Top 5 Innovative Estate Planning Techniques with Life Insurance

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Mr. Blum founded The Blum Firm, P.C. over 38 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine. He is Treasurer for the Fort Worth Symphony and the Texas Cultural Trust. He is Secretary/ Treasurer of the Pat & Emmitt Smith Charities and a member of the Boards of Directors of the Multicultural Alliance and B Sharp Youth Music Program.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

Spousal Lifetime Access Trusts with Life Insurance – the Best Way to Capture the Doubled Estate Tax Exemption

- The new tax act doubled the estate and gift tax exemption, but it cuts back in half at the end of 2025. To lock in the benefit of the doubled exemption, a couple has to transfer $22 million out of their estate. "Use it or lose it."
- Note that if a couple only transfers $11 million ($5.5 million from each spouse) in an effort to lock in the EXTRA exemption, they've actually only used the original/old exemption amount. After 2025, that couple would have zero exemption remaining. To lock in the EXTRA exemption amount, EACH spouse has to transfer $11 million.
- The most popular way to use each spouse's gift/estate tax exemption is for each spouse to create a trust for the benefit of the other because doing so preserves the resources for the spouses' benefit.
- This type of trust is often referred to as a Spousal Lifetime Access Trust, or "SLAT."

- Each spouse's gift would use part or all of their lifetime exemption amount, depending on the amount of assets transferred. Assets held in the SLAT would not be included in either spouse's estate at death. Think of it as a "Lifetime Bypass Trust" for the benefit of a spouse.

- Example
  - Husband and Wife enter into a marital property agreement in which they agree to convert a portion of their community property into two separate property halves. (Note: This partition step is necessary for residents of community property states. For residents of other states, there may be a step to first transfer some assets from one spouse to another, so each spouse owns a batch of assets.)
  - Husband creates a trust for the benefit of Wife and funds it with $11 million of his separate property.

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- Wife has access to Wife's SLAT for her needs during her lifetime. After her death, the remaining assets are split into separate trusts for the children, depriving the surviving husband of access to the assets in Wife's SLAT.
- At a later date (perhaps several months or a year later), Wife creates a separate trust for the benefit of Husband and funds it with $11 million of her separate property.
- Husband has access to Husband's SLAT for his needs during his lifetime. After his death, the remaining assets are split into separate trusts for the children, depriving the surviving Wife of access to the assets in Husband's SLAT.
- While Husband and Wife are both alive, the married couple retains access to the full $22 million.
- However, after the first death, the survivor only has access to $11 million.
- To replace the lost assets, each SLAT buys an $11 million life insurance policy on the life of the other spouse.

- If Husband dies first, at Husband's death, Wife continues to benefit from her SLAT, plus her SLAT collects $11 million on Husband's life, so her access to the full $22 million isn't diminished when Husband dies.
- If Wife dies first, at Wife's death, Husband continues to benefit from his SLAT, plus his SLAT collects $11 million on Wife's life, so his access to the full $22 million isn't diminished when Wife dies.

HUSBAND'S SLAT

- **Created by Wife to benefit Husband**
- **Holds $11 million of assets which Husband has access to for his lifetime**
- **Owns an $11 million life insurance policy on Wife's life**

WIFE'S SLAT

- **Created by Husband to benefit Wife**
- **Holds $11 million of assets which Wife has access to for her lifetime**
- **Owns an $11 million life insurance policy on Husband's life**

› The two SLATs cannot be identical or will violate the reciprocal trust doctrine.

Mixing Bowl Partnership Planning to Use an Appreciated Asset to Buy PPLI with No Taxable Gain

- A client is interested in the income tax benefits of owning Private Placement Life Insurance (“PPLI”) and wants to sell an appreciated asset to purchase PPLI. But, he doesn’t want to pay any capital gains tax on the sale of the asset.

- Example
  - The client owns a commercial building with a fair market value of $1,000,000 and a basis of $100,000.
  - The client borrows $1,000,000, secured by the building.
  - The client gifts the commercial building (with a fair market value of $1,000,000 and a basis of $100,000) to a dynasty trust, which retains the $100,000 basis. (Note: The dynasty trust is a non-grantor trust, so it can later join with the client in creating a partnership that will be a true partnership for tax purposes.)
  - The client agrees to remain responsible for paying off the loan so the trust isn’t burdened with the obligation to pay off the loan.

- The client files a gift tax return to report the gift of the building, eating up $1,000,000 of his lifetime exemption.

CLIENT	DYNASTY TRUST
$1,000,000 CASH	BUILDING WITH FMV = 1,000,000 AND BASIS = $100,000

- The client and the dynasty trust **enter into a Partnership Agreement.**
- The client contributes the $1,000,000 cash to the partnership in exchange for a 50% partnership interest. The client's outside basis is $1,000,000.
- The dynasty trust contributes the building to the partnership in exchange for a 50% partnership interest. The dynasty trust's outside basis is $100,000.

CLIENT

CONTRIBUTES $1,000,000 CASH WITH BASIS = $1,000,000

(Client's basis in his partnership interest is $1,000,000 because he had $1,000,000 basis in the asset he contributed.)

DYNASTY TRUST

CONTRIBUTES BUILDING WITH FMV = $1,000,000 AND BASIS = $100,000

(Dynasty Trust's basis in its partnership interest is $100,000 because it had $100,000 basis in asset it contributed.)

50% **50%**

PARTNERSHIP

OWNS:

- **$1,000,000 CASH (Partnership's basis in cash is $1,000,000 because contributor's basis in cash was $1,000,000 when contributed.)**
- **BUILDING WITH FMV = $1,000,000 (Partnership's basis in building is $100,000 because contributor's basis in building was $100,000 when contributed.)**

- The partnership uses the $1,000,000 cash to **buy PPLI.** The purchase should be structured where premiums are paid over time, so that the policy is not a modified endowment contract—a "non-MEC" policy.

PARTNERSHIP

OWNS:

- **PPLI WITH FMV = $1,000,000 (Partnership's basis in PPLI is $1,000,000.)**
- **BUILDING WITH FMV = $1,000,000 (Partnership's basis in building is $100,000.)**

- Note: Draft the partnership agreement and the trust so that the insured has no incidents of ownership over the policy.

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- Seven years later, **the Partnership is liquidated.**
- The client receives the building, now with a basis of $1,000,000. The dynasty trust receives the PPLI, now with a basis of $100,000.

CLIENT	DYNASTY TRUST
BUILDING WITH FMV = $1,000,000 AND BASIS = $1,000,000	PPLI WITH FMV = $1,000,000 AND BASIS = $100,000

- Because the dynasty trust is a partner of the insured, we meet an exception to the transfer-for-value rule.

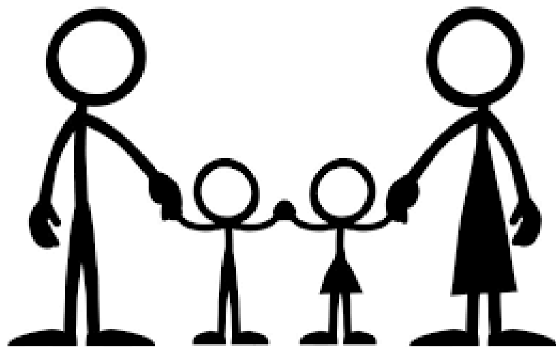
- The client **sells the building** for $1,000,000, which results in no gain, and repays the loan.
- The client essentially used the building to purchase the PPLI, without recognizing any gain.
- The trust holds the life insurance policy until the client dies.
- After the client's death when the dynasty trust receives the life insurance proceeds, there is **no gain or loss,** because life insurance proceeds are free of income tax as long as there has been no transfer for value.

- What if the client dies within the 7 years? They wouldn't receive the basis bump and will owe capital gains tax when the building is sold, but, overall, they would come out better economically.
- Example
  - Let's assume the $1,000,000 PPLI policy has a death benefit of $2,500,000.
  - The building is not in the client's estate at his death and doesn't receive the basis bump from $100,000 to $1,000,000. When the building is sold, capital gains tax will be due on $900,000 of gain. ($900,000 x 23.8% = $214,200).
  - But, the partnership receives the life insurance proceeds of $2,500,000. This is essentially a return of the $1,000,000 paid for the policy plus $1,500,000 of tax-free income.

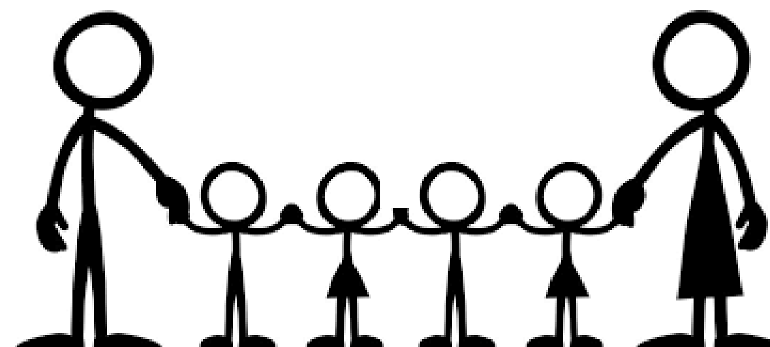
Utilizing a Life Insurance Policy with Per Capita Payout for Grandchildren

- Do you love your grandchildren equally? With a traditional per stirpes inheritance, grandchildren with more siblings will receive less than grandchildren with fewer siblings.

- Assume G-1 has a son with 2 children, a daughter with 4 children, and a $12 million estate. After G-1 dies, the son and daughter each receive $6 million. However, after G-2 dies, the son's children each receive $3 million while the daughter's children each receive $1.5 million.



$3M $3M



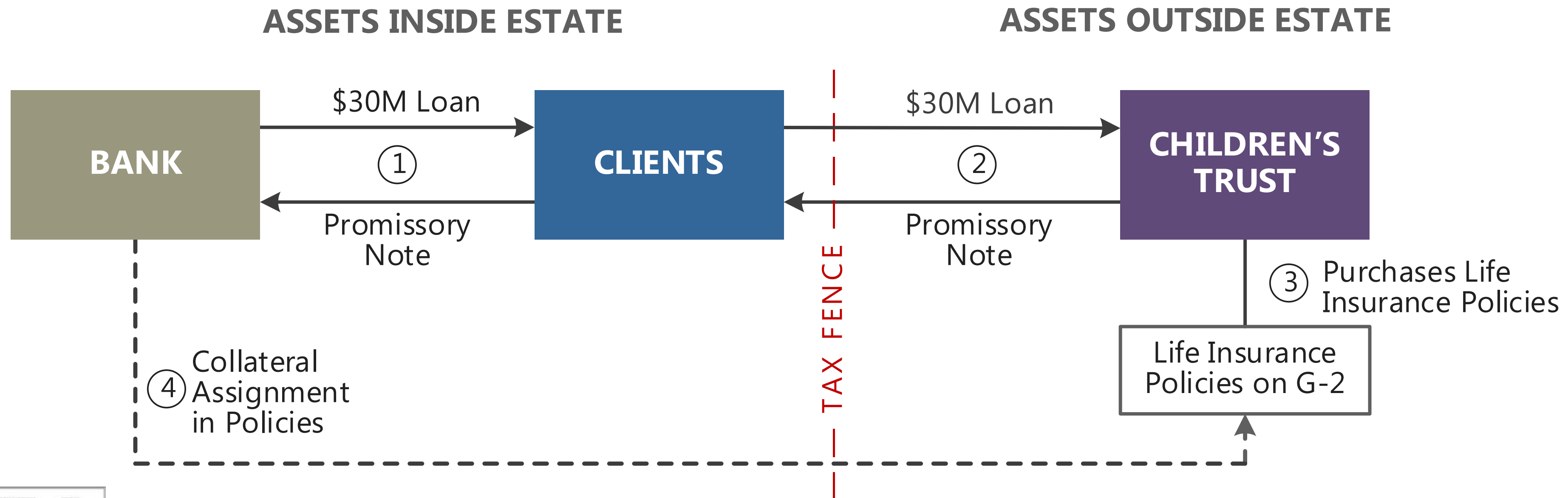
$1.5M $1.5M $1.5M $1.5M

- To lessen this blow on the cousins, consider taking out a life insurance policy that goes to all the grandchildren per capita.
- The policy can be on G-1's life for the benefit of G-3 per capita, paid to G-3 at G-1's death.
- Or, the policy can be on G-2's life for the benefit of G-3 per capita, paid to G-3 at G-2's death. Doing a policy on G-2 instead of G-1 would provide more coverage since G-2 is younger. With this scenario, G-1 can either pay the premiums as a gift or can lend money to G-2 to pay the premiums.
- The rest of the estate plan remains intact. This creates new assets to use for gifting to G-3 without disrupting G-2's inheritance.

Utilizing Intergenerational Loans to Reduce Estate Taxes and Preserve a Basis Step-Up

- For clients who own highly-appreciated assets, the problem with traditional techniques (such as gifts/sales of the assets to defective grantor trusts) is that by removing the assets from the estate, you sacrifice a basis step-up when the client dies.
- The trade-off for getting assets out of the estate is to expose the family to a 23.8% tax on the capital gain when the asset is sold after the client dies.
- Intergenerational loan planning can reduce estate tax without having to forego a stepped-up basis.
- You can have your cake and eat it too.
- Example
  - Clients own a $30 million ranch with a $10 million basis and approximately $5 million of other assets (house, etc.).

1. Clients borrow $30 million from their bank.
2. They loan the $30 million to their Children's Trust (a non-grantor trust) in exchange for a promissory note (at the long-term Section 7872 rate) which is due at the death of G-2.
3. Using the $30 million, the Children's Trust purchases life insurance policies on G-2.
4. The bank takes a collateral assignment in the policies.



- The bank is able to charge a lower LIBOR-based interest rate on the note owing from the clients because of the collateral assignment.
- The insurance policies will be unusually structured in that they will have a very high cash surrender value while also having the least amount of death benefit possible without violating IRS life insurance corridor rates.
- The estate holds the $30 million note owing from the Children's Trust. Because of the locked-in low rate and long but uncertain duration, the note receivable would be highly discounted (assume 50%).

- At the clients' deaths, their **taxable estate will be zero.**

	Before	After
Assets		
Ranch	$30,000,000	$30,000,000
$30M Note Receivable (discounted)	-	15,000,000
Other Assets	5,000,000	5,000,000
Liabilities		
Note Payable to Bank	-	(30,000,000)
Net Worth of Estate	35,000,000	20,000,000
Less Lifetime Exemptions	(22,800,000)	(22,800,000)
Taxable Estate	$12,200,000	$0

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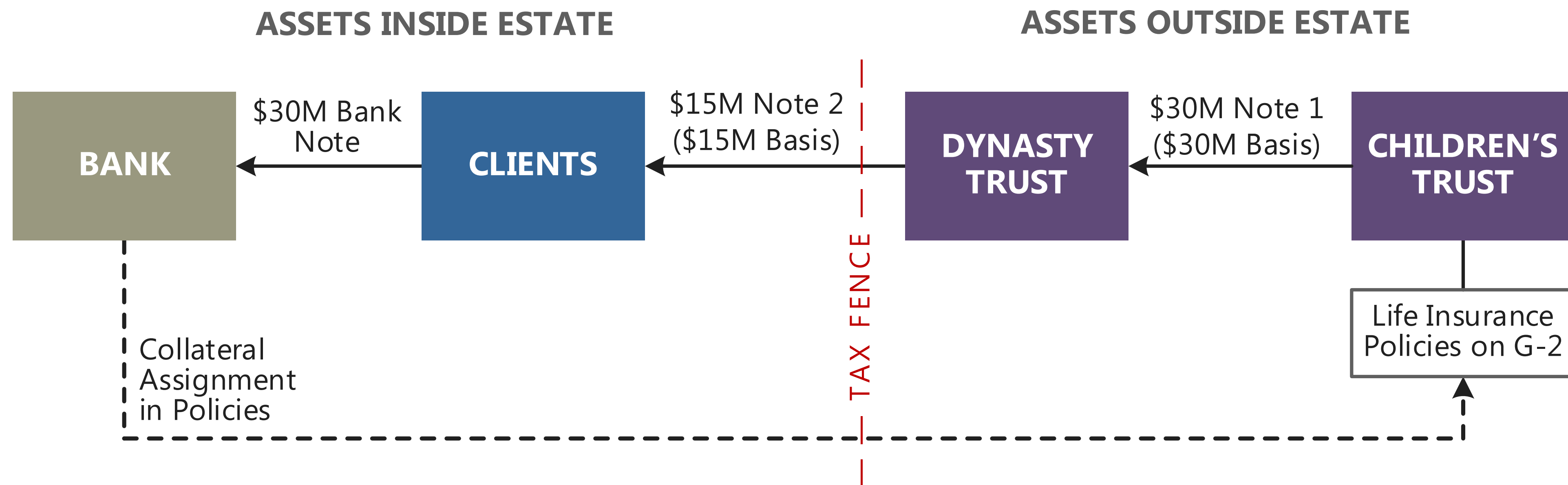
- G-2 will receive a step-up in basis in the ranch to $30 million. If G-2 sells the ranch, no income tax will be due following the sale.
- We've **reduced the taxable estate,** and we've **received a basis bump** for the ranch. BUT, at the clients' deaths, the note receivable will receive a step-down in basis to $15 million. When the note is later repaid, the estate will owe income tax on the $15 million capital gain.
- Is there a way to avoid this?
- Instead of the clients retaining the note until death, two to three years after the loans are made, the clients will want to sell the note ("Note 1") to a new grantor trust for the benefit of G-2 and G-3 (the Dynasty Trust").

- The clients sell Note 1 (the $30 million note receivable owing from the Children's Trust to the clients) to the Dynasty Trust in exchange for a $15 million promissory note ("Note 2").
- Note 2 would have an adjustable rate and different terms than Note 1 and would not be valued at a discount.



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- Since the clients sell Note 1 while the clients are still alive, Note 1 still has a $30 million basis. The clients avoid a basis step-down on Note 1 by getting it out of their estate before either of them dies.
- Since the sale is to a Dynasty Trust that is a grantor trust as to the clients, the sale is ignored for income tax purposes.
- The Dynasty Trust now owns Note 1 with a basis of $30 million.
- The clients own Note 2 with a fair market value of $15 million.

- At the clients' deaths, their **taxable estate will still be zero.**

Assets	
Ranch	$30,000,000
$15M Note Receivable (no discount)	15,000,000
Other Assets	5,000,000
Liabilities	
Note Payable to Bank	(30,000,000)
Net Worth of Estate	20,000,000
Less Lifetime Exemptions	(22,800,000)
Taxable Estate	$0

- The ranch will still receive a **basis step-up** so no income tax will be due following a sale.

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- After the clients’ deaths, the Children’s Trust can cash in the life insurance policy and pay off the $30 million Note 1 it owes to the Dynasty Trust.
- Since Note 1 is out of the clients’ estate, there is no basis step-down and the basis of Note 1 remains $30 million. Therefore, there is no gain when Note 1 is repaid.
- The Dynasty Trust uses $15 million to pay off Note 2 owing to the clients’ estate.
- Note 2 had a $15 million fair market value at the clients’ deaths, so it now has a $15 million basis. Therefore, there is no gain when Note 2 is repaid.
- The Dynasty Trust uses the extra $15 million it received to buy assets from the clients’ estate, providing the estate with liquidity to pay back the bank. There is no tax since the assets in the estate have a stepped-up basis.

Utilizing Life Insurance to Fund a “FAST” (Family Advancement Sustainability Trust) to Keep the Family Strong from Generation to Generation

- The estate planning world is shifting to include qualitative goals such as having a "successful" family—one that's:
  - physically and emotionally healthy
  - productive
  - connected for generations to come
- Baby Boomers are asking: **"To what end have I created this wealth?"**
- While the process of estate planning continues to focus on technical factors (tax, asset protection, etc.), there is an evolving call to add to that planning model a focus on clients' qualitative goals and the need to not only prepare the estate for the heirs but to also prepare the heirs to responsibly receive, manage, maintain, and pass on the estate.

- Historically, most wealthy families squander away their fortune—70% by the second generation and 90% by the time it's passing to the fourth generation. Hence, the "Shirtsleeves to shirtsleeves in three generations" proverb.
- The most common reasons for wealth transfer efforts to fail:
  - Lack of communication and trust
  - Unprepared heirs
- Study **successful families** to identify common best practices:
  - Hold family meetings and family retreats
  - Work to preserve the family's history and heritage
  - Have a system of family governance (such as how family decisions are made)
  - Set up an advisory board of the family's "go to" advisors
  - Have a process to educate the heirs

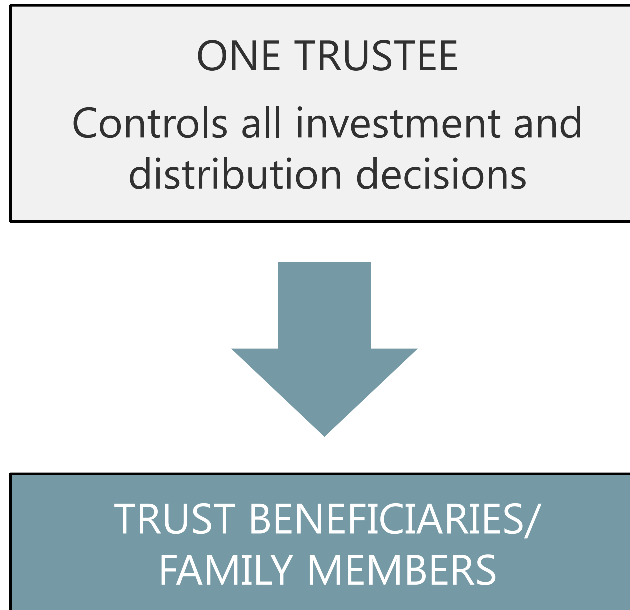
- Often the patriarch and matriarch of a family begin these best practices, pay for them, and make them happen. A problem is that after the patriarch and matriarch are gone, the children drop the ball and don't want to pay for these activities or take the time to do them.
- It takes more than G-1's hopes and dreams for future generations to succeed. Don't leave it to chance. **Hope is not a strategy.**
- G-1 needs to be intentional and implement a practical solution.
- There's a new type of trust dedicated to saving the family called the Family Advancement Sustainability Trust ("FAST").

- The FAST **provides FUNDS**
  - Funds for future generations to use to prepare heirs to be able to successfully manage an inheritance.
  - Funds for family endeavors to keep the family together after the elder generation dies, such as family retreats and family meetings.
  - Funds to train future generations on concepts like philanthropy and being responsible stewards.
- The FAST **provides LEADERSHIP**
  - Creates a leadership structure to ensure these activities happen, using a system of trustees and committees who are paid to run the FAST and charged with the responsibility for carrying out these tasks.

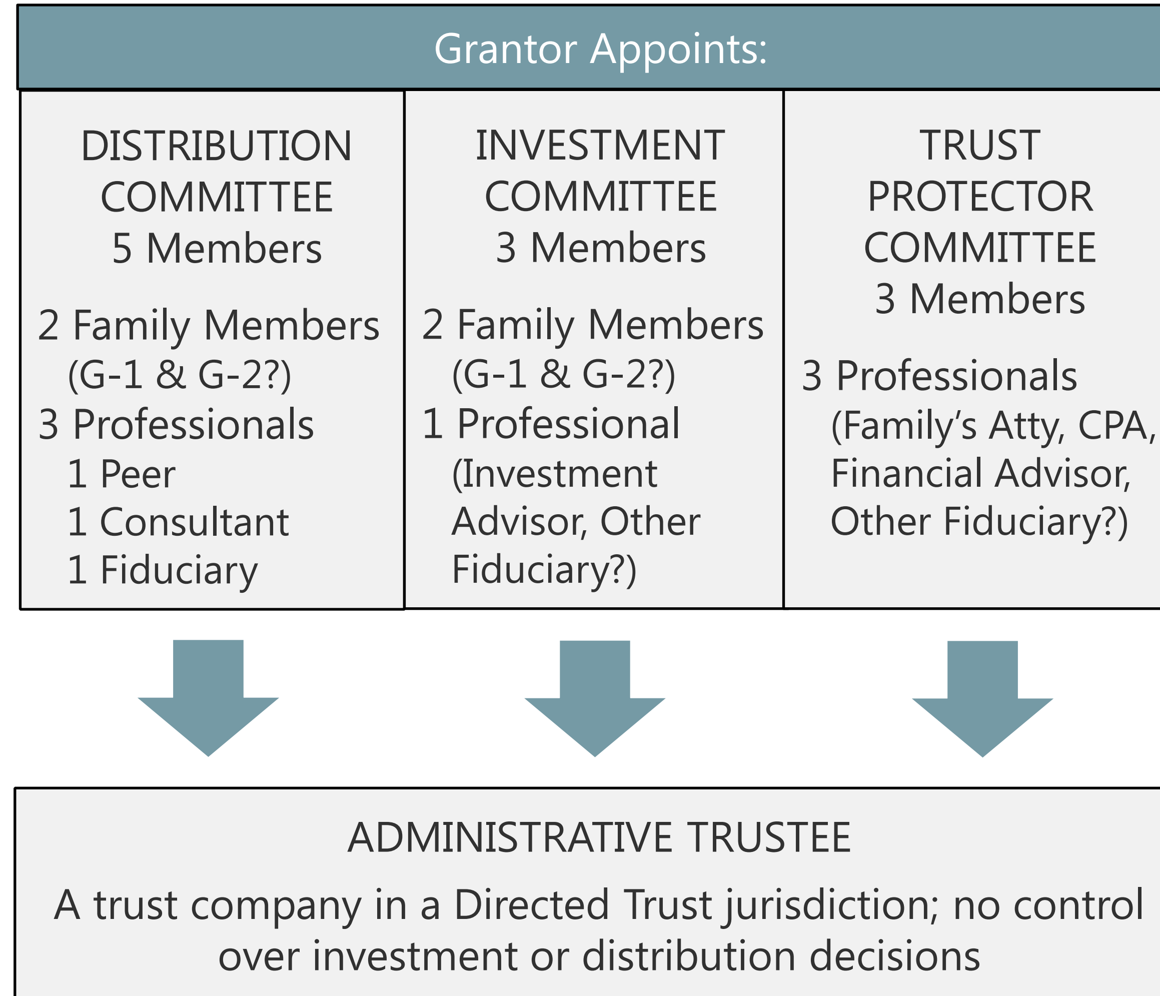
Structure of a FAST

- A Dynasty Trust created in a state with Directed Trust laws which allows decision-making authority to be split up among separate co-trustees, advisors, or trust protectors.
- This allows family members and trusted advisors to **directly participate in the governance of trust.**
- A FAST contains four separate decision-making bodies:
  - Administrative Trustee
  - Distribution Committee
  - Investment Committee
  - Trust Protector Committee

Common Law Trust



Directed Trust



Funding the FAST

- A FAST should be **created during the patriarch's and matriarch's lifetimes** to allow G-1 to mold the trust.
- While G-1 is alive, G-1 usually pays for FAST activities out of their pocket.
- The funding amount will vary from family to family according to their means and their agenda.
- A FAST can work for a family of any size. This is not just for the mega-wealthy.
- It may be minimally funded with lifetime gifts, with additional funding pouring over upon the death of G-1 (either a fixed amount or a percentage of the estate). This funding amount at G-1's death could be designed to be enough to last forever or could be only enough for a generation with the plan to replenish at each generation.

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- Funding with Life Insurance
  - A new life insurance policy is an efficient way to fund a FAST.
  - A stand-alone, special-purpose Irrevocable Life Insurance Trust ("ILIT") could hold a life insurance policy on the patriarch, the matriarch, or the second-to-die and funnel additional funds into the FAST at G-1's death.
  - Using life insurance **preserves the rest of the family's assets** for distributions (a traditional inheritance).
  - It also leverages lifetime estate/gift tax exemption so there's no estate tax cost and leverages GST exemption so the FAST is fully GST-exempt.

- The FAST could also be drafted to own the life insurance policy rather than using a separate ILIT.
- For the life insurance portion, you'd want to be sure none of the insureds have incidents of ownership, so draft it to keep the life insurance in a separate trust pocket managed entirely by non-family trustee(s).
- If the FAST were to be funded with only enough to last one generation, the FAST could also own life insurance policies on the lives of G-2 and G-3. Each policy could provide enough funds for the next generation.

› Funding with Legacy Real Estate Assets

- In addition to funding the FAST with liquid assets, the FAST can also be the ideal owner of a family's legacy real estate asset such as a family ranch or lake house.
- Use life insurance to generate sufficient funds to maintain the property.
- The FAST establishes rules for shared use.
- This **keeps the asset in the family.**
- Note: Segregate real estate in a separate entity (such as an LLC owned by the FAST) to insulate other FAST assets from liability exposure related to the real estate asset.

- A FAST can act as replacement "glue" to help **bind the family together after G-1 is gone.**

- James Grubman (Family Legacy expert) uses a football analogy to perfectly illustrate the issue:

  > Think of a football game. The focus is on the quarterback. The quarterback has perfect throwing skills. The football (the inheritance) is perfectly thrown to receivers at the other end of the field. But, no one has prepared the receivers. In fact, they don't even tell them the ball is coming. As the ball comes their way, the receivers don't know how to catch it or what to do next if they do catch it. What are the odds the receiving team will catch the ball and carry it down the field to score a touchdown?

- The Family Advancement Sustainability Trust is the vehicle to make sure the heirs are prepared when the football comes their way.