

Life Insurance and Estate Gifting

By Peter Katt

Article Highlights

- Making as large a gift as possible now can be a good strategy, given the uncertainty of future tax laws.
- The gifted amount is brought back into the estate at death at the amount of the original gift.
- If the gift appreciates between the time of the gift and the death of the person making the gift, the inheritance amount is increased.

The current estate and gift tax situation presents a significant planning opportunity for making gifts prior to December 2012.

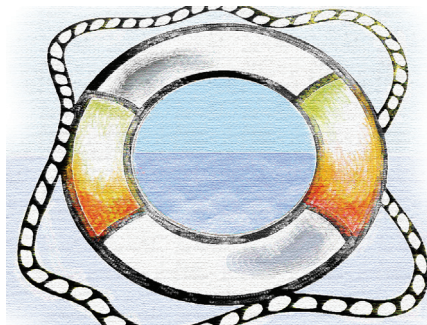
The estate and gift exemption credit for 2012 is \$5.12 million per taxpayer, up from \$5 million last year. The current law also provides for “portability.” Portability allows a surviving spouse to preserve a deceased spouse’s unused estate tax exemption by filing a federal estate tax return. Couples both dying prior to the end of 2012 can pass \$10.24 million to heirs free of transfer taxes, with a tax rate of 35% on the excess. Under the integrated estate and gift tax system, individuals can gift up to \$5.12 million over their lifetime without the payment of gift taxes. This means a couple can gift \$10.24 million over their lifetime without tax.

But before popping the champagne corks, you need to understand that the current law expires on December 31, 2012, and if the exemption is lowered, you won’t be able to transfer this amount tax free. What you do get is the earnings on the gift, so making as large a gift as possible now is usually the best strategy.

Let me explain several important estate and tax issues related to life insurance by using some examples.

Policy Alternatives

Tim and Maureen (both 50 and in great health) have the resources to immediately gift \$5 million to an irrevocable life insurance trust (ILIT). Because of the nature of their



assets, they decide using cash is the best choice. Of course the cash needs to be invested. They decide on life insurance because the death benefits are income tax-free. Although there are many life insurance options, Tim and Maureen focus on two. One is a no-lapse universal life policy with guaranteed premiums and

death benefits. The guaranteed death benefits for a \$5 million single-premium policy range from \$31 million to \$50 million, depending on the company. The company offering \$50 million is well known and has strong financial strength ratings. Obviously this is a simple decision if the no-lapse universal life approach is desired: Take the policy with a \$50 million guaranteed death benefit. With no-lapse universal life there will be low to zero cash values versus other options. Those that prefer no-lapse universal life argue that the cash value is irrelevant. Others are not comfortable without cash values for liquidity. Joint life expectancy for Tim and Maureen is 42 years. At this duration, the yield on the \$5 million investment with guaranteed death benefits of \$50 million is 5.6%, which, as noted, is income tax-free and equates to a pretax equivalent yield of 9.3%.

Of various alternatives, Tim and Maureen also wish to consider investing the \$5 million into a low-expense participating whole life policy with minimum initial death benefits. Using this design, the low-expense whole life policy has death benefits and cash values, based on the current 6% dividend rate, as illustrated in Table 1. The death benefits and cash values are compared with the no-lapse universal life values.

The participating whole life policy has an illustrated yield at joint life expectancy of 5.5%. This death benefit is

Table 1. Participating Whole Life Vs. No-Lapse Universal Life

Age	Low-Escape Whole Life		No-Lapse Universal Life	
	Death Benefits (\$)	Cash Values (\$)	Death Benefits (\$)	Cash Values (\$)
50	20,417,000	4,615,533	50,000,000	3,829,581
55	20,417,000	5,574,260	50,000,000	5,358,847
60	20,417,000	7,183,767	50,000,000	4,969,584
65	22,620,296	9,592,624	50,000,000	5,615,843
70	25,315,341	12,796,234	50,000,000	6,303,501
75	28,658,329	17,014,602	50,000,000	7,364,419
80	32,850,358	22,435,704	50,000,000	7,959,761
85	38,106,775	29,116,165	50,000,000	6,917,306
90	44,592,727	36,925,396	50,000,000	998,648
92	47,519,717	40,327,082	50,000,000	0
95	52,133,888	45,734,412	50,000,000	0
100	60,992,290	55,408,415	50,000,000	0
105	70,825,282	66,313,690	50,000,000	0

Universal life death benefits are guaranteed. Whole life cash values and death benefits depend on future dividends.

illustrated to continue increasing beyond life expectancy.

It may seem that it is a close call between the no-lapse universal life and participating whole life, but when possible inflation is considered, I believe participating whole life is a hands-down winner. The no-lapse universal life's death benefit is unchanged in the presence of inflation, but participating whole life's death benefits will be higher because inflation will cause the dividends to go up. For example, if the actual average dividend rate over 42 years is 7.5% the death benefits would be close to \$82 million, not \$47.52 million, at life expectancy. At 7.5%, this is a yield of some 6.9% at life expectancy. In addition the participating whole life policy has robust cash values versus low to zero values for the no-lapse universal life policy.

Make the Gift Now

As you will see, making as much of a gift as possible now is to your advantage. Let's consider several scenarios for Tim and Maureen. Tim and Maureen's net estate is \$12 million. They gift \$5 million with no gift tax paid and purchase the participating whole life survivor-

ship policy. Let's assume they did no other estate planning and there is little inflation. Below are estate and gift tax calculations that have been simplified for clearer understanding.

Estate and Gift Tax Credit Unchanged

At the second death (in 42 years at joint life expectancy, or age 92), Tim and Maureen's net estate is \$66,328,678 (\$7 million value in 2012 after the \$5 million gift and assuming 5.5% annual growth). The gift is added back and makes the gross taxable estate \$71,328,678. Then the \$10.24 million tax credit is applied, making the taxable estate \$61,088,678. At a 35% estate tax rate, the estate tax is \$21,381,037. Therefore, the net estate of \$66,328,678 is reduced by the tax of \$21,381,037 for an aftertax estate of \$44,947,641. When the life insurance asset (\$47,519,717 at age 92) is added, the total inheritance is \$92,467,358 in 42 years.

Let's compare this with not having made a gift in 2012. The estate value would be \$113,706,306 (\$12 million estate value in 2011 at 5.5%) at life expectancy. After applying the \$10.24 million estate tax credit equivalent, the taxable estate is \$103,466,306. The estate

tax is \$36,213,207, leaving a net estate of \$77,493,099 to the heirs.

The net estate with the \$5 million 2012 gift is \$92,467,358. This is \$14,974,259 more than if the gift had not been made. The entire amount of the difference is due to the growth on the \$5 million gift, not the gift itself, because it gets brought back into the estate in the estate tax calculation.

Estate and Gift Tax Credit Changed

Let's say that the estate and gift tax credit is changed to \$1 million equivalent per taxpayer next year. This would give Tim and Maureen an estate tax credit equivalent at death of \$2 million. With all the other figures remaining the same, Tim and Maureen are even further ahead by making the \$5 million gift this year even though the estate tax is higher under the reduced credit (\$24,265,037 versus \$21,381,037). In this latter situation the advantage again is \$14,974,259. And again this is due solely to the earnings on the gift made in 2012 outside the estate in the irrevocable life insurance trust.

Waiting 10 Years Before Gifting

If the estate and gift tax credit remains unchanged but the \$5 million gift is delayed 10 years, the net disadvantage is some \$6 million because of the power of compounding. (Gifting earlier provides more time for the amount to grow outside of the estate.) This is why the gifting should be done as soon as it becomes practical. This apparently is counterintuitive, because throughout my career I have found that the first instinct of almost all clients, and I believe a majority of attorneys, is to save the gift tax credits for just the right time and/or the perfect asset. Generally, this isn't good planning.

Citizens with the wealth to comfortably make gifts should do it as soon as possible and at the highest level that is financially feasible, up to the \$10.24 million lifetime credit. The reason this works is because it is the earnings on the gift outside the estate that enhances total inheritance to family, even if the estate and gift tax credits are reduced in 2013.

Be Careful With Non-Cash Gifts

An interesting issue is what kind of assets should be gifted. The four most common categories are closely held business stock, marketable securities, real estate and cash.

A problem with the first three occurs if the gifted asset declines in value from the time of the gift to death, since the gifted amount is brought back into the estate at death at the value of the original gift. If a \$5 million piece of real estate had been gifted that is worth \$3

million at death, \$5 million is brought back into the estate for estate tax tabulation. I have observed several clients who had gifted hard assets only to see their value tumble in the past several years.

The bottom line is that it can be risky to gift assets other than cash. ▲

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Feature: Mutual Funds

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the key characteristics you examine when looking at mutual funds, consider an index fund. Since they don't rely on the skills of an active manager, their costs tend to be lower. Some actively managed funds do a good job of controlling costs, however. Fidelity Small Cap Discovery fund (FSCRX) has a tax-cost ratio below the average for small-cap stock funds, and it kept its portfolio turnover to just 11% last year.

Further Evaluation

Before investing in any fund, read

the prospectus. Have a clear understanding of the fund's objective, strategy, risks and cost structure.

Next, obtain the latest fund report and review the holdings. What securities are currently being held in the fund? How much of the portfolio is concentrated in each of the key holdings? If the fund manager provides commentary, read it to get additional insight into his thought process.

Finally, remember that even though mutual funds are intended to be long-term investments, you should never buy and then forget about them. Like any investment, mutual funds should

be periodically monitored to make sure the objective has not changed and the fund is performing as expected given prevailing market conditions and historical performance.

Pay attention not only to current performance, but also to current performance relative to historical performance and relative to the fund's category average. A mutual fund that lags in market conditions that it historically has done well in should receive more scrutiny than a mutual fund that is following its historical volatility trends and is producing returns that are similar to those of its peers. ▲

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