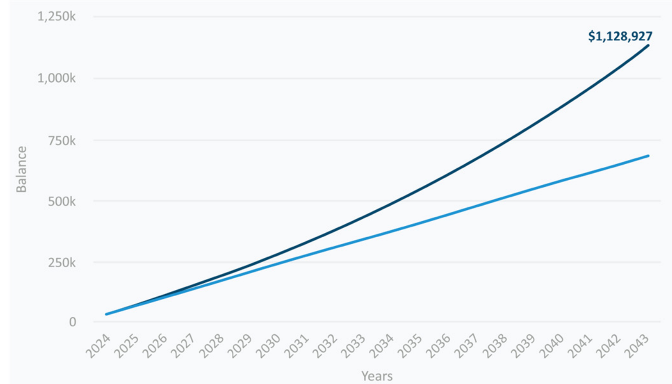
One key factor to keep in mind for transferring wealth to the next generation is this: Change is inevitable.

The current federal estate tax has gone through a constant stream of changes over the past few decades. There have been attempts to repeal the tax, changes to the exemption amount, and changes to the tax rates. In recent years the changes have favored reduced taxes, but this has not always been the case. During times of national crisis there have been significant tax increases. In fact, President Biden campaigned on reducing the exemption amount to as low at $3.5 to $5 million and increasing estate and gift tax rates. Furthermore, his budget proposals since taking office have included provisions that would require gain recognized at death and on lifetime transfers. Even if nothing is done, the current exemption will expire on January 1, 2026, going back to the 2018 level of $5 million (with index adjustments).

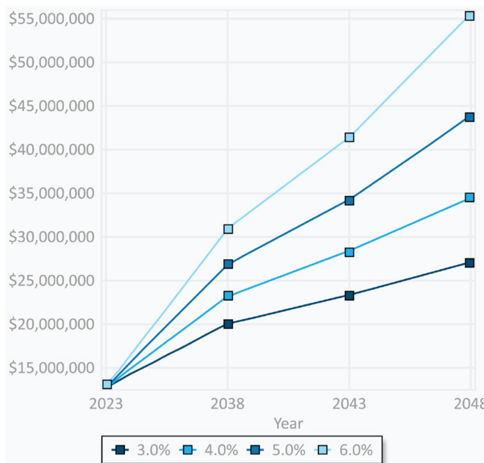
Families may also go through many different changes as time goes on. Some are positive – grandchildren come into the world, marriages add new family members, family business success is achieved, and some are negative – divorce separates families, family friction creates rifts, and family members may pass away well before their time. With each change, goals for passing on wealth may change as well.

Impact of Annual Exclusion Gifting



Demonstrates $34,000 annual exclusion gifts by a couple to one beneficiary each year for 20 years at 5% growth.

Impact of $12,920,000 Exemption Gift



Many of the more common estate planning strategies involve the transfer of wealth prior to death especially now when the estate tax exemption is at an historic high and values may be depressed as a result of the chaotic market over the past couple of years. Some of the estate strategies include gifting of assets, selling of assets, or loans to family members. Before making such a transfer, families should analyze their own financial/income needs and consider how those needs could potentially change. Gifting strategies may reduce estate taxes and protect family wealth from creditors, but what if financial needs change, such as through a business failure, economic downturn, or unexpected disability?

While making a gift of an amount equal to a large part of, or all of, the exemption will produce better results than sporadic modest gifting it's not for everyone. In fact, a survey conducted by the AICPA revealed that less than 10% of clients worth $10 million or more have used part of their exemption. It is not surprising that many individuals fail to make lifetime gifts in excess of the $17,000 (2023 indexed) annual exclusion. Many individuals, including wealthy individuals, are reluctant to give up control of assets because of a fear that they may need access to the funds for financial emergencies. In fact, one reason life insurance is a popular asset for gifting is because most individuals are willing to relinquish ownership of their policies to avoid estate taxation.

Given the opportunity that currently exists to make large gifts between now and 2026 when the doubling of the exemption is set to expire we thought it time to review how it is possible to retain a level of flexibility while setting the stage to benefit from a lifetime transfer of wealth. The following are brief summaries of strategies designed to accomplish various estate-planning goals using life insurance while retaining a level of flexibility.

Characteristics of the Best Assets to Gift

- Assets expected to appreciate after the date of the gift.
- Assets at the time of the gift have a small gift value.
- Assets able to minimize or avoid income tax – now & in the future.
- Assets one is willing to give up

Characteristics of Life Insurance

- Predicable death benefit value not subject to market fluctuation.
- Death benefit is greater than premiums paid.
- Death benefit can be received income and estate tax-free – avoiding capital gains tax that may apply to the appreciation on other assets owned outside of estate.
- Premiums can be structured to avoid or minimize gift tax.

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Private Financing *Summary of Strategy*

Basic Design

- Life insurance policy (individual life or second-to-die) is owned by a family member of trust typically structured as a grantor trust.
- The insured lends money to the owner of the policy to pay premiums, documented by a promissory note. Basically, the insured acts as the "bank."
- The loan can be made annually or in a lump sum.
- Where the loan is structured as a large lump-sum amount to a trust, the financial advisor can invest the funds and use the dividends/ distributions from the investment to pay the insurance premiums.
- Interest is charged at the appropriate applicable federal rate which depends on the terms of the loan and are typically lower than commercial loans. The loan agreement may allow interest rates to be accrued.
- The insurance policy may be used as collateral to secure the note.
- At the end of the loan period, the trust or family member repays the debt. Consequently, the note value is included in the estate.

Advantages

- The lender retains the flexibility to forgive the loan (turning the loan into a gift if it's determined that the insured wants to use the high estate exemption) or seek repayment should s/he need cash flow.
- The loan(s) for premium payment are not considered gifts as long as there is a legitimate intention to repay the loan.
- One of the most appealing aspects of this arrangement is the promissory note terms are more flexible than commercial loans.
- Loan rates can be renegotiated in periods of declining interest rates.
- The life insurance proceeds and the investments owned by the trust are excluded for the estate.

Considerations

- It's very important that the loans be treated as a loan by the IRS, and not a gift; therefore, the formalities associated with a loan must be followed.
- If annual loans are made each year as the premium comes due, the interest rate charged will fluctuate from year to year.
- The insured may make gifts to the trust to assist in the shortfall of the premium payment or help pay the interest, but caution must be used to avoid below-market loan treatment or deferral charges under the Split Dollar Regulations §1.7872-15(a)(4) and (h).

Standby Survivorship *Summary of Strategy*

Basic Design

- Utilizes a second-to-die life insurance policy on the life of a married couple.
- The spouse with the shorter life expectancy is named the initial owner.
- The Standby Survivorship Trust is named the contingent owner and primary beneficiary.
- Premiums are paid out of the policyholder spouse's separate assets.
- Standby Survivorship Trust can be:
    1. Irrevocable life insurance trust
    2. By-pass/Family trust established in the policyholder's estate document

The non-policy owner spouse cannot be the trustee of the trust, but can be a trust beneficiary.

- Upon the death of the policyholder spouse, the policy automatically changes ownership to the Standby Trust.

Advantages

- No gifting is required.
- While both spouses are alive, the policyholder has full access to policy cash values.
- Policyholder spouse can gift the policy to a trust in the future, when more confident they will be subject to estate tax, and as long as one of the spouses is alive three-years from the transfer the policy is not subject to estate tax.
- If the policyholder spouse dies first (as expected), the fair market value of the policy is included in that spouse's estate (not the death benefit) but is expected to be sheltered from estate tax by the exemption. At the death of the surviving spouse the proceeds are not subject to estate tax.

Considerations

- Typically, the premiums are structured as a "limited pay" lasting no longer than the life expectancy of the policyholder spouse to avoid the need to make gifts once the policy ownership changes to the Standby Trust.
- If the spouse with the longer life expectancy (non-owner spouse) dies first, the policy owning spouse will need to determine if, based on the facts at that time, they need to consider strategies for removing the policy from his/her estate if estate taxes are still a concern, or to continue owning the policy if taxes are no longer a concern.

Private Split Dollar *Summary of Strategy*

Basic Design

- A family member or irrevocable life insurance trust is the owner and beneficiary of an individual life or second-to-die insurance policy.
- Similar to the private financing strategy, but instead of a loan agreement, the insured(s) enters into a collateral assignment split-dollar agreement with a family member or trust.
- The collateral assignment split dollar agreement can be structured as either:
    1. Non-equity arrangement where the insured(s) pays the premiums and retains the right to receive back the greater of premium contributions or the entire policy cash value out of the policy cash value and/or death benefit, or
    2. Equity arrangement where the insured(s) pays the premiums and retain the right to receive the cumulative premiums paid back out of the policy cash value and/or death benefit. In this arrangement any cash value exceeding the cumulative premiums is retained by the trust or family member.
- During the term of the split dollar agreement the insured(s) own the policy cash value and death benefit at least equal to the cumulative premium while the family member or trust owns the balance.

Advantages

- The gift is minimal because premium payment is not considered the gift value. The gift value depends on the split dollar agreement structure.
    1. In a non-equity arrangement the gift is measured by the Table 2001 term rates.
    2. In an equity arrangement the premiums are treated as a loan so the gift is measured by a special split dollar blended loan interest rate.
- Potential for access to policy cash value.
- Flexibility to “forgive” repayment of the cumulative premiums.
- At the death of the insured(s) the part of the policy the insured(s) retain is subject to estate tax, but the balance is not subject to estate tax.

Considerations

- Under either collateral assignment split-dollar variations, if the insured chooses to forgive the amount they have a right to recover under the agreement, it will be considered a gift to the trust for federal gift tax purposes.
- It is important to develop a repayment strategy especially in non-equity individual life and second-to-die arrangements. When and how will the trust repay their obligation? If policy cash values will be used to repay the obligation, the policy should be properly funded and monitored. The obligation may also be repaid at the death of the insured. In this case the repayment would be paid to the insured’s estate.

Spousal Lifetime Access Trust (SLAT) *Summary of Strategy*

Basic Design

- An irrevocable life insurance trust is the owner and beneficiary of an individual life insurance policy insuring the life of the premium paying spouse.
- The non-insured spouse may be the sole beneficiary of the trust while living but other heirs may also be beneficiary.
- The beneficiary spouse can be trustee and receive distributions of income and principal limited to health, education, maintenance and support. However, if an independent trustee is appointed the beneficiary spouse can receive discretionary distributions (for any purpose)
- The beneficiary spouse can be given a testamentary limited power to appoint the trust principal to anyone other than themselves, their creditors, or creditors of their estate. In many states the insured/grantor spouse cannot be a future trust beneficiary.
- It may be possible to establish dual SLATs, one insuring each spouse with the other spouse the trust beneficiary, if the trusts are different from each other.

Advantages

- The insured spouse’s access to policy cash value is indirect while both spouses are alive.
- Death proceeds are removed from the estate of both spouses.

Considerations

- A divorce from the trust beneficiary spouse eliminates indirect access to the policy values by the insured spouse and leaves the ex-spouse as trust beneficiary. Legal counsel may add trust provisions to mitigate this risk.
- If the beneficiary spouse predeceases the insured spouse, the insured spouse’s indirect access ends. However, if the trust is established in one of the 19 self-settled domestic asset protection states it’s possible for the beneficiary spouse to appoint the insured spouse as a trust beneficiary.
- Where dual SLATs are established with identical provisions there are risks that the IRS may consider them reciprocal trusts and include the death benefit in the estate of each insured spouse.

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