number of years. A self-canceling installment note (SCIN) is a somewhat different wrinkle that has some useful estate planning benefits.

Use a SCIN when a client needs to move a highly appreciated asset out of the estate with minimal estate tax consequences. Generally, SCINs work best for clients who are much older than the children to whom they are selling the appreciated property. Should the client predecease the term of the self-canceling installment note, the debt is automatically forgiven according to the terms of the note.

Take care to avoid improperly designing the SCIN and having the installment sale be deemed part sale and part gift. Be sure that both parties bargain for the value of the cancellation provision and that it is writ-



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ten into the sale contract. Reflect this risk premium in the sale price (thus raising the price over the fair market value) or by negotiating a higher-than-market interest rate.

Managing Capital Gains and Interest Income

Structure the SCIN according to the tax situations of the buyer and seller. For example, if the risk premium is reflected in the sale price, then the seller reports more capital gain and less interest income on receipt of each installment payment. The buyer, on the other hand, pays less interest (potentially deductible depending on the nature of the asset) but has an increased basis on which to depreciate the asset. Given their individual tax circumstances, such an arrangement might be more beneficial than placing the risk premium entirely in the note's interest rate.

Seller Relinquishes All Control

Craft the installment sales contract so it is evident the seller does not retain any control over the property after the sale. This includes any restrictions imposed by the seller on use of the property or possible future sales. Additionally, it is best not to use the property itself as collateral to secure the note. Avoiding this effectively eliminates any right the seller could have of reacquiring the property, which right would negate the SCIN.

Insurance Uses

Use an insurance policy to tie up the loose ends to this transaction. Because the asset is now in the buyer's estate, a life insurance policy on the buyer will cover the future estate tax to the buyer's heirs that was just increased by this transaction. Additionally, the seller may require a life insurance policy on the buyer in the event the buyer dies before the SCIN is repaid and the seller is still alive. Under such circumstances, the seller needs to be paid the remainder owed on the note. Insurance guarantees performance.

Example

Assume Bob is 85-years old and not in good health. His estate owns an industrial building valued at \$1M. Bob wants to move this asset out of the estate. His son, John, buys the building using a SCIN. Terms of

the SCIN are a risk premium adjusted purchase value of \$1,082,800, a note whose term is 10 years with a 20-year amortization and a risk-adjusted interest rate of 4.94 percent (market rate is 3.6 percent). Bob receives two annual payments totaling \$188,276 before he dies at age 87. On Bob's death the note is cancelled and John now owns the \$1M building free and clear without any estate tax consequences. John also has an insurance policy to pay for the future estate tax on his building.

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Charitable Remainder Unitrust

Without using a charitable remainder unitrust (CRUT)

the standard way to reduce the tax on appreciated assets in the estate would have been to buy a life insurance policy on the person who owns the estate equal to the estimated estate tax. However, creating a CRUT often provides a better solution.

Purpose of a CRUT

CRUTs effectively remove appreciated property from the estate. The donor receives an immediate tax deduction equal to the present value of the remainder interest in the asset that will pass to the charity at the end of the CRUT's specified term. The donor also receives a variable annuity from the income produced by that asset. Then, at the end of the specified term or on the donor's death the property transfers to one or more qualified charities specified earlier by the donor. It seems that everyone wins with a CRUT, except the donor's heirs who will not receive the property that went into the CRUT in the first place.

Replacing Transferred Wealth

Insurance policies provide an excellent way to replace the wealth transferred to the CRUT. The tax deduction from creation of the CRUT and/or the annuity payments from income generated by the CRUT are used to purchase a life insurance policy on the donor the benefits of which are approximately equal to the donated asset's value. The policy is owned outside the donor's estate and names whomever the donor wants as beneficiaries. On the donor's death, the asset in the CRUT goes to the charity (which pays no estate

tax) and the insurance proceeds are distributed to the beneficiaries. Since the insurance policy was purchased outside the estate, the beneficiaries pay no estate tax either. Essentially, the insurance policy was paid for with the tax deduction and annuity payments from the donated asset. Estate taxes are reduced or held to the minimum as a result of the CRUT.

For Example

Let's say that Peter, who is now 82, has an apartment building worth \$5M in his estate with a cost basis of \$2.5M. A third party wishes to buy the property. Peter creates a CRUT and transfers the apartment building to it. The CRUT now sells the building and pays no Federal income taxes on the \$2.5M in capital gains. The resulting tax deduction from donation of the property not only helps Peter's current tax situation, but he uses part of the tax savings to buy a \$5M life insurance policy owned by his two grandchildren who are the named beneficiaries. Premiums on the policy are funded by the fixed percentage of the trust's value paid to him for the rest of his life. When Peter died the next year, the remaining value of the trust reverted to the charity. His two grandchildren received the \$5M in death benefits paid by the insurance policy. With a plan of this design, Peter may have also considered generation skipping issues, which would protect these funds from the GST tax fostering even greater wealth accumulation. End result: Peter did a great thing for his favorite charity without reducing the heir's inheritance.

Grantor Retained Annuity Trust

Most estate planners have used GRATs for years. They often provide the flexibility required for situations where a client wants to retain the income from a high-yielding asset that is rapidly appreciating and which they want to transfer to a child with minimal gift and estate tax consequences.

- In the event the transferor dies before the GRAT term expires, the GRAT assets will revert back to the estate;
- Valuation of the annuity interest and any other retained interests depends on who the designated

named beneficiary is and who retains the annuity and other interests relative to the transferor

- When unrelated parties are the named beneficiaries, all interests are valued according to their actuarial present values under Code Sec. 7520

When the amount of the annuity payments to the transferor are less than the appreciating value of the trust assets, the excess amount accumulates for the benefit of the remainder beneficiaries. Using a well-crafted GRAT, this makes it possible to transfer rapidly appreciating assets the value of which greatly exceeds their gift tax value.

What happens when the transferor dies before the GRAT term expires and the trust requires the assets to revert back to the estate? This is where astute estate planning pays for itself. If the beneficiaries are family members, the

gift tax value on the reverting assets may be zero. For such a case, valuation rules under Code Sec. 2702 may apply.

Creative Insurance Techniques

Conversely, what happens when the transferor dies before the specified term of the GRAT and the trust terms require assets to revert back to the estate? This unfortunate occasion and the resultant asset transfer back into the estate will eventually trigger estate taxation and undo the estate tax benefits for which the GRAT was originally established. What to do? The answer is to bullet-proof that estate tax savings from the beginning using a life insurance policy.

Assume that a quite healthy, 72-year-old Michael establishes a GRAT whose term is just 10 years and transfers a \$1M condo into it. At the same time Michael buys a life insurance policy on his life. The policy is owned by Sean, his son and a designated beneficiary of the GRAT. The death benefits paid by the insurance policy on Michael's death should be approximately equal to the estimated federal estate taxes that would be paid should Michael outlive the relatively short term of the GRAT. Michael's use of insurance makes both the term of the GRAT and his age and health less of a factor in structuring the trust. This is just one of a number of other creative uses for insurance as related to GRATs that smart estate planners can employ.

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Trends in Trust and Instruments for Estate Planning

With interest rates at relatively low levels (at the time of this writing the Fed just lowered rates 25 basis points with another 100 basis point drop a near term possibility), placing leveraged, income producing real estate in a trust such as described here throws off significant income to the trust and ultimately to the

beneficiaries. I see creative use of such trusts enjoying resurgence in estate planning popularity as the economy weakens. Additionally, with income taxes all but certain to rise over the next years regardless of who occupies the White House, clients will demand that their estate planners become more creative and aggressive. Trusts, combined with insurance to be sure they accomplish their intended purpose, are excellent tools.



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