

Fickewirth Tax Newsletter

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Dear Reader,

Traditionally, the United States has imposed three types of taxes on wealth transfers:

- a gift tax on the net value of assets one person gives to another,
- an estate tax on the net value of assets transferred when a person dies,
- a generation skipping transfer (GST) tax, currently waived until the end of this year, on the net value of some wealth transfers to grandchildren and other individuals during life or upon death.

The current federal gift, estate and GST tax exemption of \$5.12 million (surplus taxed at 35%) is scheduled to end this year. Furthermore, the limitation on itemized deductions is scheduled to be reinstated January 1, 2013, barring any action by Congress. Since donations to qualified charities are generally included as an itemized deduction on your tax return, this would make philanthropic giving considerably less tax advantaged.

In light of the uncertain tax landscape beyond 2012, it's worth considering strategies using life insurance to transfer wealth to your beneficiaries. Life insurance proceeds are typically taxed as part of your estate if you own the policy when you die. However, if you're not the policy owner of record, the proceeds are not considered part of your estate when you die and not subject to estate taxes, nor will your beneficiary have to pay income taxes on the proceeds.

What follows in this month's newsletter are examples of sophisticated wealth transfer strategies using life insurance in combination with other estate planning vehicles to protect assets from taxation.

Cordially,



Jennifer Lincicum

Life Insurance Strategies to Avoid Taxes

There is a wide variety of permanent life insurance policies, including whole life, universal life, and variable universal life insurance, which combine a death benefit with investment opportunities. Currently, the appreciation earned by investment options and the death benefit are distributed free of income tax. Furthermore, if certain types of trusts own the policy, estate taxes can be avoided as well.

Life insurance vehicles are considered a critical component of tax planning for most high-net-worth individuals. When used correctly in combination with other estate planning vehicles, life insurance strategies can be tailored to solve for very specific desires, as illustrated in the following hypothetical estate tax planning scenarios.

Case Study #1: Remove Highly Appreciated and Illiquid Assets from an Estate

A couple in their late 60s owns a portfolio of highly appreciated and illiquid real estate holdings that generate a high rate of return. While they don't want to liquidate these holdings, they would like to transfer a portion to their children while they are still alive in order to reduce their taxable estate.

The couple creates an irrevocable Grantor Retained Annuity Trust (GRAT) to transfer some of the real estate to their children. A GRAT works like an annuity, wherein the older couple will receive annual payment from the trust for a fixed period of time. At the end of the term, any remaining value in the trust is transferred to their beneficiaries free of taxes. Should the couple pass away before the trust period ends, the assets will revert back to their taxable estate, eliminating any potential gift tax benefit.

In this scenario, the GRAT is set up for five years, during which time the couple continues to receive interest from the real estate holdings. Since the potential exists for these assets to go back into the estate, the couple's adult children decide to purchase a Joint Survivor Life Insurance Policy based on their parents' lives. That way if their parents die before the end of the GRAT term, the life insurance proceeds can be used to pay taxes on the full estate.

However, if the parents are still alive at the end of the GRAT term, the remaining assets are gifted tax-free to the children. When their parents eventually pass away, the children can use the insurance policy's death benefit to pay taxes on the rest of their parents' estate.

Case Study #2: Boost Charitable Contributions and Create a Tax-Free Inheritance for Heirs

A widow in her mid-sixties makes regular gifts to her favorite charity. She wants to increase her annual gift without tapping the principal of the \$1 million bond portfolio that she intends to leave to her children.

The widow transfers her bond portfolio to a Charitable Lead Annuity Trust (CLAT), essentially removing \$1 million from her taxable estate. The trust then uses the money to purchase a single premium immediate annuity and a fixed life insurance policy. She uses the immediate annuity distribution to continue her regular charitable gifts, which enables her to increase the gift amount by 25% in tax-free dollars. Upon her death, her beneficiaries will receive \$1 million from the life insurance policy free of both income and estate taxes.

Case Study #3: Charitable Organization Seeks Greater Yield on Gifted Investment

A charitable organization has received a \$1 million fixed income investment, which is not providing much in the way of yield in today's low interest rate environment. It would like to increase the annual yield without having to sell the investment.

The foundation uses \$1 million from other fund sources for two purposes. It pays \$40,000 to purchase a life insurance policy and \$960,000 to purchase a single premium immediate annuity (SPIA). Both contracts are based on the life of one of the foundation's older members. Note: a life insurance policy may only be issued when the applicant has an insurable interest.

Since today's annuities currently provide high annual payments for seniors age 70 to 89, the SPIA currently pays the organization a much higher yield than it receives from the original fixed income investment. When the older member dies, the life insurance death benefit will pay out a tax-free death benefit that the foundation can then use to repay the original \$1 million investment used to purchase both the policy and the SPIA.

Meanwhile, the original fixed income investment remains intact. Thus, this strategy is able to provide a significantly higher annual yield while still protecting the original \$1 million investment, and the SPIA distributions are not taxable since the recipient is a charitable organization.

Case Study #4: Gift Assets without Using Lifetime Gift Exclusion

An elderly widower has already maxed out his lifetime gift exclusion to heirs. However, he wants to gift another \$1 million from his estate without triggering gift taxes.

He combines an irrevocable Grantor Defective Trust (GDOT) with a limited liability company (LLC). A GDOT essentially "freezes" the value of an asset and transfers the asset out of a taxable estate. However, it is considered "defective" because it does not remove responsibility for income taxes generated by assets held in the trust. The grantor must pay these taxes even though he is not entitled to any trust distributions.

In this scenario, the widower funds the LLC with \$1 million. This money is effectively moved out of his estate, but he is still responsible for any capital gains taxes generated by the trust. The LLC uses the money to purchase a single premium immediate annuity and a life insurance policy with a \$2.5 million death benefit. Both policies are based on the widower's life.

The widower then sells his interest in the LLC to the GDOT for a promissory note valued at \$700,000, discounted from the original \$1 million due to its lack of liquidity and control. The promissory note will earn interest at the applicable federal rate, on which the widower will have to pay income taxes.

When the widower dies, the \$2.5 million in life insurance proceeds can be used to pay back the \$700,000 promissory note, with the excess amount (approximately \$1.8 million) left to his heirs without triggering gift taxes. Note: the initial investment of \$1 million will need to earn 12% over his life expectancy in order to yield \$1.8 million.

Case Study #5: Liquidate Life Insurance for Medical Bills

A widow in her seventies is a diabetic who has been diagnosed with cancer. Her husband has been dead for over a decade and both of her children are grown and financially stable. She, on the other hand, needs money to pay for medical bills and ongoing treatments, so she sells her life insurance policy in a life settlement transaction to get the cash she needs to live comfortably.

Typically, a life settlement is designed for someone 65 years or older who has developed a health condition that renders life expectancy between two and 15 years. The more serious the medical condition, the greater the potential cash value of the life insurance policy. Life settlement transactions generally involve policies with a face value of \$1,000,000 or more, with cash settlements yielding two or three times more than the surrender value.

Bear in mind that the settlement amount up to the cash surrender value (minus the premium payments she paid that exceeded the cost of insurance) will be taxed as ordinary income, and life settlement proceeds above the cash surrender value will be taxed as capital gains.

Recent Cases and Rulings

IRS Private Letter Ruling 201216045: CLAT with Ascending Annuity Payouts
April 20, 2012

The IRS issued a massive Private Letter Ruling for an irrevocable, testamentary charitable lead annuity trust (CLAT) that went to court and successfully petitioned for the annuities to be ascending in value rather than straight-line. The trust in question asked the IRS about the potential tax consequences of these ascending distributions under a wide variety of I.R.C. provisions. The IRS determined that the charitable lead annuity trust will satisfy the requirements of 2055(e)(2) for guaranteed annuity interest and therefore the property of the taxable estate of the decedent will qualify for a charitable deduction under 2055(a).

The Lincoln National Life Insurance Company v. Joseph Schlanger
2006 Insurance Trust, C.A. No. 09-506-BMS, 2010 WL 2898315 (D. Del. July 20, 2010)

An insurer sought a judicial declaration that a life insurance policy was void as an illegal contract wagering human life that accordingly lacked an insurable interest. The Supreme Court of Delaware held that a life insurance policy lacking an insurable interest was void as against public policy and thus never came into force.

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employee benefit brokers and consultants.

Our expertise lies specifically in the design, implementation,
communication and administration of cost effective benefit plans.
We welcome your inquiries.”

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. Please seek competent counsel to determine and satisfy your individual needs.

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