



# The Wealth Counselor

A monthly newsletter for wealth planning professionals

## Paying for Large Insurance Premiums

Volume 4, Issue 7

Adding life insurance owned by an ILIT is often the best way to achieve a client's estate and wealth planning goals. This presents two problems for the planning team - getting the client to act and, with large policies, creating a premium payment structure that minimizes the use of the client's gift tax lifetime exemption (\$1,000,000 in 2009), because large policy premiums very often exceed the client's available gift tax annual exclusions (\$13,000 per donor per beneficiary in 2009). This issue of *The Wealth Counselor* explores some solutions to these problems.

### Overcoming Client Resistance

Few clients ever wake up and think, "I want to add some life insurance today."

Indeed, many clients do not "like" life insurance and look on it as a "purchase," despite the fact that its tax benefits often make it an excellent "investment" as well as one of the ideal tools to accomplish the client's goals. Thus, it is incumbent upon the planning team to help the client understand the value created by investing wisely in life insurance as a part of implementing the client's complete plan.

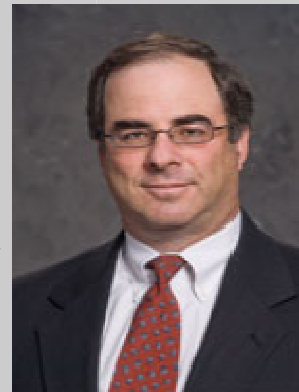
With higher net worth clients, that resistance is often exacerbated because the life insurance premium will exceed the gift tax annual exclusions available to the client. This can be overcome by the planning team finding a way for the premiums to be paid without exposing the client to gift tax liability. For clients who have not already exhausted their \$1 Million lifetime gift tax exemption, using some or all of it may be a good option. For clients who do not have available lifetime exemption to use, the planning team must, and in other cases should, consider other available strategies to pay insurance premiums without incurring gift tax.

**Planning Tip:** By creating the cash flow to pay life insurance premiums, the planning

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team can simplify the client's decision-making process and help eliminate any preconceived notions about life insurance.

## **Premium Funding Solutions**

### ***Split-Dollar Arrangements***

"Split-dollar" premium payment involves two parties contracting to split the premium payment obligations and entitlement to the death benefits of a life insurance policy. Split-dollar arrangements are often used for executive compensation. By reducing the "gift" portion of the premium, split dollar allows the client to leverage any available gift tax annual exclusions.

Final IRS regulations effective January 1, 2004, provide that the income taxation of split-dollar life insurance arrangements will be determined under one of two sets of mutually exclusive rules, depending on who owns the policy.

### ***The Loan Regime***

If the executive owns the policy, the IRS treats the employer's premium payments as loans to the executive (or an ILIT formed by the executive). Consequently, unless the executive pays the employer interest on the loan at the Applicable Federal Rate (AFR), the executive will be subject to tax on the difference between market-rate interest and the actual interest charged. The loan can be demand, or short-, mid- or long-term.

### ***The Economic Benefit Regime***

If the employer owns the policy, the IRS treats the employer's premium payments as providing taxable economic benefits to the executive. The economic benefits include the executive's interest in the policy's cash value as well as the cost of current life insurance protection. In other words, the IRS imposes tax on the annual term insurance cost (formerly known as "PS 58 cost") as dictated by the IRS (Table Rate) or the insurer's alternative term insurance rates.

### ***Private Split Dollar***

Split-dollar arrangements can also be made outside the employment relationship - as between family members. These arrangements are commonly referred to as "private split-dollar." Often, but not exclusively, the parties to the arrangement are the insured and the trustee of an ILIT of which the insured's children or other family members are beneficiaries.

## **Premium Financing**

Premium financing involves someone (the insured, the employer, or the trustee of an ILIT) borrowing money to pay the insurance premiums. In the traditional premium financing arrangement, the policy owner collaterally assigns the policy to the lender, and interest due on the cumulative premium loan is paid currently, accrued and paid later from the policy cash value or death benefit, or a combination of the two. Upon repayment of the loan the lender releases the collateral assignment of the policy.

**Planning Tip:** While premium financing is still an option in limited circumstances, the recent credit crunch has made this option less viable.

### **Exit Strategy Planning**

When planning with split-dollar arrangements or premium financing, it is critical to have an exit strategy that will ensure that funds are available when they are needed. Exit plans can be complex strategies. What is provided here is merely an overview of some ways to generate the funds needed for a rollout from either a split-dollar or premium financing arrangement. A prior issue of *The Wealth Counselor* addressed these strategies in more detail.

**Planning Tip:** The exit strategies discussed here work best in a low-interest-rate environment like the present.

### ***Installment Sale***

An installment sale of income-producing and/or appreciating assets to the ILIT can provide the cash to terminate the split-dollar arrangement or pay off the premium finance loans. Typically, an outright gift of assets is made to the ILIT and those assets plus the assets purchased are used as collateral for the installment purchase. To avoid the imputation of an additional gift, the installment purchase contract must provide for an interest rate on the unpaid balance at least as high as the Applicable Federal Rate (AFR) for the month of the sale.

Accelerated accumulation of value in the trust can be achieved by making gifts of and purchasing "discounted" assets, such as interests in a family limited partnership or family LLC.

**Planning Tip:** For the installment sale technique to work properly, the sale must pass the arms-length test of being for full value and adequately secured as to any part of the sale price that is not paid up front. If it is not, the IRS will treat the transaction as part sale and part gift.

### ***Installment Sale to Grantor Trust***

"Grantor trust" is a term defined by the Internal Revenue Code (IRC). A grantor trust is disregarded for tax purposes. Note, however, that there are two sets of "grantor trust" definitions - one for income taxes and a slightly different one for estate and gift taxes. With careful design, an irrevocable trust can be a grantor trust for income taxes - yet not be a grantor trust for gift and estate taxes.

By using this long-recognized wrinkle in the IRC, the strategies for transfers of assets by gifts and sales to trusts discussed above can all be virtually "supercharged." Making the recipient trust a grantor trust for income tax purposes but not for estate tax purposes produces tax-free compounding of income in the trust and estate depletion for the donor through paying taxes on that same income. And paying those taxes is not an additional

gift to the trust.

Designing the ILIT as a grantor trust for income tax only (sometimes called an IDGT or "Intentionally Defective Grantor Trust") can accelerate the accumulation of value in the trust. That is because with an IDGT, (a) the trust income is attributed to the grantor so the grantor pays all of the income taxes; and (b) interest paid from the IDGT to the grantor is not income to the grantor. Importantly, the grantor's payment of the income taxes is not a gift to the IDGT.

**Planning Tip:** A client may tire of paying taxes on income not received. Also, something can change and result in the additional income tax burden being unbearable or undesirable. To deal with such contingencies, good planning includes having a "spigot" provision in the IDGT grantor trusts so that the trustee can terminate the grantor trust status for income taxes.

**Planning Tip:** An installment sale to an IDGT is also a useful planning tool for creating a cash-flow stream without incurring the income taxes that would result from an ordinary installment sale.

#### ***Grantor Retained Interest Trusts***

An alternative to the installment sale to an IDGT is creating a Grantor Retained Annuity Trust (GRAT) or Grantor Retained Unitrust (GRUT). A GRAT pays the donor a fixed amount per year for a term of years. A GRUT is like a GRAT except instead of an annual payment set on creation of the trust the annual payment is a fixed percentage of the value of the trust assets as determined annually. GRATs and GRUTs are irrevocable trusts that are specifically authorized by the IRS regulations interpreting the IRC. Like the installment sale to an IDGT, a GRAT or GRUT permits the client to make a lifetime transfer of assets to an irrevocable trust in exchange for a fixed payment stream for a specified term of years.

At the end of the GRAT or GRUT term of years, after making the final payment to the donor, the balance of the trust property (the "remainder interest"), if any, transfers to a designated beneficiary or beneficiaries. If a GRAT or GRUT is used as an exit strategy for a split-dollar arrangement or premium finance loan, the beneficiary would be the ILIT.

**Planning Tip:** An installment sale to an IDGT has two potential benefits over a GRAT or GRUT for creating a cash-flow stream. First, an installment sale works with a dynasty trust (i.e., one that is exempt from generation-skipping transfer tax so that it can go on for generations) whereas a GRAT or GRUT may not. That is because the only gift to the IDGT is of the "seed" assets, whereas with a GRAT or GRUT, the size of the gift for gift tax purposes is established at the inception of the trust, but the value for GST tax purposes cannot be made until the trust's term ends, and then it is the entire remainder interest amount. Also, if the client dies before the payment stream ends, the installment sale provides a better tax result.

Each month, the IRS publishes a set of interest rates that are applicable for the coming month. Three are the short-, mid-, and long-term loan rates (AFRs) discussed above. Another is the "Section 7520 rate." It is 120% of the mid-term AFR.

The anticipated remainder interest of a GRAT or GRUT for gift-tax purposes is determined at the inception of the trust using the Section 7520 Rate.

**Planning Tip:** Because the determination of the anticipated remainder interest of a GRAT or GRUT is made at the trust's inception using the Section 7520 Rate, the anticipated remainder interest value can be set to virtually zero. Then, if the actual results beat the Section 7520 Rate, the actual remainder interest passes without using any gift tax exclusion or exemption.

An easy way to explain how a GRAT works to the clients is "heads you win, tails you tie." If the performance of the assets in the GRAT exceeds the Section 7520 Rate, the excess value is transferred without estate or gift tax. If the performance of the assets in the GRAT equals or falls below the Section 7520 Rate, the client gets all the GRAT assets back.

**Planning Tip:** Like installment sales to grantor trusts, GRATs are particularly suited for assets expected to grow rapidly in value. GRATs are also particularly suited for assets that have been the subject of downward value adjustments, such as those represented by minority interests in closely held businesses, FLPs and FLLCs.

During the term of years of the GRAT or GRUT, the client/donor can be the GRAT's sole trustee or a co-trustee with complete control over all decisions of the GRAT or GRUT and the assets in the GRAT or GRUT. That is often a good selling point for the client who wants to remain in control. Alternatively, the client can appoint a financial advisor to manage GRAT or GRUT assets.

**Planning Tip:** The client cannot participate in any way in making distribution decisions for the IDGT because that would make the IDGT a grantor trust for estate tax purposes. Because of this, many practitioners feel it is too dangerous to give the client any control over the IDGT. Thus, the client who is not ready to turn over control may favor the GRAT or GRUT solution.

### **Conclusion**

Helping clients pay for large insurance premiums can be the single factor that distinguishes the planning team from others - and it may be the only way to ensure that clients accomplish their planning objectives. The planning team must work together to implement these strategies as they require input from the accounting, legal, insurance, and financial planning team members.

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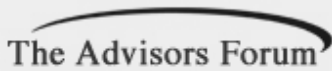
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