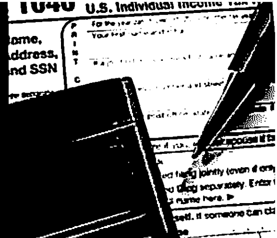


FEATURE:
ESTATE PLANNING & TAXATION

By **Martin M. Shenkman, Richard L. Harris** & **Lawrence Brody**

The Split-Dollar Legacy Trust

An insurance strategy that can achieve multiple planning goals in 2012

Every advisor is aware of the importance of clients making large gift transfers before 2013. Changes to the law are expected, including a reduction in the gift and estate tax exemption amount and a limit on the time in which the generation-skipping transfer (GST) tax exemption can be allocated to produce a zero inclusion ratio for a trust. But, what can the descendants of ultra-wealthy parents do in 2012? The answer may be what we'll call the "split-dollar legacy trust" (SDLT). This technique entails some unusual applications of an insurance plan to potentially achieve valuable planning benefits, which could be lost if this technique isn't implemented in 2012.

When Strategy Applies

This strategy applies in a situation in which parents are ultra-wealthy and have used up their exemptions funding their own irrevocable GST trusts (whether self funded, gift split or otherwise). Their children may have only moderate wealth in their own names. Time is running out on the $5.12 million gift tax exemption. Is there a way that the parents can use their assets to fund GST trusts using their children's exemptions (not their own) before the law changes to limit the duration for which the GST tax exemption can be allocated? Perhaps this planning can be structured to create a grantor trust for the children, before the benefits of grantor trusts are eliminated, as suggested in the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, released Feb. 13, 2012 (known as the "Green Book"). Successfully grandfathering these key tax benefits could provide wealthy heirs the keystone to their own future estate planning. Additionally, suppose the parents could freeze the value in the child's estate, as well as produce a likely discount at the parents' deaths. Achieving all these goals at once might well be the estate-planning Triple Crown.

A Hypothetical

Mom and Dad have assets in excess of $250 million. They have three children, Alice, Betty and Carol. Alice and Betty are both married, and they each have two children. Mom and Dad have used $10.24 million in assets to fund GST trusts. They've used that seed money to sell a net $50 million interest in Family S corporation to the trusts in exchange for an installment note. Mom and Dad's wealth is new to them. So, they're unwilling to sell more of the business. The business is very healthy and generates much more income than they need to support their lifestyle. They also have $50 million in liquid assets, primarily municipal bonds. They're willing to use some of their liquid assets to transfer more money to the GST trusts, if they can find a way to do so without incurring gift taxes on the transfer.

Two Options

Mom and Dad may consider two options:

Option 1. Make intrafamily loans of $5.12 million to each of their children at the appropriate applicable federal rate (AFR) for the term of the loan.[1] The children can then gift the money to their own GST trusts, which are similar to the trusts set up by their parents. Carol's (the unmarried child's) trust would leave her share to her

Left to right: **Martin M. Shenkman** is an attorney in Paramus, N.J. **Richard L. Harris** is the managing member of Richard L. Harris LLC in Clifton, N.J. **Lawrence Brody** is a partner at the St. Louis law firm of Bryan Cave LLP

children, if any. Otherwise, it would go to a trust for the benefit of her nieces and nephews.

But, this option raises problems. What will secure the loan if the funds the children borrow from their parents are gifted to an irrevocable trust? And, while there's *authority for* intrafamily loans using the appropriate AFR,[2] what justifies the loan if there's ultimately no collateral? Many attorneys look to commercial loans as a benchmark for establishing the legitimacy of intrafamily loans. Because of the lack of collateral, most attorneys wouldn't be comfortable with this transaction. What can be done to achieve the desired result? Likely nothing. Worse, the consequence of this transaction, should

The sale of the policy doesn't fall directly under gift tax regulations.

the Internal Revenue Service apply a step-transaction theory, would be to recharacterize the purported loan to the children, followed by the children's gift to their trust, as a gift by Mom and Dad to the trusts. Since Mom and Dad already used up nearly all of their gift and GST tax exemption amounts, this recharacterization could trigger substantial gift and GST taxes at the current 35 percent rate and would subject trust distributions to skip persons to the GST tax.

Option 2. A better option may be for the parents to create an SDLT. Instead of making an outright loan to each child, Mom and Dad make a split-dollar loan to each child, which the child uses to purchase life insurance on her own life. The child is the owner of the policy. (More about that later.) Each child chooses her own beneficiary.

The loan will be for $6.12 million to each child, secured by the death benefit of $15 million permanent life insurance policies.[3] Interest will accrue at the AFR on the parents' split-dollar loan to the children, as permitted under the split-dollar loan regulations.[4] The loan is repayable at the death of the child/insured, an arrangement specifically allowed under the Treasury regulations.[5]

The children (borrowers) and parents (lenders) execute the appropriate loan and collateral documents. Additionally, they attach a statement to their income tax returns for the year of the loan, stating that the parties intend that the loan will be repaid. Under the Treasury regulations, this assures that the IRS will respect the transaction as a loan.[6]

Then, each child retains $1 million to cover some of the future premiums, using the remaining $5.12 million as a gift to their own GST grantor trust.

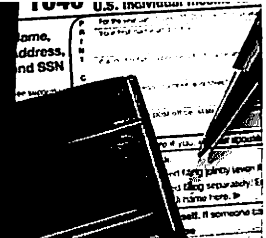
Potential Results

Assuming the parents decide on Option 2, there are two possible results that can occur, depending on who dies first—the parents or the child.

Result #1: Mom and Dad die first. The most likely scenario is the children survive their parents. Each child could be, under the parents' wills, the beneficiary of her own note. An appraiser will have to value the split-dollar note as part of the surviving parent's estate. What's the value of a note, with interest at a low AFR, that doesn't pay the interest until maturity and that can only be repaid at the child's death? A reasonable appraiser will likely apply various discounts to the note—for the low interest rate, the creditworthiness of the borrower, the accrual, rather than payment, of the interest and the fact that the loan isn't repayable until the borrower's death. Certainly, if the estate had any other similar loan receivable, a substantial discount would be appropriate.

After the parents' deaths, each child will have the opportunity to transfer or sell the policy to a generation-skipping irrevocable life insurance trust (ILIT) using an appropriate value for the policy.[7] The purchaser of this policy could be the grantor trust the child creates as part of the SDLT plan. That trust, from the outset, could name an independent insurance trustee and appropriately restrict the child's control over any life insurance.

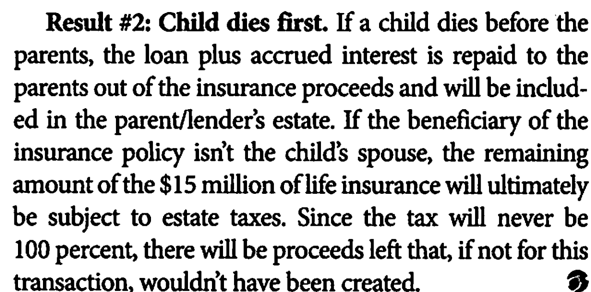
The sale of the policy has two potential advantages. First, if the sale is for full and adequate consideration, it may not be subject to the Internal Revenue Code Section 2035 three-year rule (that is, it won't be subject to estate tax if the transferor dies within three years of the gift). The sale doesn't fall directly under gift tax regulations. While there's nothing on point, if the IRS successfully challenges the value used as too low,



it's arguable that some of the proceeds will be in the child's estate as part gift, part sale. Proper valuation is critical. Second, assuming the ILIT is a grantor trust,[8] there won't be a transfer for value triggered on the sale. Because the child was the beneficiary of her own loan from the estate, the obligation disappears. The parents' GST trust can make a split-dollar loan for the child's self-settled grantor trust to purchase the child's life insurance policy.

The three major benefits to this transaction are: (1) the use of the child's $5.12 million exemption while it's still available; (2) the potentially discounted value of the loan in the parents' estate; and (3) the creation of liquidity for the child's estate by using life insurance. A fourth potential benefit is that if either the parents' or a child's estates are illiquid, the trusts can make a *Graegin* loan (that is, a loan to the estate to pay estate taxes and for which the estate gets an up-front interest deduction, thereby reducing the value of the estate).[9]

Quantitatively, assuming a possible discount of the note by 50 percent, the SDLT transaction has reduced the parents' estates by roughly $9 million. The plan has also moved $15.36 million immediately into a GST, grantor self-settled trust using the children's exemptions. And, it's added $45 million more to GST trusts from the ultimate life insurance proceeds.



Result #2: Child dies first. If a child dies before the parents, the loan plus accrued interest is repaid to the parents out of the insurance proceeds and will be included in the parent/lender's estate. If the beneficiary of the insurance policy isn't the child's spouse, the remaining amount of the $15 million of life insurance will ultimately be subject to estate taxes. Since the tax will never be 100 percent, there will be proceeds left that, if not for this transaction, wouldn't have been created.

Endnotes

1. Internal Revenue Code Section 7872.
2. *Ibid.*
3. It's important that the amount of the loan can be justified relative to the face value amount and premium of the policy.
4. Treasury Regulations Section 1.7872-15(g)(4).
5. Treas. Regs. Section 1.7872-15(e)(5)(ii).
6. Treas. Regs. Section 1.7872-15(d)(2).
7. For a discussion of the issues about and methods of valuing a life insurance policy, *see* Richard L. Harris, "Transferring Life Insurance by Gift or Sale," *Trusts & Estates* (April 2011) at p. 37.
8. For information about using the "power to substitute" as the clause creating the grantor status and inclusion of the policy under IRC Section 2042, *see* Richard L. Harris, "Substituting a Life Insurance Policy in an Irrevocable Trust," *Trusts & Estates* (April 2012) at p. 54.
9. *Calumet Industries Inc. v. Commissioner*, 95 T.C. 257 (Sept. 13, 1990); IRC Sections 166, 446, 6501.

SPOT LIGHT

Fan-tastic

"L'Éventail" (51 in. by 33 in.) by Eugène Grasset sold for $550 at Swann Auction Galleries' recent Discovery Sale on June 28, 2012 in New York. Grasset got his start as a painter and sculptor of fine art. However, he gained his greatest notoriety as a graphic designer of commercial art, particularly the French style posters popular in the 1880s.

By **G. Scott Budge**

Grief and Estate Settlement

Mitigating a challenging risk to families

"She's gone, Sarah... Mom's gone."
"No, it can't be true."
"Yes, she died this afternoon. Now what do we do?"

Whether anticipated or not, the death of a loved one is both an ending and a beginning. This article concerns the latter and discusses a set of risks often misunderstood by families and their advisors as they navigate the dual realities death sets in motion around estate settlement and grieving. This cluster of risks is essentially about specific relational dangers that can have damaging effects on family life and set the stage for downstream degradation of wealth through litigation. While this article is neither a treatise on estate settlement procedures nor a full articulation of grief process research, it highlights a key set of issues that families and their advisors should be alert to when a loved one dies. Signs that relational risks are heightening during the settlement process don't require an expert to see, but do require a willingness to consider and give legitimacy to the dual nature of what's going on: a sequential and organized process tied to calendar time and an often elliptical, disorganized and complicated process of grieving, unfolding in nonlinear and potentially disruptive sequences. The key risk of this asynchronous process is that care and attention isn't paid to both sides.

Estate Settlement Process

At a high level, the estate settlement process draws on the administrative and executional skill of the firm running it. Some combination of grace, tact and attention to detail enables management of the typical steps and timeline of estate settlement. *Estatesettlement.com* provides the essence of the month-by-month sequence, from Month 1 (read will) through Month 5 (prepare federal estate tax return Form 706) and Month 9 (distribute assets to beneficiaries and close estate).[1] This process requires an expert choreography of attorney, accountant, personal representative or executor, banks, brokerages, title holders of all sorts and the beneficiary group, all reflective of the need for thoughtful assembly and disassembly of a virtual, collaborative team—which is no small feat.[2]

It also has a relative urgency attached to it. The nine month timeline set in motion by a death can have hundreds of line items that need tracking down in an estate of any complexity, and the penalties for missing tax payments and filings compound rapidly. This means that the clock is ticking on a process that has an already relatively high malpractice risk.

Processing Death

Death is both a singular anticipation and universal part of what defines us as the one species whose members live against the foreshadowing of this inevitability. We will each die in a singular way, yet we're caught collectively in what German existential philosopher Martin Heidegger called a "constant tranquilization about death."[3] Language makes us unique among the species as historical beings, and a primary lesson of this history is that our inevitable future is death. We can't deny this, but expend massive energy trying.

One doesn't need to be familiar with Heidegger to understand that estate settlement, like our existential orientation to death, is about mechanizing the distribution of assets for the living. Herein lies an important challenge. In the painful opening dialogue between

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