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Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2532

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Subject: Robert Finnegan & Planning in Uncertain Times Part III: The Cost of Delay, With Life Insurance

"*With all of the uncertainty surrounding the future of the transfer tax system, many clients will consider delaying planning because it seems like a prudent course. It is important however that they understand the substantial cost of delay in terms of wealth transferred to the family.*

That said, the cost of delaying planning is substantial and dramatic. Repeal is by no means certain. Yet regardless of the outcome of estate tax reform, planning is as essential today as it was 6 months ago and as it will be in 6 months or 20-years. No one knows what tax laws will be in place in the future, but then we never have – and that has not stopped planning in the past.

Estate planning is not just or even primarily about taxes - it is primarily about eliminating or minimizing all threats-to-wealth and ensuring family security. The planning environment is the most favorable it has ever been and the tools are available to ensure our clients' security and in many cases access to transferred assets. We can rest assured that substantial taxes and other threats-to-wealth are in our clients' futures and, for many of our clients, top-shelf planning should continue unabated."

In Estate Planning Newsletter #2492, **Robert Finnegan** provided members with Part 1 of his commentary that reviewed the path to estate tax repeal under President Trump's plan or the GOP Blueprint as well as the likely "permanence" of any legislation. In Estate Planning Newsletter #2526, he provided members with Part 2 of his commentary that analyzed the high costs that can result when clients decide to delay gifting. Part 2 of his commentary did not include life insurance.

In Part 3 of his commentary, he continues his analysis of the cost of delaying planning for five or ten years based on the same core assumptions, but includes the purchase by a dynasty trust of a fully guaranteed, survivorship universal life insurance policy funded with a private split dollar plan (economic benefit regime) between the grantors and the dynasty trust.

Robert W. Finnegan, J.D., CLU, is the estate planning attorney for **Highland Capital Brokerage** where he specializes in business, estate, charitable and life insurance planning, with an emphasis on planning for the ultra-high net worth client. He has been published in a number of national trade magazines including Estate Planning, Probate and Property and the Journal of the American Society of CLU and ChFC, and spoken at numerous industry meetings. Throughout his career, he has designed and utilized financial models to evaluate and compare complex transactions, including gift/sales to dynasty trusts (typically intentionally defective grantor trusts) and the impact of life insurance on the overall planning results.

Here is his commentary:

EXECUTIVE SUMMARY:

This newsletter analyzes the cost of delaying planning for five or ten years, and reviews the purchase by a dynasty trust of a fully guaranteed survivorship universal life insurance policy funded by a private split dollar plan (economic benefit regime) between the grantors and the dynasty trust.

COMMENT:

<u>The Model and Model Assumptions</u>

The value of a simulation model is not as a crystal ball with the ability to predict the actual amount of wealth that will be transferred in the future; rather it is the ability to compare and contrast various hypothetical scenarios. This analysis evaluates the cost of delaying planning by focusing on the wealth transferred via a dynasty trust and the grantors' estate at the assumed joint life expectancy of age 90/year 31 based on the following assumptions[1]:

- The model carves $15M of assets out of the clients (husband and wife) estate.

- Assets grow at a 5% pre-tax return and a 4% after-tax return (20% tax on earnings).
- The dynasty trust purchases second-to-die or survivorship life insuring the husband and wife at preferred non-tobacco rates.
- The same life insurance product purchased today is available in five or ten years.
- Husband and wife currently each age 60 are and remain in excellent health.
- The policy is funded with a private split dollar plan (economic benefit regime)[2].
- Upon the second death, estate assets will be subject to a 40% estate tax (federal only).
- The estate and GST taxes are repealed under Budget Reconciliation, the gift tax is not repealed. Repealed taxes sunset (i.e. return) in five or ten years.

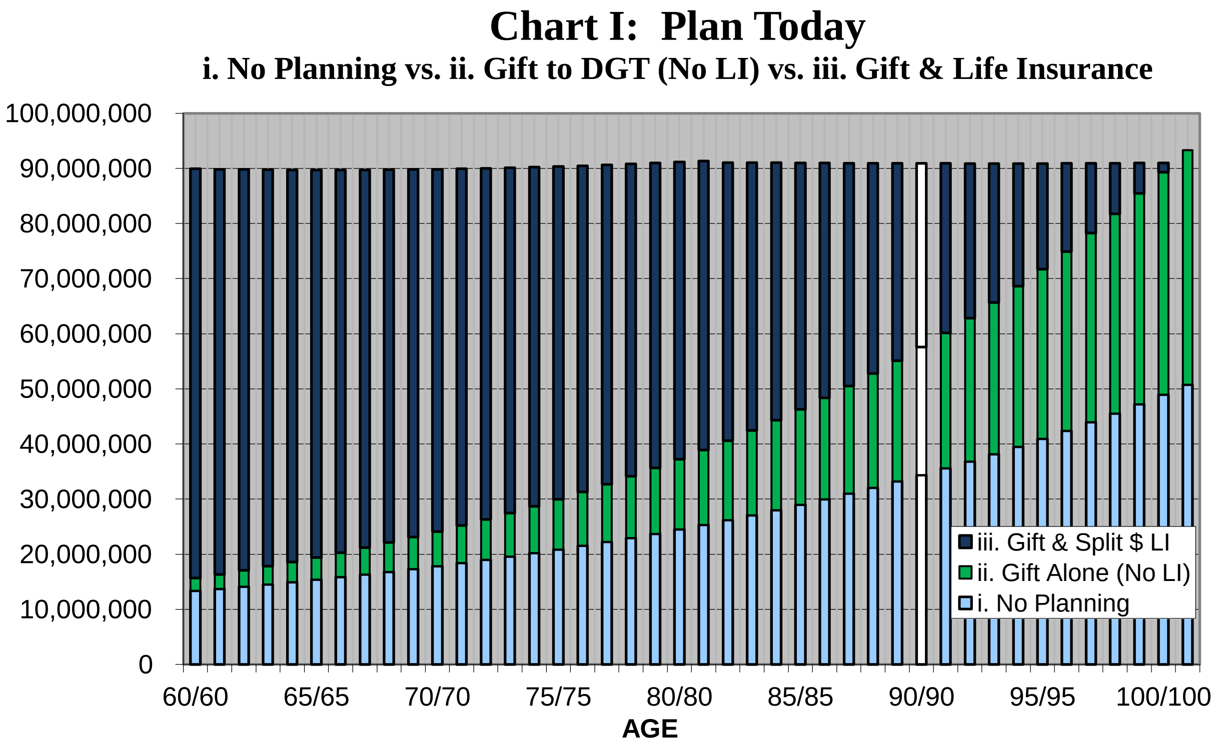
The cost of delaying planning is evaluated for three future scenarios, each based on different planning parameters (available gift and GST exemptions, discount and long term AFR). For each of these three hypothetical scenarios, the wealth transferred at life expectancy by the Plan Today (baseline) is compared to delaying planning for five or ten years.

The assumptions made in this analysis are extremely reasonable and well within the realm of possibility. In fact, actual changes to the tax laws, insurability, AFRs and product availability could be far more onerous than those assumed here translating into a far greater cost due to delaying planning.

I. Plan Today (Baseline)

Chart I below, demonstrates the benefits of planning today in any given year for the following three scenarios[3] and establishes the baseline (Scenario iii.) for the cost of delay analysis.

i.) No planning[4].
ii.) Gift $15M of assets (net $10M), no life insurance[5].
iii.)Gift with $75M SUL G life insurance[6].



Based on the chart above, it is interesting to note that 1) the gift alone (no life insurance) takes times to move substantial wealth, and 2) if at least one spouse lives to age 100, the heirs would have been better off with the gift alone[7]. This suggests a balance of strategies to hedge the opposing risks of premature death against that of living too long[8].

The following table summarizes the results at assumed life expectancy (age 90/90, year 31). The numbers under **iii. Gifts & LI** become the baseline for the cost of delay comparisons that follow[9].

Table I: Planning Today with and Without Life Insurance at LE (Age 90)

GST Exempt Character	Plan Today		
	i. No Planning	**ii. Gift (No LI)**	**iii. Gift & LI**
Exempt	$10,000,000	68,070,592	**106,628,263**
Non-Exempt.	$24,258,201	**(10,484,155)**	**(15,716,086)**
Total	$34,258,201	57,586,438	**90,912,177**

II. The Cost of Delay

The balance of this analysis compares the net wealth transferred at clients' assumed joint life expectancy (age 90, year 31) if the clients plan today (baseline) versus delaying planning for five or ten-years for each of the following three scenarios:

A. The gift, estate and GST exemptions remain at $10M; a 33 1/3rd% discount is available; and the AFR remains at 2.75% (the January 2017 Long Term AFR). Clients plan with $15M only (i.e. appreciation until the delayed planning date is accounted for as an asset of the estate).

B. Same assumptions as A, except that in the Plan in 5-Years and Plan in 10-Years scenarios, clients plan with $15M plus appreciation from today until the planning date.

C. The gift, estate and GST exemptions have been reduced to $7M, a 20% discount is allowed, the AFR has increased to 3.75% and clients plan with $15M plus appreciation from today until the planning date.

The grantor's premium advances under the split dollar plan are additional outlays that are accounted for as an expense in the estate along with the loss of the use of those funds[10]. It is important to note that when planning is delayed, substantially less insurance can be funded with the same assets. The reduced amount of coverage reflects the higher premiums at the older ages and the fact that less wealth is being transferred in trust with resulting lower cash flows.

A. Same assumptions as Plan Today, excess funds included in the estate.

Table IIIA: Net to Family at LE (Age 90)

Table IIA Assumptions:
Plan Today (baseline): $15M Gift ($10M Net), 1/3rd Discount, $75.0M of Life Insurance
Plan in 5-Years: $15M Gift ($10M Net), 1/3rd Discount, $60.0M of Life Insurance
Plan in 10-Years: $15M Gift ($10M Net), 1/3rd Discount, $47.5M of Life Insurance

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Plan Today vs. in 10-Years
Dynasty Trust	106,628,263	84,031,976	66,617,874	**40,010,389**
Estate	**(15,716,086)**	**(5,461,886)**	2,170,707	**(17,886,793)**
Total	**90,912,177**	**78,570,090**	**68,788,581**	**22,123,596**

Even assuming a 2.5% rate of inflation, on a present value basis the improvement due to planning today equates to $18.6M more to the dynasty trust, **($8.3M)**[11] less to children via the estate and $10.3M more to the family overall.

II. The Cost of Delay (Continued)

B. Table IIB reflects the same assumptions as A. above but, rather than treating the excess growth of the $15M as an estate asset, it assumes that the clients are willing to plan with the greater amounts (based on the 4% after-tax growth rate, $15M would grow to $18.25M in 5-years and $22.2M in 10-years). The additional growth above $15M would have to be sold to the trust, since the available $10M gift and GST tax exemption would only shelter the basic $15M gift at a 1/3rd discount[12].

Table IIB: Net to Family at LE (Age 90)

Table IIB Assumptions:

Plan Today (baseline) with $15.00M:	$15M Gift ($10M Net), 1/3rd Discount No sale $75.0M SUL G Life Insurance
Plan in 5-Years $18.25M:	$15M Gift ($10M Net) $3.25M Sale ($2.17M Net), 1/3rd Discount, 2.75% AFR $65.0M SUL G Life Insurance
Plan in 10-Years with $22.20M:	$15M Gift ($10M Net) $7.20M Sale ($4.80M Net), 1/3rd Discount, 2.75% AFR $50.0M SUL G Life Insurance

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Plan Today vs. in 10-Years
Dynasty Trust	106,628,263	92,601,834	77,739,009	**28,889,254**
Estate	(15,716,086)	(9,387,210)	(3,881,803)	**(11,834,283)**
Total	90,912,177	83,214,624	73,857,205	**17,054,972**

Even assuming a 2.5% rate of inflation, on a present value basis the improvement due to planning today equates to $13.4M more to the dynasty trust, **($5.5M)** less to children via the estate and $7.9M more to the family overall.

II. The Cost of Delay (Continued)

C. This scenario assumes that the planning environment has worsened as follows:
   i. The combined gift and GST tax exemption is reduced to $7M (from $10M).

ii. The long term AFR has increased to 3.75%[13] (from 2.75%, December 2016).
iii. The available discount has decreased from 1/3rd to 20%.
iv. As a result of the lower exemptions and reduced discount, the client can only gift $8.75M ($7M/(1-20%)), and will sell the balance in a discounted sale with an interest only note with a balloon payment at the end of year 15.

Table IIC: Net to Family at LE (Age 90)

Table IIC Assumptions:

Plan Today (baseline) with $15.00M: $15M Gift ($10M Net), 1/3rd Discount
No sale
$75.0M of Life Insurance

Plan in 5-Years with $18.25M: $8.75M Gift ($7M Net), 20% Discount
$9.5M Sale ($7.6M Net), 20% Discount, 3.75% AFR
$42.5M of Life Insurance

Plan in 10-Years with $22.20M: $8.75M Gift ($7M Net), 20% Discount
$13.45M Sale ($10.76M Net), 20% Discount, 3.75% AFR
$27.5M of Life Insurance

Transferred From	Plan Today	Plan in 5-Years	Plan in 10-Years	Plan Today vs. in 10-Years
Dynasty Trust	106,628,263	63,820,899	50,138,253	**56,490,010**
Estate	(15,716,086)	2,406,689	7,097,120	**(22,813,206)**
Total	**90,912,177**	66,227,589	57,235,372	**33,676,805**

Even assuming a 2.5% rate of inflation, on a present value basis the improvement due to planning today equates to $26.3M more to the dynasty trust, **($10.6M)** less to children via the estate and $15.7M more to the family overall. Comparing Plan Today to Plan in 5 or 10-Years, there are three reasons for the dramatic difference.

- Assuming a smaller exemption ($7M vs. $10M) and a lower discount results in a much smaller gift with the balance being transferred with a sale. A sale is far less efficient than a gift because the note principal plus interest are assets of the estate.

- A gift today can purchase $32.5M more in life insurance ($75M vs. $42.5M) than waiting 5-years and $45M more ($75M vs. $30M) than waiting 10-years, and that is assuming clients remain preferred non-tobacco risks.

- $15M gifted today provides a greater wealth transfer benefit than if $15M is transferred in five or ten years.

The cost of delaying planning would of course be far greater if one of the spouses had become rated or uninsurable or had passed away, or if the products available in the future are not as favorably priced as today.

As the preceding analysis demonstrates, the cost of delaying planning is substantial and dramatic. Repeal is by no means certain. Yet regardless of the outcome of estate tax reform, planning is as essential today as it was 6 months ago and as it will be in 6 months or 20-years. No one knows what tax laws will be in place in the future, but then we never have – and that has not stopped planning in the past. Estate planning is not just or even primarily about taxes - it is primarily about eliminating or minimizing all threats-to-wealth and ensuring family security. The planning environment is the most favorable it has ever been and the tools are available to ensure our clients' security and in many cases access to transferred assets. We can rest assured that substantial taxes and other threats-to-wealth are in our clients' futures and, for many of our clients, top shelf planning should continue unabated.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Robert Finnegan

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[1] For additional model assumptions, see [Estate Planning Newsletter #2526].

[2] The private split dollar plan (economic benefit regime) is designed and modelled as follows:

- The trust is the owner & beneficiary of policy.
- The trust collaterally assigns interest in the policy to the grantors utilizing a restricted assignment so that the insureds do not hold any incidents of ownership under Code §2042.
- The Grantors (Interest in the Policy) advance each annual premium less Economic Benefit Cost, own 100% of Cash Value (CV) and the death benefit share equals the greater of the CV or the cumulative premium advances.
- Trust pays economic benefit cost from trust cash flow and designates the beneficiary of the death benefit equal to the total policy death benefit less the Grantor's interest.
- Economic Benefit Cost (EBC).The EBC or one year term cost equals the trust's share of death benefit times the appropriate one-year term cost (rate/$1,000 of death benefit). The rate/$1,000 varies each year based on insured(s) attained age as follows: Table 2001 rates while both insureds are alive and the carrier's rates following the first death.
  <u>Note:</u> The carrier's rates must be published (i.e. known to the public) and regularly sold as required by Rev. Rul. 2002-8.
- Rollout (termination). In year 23, the trust repays Insureds the greater of the policy cash value or the premiums advanced by the grantor.
- Following rollout, the trust owns the policy outright and pays each annual premium from trust cash flow.

[3] Scenarios i.) and ii.) were the basis of the analysis in Estate Planning Newsletter **#~~2526~~** – please provide link Part II.

[4] The $15M earns 4% after-tax and upon the second death, the value in excess of the $10M estate & GST tax exemptions is subject to the estate tax.

[5] Gift $15M of assets, discounted by 33 1/3rd%, for a net gift of $10M to a dynasty trust that is also a defective grantor trust. Trust assets earn 5% pre-tax, taxes are paid by the grantor so that the estate is reduced by the tax burn equal to the income taxes paid and the loss of the use of the funds used to pay income taxes.

[6] Gift $15M today (discounted to $10M) and funding $75M of guaranteed survivorship UL with Private Split $ (economic benefit regime) assuming a first death in year 11. The life insurance policy is a fully guaranteed survivorship universal life insurance. The amount of insurance varies as noted in each scenario based upon i) the premiums based on the insureds attained ages (assuming they still qualify or preferred non-tobacco rates) that can be supported by trust assets both during the split dollar plan and after when the trust is responsible for each annual premium. As a “stress test”, the model assumes a first death in year 11 reflecting the possible higher term costs.

[7] There is always a “crossover year” where, if one of the insureds lives long enough, the clients would have been better off not purchasing the insurance.

[8] The life insurance and the assets that support it hedge against the premature death of the clients; additional assets gifted or sold to the trust hedge against the client living “too” long.

[9] As illustrated in the Chart I, the wealth transferred with the **ii. Gift (No LI)** scenario surpasses the **iii. Gift & Life Insurance** scenario at age 100.

[10] For this reason, this analysis serves as a comparison not as a projection.

[11] The $15M assets used in this analysis represent a fraction of the total estate. Although the children will receive significantly less as a result of planning today, they will potentially receive substantial assets from those other estate assets.

[12] Although it could be argued that the gift and GST exemptions would increase over the five or ten year delay in planning period, that increase would be available for the Plan Today as well as plan in five or ten years, in other words, it would be a “wash”.

[13] For years 2007-2011, The Long Term AFR equaled or exceeded 3.75% for 47 (out of 60) months. Since 2012, the Long Term AFR has remained below 3.75%. The average Long Term AFR for 2007-2016 is 3.70%.