Life Insurance & Estate Planning: Tricks, Traps & Tools

Florida Fellows Institute V

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LARGE POLICIES/BIG PREMIUMS – LOTS OF CONUNDRUMS

- For most high net worth clients, life insurance is very often a big part of the plan; indeed, Pratt very often refers to life insurance as his “sixth man”!
- With a large policy, the biggest challenge is the funding of the premiums.
- This presentation will discuss various alternatives taken from different client fact patterns, and will serve as an example of different ways to skin the cat, so to speak.

THE GATOR FAMILY

- Meet Richie (58) and Lauren (55) Gator.
- The Gators have three sons, Louis (32), Sam (30) and Don (28).
- Louis has two sons, Jolyon and Leslie, who are 2 year old twin boys; Sam has three sons, Bruce, Jack and David, who are ages 6, 4 and 2, respectively; and Don has the only daughter, Cristin, who is 2.
- Richie’s mother is deceased, as are Lauren’s parents; Richie’s father, Dennis, is 87 and going strong.
- Richie and Lauren are very close with their siblings and their siblings’ kids and grandkids - two Michaels, two Davids, Fred, Yariv, Karen, Mindy, Charlene, Grayson, Lee-ford, Steven, Patricia, Larry, Georg, Alessandro, Antonio, Marty, Brian, David, Abe and Jack.

GATOR ASSETS

- Richie and Lauren have a very successful internet-based marketing company, GatorNet Marketing, structured as an S corporation (each owns 50% of the stock); it's value is estimated at $60 million. Profits after reasonable compensation are approximately $3 million per year.
- They are also slumlords, owning 200 college houses and apartments in Gainesville. All of the real estate is in a Florida limited liability limited partnership, GatorHousing LLLP; the value is estimated at $40 million and the annual net rent to the partnership is about $2 million.
- Each of Richie and Lauren are the 50/50 members of a Delaware LLC that is the 1% general partner of GatorHousing LP, and each of them are also 49.5% limited partners in the partnership.
- Richie and Lauren also have about $10 million in investment accounts and cash, and retirement plans that total $10 million.

ESTATE TAX EXPOSURE/ PRIOR PLANNING/ANNUAL GIFTS

- Richie and Lauren have done some estate planning over the years but are still fairly illiquid for purposes of paying estate tax upon the surviving spouse's death. Indeed, the Gators have a very rough estate tax exposure of $40 million, using today's values.
- Each of Richie and Lauren created non-reciprocal SLATs at the end of 2020, and each SLAT has about $13 million in marketable securities and some additional miscellaneous investments.
- When each grandchild was born, Richie and Lauren front loaded a 529 educational plan for the grandchild with the maximum amount permitted i.e., $15,000 x 5 x 2. Thus, each grandchild's college educations should be set. After the 5 year gifting period has passed, they will want to continue annual exclusion gifts to each grandchild using "GST annual exclusion" trusts.
- Richie and Lauren help their kids each year by making annual exclusion gifts to each child and each child's spouse. This gifting cannot stop….
- Dennis has done extensive planning over the years. While he has moved a fair amount of wealth, and used both his estate/gift tax and GST tax exemptions prior to 2021, he still has a net worth of $20 million, consisting mostly of blue chip stocks and tax-exempt bonds.

RICHIE AND LAUREN'S OBJECTIVES

- Minimize estate taxes.
- Continue to be able to use "excess" cash to reinvest in business and real estate.
- Avoid "fire" sale of company and real estate upon death.
- Divide all assets evenly between their descendants, per stirpes (all in trust).
- Create an educational fund for the descendants of their siblings, to be funded upon the second of their deaths.
- Leave at least $5 million to the University of Florida (specifically to the Levin College of Law to be used exclusively for the LL.M. program in tax…), and maybe more….

COST OF SECOND-TO- DIE LIFE INSURANCE/ INSURANCE TRUST

- As previously mentioned, the Gators have a very rough estate tax exposure of $40 million, using today's values. They anticipate that this number will go up and are ready to implement freeze techniques to shift appreciation to future generations. However, they want to save the "freeze technique" conversation for another day….
- To play it safe, they want to buy $50 million of second-to-die life insurance.
- Based on their ages and health, the cost would be less than $8,000 per million of coverage, which equates to about $400,000 of premium per year.
- In order to avoid estate tax on the insurance, an insurance trust must obviously be used.

How much would it cost to bequeath an additional $50,000,000 to GATOR descendants (without exemptions)?

Estate/Gift Tax Rate:	40%
GST Tax Applicable Rate:	40%
To Make a Transfer of $50,000,000, it Takes:	**$138,888,889**
You Start With:	$138,888,889
You Pay Federal Estate Tax on $138,888,889 at 40%:	$55,555,556
This Leaves You With:	$83,333,333
You Pay GST Tax on $83,333,333 at 40%:	$33,333,333
Net Remaining for Descendants:	**$50,000,000**

LIFE INSURANCE AS A UNIQUE INVESTMENT ASSET/ $50,000,000 INSURING RICHIE & LAUREN

- **No Lapse Guarantee Policy:**
  - Fixed Premium: $383,020.
  - Years to Pay: LIFETIME.
  - Cash Value: None.
  - Death Benefit Guarantee: Lifetime.

- **Increasing Cash Value Policy:**
  - Flexible Premium: $383,020.
  - Year to Pay: 37 Years or less.
  - Initial Death Benefit Guarantee: 37 years.

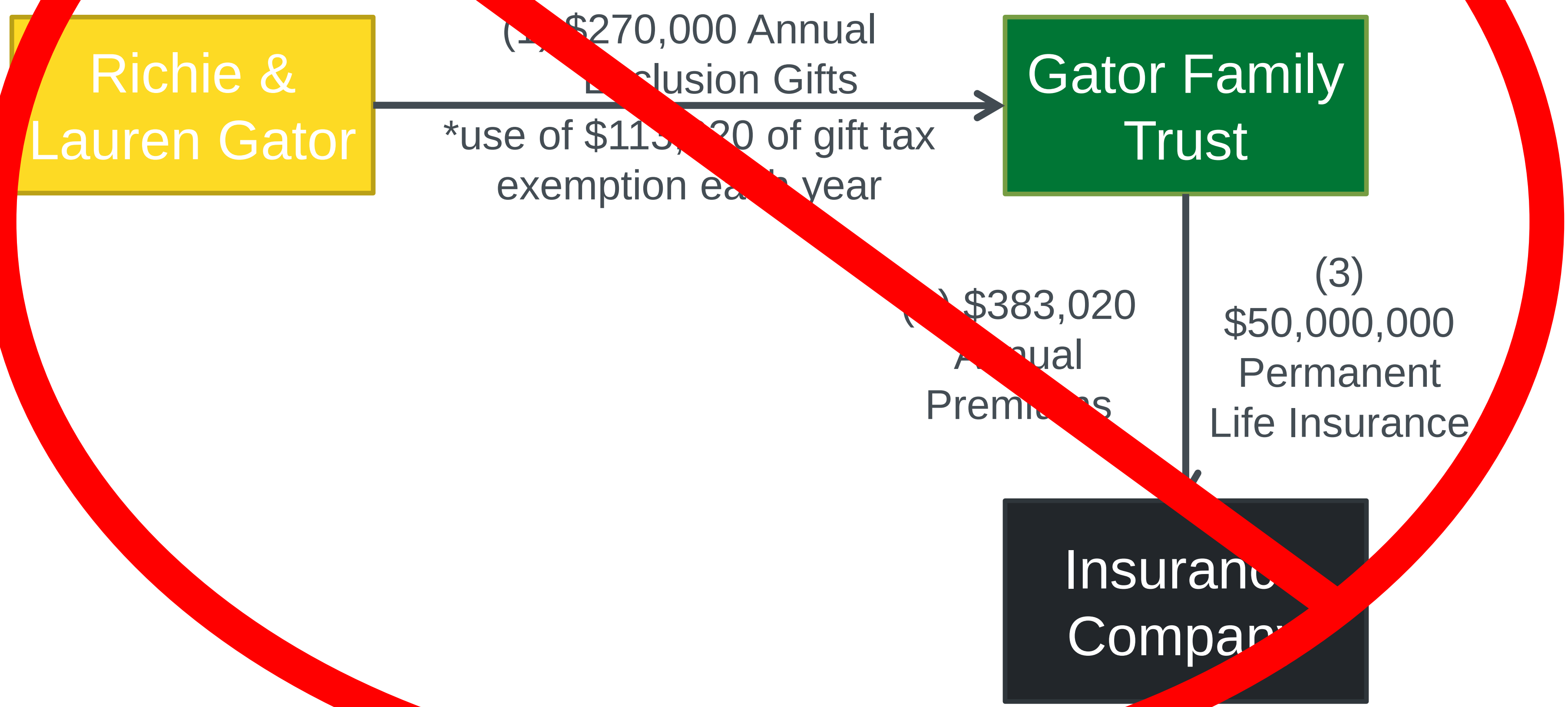
THE OBVIOUS – THE CRUMMEY TRUST – A NON-STARTER…

- Yes, the Gators have three children and six grandchildren, and they could gift $270k ($15k x 2 x 9) per year to a traditional Crummey trust, which would be a start.
- BUT, they front-loaded 529 plans for each grandchild and want to continue making annual exclusion gifts to their kids and their spouses, and will make annual exclusion gifts to each grandchild using GST annual exclusion trusts after the 5 year period for each 529 plan has expired.
- So the traditional insurance trust won't work.

THE NOT SO OBVIOUS – THE CRISTOFANI TRUST

- The *Cristofani* case is alive and kicking, and too often forgotten. Contingent beneficiaries can be counted, provided their interests are not illusory.
- The advisor should look beyond the immediate family for additional gifting "units" – it is not uncommon for a wealthy patriarch or matriarch to want to take care of collateral family members.
- As indicated above, Richie and Lauren are very close with their siblings and their siblings' kids and grandkids - two Michaels, two Davids, Fred, Yariv, Karen, Mindy, Charlene, Grayson, Lee-ford, Steven, Patricia, Larry, Georg, Alessandro, Antonio, Marty, Brian, David, Abe and Jack. These 22 individuals can form the foundation for a Cristofani Trust.

The Obvious – The Crummey Trust



THE CRISTOFANI TRUST PUT TO WORK

- Richie and Lauren want to leave $100k to each of their siblings and each of their sibling's kids (10 in total), and they also want to establish an educational trust for $1 million for the benefit of the grandchildren of their siblings (12 in total).
- There are 22 ancillary family members, or "units" - that's up to $660k ($15k x 2 x 22) per year of annual exclusion gifting!
- By adding the ancillary relatives to the insurance trust and counting them for annual exclusion purposes, a funding mechanism has been created.
- Florida Statutes Section 736.0306 allows a settlor of an irrevocable trust to appoint a "Designated Representative" to receive notices on behalf of a beneficiary.
- For trusts with many beneficiaries, a Designated Representative should/could be named to receive Crummey notices and other required accountings, statements, etc.
- For second-to-die policies, always consider that annual exclusion gifts will be cut in half upon the first death – consider leaving all or a portion of the first dying spouse's estate tax exemption to the insurance trust to be used to fund the annual exclusion gifts that will no longer be made from deceased spouse. Alternatively, consider decanting "premium amounts" from an existing trust; remember, it is not necessary to decant all assets from a particular trust.
- So Richie and Lauren will include the specific bequests of $2 million in the insurance trust with the residue going to their descendants, in trust.
- Total insurance will be $52 million and the annual premium will be $398,340 per year - there is more than a sufficient amount of units for annual exclusion purposes.

NOT RECREATING THE WHEEL – THE SLATS

- Practitioners should always examine the existing landscape to see if a funding vehicle is already in place.
- There may already be one or more trusts flush with marketable securities and cash that can be used to fund life insurance.
- Consider the Gators – each of them created a SLAT in 2020 that has $13 million of marketable securities.
- By using Florida's decanting statute (Florida Statutes Section 736.04117), an independent trustee with absolute discretion could make distributions of principal from one or both of the SLATs to the insurance trust that will own the survivorship insurance. Thus, each SLAT could distribute $200,000 to the insurance trust each year.
- It is critical to address GST issues – the SLATs should be GST exempt and the insurance trust should be GST exempt.
- While the decanting statute only allows distributions of principal, cash is cash and a trustee could allocate traditional income to principal or add it to principal each year.

PAY OR APPLY/INTERNAL DECANTING PROVISION

- And even better than relying on Florida's decanting statute, which has certain notice requirements and could be cumbersome, many trusts have a standard "pay or apply" provision, such as the following:
  - <u>Appointee Trusts</u>. Any income or principal payable to one or more beneficiaries of any trust hereunder (the "Invaded Trust") may be appointed, in the absolute discretion of the Trustees and without the consent or approval of any beneficiary or court, to a trust (the "Appointee Trust") for the benefit of any one or more of such beneficiaries to the exclusion of the others. The Appointee Trust may be (a) a preexisting trust, (b) a trust created for the purpose of receiving the appointed property, including, without limitation, a trust declared by the Trustees of the Invaded Trust, or (c) the Invaded Trust itself as modified by the Trustees (the Trustees are authorized to modify any trust hereunder in the exercise of such power of appointment, provided that the trust as modified qualifies as an Appointee Trust). Any appointment under this Paragraph shall be made by a written instrument executed with the same formalities as a Will or signed and acknowledged in the presence of a Notary Public. The Appointee Trust may, in effect, postpone the vesting of such income or principal beyond a beneficiary's lifetime, provided, however, that in no case shall the Appointee Trust (or any further trusts created thereunder) continue longer than the maximum period set forth in Paragraph 15.19. The receipt by the Trustees of the Appointee Trust shall be a full discharge to the Trustees of the Invaded Trust for such appointed property. The Trustees of the Invaded Trust may, but shall not be required to, notify the beneficiaries of the Invaded Trust of any appointment under this paragraph. The Trustees hereunder shall have no duty to exercise any power granted under this paragraph and shall not be liable to any person for not exercising any such power. Notwithstanding any other provision of this Declaration, the Trustees, in exercising any such power, may disregard (a) any rules of law that may require impartiality as among the beneficiaries and (b) any provision of this Declaration that may otherwise require the Trustees to give primary consideration to the needs and/or wishes of one or more particular beneficiaries.

PAY OR APPLY/INTERNAL DECANTING PROVISION (cont'd)

- <u>Limitations on Power</u>. No power under Paragraph 15.8.1 may be exercised in a manner that jeopardizes any federal or state income, gift or estate tax deduction, benefit or exclusion originally claimed with respect to any contribution to the Invaded Trust, including, but not limited to, (a) the annual exclusion under Section 2503(b) of the Code, (b) the exception for transfers in trust for a minor under Section 2503(c) of the Code, (c) any marital deduction, (d) any charitable deduction and (e) the qualification of a transfer as a direct skip under Section 2642(c)(2) of the Code. In addition, no shares in an "S Corporation" (as defined in Section 1361 of the Code) may be appointed to an Appointee Trust unless said trust can become an eligible S Corporation shareholder under the terms of said Section 1361. Whether or not the grantor of the Invaded Trust is treated (under Subpart E, Part 1, Subchapter J, Chapter 1 of the Code) as the owner of any portion of the Invaded Trust as provided in the Code shall not be considered a tax benefit for purposes of this paragraph.

ADVANCED PLANNING I – THE S CORP

- As mentioned above, Richie and Lauren have a very successful internet-based marketing company, GatorNet Marketing, structured as an S corporation (each owns 50% of the stock); it's value is estimated at $60 million. After paying reasonable compensation, profits are approximately $3 million per year.
- Richie and Lauren could use a portion of the profits to pay the insurance premiums.
- Richie and Lauren want to maintain control of the corporation.

PLANNING WITH THE S CORPORATION

- GatorNet Marketing will be recapitalized into voting and non-voting shares – each of Richie and Lauren will exchange their 50 shares of stock for 50 shares of voting stock and 450 shares of non-voting stock.
- The recapitalization will not affect the S status, as an S corporation can have more than one class of stock, provided that the only distinction between the classes is voting rights.
- Richie and Lauren will create an irrevocable trust for the benefit of their descendants. The trust will include all insurance related provisions i.e., to apply for policy, pay premiums, etc. In other words, it will be an insurance trust!
- This trust will be structured as a "grantor" trust for income tax purposes and will give the trustee the authority to make an election to be treated as a QSST or ESBT (which will be necessary upon each of Richie and Lauren's deaths). Each of these types of trusts is permitted to own stock in an S corporation.

PLANNING WITH THE S CORPORATION (cont'd)

- Richie and Lauren each will gift 100 shares of non-voting stock (10% each) to the trust. Assuming a 33 1/3% overall discount (for minority interest and lack of marketability), each gift will be $4 million ($60 million x 10% = $6 million;
$6 million x 33 1/3% = $2 million;
$6 million – $2 million = $4 million).
- On a going forward basis, 20% of the profits will be distributed to the trust. This would equate to $600,000; $400,000 of this amount will be used to pay the annual premiums!

PLANNING WITH THE S CORPORATION (cont'd)

- Of course, Richie and Lauren could gift/sell more (non-voting) stock to the trust to maximize the use of their gift tax exemptions and freeze the growth of the transferred stock.
- Alternatively, Richie and Lauren could gift/sell (non-voting) stock to their respective SLATs and each SLAT could decant the cash to the trust, as discussed previously.

ADVANCED PLANNING II – THE REAL ESTATE

- Similar to the planning with the S corporation, each of Richie and Lauren could gift all or a portion of their limited partnership interests in GatorHousing LLLP to the insurance trust (or to their SLATs, which would then make the distributions discussed above).
- Assume that each of Richie and Lauren gift 20% of their limited partnership units to the trust. Each gift would be valued at $5.6 million, assuming a 30% discount ($40 million x 20% = $8 million; $8 million x 30% = $2.4 million; $8 million – $2.4 million = $5.6 million).
- On a going forward basis, 40% of the annual distributions (i.e., the net rental income) would be made to the insurance trust, which will be used, in part, to pay the annual premiums – this equates to $800,000 (40% x $2 million)!

THE RETIREMENT PLANS

- There are $10 million of retirement plans which will ultimately be subject to estate tax and income tax.
- This money represents the ideal asset to leave to charity, as contemplated i.e., the Levin College of Law – LL.M. program in tax – GO GATORS!
- It also could serve as “found money” that can be used to supplement the required premiums for the life insurance policy.
- It is possible to structure the payment schedule so that premiums are small in the early years (i.e., the years until required minimum distributions (RMDs) must begin), and then increase after RMDs start (i.e., 4/1 after IRA owner becomes 72).

THE RETIREMENT PLANS (cont'd)

- For example, to buy $25 million of life insurance, Richie could gift $64,000 per year to the trust for 12 years, and then $350,000 per year beginning in the 15th year when RMDs will begin. At that time, RMDs will likely exceed the annual premium i.e., today the retirement plans are $10 million and a 4% RMD would be equal to $400,000. Over the next twelve years, the plan will continue to grow tax free.
- Upon Richie's death, if he dies first, Laura would "roll over" the IRA and continue the payments. Upon the last death, the balance of the retirement plans would go to the Levin College of Law estate and income tax-free!