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Back to Basics: How to Plan for Needed Cash in an Estate

With all the permutations of sophisticated life insurance planning it is easy to forget why we use permanent life insurance to begin with: *to provide liquidity exactly when needed*. A permanent life insurance policy provides needed cash which can be used to:

1. Pay transfer taxes, including income, estate and generation-skipping transfer taxes;
2. Transfer a business interest so the business can continue in the hands of the surviving owners; and
3. Equalize inheritance among family members, especially when an illiquid business comprises the bulk of family wealth.

Paying Transfer Taxes

During lifetime, property transferred to anyone, other than a U.S. citizen spouse, is subject to gift taxes up to a rate of 45% in 2009.¹ And, when property is transferred at *death* to anyone, including a non-citizen spouse, the property may be subject to the highest federal estate tax rate of 45% in 2009, though most property transferred to a citizen spouse may benefit from a reprieve through the use of the *unlimited marital deduction*. The unlimited marital deduction delays estate taxation on assets transferred to a surviving spouse until the surviving spouse's death. Regardless, the estate will still need cash to fund the net tax obligation. When a gift is made to a "skip person," or someone who is one generation below the grantor of the gift, such as a grandchild, we need to contend with an *additional* tax known as the *Generation-Skipping Transfer Tax* (GSTT).

Fortunately, however, various exemptions from taxes are allowed before transfer taxes are imposed. For example, the estate and GSTT exemption is \$3,500,000 per person in 2009, and the annual gift tax exclusion in 2009 is \$13,000 per donee in 2009. Typically, estate planners use these tax-exemptions strategically in a lifetime giving plan to reduce the taxable assets at death, maximize wealth transfer or to move a family business tax efficiently to the next generation. The shortfall in liquidity can then be purchased at discounted dollars through the use of life insurance.

Transferring a Business Interest to the Next Generation

Making gifts of non-voting business interests to a Grantor Trust for the benefit of family members who will eventually assume ownership of a closely-held enterprise is a common wealth transfer strategy. This strategy also gives the business owner the luxury of time to wean heirs into taking over control of the business operations. It is then possible to utilize the income generated from the transferred business interests to fund a life insurance policy outside the taxable estate. Depending on the type of asset transferred to the trust, such as an interest in a closely-held corporation or a partnership, the value of the gift may be discounted for gift tax purposes to account for a marketability or minority interest discount. These discounts allow an individual to transfer more to heirs in a shorter period of time with minimal to no gift tax cost.²

Transferring wealth at minimal tax cost may also be achieved through the *sale of assets* directly to heirs, or to a trust for the benefit of heirs, as opposed to having the patriarch of the family make a gift of such assets outright during lifetime. Again, business interests that are eligible for valuation discounts can serve not only to reduce the sales purchase price for family members, but may also reduce the amount of time it takes to transfer the asset. The income generated from the discounted business interests transferred can then be used to fund a life insurance policy outside the taxable estate. Additionally, life insurance can fund Buy-Sell arrangements between business owners to provide the funds needed for the business entity or each individual owner or key person, to buy out the deceased owner's share at death. There are a number of ways to structure the arrangements and each of these arrangements can be funded efficiently with life insurance.

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Liquidity Planning for Estate Equalization

When transferring a business interest to the next generation, clients may be concerned about being fair in how much they give of their wealth to each of their children. Here, a life insurance policy can be used to equalize assets for heirs *not* involved in the business. Furthermore, when a non-citizen spouse is part of the equation it makes sense to consider the sale of assets to the non-citizen spouse, or to a trust for his or her benefit, in order to avoid premature taxation. That is, the estate taxation of assets owned by a non-citizen living in the United States is significantly different than that of a U.S. citizen in two very important ways:

- First, a non-citizen spouse does not get the benefit of an unlimited estate tax marital deduction.
- Second, even if a gift is made in trust to benefit a non-citizen spouse, the gift does not qualify for the marital deduction unless the trust is established as a Qualified Domestic Trust (QDOT), which essentially delays estate taxation on the trust income only.

Although a QDOT is certainly a viable planning option often used, an Irrevocable Life Insurance Trust (ILIT) with spousal access provisions can be used as an alternative to a QDOT. An ILIT with spousal access provisions provides the non-citizen spouse with death proceeds to fund an income stream for the surviving spouse's lifetime while providing the family with *liquidity to fund estate taxes or equalize inheritance* at death.

Estate liquidity is an essential component of planning. It is difficult to find another financial vehicle that is as efficient and self-completing as a permanent life insurance policy in providing heirs with the cash when it is needed most.

1. In the U.S., as a result of the Economic Growth and Tax Relief and Reconciliation Act (EGTRRA) of 2001, the lifetime applicable gift tax exclusion amount that is not subject to federal gift tax is \$1,000,000 per person. See IRC §2503 (b). In order for gifts to qualify for the exclusion, the trust beneficiaries must be given rights of withdrawal known as "Crummey powers." Based on EGTRRA, the estate tax rates are scheduled to decrease and the estate tax exemptions available from estate tax are scheduled to increase through 2010, effectively minimizing the estate tax. EGTRRA expires on December 30, 2010 and the estate tax rates and exemption in place in 2001 will once again apply. There is some question, however, as to whether additional legislation will take place prior to 2011 to eliminate the estate tax altogether, or whether compromise legislation will take place in which estate taxes remain low. The assumption here is that no new legislation will take place and that the 2001 rates and exemptions will be reinstated for 2011 and later years.
2. In the U.S., the value of an interest in a closely-held corporation, a partnership or other asset, may qualify for a valuation discount to reflect either or both a minority interest discount and a lack of marketability discount. The discounts can be considerable, ranging from 15% to 40% of the underlying value of the assets. Therefore, when planning for a non-citizen spouse especially, it makes sense to apply these valuation principles in the business transfer plan to get as much of the business interest to the non-citizen spouse as possible, as quickly as feasible since the marital deduction is not available at the citizen spouse's death. When a non-citizen spouse is in the picture, without the ability to transfer interest at a discount, there is the unseemly potential for a business to be liquidated at death to pay estate taxes. Moreover, an additional discount for landowners may be available in the U.S., as well as a few other countries, to discount the value of a ranching or farming business that can be helpful in minimizing transfer taxes in the business transfer plan and to provide current income tax benefits.