When feasible, gifting cash and investing in life insurance with minimal increasing death benefits will maximize the long-term tax-free benefits within a safe investment vehicle.

Passing on Your Wealth: Gift Planning and the Use of Life Insurance

By Peter Katt

The transfer of wealth to succeeding generations is subject to a stiff tariff, known at the federal level as the unified estate and gift tax and at the state level as the inheritance tax. Gifting can substantially increase the amount of wealth that can be transferred to your heirs, beating the tax grinder out of unnecessary fodder, and life insurance products offer an excellent means to accomplish this.

This column discusses various gifting strategies to enhance wealth transfers, and illustrates how life insurance products can be used in the process.

Why Gift—and When?

Federal estate and gift taxes are based on a percentage of asset values subject to them. Under current law the first $1.2 million for couples (if proper estate planning has been established) is not subject to federal estate taxes. Values in excess of $1.2 million are subject to estate taxes that begin at 39% and quickly rise to 55%. For example, an estate value of $12.0 million would be subject to combined federal estate and state inheritance taxes of about $5.6 million at the second spouse's death. Therefore, a primary estate planning concept is to transfer future estate asset growth to subsequent generations for estates that have no economic need for growth. A primary method of doing this is via gifts.

On the other hand, gifting should only be done if estate owners have sufficient income and assets after gifting to provide for their desired lifestyle and financial security. That is, it doesn't make much sense to make major sacrifices in order to make it easier for children.

Thus, certain gifting strategies are beneficial for those with assets above $1.2 million, while the more extensive strategies are primarily beneficial for those whom I would term "rich."

How much do you need to be considered rich? The popular press, reporting on class warfare political rhetoric, frequently identifies the rich as citizens having reached certain income plateaus, such as $100,000. But this doesn't really define rich. Rich is when invested assets are capable of producing disposal income that far exceeds even extravagant living standards. Using this definition, individuals with assets of up to $6 million could be considered financially independent, or even wealthy, but I would define rich as couples with assets in excess of $6.0 million.

Gift Planning

Please note that, in this discussion, I am purposely ignoring some estate and gift tax rules in order to avoid having this column read like the tax code. The ignored rules do slightly change some of the computations shown below, but they don't change the concepts. *However, anyone considering any of the strategies mentioned in this column should consult their tax adviser.*

When income and asset values allow for gifting, four distinct methods can be considered:

• ***Annual Exclusion Gifts:*** Gifts of $10,000 per spouse can be made annually to children (or anyone else for that matter) without any gift taxes or reductions in the estate and gift tax credits. Therefore, if a couple has two children they could gift $40,000 annually, and as grandchildren might come along they could increase the annual exclusion gifts by $20,000 per grandchild per year. Annual exclusion gifts can be given directly to children, or to an irrevocable trust to be distributed to children later. Couples with estates of $1.2 million to $3.0 million should consider some level of annual exclusion gifts compatible with their budgets. Couples with estates of $3.0 million to $6.0 million may be in a position to make maximum annual exclusion gifts, depending of course on the number of children and grandchildren. For example, if a couple with two children and four grandchildren with a current estate of $6.0 million gifted the maxi-

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mum annual exclusion gifts ($120,000) for a period of 30 years, which would have otherwise increased in value at a rate of 6.5% within their estate, in 30 years their estate would be about $11.0 million less, and taxes would be about $6.0 million less. Their children would have an increased inheritance of $6.0 million, the amount of the taxes avoided because future increases in estate values were reduced via the gifts.

•Estate and Gift Tax Credits: Couples have estate and gift tax credits that are the equivalent of $1.2 million (or $600,000 individually), therefore cumulative gifts above annual exclusion gifts can be made without any gift taxes being due until they total $1.2 million. In most cases, estates in excess of $6.0 million could be making annual exclusion gifts and gifts using the estate and gift tax credits, and the sooner the better because unlike annual exclusion gifts, which remove the actual amount of the gift and any future growth they may experience from the estate, gifts using the estate and gift tax credits are brought back into the estate at the second death at their gifted value, so it is the future growth of such gifts that is removed from the estate. For example, if a couple use their estate and gift tax credits to make their $1.2 million gifts, and the value of this gift is $7.9 million at the second death, they have effectively removed $6.7 million of potential future value from their estate ($7.9 million minus $1.2 million), reducing estate taxes by about $3.7 million, which is the additional amount transferred to children due to the forethought of using the estate and gift tax credits early, giving them time to substantially increase in value.

•Making Gifts and Paying Gift Taxes: Gifts that exceed the annual exclusion amount on an annual basis and exceed the estate and gift tax credits (equivalent of $600,000 per spouse) on a cumulative basis are subject to current gift taxes. Making gifts and paying current gift taxes compared with retaining the same amount within the estate and paying an estate tax at death is very advantageous, but for many tax professionals and their clients this is an option that has been as popular as the plague because of a great distaste for paying taxes rather then deferring them. The reason paying current gift taxes can be very advantageous is that the amount of the gift tax isn't included in the amount of the gift, whereas the amount of subsequent estate tax is included. A simple example will explain. Sam and Helen Rich, with assets valued at $12.0 million, including $10.0 million of marketable securities and cash equivalents, have used their estate and gift tax credits ($1.2 million) in previous years and have used their annual exclusion gifts in the current year. They are seeking advice on how to reduce the future growth of their assets even more while leaving everything to their heirs. They have the cash flow and asset base to make additional gifts and pay current gift taxes without causing any decline in their desired lifestyle or financial security. A taxable gift of $1.0 million will cause them to also pay a gift tax of $550,000 for a total cash outlay of $1.55 million. The immediate response to someone recommending such a course is—*are you nuts?!* On the contrary, if the $1.55 million is retained within the estate and the Riches die, the estate tax on this $1.55 million is $852,500, leaving only $697,500 for their heirs as opposed to $1.0 million had they made the gift and paid the gift taxes (I am ignoring the fact that the gift taxes were paid within three years of death and would be brought back into the estate for purposes of calculating the estate tax to make a simple point). The payment of gift taxes on lifetime transfers can significantly reduce overall transfer taxes (increasing the amount to heirs). However, the downside is if the estate and gift tax laws are substantially changed or eliminated without any relief for those who have paid previous gift taxes, families would lose the gift taxes they paid.

•Generation Skipping Transfers (GST): These are asset transfers that skip the next generation. Since estate and gift taxes are imposed every time assets are transferred (the reverse of going past GO in Monopoly) the ability to transfer assets to grandchildren and beyond would save a great deal of estate taxes. Of course, Congress thought of this and plugged up this loophole with a GST tax. GSTs are subject to the same rules regarding transfers to the next generation, plus they are also subject to special rules and another level of transfer taxation. Of importance to the rich is that there is a $1.0 million GST tax exemption per person. Therefore, many rich clients make GSTs to take advantage of the $1.0 million exemptions. Sometimes these exemptions are used as lifetime transfers, with and without the payment of current gift taxes, and sometimes the exemptions are used post-death. An example of using the GST exemptions will be presented in the case study below.

Types of Assets Gifted

Selecting the type of asset to be gifted is very important. The types of assets gifted will usually be closely held business interests, real estate, publicly traded securities, and cash. It is imperative that assets gifted go up in value, otherwise transfer taxes will be higher than need be. For example, if the Riches gift closely held business stock with a current value of $1.0 million that declines in value to $500,000 by the time of the second death, estate and gift taxes will be $275,000 higher than they needed to be because the value of the original gift at the time of the second death is *brought back into the estate* to calculate the ultimate tax, which was $1.0 million, not the subsequent $500,000 value. The $275,000 is the difference in the estate tax rate for a $1.0 million value compared to an asset valued at $500,000.

Another important issue when considering what types of assets to gift are their cost basis. When securities or real estate are gifted, the person or trust beneficiaries (donee) receiving the gift retains the cost basis of the person who makes the gift (donor). The issue of possible capital gains tax exposure is relevant because assets retained by the donor receive a *step-up* in basis at the donor's death. For example, if real estate with a fair market value of $1.0 million and a cost basis of $100,000 is gifted and the donee sells the gifted real estate for $2.0 million, there is a capital gain of $1.9 million. However, if the donor had retained the real estate and died when the fair market value was $2.0 million, the real estate would have a new cost basis of $2.0 million. Balancing potential estate and gift tax savings with possible capital gains tax exposure should be considered when selecting assets to be gifted.

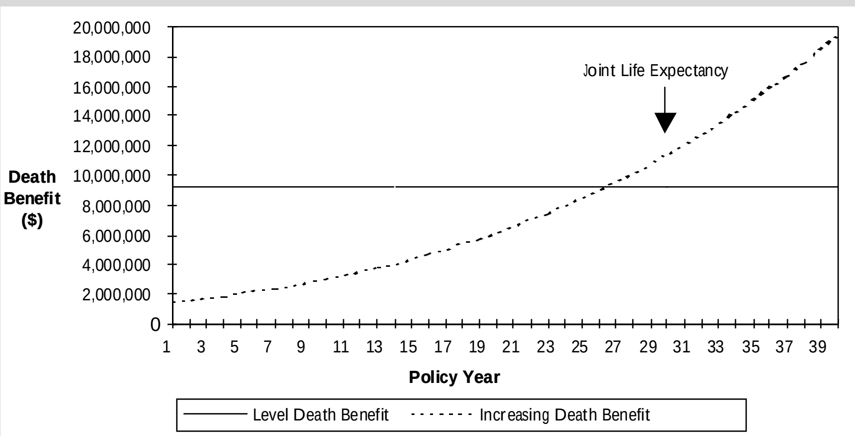
The safest type of asset to gift is cash that can either be enjoyed immediately by donees or invested. The amount of the cash gifted is its cost basis, and when gifted to an irrevocable trust, it should be invested prudently, making it very unlikely that its value will decrease from the time of the gift to the donor's death.

Table 1.
Wealth Transfer Policy Design Comparison

Insureds: Sam Rich, 60, male, standard non-smoker
Helen Rich, 60, female, standard non-smoker
Joint Life Expectancy: 30 years

Policy Year	Target Annual Premium ($)	Maximum Level Death Benefit* ($)	Rate of Return (%)	Minimum Increasing Death Benefit ($)	Rate of Return (%)	Probability of at Least One Being Alive (%)
5	120,000	9,200,000	110.4	2,107,098	45.3	100.0
10	120,000	9,200,000	35.7	3,054,885	16.5	99.7
15	120,000	9,200,000	18.7	4,391,027	10.5	98.3
20	120,000	9,200,000	11.6	6,177,613	8.3	92.8
25	120,000	9,200,000	7.8	8,471,383	7.3	79.2
30	120,000	9,200,000	5.5	11,367,283	6.7	55.7
35	120,000	9,200,000	4.0	15,001,233	6.3	29.1

Comparison of Projected Death Benefits



**Maximum level death benefit under current pricing assumptions. It is likely that target premiums would be adjusted up and down as pricing components, especially investment yields, change.*

Projected values are based on current pricing assumptions for a low-load survivorship policy, including a current interest crediting rate assumption of 6.4%. Actual policy values would differ from these projected values based on future changes in pricing assumptions.

Life Insurance and Gifting

Since I found it necessary in this column to outline the concepts of wealth transfers via gifts, there isn't room for a complete discussion of using life insurance as the funding vehicle, so the life insurance component here is treated in a bare-bones manner.

Most estate planning advisers think of life insurance as a liquid asset to pay estate taxes. However, in many instances the assets of "the rich" are comprised primarily of marketable securities. It is this situation, estates without liquidity concerns, to which this column is directed. When liquidity isn't the concern, the threshold issue is the transfer of future estate growth to subsequent generations via gifts. Life insurance is an ideal wealth transfer asset when cash is gifted and must be invested because life insurance's benefits are not subject to income or capital gain taxes and can therefore produce an aftertax rate of return that is superior to investing in a similar manner (for instance, bonds) outside of life insurance.

The preferred wealth transfer life insurance design is a personal preference made by clients. Either a maximum level death benefit design or an increasing death benefit design can be selected. Table 1 provides a graphical presentation of the choice Sam and Helen Rich (our case study couple) have for a life insurance purchase for their annual exclusion gifts. They selected the increasing death benefit design for all purchases because they want to maximize the long-term benefits under the conditions that one or both live beyond joint life expectancy, which for them is 30 years.

Case Study

Sam and Helen Rich are both 60 years old, in excellent health, with a net worth of $12.0 million. They recently sold their manufacturing business, netting $7.0 million, which, added to $3.0 million invested in tax-free bonds, gives them a total of $10.0 million of marketable securities or cash. They also have $2.0 million in real estate. Their income from a non-compete clause, various corporate director positions and the tax-free bonds is $600,000, or $425,000 after taxes. Sam and Helen have two children and four grandchildren, all of whom are in good health and doing very well. Their present income is more than they need for the lifestyle they enjoy and they intend to invest the $7.0 million recently received conservatively, but for growth, to be ultimately distributed to their children and grandchildren. Sam and Helen are perfect candidates to begin maximum gifting in order to transfer future growth in their estates.

Here are the gifting decisions they make and the results [Note that all gifts are cash and invested in low-load universal survivorship life with minimum increasing death benefits to emphasize long-term benefits. Under current pricing conditions the expected long-term rate-of-return for the universal life policies will be about 6.5%, which is income and capital gain tax-free. This is about 130 basis points below the before-tax return of the underlying investments, primarily investment-grade bonds. A 6.5% rate of return is the pre-tax equivalent of about 10.8%. Sam and Helen could also have decided to purchase some of this life insurance as variable universal life and had cash values invested in equities with a tax-free rate of return about 230 basis points below long-term equity results.]:

- For the purposes of this column, Sam and Helen make the maximum annual exclusion gifts ($120,000) to an irrevocable trust that has purchased life insurance in order to dramatize the effects of gifting on reducing future estate growth. In real life, Sam and Helen would probably use some or all of these annual exclusion gifts as direct cash gifts to their children. Based on current pricing, the value of a low-load universal survivorship life policy funded with $120,000 annual premiums would be about $11.0 million in 30 years, at the assumed second death. The $11.0 million life insurance proceeds aren't subject to income or capital gains taxes, and they are not in Sam and Helen's estate, saving their children about $6.0 million in estate taxes that would have been due if these gifts hadn't been made.
- Sam and Helen also gift $1.2 million, using their estate and gift tax credits. This gift is also invested in life insurance within the irrevocable trust. In 30 years the insurance proceeds are projected to be $7.9 million. Remember, the value of the original gift is brought back into the estate, so the amount of wealth transfer has been $6.7 million ($7.9 million minus $1.2 million), with an estate tax savings of about $3.7 million, compared with Sam and Helen not having used their estate and gift tax credits.
- Sam and Helen also decide to gift an additional $2.0 million to a separate GST irrevocable trust to use their generation-skipping transfer exemptions. They pay current gift taxes of $1.1 million in order to do this, or a total cash outlay of $3.1 million. The $2.0 million GST gift will be invested and probably not be used by their children since they will inherit sizable fortunes without the GST funds. Therefore, it is decided to invest the $2.0 million GST gift by purchasing a low-load universal survivorship life policy insuring their two children who have a much longer joint life expectancy than Sam and Helen (53 years versus 30 years), during which time a wealth transfer life insurance policy is projected to continue to grow tax-free. Assuming current life insurance pricing assumptions, the proceeds from a policy insuring Sam's and Helen's two children in 53 years are $56.3 million that won't be subject to transfer taxes again until their grandchildren's deaths (or longer if the grandchildren don't withdraw funds from the GST trust). By comparison, if Sam and Helen didn't make this taxable gift and instead invested $3.1 million (gift of $2.0 million plus $1.1 million in gift taxes) within the estate, it would have grown to $20.5 million in 30 years (their joint life expectancy) and would have been subject to estate taxes of $11.3 million for a net to their children of $9.2 million. This would be reinvested by their children, growing to $39.2 million at their children's joint life expectancy in 23 years, subject to estate taxes of $21.5 million. Sam and Helen's grandchildren would net $17.7 million, compared to the $56.3 million via a 1996 taxable gift invested in a survivorship policy insuring the children within a GST trust.

Conclusion

Individual investors who have accumulated considerable wealth can use various gifting techniques to substantially reduce the amount of transfer (estate and gift) taxes their assets will be subject to, if they have the cash flow and asset base remaining after such gifts to provide for their own desired standard of living and financial security. Gifting cash is preferable, and investing in life insurance that features minimal increasing death benefits will maximize the long-term tax-free benefits within a very safe investment vehicle. In the case study presented here, the gifting Sam and Helen Rich did saved their heirs, on a net present value basis (discounted at 6.5%), about $2.9 million from a 1996 asset base of $12.0 million, for a 24% increase in subsequent transfers to children and grandchildren.