



LIFE INSURANCE

Combining Estate Planning Techniques – A Powerful Strategy

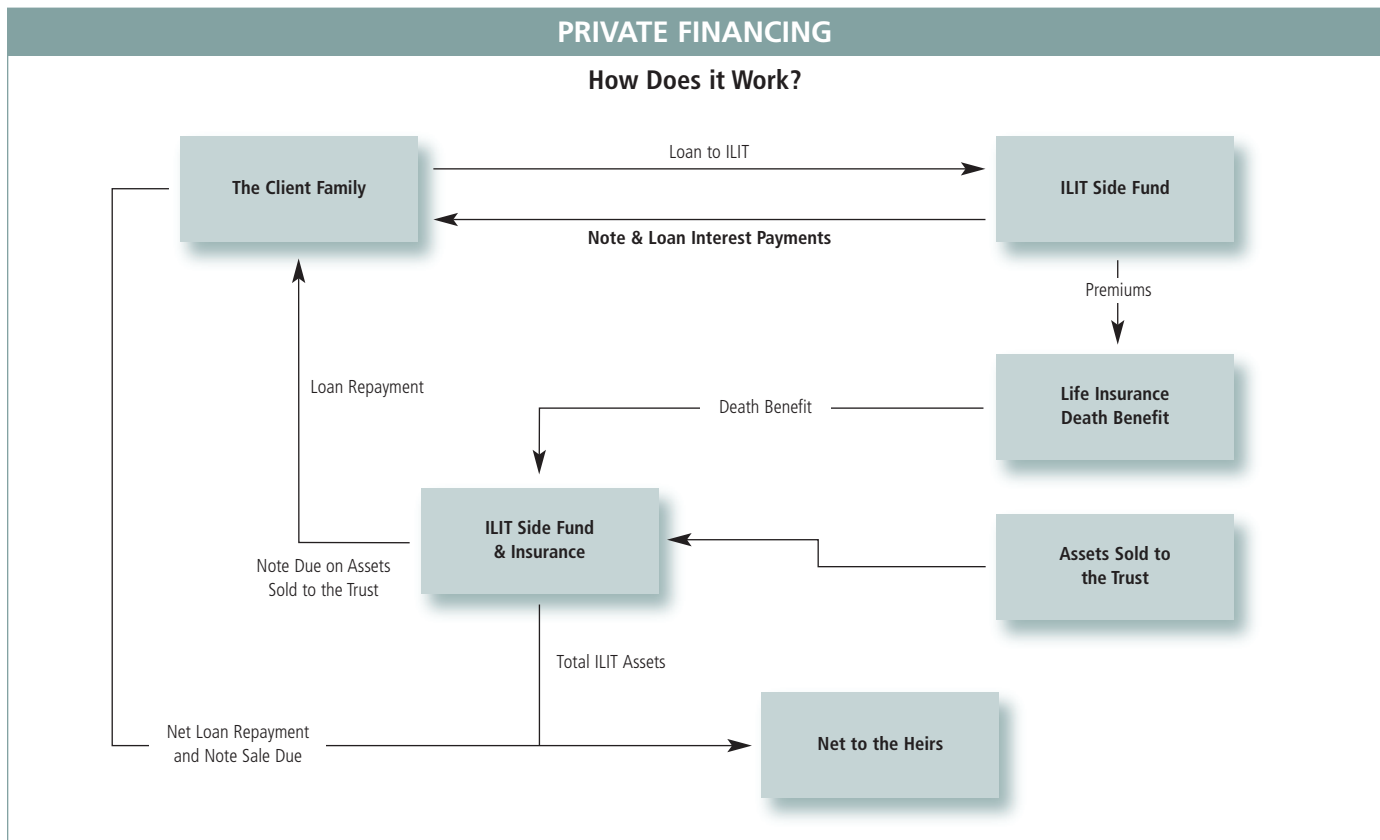


Life insurance can help meet many wealth transfer goals. The death benefit could cover estate taxes, for instance, avoiding liquidation of much of the estate to meet the estate tax bill. Even though a life insurance policy owned by an Irrevocable Life Insurance Trust (ILIT)¹ will keep the proceeds from being subject to estate tax, the payment of large premiums during lifetime could result in gift tax.

THE SOLUTION

A Private Financing arrangement between the client and an ILIT can address many gift tax concerns associated with purchasing a policy. Private Financing can also be combined with certain other commonly used techniques to further facilitate a client’s business transfer or charitable goals.

Unlike gifts of cash, loans from client to ILIT are not subject to gift taxes. Under a financing arrangement, a client could make annual cash loans, or a lump-sum loan, to the ILIT under a fair market note. The ILIT can then use cash from the loans to fund the premium payments. Repayment of the loan principal, including any accrued interest, could come from the life insurance proceeds or from the ILIT’s invested side fund. Repayment could also take place during a client’s lifetime through the use of other estate planning tools that may already have been established or that the client has in development.² Combining multiple planning vehicles, techniques and trusts can boost the transfer of family wealth and growth outside of the taxable estate.



HOW IT WORKS

Stage 1: Loan To ILIT: Working with their attorney(s), the client establishes a Grantor ILIT³ during lifetime. The client lends the ILIT the cash required (the life insurance loan) to fund annual premiums on life insurance on their life. The loan could be a lump sum of cash, or the client could set up scheduled transfers of funds, which the ILIT then uses to make annual premium payments to the insurance company. Interest on the life insurance loan can be paid by the ILIT annually, or it can be accrued.⁴

Stage 2: ILIT Purchases Life Insurance

Stage 3: Loan Repayment: Eventually, the ILIT must repay the principal on the life insurance loan, along with any accrued interest. Possible sources of funds to do so include:

- a. The life insurance proceeds; or
- b. The ILIT's side fund, made up of the growth on the lump-sum loan, net of annual premium payments and/or tax-free gifts⁵ the client may have also made to the side fund; or
- c. Sale to the ILIT: Incorporating the popular Sale to a Grantor Trust (SAGT) planning strategy, the client makes a sale to the ILIT, on an installment basis,⁶ of income-producing closely held business interests, such as corporate or partnership interests⁷ (the asset sale loan).⁸ The ILIT uses the income generated by the asset to make payments to the client on the asset sale loan, and could also use it to repay any outstanding loan balance from the life insurance loan, as well as meet ongoing policy premiums; or
- d. An existing trust in which the ILIT is named as beneficiary of the balance of the assets, such as:
 - Grantor Retained Annuity Trust (GRAT), or
 - Charitable Lead Trust (CLT)

THE ELEMENTS OF FINANCING WITH SALE TO ILIT

The client lends the ILIT the funds to enable it to purchase the life insurance that will be incorporated into the client's estate plans. The client then sells an asset to the ILIT using a SAGT technique, allowing the ILIT to use income from the asset to meet its obligation to the client under the life insurance loan.

FINANCING THE LIFE INSURANCE

Financing privately in the form of a fair market loan arrangement between client and ILIT means premium payments will not be subject to gift tax. The client makes annual gifts to the trust in the amount of the loan interest only, and that amount may be tax free if the client has annual gift tax exclusions available.⁹ Alternatively, loan interest may be deferred so there are no out of pocket costs either to client or to the trust. Rates need not be fixed and may change annually.

- The client can lend the ILIT funds to meet annual premiums on the life insurance, either in a lump-sum or scheduled amounts.
- The ILIT, as borrower, will own the life insurance policy and make premium payments using the borrowed funds.
- Loan interest can be paid to the client annually or can be deferred for a period of time.¹⁰

SALE OF AN ASSET

The sale of the asset would usually involve an installment note (the asset loan), with the principal due at the end of the note. Such a sale offers several advantages.

- As grantor of the ILIT, the client will be responsible for the trust's income taxes, leaving all the trust assets intact for the benefit of heirs.¹¹
- The asset sale will remove that asset's future growth and income from the client's estate,¹² immediately freezing the size of the taxable estate.
- Certain assets could be valued at a discount, allowing the client to transfer even more in a shorter period of time.

- In some cases, the client may be able to give away or sell an interest in an asset without giving up control of it.¹³
- Income from the asset can be used to pay interest as well as principal on the asset loan,¹⁴ and is significantly leveraged when used to fund premiums on the life insurance. Life insurance proceeds are generally not subject to income and estate taxes.¹⁵

The installment note should be established as a fair market loan, and the loan interest set at least equal to the Applicable Federal Rate (AFR) at the time of the sale.¹⁶ Prior to the sale, an initial tax-free gift of cash and/or income-producing assets should be made to the ILIT totaling at least 10% of the value of the assets being sold.

THE POWER OF DISCOUNTED GIFTS

The value of an interest in a closely held corporation, partnership or other asset may qualify for a valuation discount to reflect either or both a minority interest discount and a lack-of-marketability discount. The client may be able to achieve maximum leverage with the transfer of such interests in a gifting program. The discounts can be considerable, ranging from 25%–40% of the underlying value of the assets, and the amount of time it takes to transfer the assets gift tax free can be minimized.

THE COMPONENTS OF DISCOUNTING

- **Lack of Marketability.** A discount may be available to reflect the technical and practical restrictions on the owner's ability to transfer the asset.
- **Minority Interest.** This discount may be available because the owner of an interest or asset may not have the power to manage or control the underlying net asset value.

BENEFITS

PRIVATE FINANCING

- **Minimal or No Gift Tax.** By privately financing life insurance premiums, the client may preserve wealth through the use of life insurance while minimizing or avoiding gift tax.
- **Heirs Receive Loan Repayment.** Unlike a third-party loan, there is no third-party lender to repay. Heirs will receive the life insurance policy as well as the loan balance they repaid, net of estate tax.¹⁷
- **Minimal Risk.** Unlike conventional loans, there are no third-party loan costs, collateral requirements or loan call risks.
- **No Income Tax.** The loan interest income is not subject to income tax if the ILIT is a Grantor Trust for income tax purposes.¹⁸

SALE OF ASSETS

- **Low, Fixed Interest Cost.** The client can transfer an asset by selling the asset to the ILIT at a currently low, fixed interest rate.
- **Discounted Sale.** An asset can be sold to heirs at a significant discount.
- **Leveraged Income.** The income generated from the asset's actual value can be leveraged with life insurance.
- **Additional Tax-Free Gift and Trust Assets Are Preserved.** Since the client pays the trust income tax bill, payment of taxes is the equivalent of an additional tax-free gift, and assets in the trust are preserved and can grow outside the taxable estate.
- **Arbitrage.** The difference between the asset's actual value and its sales price funds the life insurance leverage.
- **Asset Protection.** The trust can provide asset protection for the beneficiaries, potentially through multiple generations.

CONSIDERATIONS

PRIVATE FINANCING

- **Non-Deductible Loan Interest.** Loan interest paid by the trust or other entity is not deductible in any circumstance.
- **Possible Estate Tax Cost.** If the loan is repaid at death, the loan balance will be paid to the estate and may be subject to estate tax before being distributed to heirs. This means that heirs will receive the loan balance after it has been taxed at the estate tax rate.
- **Potential Income Tax Cost.** If an existing trust or partnership lends funds to the ILIT, or if the ILIT is not a "Grantor Trust," the loan interest payments, when received, may be subject to income tax.
- **Liquidity Requirement.** Client must have the cash available to make the loan. Adverse gift tax consequences may result if assets other than cash are "loaned" to the ILIT. In addition, if assets are liquidated to make the loan, loan income taxation may result.

SALE OF ASSETS

- **Non-Deductible Loan Interest.** Since this is an income-tax-neutral transaction, client does not recognize capital gain on the sale of the asset nor income tax upon receipt of the loan interest payments. However, loan interest paid by the trust is not deductible.
- **Favorable Grantor Trust Ruling, 2004.** Although the trust may reimburse the client for the trust income taxes the client pays, the trust should not be required to provide the reimbursement.¹⁹
- **Asset Control.** Client may lose control of the asset when sold to the trust.
- **Appraisal.** A professional appraiser may be needed to value closely held assets and real estate.
- **Liquidity.** Cash flow is required to pay income tax on trust income.

CASE STUDY: HANK AND IRENE DUNCAN

Hank and Irene Duncan are 62 and 58 years old. Hank is a Standard Plus Non Smoker, and Irene is a Preferred Non Smoker. Their business enjoys annual cash flow of 7% and annual growth estimated at 3%.

Two of their four children work for the business. The Duncans would like to pass the business on to them but also want to equalize inheritances for the other two. The Duncans recapitalize the business into voting and non-voting stock. They will retain the voting stock and pass it under their wills to the two children involved in the business.

The non-voting stock will be held by an ILIT which will eventually pass it to the two children working in the business. Lack of control associated with the non-voting stock, valued before discount at \$10 million, will facilitate a 30% discounted valuation. The Duncans make a gift of stock worth \$2 million (after discount) to the ILIT, using up their combined \$2 million lifetime gift exemptions. They sell the remaining non-voting stock to the ILIT, discount-valued at \$5 million, under a long-term note.

Hank and Irene establish a grantor ILIT that will purchase a John Hancock Protection SUL-G 10 policy (Form 10PROSULG) with a \$10 million death benefit to benefit the children not working in the business. They will make two annual loans to the ILIT of \$96,556 each, under promissory notes, enabling the ILIT to pay the first two annual premiums on the policy while the \$5 million stock sale is being finalized. Once the stock sale is complete, cash flow from the business enables the ILIT to repay the principal and accrued interest on the loaned premiums, as well as to service the note on the stock sale and also meet ongoing policy premiums.

1. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
2. An existing trust must have provisions that allow for the loan repayment to take place. It is also necessary that the beneficiaries of the existing trust and those of the ILIT are the same or an unintentional gift tax may result.
3. If the ILIT is established as a "Grantor Trust," for income tax purposes, the loan interest income paid to the client from the trust should not be treated as taxable income. See Rev. Rul. 85-13 and IRC §§671-678. If an existing partnership or Non-Grantor Trust is the lender, the loan interest income paid to it by the ILIT will be taxable.
4. A fair market loan arrangement requires the use of Applicable Federal Rates (AFR), published by the Internal Revenue Service through a monthly Revenue Ruling.
5. The gift tax annual exclusion allows each individual to give up to \$13,000 per year (indexed annually for inflation and subject to specific rules) to an unlimited number of people without paying federal gift taxes.
6. It is generally recommended that the client, as grantor of the trust, make a gift of seed money to the ILIT before the trust purchases any assets from the client. The seed money should be approximately 10% of the expected sale price.
7. The client may be able to transfer interests of a properly structured Family Limited Partnership (FLP) or Limited Liability Company (LLC) while retaining control over the assets as general partner.
8. Sale of an asset on an installment basis should be limited to a term that does not exceed life expectancy.
9. Usually, gifts made to a trust will be covered by the client's lifetime gift tax exemption amount and any available annual exclusion gifts. The lifetime applicable gift tax exemption amount refers to the cumulative amount that can be given away free of gift tax during lifetime (currently \$1,000,000). The annual exclusion gift is the amount of annual gifts that each individual can make (to an unlimited number of people) without paying federal gift tax. In 2009, this amount is \$13,000 per individual per year. In many cases, the gift of the loan interest amount may be tax free if you have annual gift tax exclusions available. If applicable, the client's spouse can make tax-free gifts utilizing his or her exemptions as well.
10. If established as a "Grantor Trust," for income tax purposes, the loan interest income paid to the client from the trust will not be treated as taxable income. See Rev. Rul. 85-13. If an existing partnership or Non-Grantor Trust is the lender, the loan interest income paid to it by the family trust will be taxable.
11. See IRC Sections 671-678. The Grantor ILIT takes advantage of the difference between how the trust will be taxed for estate tax purposes and income tax purposes. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws, including the generation-skipping transfer tax (GSTT) applicable to beneficiaries who are more than one generation removed. Failure to do so could result in adverse tax treatment of trust proceeds.
12. See IRC Section 2503(b). Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws, including GSTT applicable to beneficiaries who are more than one generation removed. Failure to do so could result in adverse tax treatment of trust proceeds. Gifts of a life insurance policy may be included in the gross estate of the insured depending on whether at the time of death (or in the three years prior to death) the insured held any incidents of ownership in the policy.
13. The client may be able to transfer interests of a properly structured family limited partnership (FLP) or Limited Liability Company (LLC) while retaining control over the assets as general partner.
14. Interest on the asset loan cannot be accrued and must be paid immediately.
15. In a properly drafted ILIT, life insurance proceeds should be received by the trust free of income and estate tax. Life insurance cash values grow tax deferred during lifetime.
16. The loan interest paid to the client by the Grantor Trust will not be income taxable. See Rev. Rul. 85-13. The Applicable Federal Rate is the fair market rate that is published monthly by the government.
17. If the beneficiaries of the life insurance are the same as the beneficiaries of the estate, then it is possible that they will receive the loan repayment net of estate tax from the estate as well.
18. If established as a "Grantor Trust," for income tax purposes, the loan interest income paid to the client from the trust will not be treated as taxable income. See Rev. Rul. 85-13. If an existing partnership or Non-Grantor Trust is the lender, the loan interest income paid to it by the family trust will be taxable.
19. See Rev. Rul. 2004-64.

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