WRMarketplace
An AALU Washington Report

The WRMarketplace is created exclusively for AALU members by experts at Baker Hostetler LLP and the AALU staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partne**r. WR Marketplace #19-23 was written by **Jonathan M. Forster, Partner, and Jonathan A. Schwartz, Associate, Baker & Hostetler LLP**.

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TOPIC: Better Together – The Importance of Collaboration Among Client Advisors When Acquiring Life Insurance (With Case Study).

MARKET TREND: Sophistication of life insurance products and complexity of tax laws have made it vital for advisors of all types to work together in crafting insurance plans.

SYNOPSIS: WRMarketplace 19-19: Legacy Management: A Fresh Look at an Age-Old Business discussed how legacy planning in today's environment requires collaboration among clients' attorneys, accountants, insurance advisors, and financial advisors. As a follow-up, this Report focuses on the importance of applying those principles specifically to life insurance planning and illustrates how a move away from each advisor working in isolation to an integrative approach involving all disciplines can easily avoid missteps and result in improved client outcomes.

TAKE AWAY: The purchase of life insurance products and their implementation into a client's broader legacy planning strategy requires clients to navigate through a complex web of financial and cashflow management strategies, transfer tax considerations, and tax reporting obligations that must be approached differently on a client by client basis. Failure on the part of advisors to work together can result in avoidable planning gaps, most notably: (1) inability to fund premium payments on a sustainable basis; (2) inefficient use of lifetime estate, gift and GST tax exemption; and (3) poor product maintenance leading to negative outcomes.

Previous *WRMarketplaces* have covered the many reasons why clients should use life insurance as a part of a comprehensive legacy plan to preserve wealth and family harmony among future generations. This Report focuses on the importance of collaboration among advisors in implementing insurance based legacy planning.

CHOOSING THE RIGHT POLICY

The purchase of any life insurance policy must begin with a discussion between the client and the client's advisors as to the purpose of the policy. As discussed in previous Reports, life insurance can be used to provide liquidity for payment of estate taxes, to support an estate's obligation under a buy/sell agreement, to ensure sufficient assets to maintain a surviving spouse's standard of living, and to fund an inter-generational legacy. The importance of life insurance as part of an overall wealth transfer plan cannot be overstated because of its unique tax characteristics and its mortality hedging feature.

The policy selection discussion must include the client's full roster of advisors. A financial advisor is needed to determine the client's available cashflow to support premium payments weighed against their projected annual expenditures; clients and advisors not only must identify the need, but also the client's budget. An attorney is needed to review existing estate planning vehicles and identify opportunities for transfer tax efficient funding in light of the client's projected estate tax exposure and gifting bandwidth. Once the extent of the need for coverage and ability to fund premiums has been locked down, the insurance advisor will be expected to present the client with the full menu of appropriate products, from single life policies to survivor, term vs. permanent policies, and options for timing of premium payments (e.g., level vs. paid up).

While clients are working with their advisors to determine the face amount that is appropriate for their unique plans, the insurance advisor will begin the underwriting process to help pinpoint the costs. Meanwhile, the attorney will be preparing an irrevocable life insurance trust ("**ILIT**") to be the owner and beneficiary of the policy from the date of issuance. This will ensure that the policy proceeds are excluded from the client's taxable estate and provide financial stewardship and creditor protection to the trust beneficiaries. Fiduciaries must be selected and apprised of their fiduciary duties and responsibilities with regard to the ILIT and/or other trusts.[1]

THE RIGHT POLICY HAS BEEN IDENTIFIED – NOW WHAT?

At this stage, collaboration among advisors becomes even more critical. The client's attorney should make sure that the insurance advisor and financial advisor are aware of the client's remaining lifetime transfer tax exemptions. If the client has sufficient cash flow and available exemption, it may be preferable to fund the ILIT with a large upfront gift and a shorter premium duration to lock in the use of the expanded lifetime exemption amounts scheduled to sunset at the end of 2025. Clients with limited exemptions may need a longer runway for premium payments if they are relying on annual exclusion gifts for funding, or they may need to seek alternative funding methods, such as private split-dollar agreements.[2] For all these moving parts to work cohesively, it is incumbent on advisors to share relevant information with each other.

PLANNING IN ACTION: CASE STUDY

Identifying the Need

Wendy is a 76-year-old unmarried woman who owns a 51% interest in a closely held business valued at $500 million ("**W Co.**"). Ownership of the remaining 49% of W Co. is spread among her four children and an irrevocable grantor trust created by Wendy for the benefit of her descendants. Wendy has used $2 million of her lifetime gift and generation skipping transfer ("**GST**") tax exemptions. Including other assets, Wendy's taxable estate is worth $300 million, with a projected federal estate tax bill of roughly $116 million. Wendy and her children anticipate a future liquidity event for W Co. sometime in the next five years, but if Wendy passes in the interim, the concentration of her wealth in W Co. interests will leave her estate well-short of cash to cover the tax bill.

Wendy's advisors knew that the entire tax bill could not be covered through life insurance alone, but Wendy instructed them to consider life insurance as part of an overall estate tax liquidity and/or deferral plan[3] and determine how big of a cushion could be provided through the purchase of one or more life insurance products. As part of the product selection, in addition to Wendy's insurability, the advisors had to evaluate how much coverage Wendy could feasibly purchase based on her available cashflow for premium payments, which was limited due to the concentration of her wealth in W Co. and other illiquid investments (at least until the anticipated liquidity event).

Choosing the Product

Wendy's insurance advisor was tasked with finding a product that conformed to her cash budget. The planning began with an underwriting process to determine the true product pricing (rather than relying on an estimate), which allowed the insurance advisor to identify the suite of available products and carriers, some of whom may be more comfortable than others issuing a policy on Wendy's life based on her prior medical history and age.

In consideration of Wendy's limited liquidity at the time of purchase, the insurance advisor was able to procure a blend of permanent and term coverage with total face amount of $40 million. $25 million permanent coverage was structured to require only minimal payments for the first 10 years, with premiums substantially escalating thereafter. The selection of this option assumed that W Co. would be sold in five years, rendering this path sustainable. It was recommended not to use guaranteed products to increase payment flexibility. An additional $15 million 10-year convertible term policy was added as well, with the same notion - to provide gap coverage in the event of Wendy's passing before W Co.'s expected liquidity event. This program would need to be closely monitored post-closing since the structure aligned closely with W Co.'s intended sale.

Estate Planning Considerations

Identifying the appropriate products early in the process gave Wendy's attorney, financial advisor, and accountant adequate time to thoughtfully consider the best approach to funding premiums. This was critical because in the interim, Wendy's medical exams could have lapsed, or, even worse, her medical profile could have changed, nullifying quotes procured under prior medical assumptions and negatively impacting final pricing. Two new ILITs (ILIT #1 and ILIT #2), created as grantor trusts with respect to Wendy, were formed to acquire and hold the new $40 million of coverage. With the benefit of advanced notice, the attorney was able to draft the new ILITs and have Wendy execute them before the policies were ready for purchase.

ILIT #1 was crafted to acquire the permanent coverage on Wendy's life. Since Wendy's existing irrevocable trust (Trust #3) had accumulated substantial cash from prior W Co. dividends, Wendy and her advisors decided to fund the premium payments for ILIT #1's policy purchase by using a split-dollar loan arrangement between ILIT #1 and Trust #3, whereby Trust #3 would make annual loans to ILIT #1 (taking advantage of the current low interest rates and using its available cash from W Co. dividends). ILIT #1 agreed to repay the loans upon termination of the arrangement (no later than Wendy's passing), using the policy's death benefit (if not repaid earlier).[4] As long as both ILIT #1 and Trust #3 remain grantor trusts, there should be no income tax consequences from the loans. The term policy was acquired by ILIT #2 and funded by taking advantage of Wendy's annual exclusions which, when utilized with respect to her four children, would allow her to transfer up $60,000 per year to ILIT #2.

These ILIT funding arrangements allowed Wendy to maintain flexibility to make use of the temporarily increased lifetime gift/estate and GST tax exemptions ($11.58 million in 2020) before their scheduled sunset. Wendy could subsequently apply her remaining lifetime gift and GST tax exemptions to make additional gifts to her children and/or the trusts, including to facilitate exit planning for the split-dollar arrangement.

Closing the Case

Having secured the policies for Wendy, the advisors divided up the remaining <u>initial</u> tasks:

- Wendy's financial advisor worked with her to make a nominal cash gift (e.g., $100) to ILIT #1 so that its creation could be reported on Wendy's gift tax return. ILIT #2 was funded with the necessary cash to pay the premiums on the term policy it acquired.

- Wendy's accountant and/or attorney prepared gift tax returns to report the funding of ILIT #1 and ILIT #2. With regard to the GST tax:

    - The return preparer elected <u>affirmative allocation</u> of Wendy's lifetime GST tax exemption to the nominal transfer to ILIT #1 to establish the trust (and the proceeds of the insurance policy) as fully exempt from GST tax.

  - The return preparer <u>opted out</u> of the allocation of Wendy's lifetime GST tax exemption with respect to transfers made to ILIT #2 because it owned a term product. If Wendy declined to convert the policy into permanent coverage, ILIT #2's policy would lapse if Wendy survived 10 years, effectively wasting any lifetime GST exemption allocated to that ILIT.

- Wendy's attorney worked with the ILIT trustees to prepare *Crummey* withdrawal notices, as applicable, to the transfers made by Wendy to the ILITs so that those transfers would qualify for the use of her annual exclusion.

- As both ILITs were created as grantor trusts, Wendy's accountant worked with the trustees to provide a grantor trust letter to Wendy for the tax year so that any items of income, deductions, and credits could properly flow through to Wendy's personal income tax returns.

<u>Ongoing Administration</u>

Attorneys and other advisors are often primarily focused on closing the initial transaction. Many do not have ongoing maintenance plans in place or teams to manage them. This is problematic as many insurance products and the approaches used to procure and fund them require annually recurring maintenance and audits. Accordingly, in Wendy's case:

- Wendy's financial advisor could work with the trustees of the ILITs to run annual audits on the permanent policies to ensure adequate funding and monitor policy performance, which can, for certain products, be tied to interest rates or even stock market results. If the policy is not a guaranteed product, the costs of the policy can change over time. Failure to monitor could result in loss of death benefits. Similarly, failure to timely pay premiums on the term policy could result in loss of coverage.

- Wendy's attorney should continue to work with the trustee to issue required annual *Crummey* withdrawal notices to be sure that the additional transfers to ILIT #2 qualify for the use of Wendy's annual exclusion. The IRS continues to focus on ILIT administration, making proper management critical to ensuring the intended benefits of the planning.

- Wendy's attorney or accountant should continue to: (1) coordinate annual income tax reporting as long as the trusts remain grantor trusts; and (2) file annual gift tax returns as required, with a particular focus on confirming proper allocation of Wendy's lifetime GST exemption to any gifts from Wendy to the ILITs.

- The attorney and the accountant should track the split-dollar loan regime advances made by Trust #3 to ILIT #1 and work together with Wendy's financial advisor to consider a long-term exit strategy from the arrangement, especially as the premiums begin to rise after the initial 10-year period.

- Wendy's insurance advisor should continue to check in with Wendy and her advisors regarding the options and related costs to convert the term policy owned by ILIT #2 to permanent coverage and whether W Co.'s sale occurs timely to ensure the permanent product is sustainable.

EASILY AVOIDABLE MISSTEPS

The case study highlights the best-case scenario when all of a client's advisors work together in unison towards a common goal. Such collaboration can easily avoid negative outcomes from the missteps or oversights that frequently occur when advisors fail to work together, including:

Inability to Fund Premium Payments

A major pitfall that results from a lack of collaboration is the selection and purchase of a policy with premiums that are not workable for the client. The failure to ascertain available cash flow can result in the purchase of products that may be viable at the date of purchase but soon thereafter become a financial burden on the client, potentially resulting in clients (or trusts they created) having to surrender the policy. In some instances, the client simply cannot maintain his or her lifestyle and simultaneously support the necessary premium payments. A team-centric approach involving all the client's advisors, however, can identify this issue from the outset and may reveal previously unconsidered options that can fund premium payments while maintaining the availability of existing cash to the client. Some examples include using cascading GRATs to fund premium payments, particularly if policy proceeds are not intended to be exempt from GST tax, or, as in the case above, establishing split-dollar agreements between a newly-formed ILIT and a pre-existing trust that may have access to cash from prior planning.

Inefficient Use of Transfer Tax Exemption

As life insurance and ILITs are mainstays of estate planning, advisors must ensure that clients' available lifetime gift/estate and GST tax exemptions are being put to their highest and best use. Some common missteps in this regards include:

- Failure to issue C*rummey* withdrawal notices with regards to gifts meant to qualify for the annual exclusion amount, potentially resulting in the loss of annual exclusion gift opportunities and unintended reductions of lifetime exemption amounts.

- Over-allocation of GST tax exemption to trusts that own term products, resulting in less GST tax exemption available for use with dynastic wealth transfers involving permanent coverage or other high growth assets.

- Failure to adequately disclose certain planning transactions to the IRS, leaving open the possibility of challenge and loss of exemption or payment of gift tax years after a transaction is completed.

Poor Product Maintenance

The insurance advisor should make certain that the ILIT trustee is receiving the premium notices from the policy carrier and should advise the trustee on the appropriate date for payment (copies of the notices could be provided to the insured and the attorney to ensure everyone is informed). Late premium payments (and sometimes early premium payments) can adversely impact the guarantees associated with certain types of policies. Financial advisors should ensure that any cash transfers are completed well in advance of the deadline so that formalities regarding which accounts remit payment to carriers can be scrupulously observed. Any disregard for such formalities could be challenged on an estate/gift tax audit and result in loss of exemptions or payment of gift tax.

Critically, the policies themselves also must be monitored for performance in light of rising or falling interest rates and, in some cases, market fluctuations. Certain products, like indexed universal life, rely on many variables. Trustees must ensure policies are adequately funded to avoid lapse or reduction of death benefits. It may be advisable for the trustee to annually procure an independent audit of each trust-owned policy to avoid any liability for loss of policy value that may otherwise result.

TAKE AWAY

The purchase of life insurance products and their implementation into a client's broader legacy planning strategy requires clients to navigate through a complex web of financial and cashflow management strategies, transfer tax considerations, and tax reporting obligations that must be approached differently on a client by client basis. Failure on the part of advisors to work together can result in otherwise avoidable planning gaps, most notably: (1) inability to fund premium payments on a sustainable basis; (2) inefficient use of lifetime estate, gift and GST tax exemption; and (3) poor product maintenance leading to negative outcomes.

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[1] See e.g., *WRMarketplace 19-14 - Watch Your Step: Fiduciary Pitfalls for Trustees of Irrevocable Life Insurance Trusts* for an overview of these responsibilities and other important insights on this topic.

[2] See e.g., *WRMarketplace 16-24 – Private Split Dollar in Action – Ensuring a Legacy* for a discussion of private split-dollar planning.

[3] See *WRMarketplace 19-16 - The §6166 Estate Tax Deferral for Closely Held Business: Q&As* and *WRMarketplace 19-18 - Post-Mortem Liquidity Planning: A Fiduciary's (Limited) Toolbox* for a discussion of estate tax liquidity and deferral planning options for estates concentrated in a closely-held businesses or other single asset.

[4] See e.g., *WRMarketplace 17-36 - Turbo-Charged Split-Dollar.*