Trendy and Abused Estate Planning Techniques

Presented By:

Keith Buck, J.D., LLM, CLU
Assistant Vice President, Advanced Designs
Pacific Life Insurance Company

Today's Agenda

- Discuss pros and cons of the following 3 concepts:
  - Using Captive Insurance Companies as wealth transfer vehicles
  - Shark-Fin CLATs
  - Generational Split Dollar

Captive Insurance Companies

6 Potential Income Tax Increases

Effective January 1, 2013

	2012	2013
1. Top Income Tax Rate[1,2]	35%	39.6%
2. Top Capital Gains Rate[1,2]	15%	20%
3. Medicare Surtax on Net Investment Income[3]	0%	3.8%
4. Medicare Payroll Tax Surcharge on Earned Income[3]	0%	.9%
5. Phase out of personal exemption[1,4]	No	Yes
6. Phase out of itemized deductions[1,4]	No	Yes

[1] Implemented as part of the American Taxpayer Relief Act (ATRA) of 2012.
[2] Applies to individual taxpayers with a Modified Adjusted Gross Income of more than $400,000 and joint income tax filers with more than $450,000 of income.
[3] Implemented as part of the Patient Protection and Affordable Care Act of 2010. Applies to individual taxpayers with a Modified Adjusted Gross Income of more than $200,000 and joint income tax filers with more than $250,000 of income.
[4] Applies to individual taxpayers with a Modified Adjusted Gross Income of more than $250,000 and joint income tax filers with more than $300,000 of income

So What Does This All Mean?

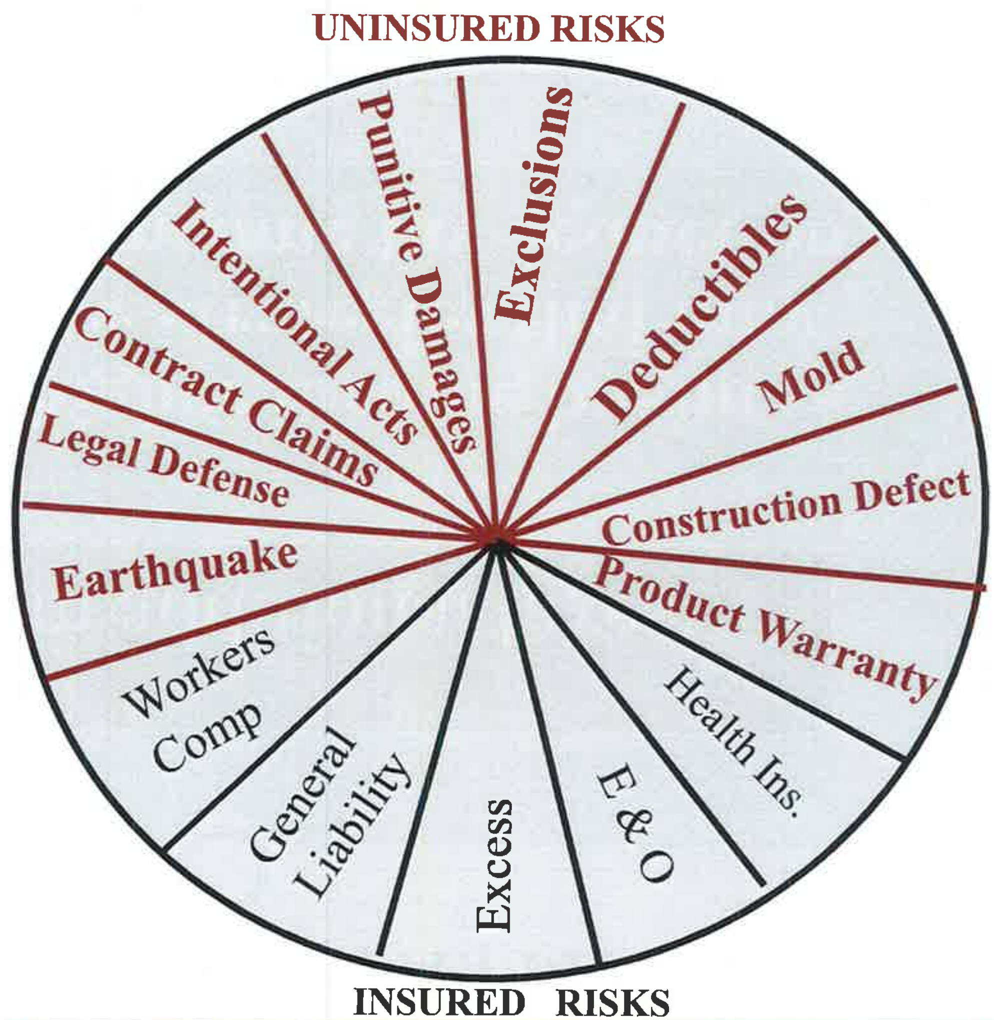
$73,633 in additional taxes!*

As a result, higher income business owners desire strategies that may create a large income tax deduction

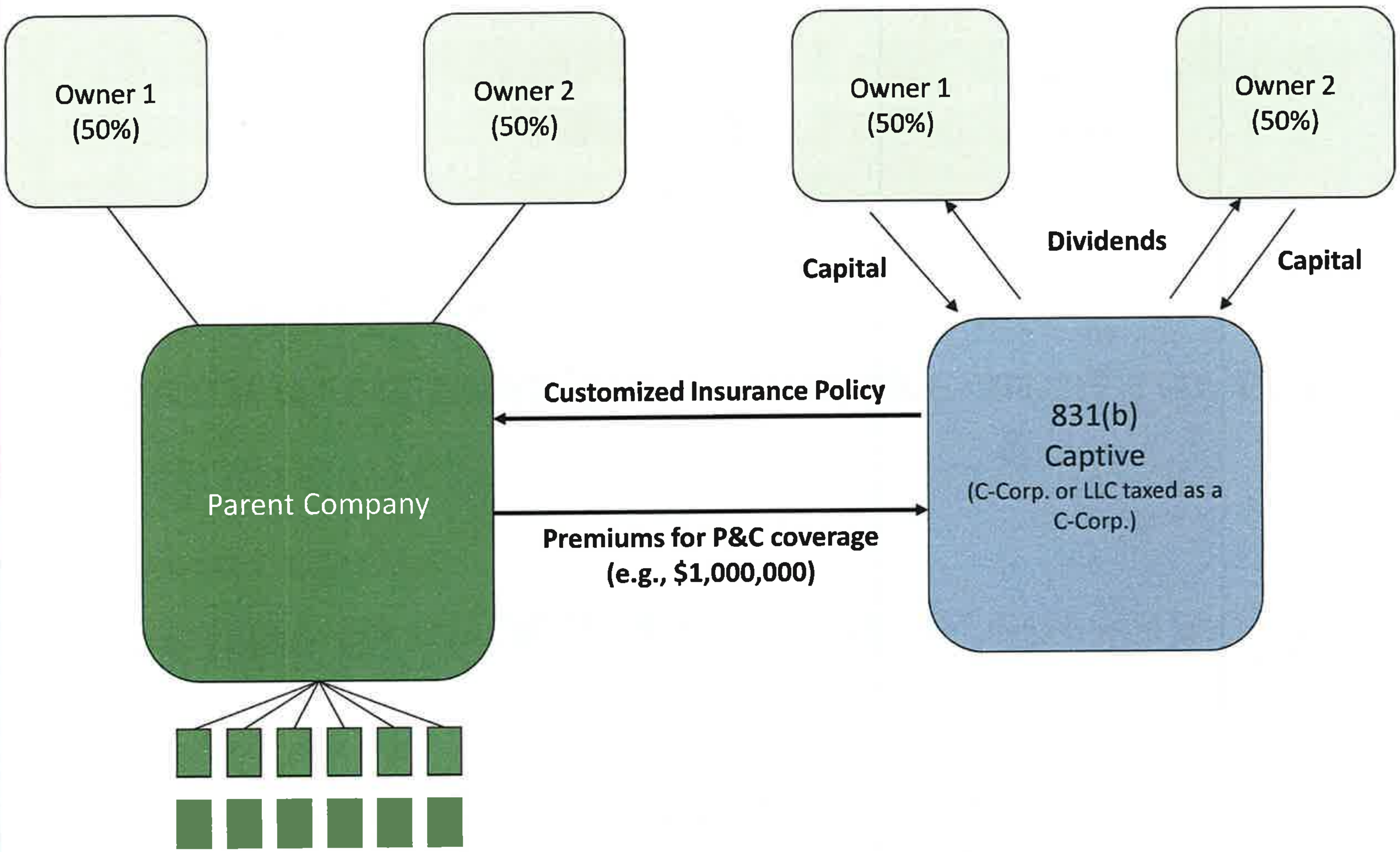
*Taxpayers with taxable income in excess of $450,000 will pay, on average, an additional $73,633 in tax beginning in 2013 when compared to 2012. This represents the top 1% of income tax payers.
Source: "You're Rich. How Much More Tax Will You Pay In 2013?" T. Nitti, Forbes Magazine, 1.9.2013; found at: http://www.forbes.com/sites/anthonynitti/2013/01/09/youre-rich-how-much-more-tax-will-you-pay-in-2013/
This figure is based on the following assumptions: 1) all of the 2012 tax rates were extended; 2) the 2% payroll tax cut was extended; and, 3) the two additional "Obamacare" taxes were never enacted .

What Is a **Captive Insurance Company?**

C-Corporation created for the purpose of writing *property and casualty (P&C) insurance* to a relatively small group of insureds



What Is a **Captive Insurance Company?** (cont.)



Advantages of a Captive

Primary

- **Ability to obtain more comprehensive risk protection**
- **Improved cash flow management for self-insured risks.**

IRS Guidance – It's All About the Risk

- **More than ½ of business must constitute "insurance"**
  - **Risk Shifting -- risk of economic loss transferred to another.**

Advantages of a Captive

Ancillary

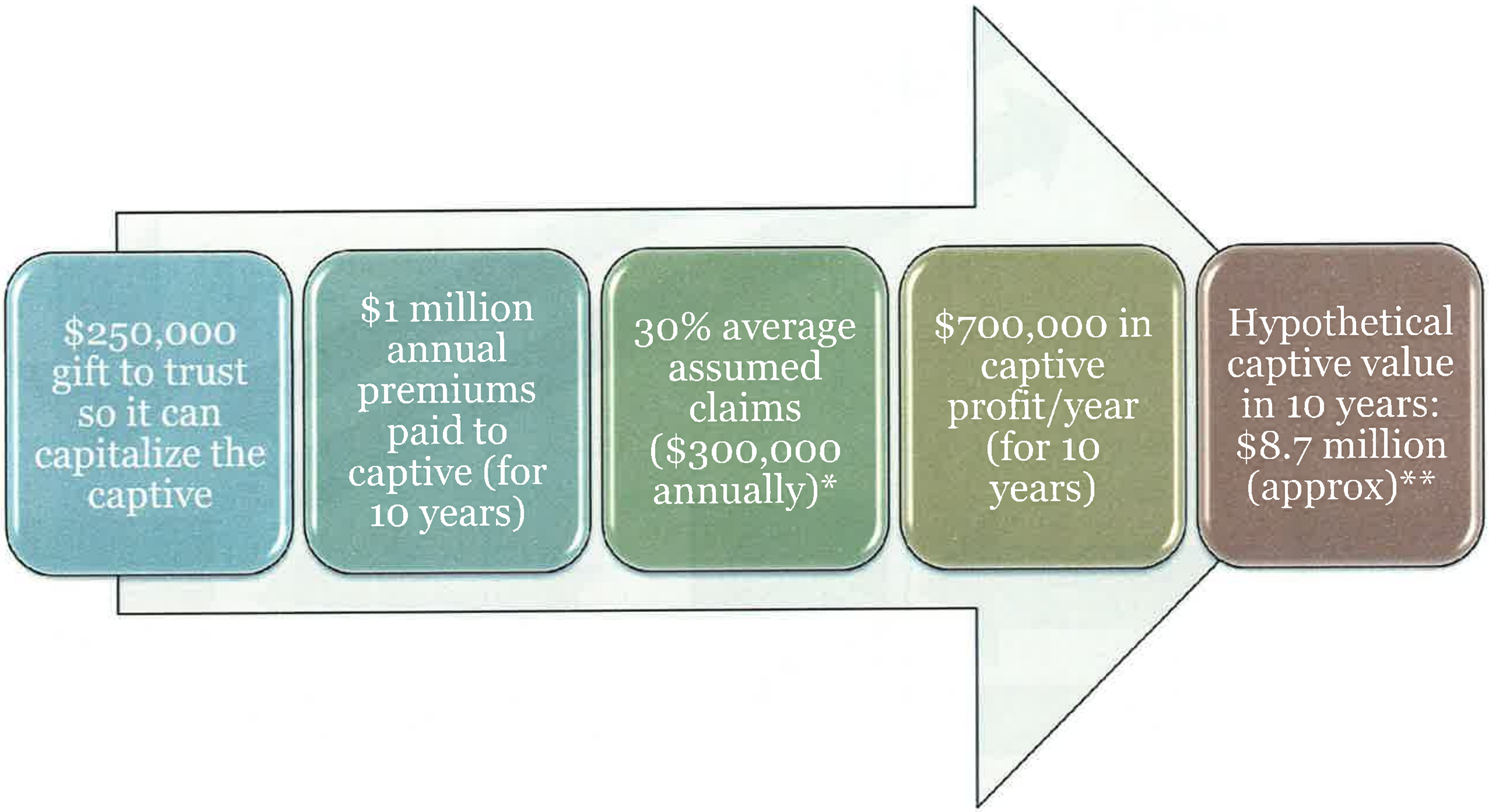
- **Favorable tax treatment**
- **Ability to profit from favorable claims experience**
- **Estate planning opportunities**

Abusive marketing examples

Estate Planning With a Captive

- Potential estate reduction benefits if captive is owned outside the estate (e.g., by heirs or trust)
  - Ability to remove assets from business owner's estate with minimal gift tax consequences
    - Growth (i.e., favorable claims experience) occurs outside the business owner's taxable estate
- Potential ability to use captive assets to assist business owner to purchase life insurance for estate tax liquidity

Potential Estate Reduction Benefits of a Captive

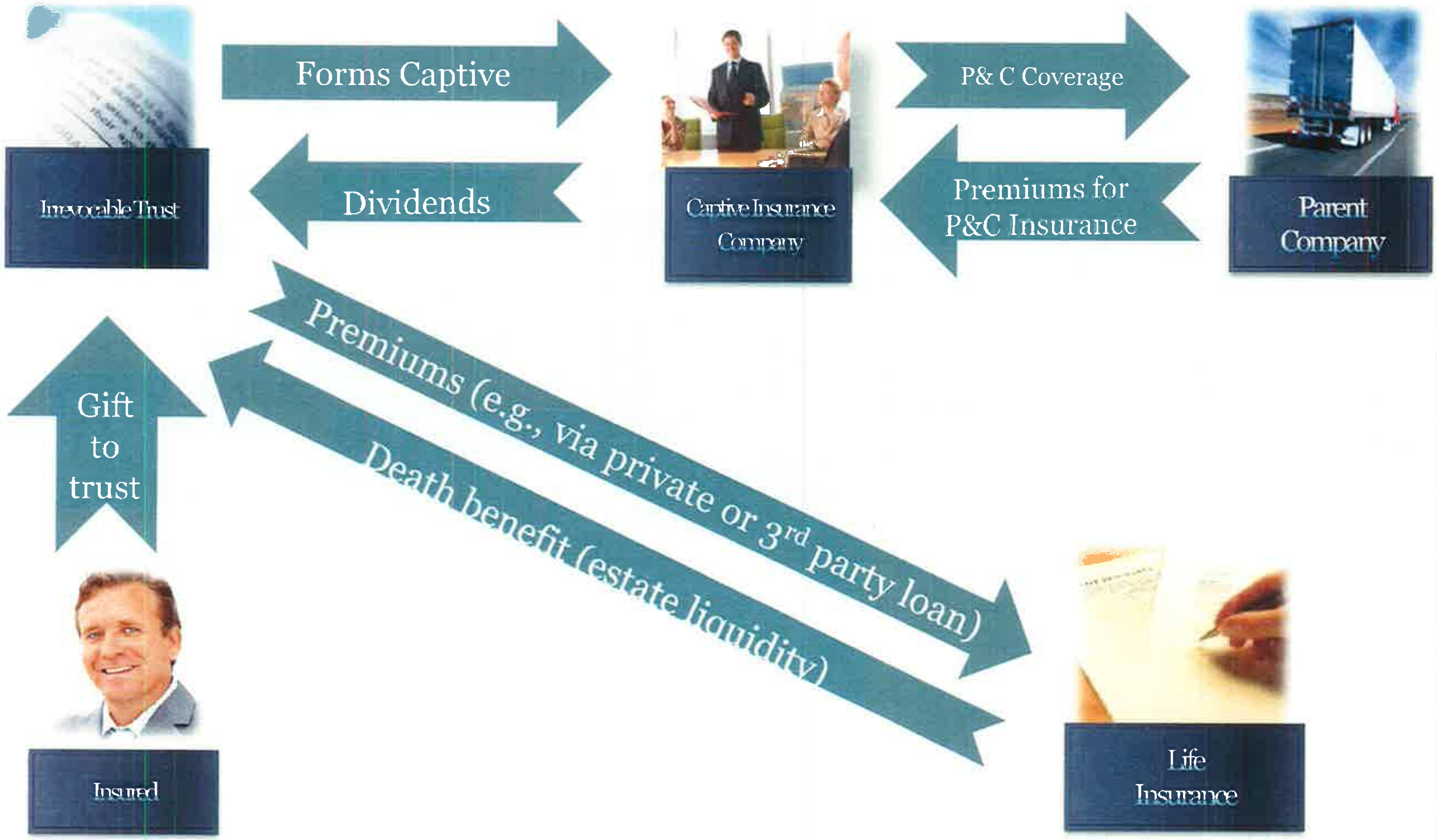


* Actual claims experience may be better or worse.

** This assumes that the hypothetical $700,000 annual profit has an after tax growth rate of 4% over 10 years

Captives & Life Insurance

Example



“Shark-Fin” CLATs

What is a CLT?

- Charitable Lead Annuity Trust (CLAT)
  - Donor creates and funds a trust
  - Trust pays a fixed annuity to a qualified charity
    - Either a specified term of years (e.g., 10 years) or for a term measured by the life of one or more individuals
  - At the end of the term, assets in the trust pass to a remainder beneficiary (e.g., the donor's heirs).
  - Typically used by wealthy individuals with no current need for certain assets but want to benefit heirs and a charity.

How the "Shark-Fin" CLAT Came to Be…

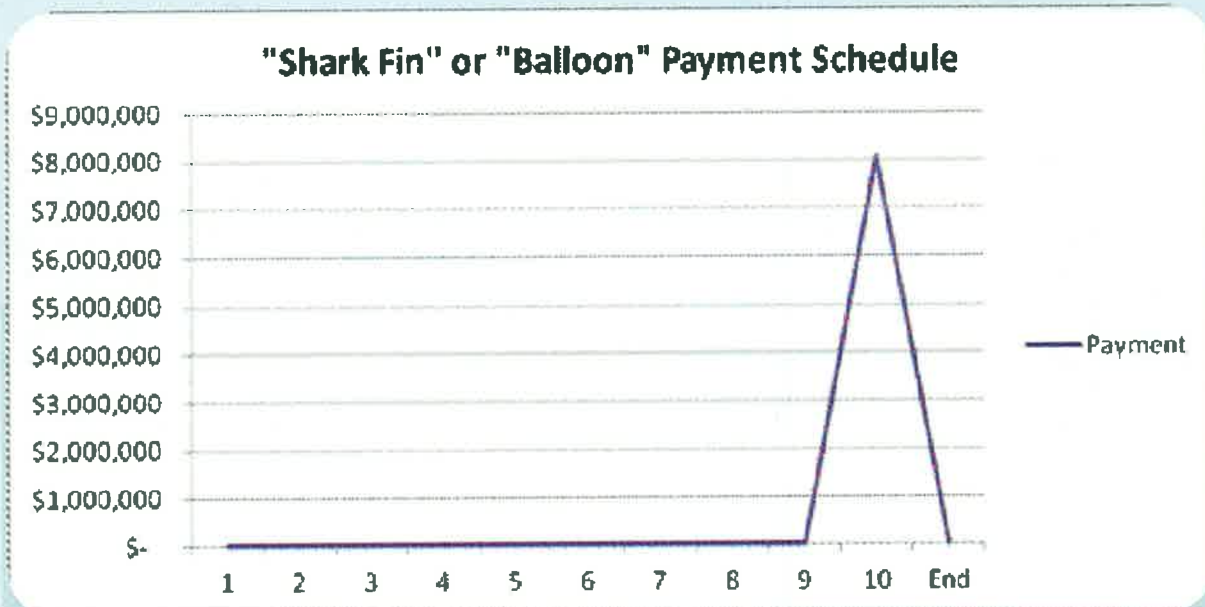
- Arose after Revenue Procedures 2007-452 and 2007-463
  - IRS sample form states that CLAT may provide for an annuity amount that is initially stated as a fixed dollar amount "but increases during the annuity period."
- This language gave birth to the Shark-Fin CLAT
  - Variation of a traditional CLAT
    - Also known as:
      - "Variable CLAT" or "V-CLAT,"
      - "Enhanced CLAT" or "E-CLAT"
      - "Balloon CLAT"

How Does a Shark-Fin CLAT Work?

- Trust pays a series of small/minimal initial payments to the charity)
  - Allows trust assets to remain invested within the CLAT for a longer time potentially providing for more growth in the initial years
- At end of trust term, large (balloon) payment(s) made (i.e., "back loading")
  - Allows for a significant buildup of funds during the lead period
  - End result: May increase both the total charitable distributions and the amounts passing to the CLAT remainder beneficiaries
    - Fluctuations in value of trust in the early years become less of a factor

Sources:
-"Do Shark-Fin CLATs Have Teeth?"; J. Guarino, January 26, 2012 found at http://www.newwealthadvisors.net/alerts-and-insights/blog/2012/01/do-shark-fin-clats-have-teeth
-"IRS Allows 20% Escalating Annuity Payments in a Testamentary Charitable Lead Annuity Trust ("CLAT")"; AALU Washington Report Bulletin No. 12-27, June 6, 2012

Sample Shark-Fin CLAT Payment Schedule



Enter Life Insurance …

1. CLAT created for duration of grantor's life (vs. term of years)
2. Trust sets aside a small portion of the assets to make the annual payments to the charity
3. Trust uses most of the CLAT funds to purchase a single premium life insurance policy on grantor's life
4. At the grantor's death the CLAT terminates and a balloon payment is made to charity using the life insurance proceeds
5. Remainder of life insurance proceeds passes to the CLAT beneficiaries

Can potentially transfer significant wealth to the next generation with limited estate or gift tax liability

Shark-Fin CLAT Example

- 60 year old male contributes $1 million to a CLAT
  - CLAT term is for the life of the donor and is a grantor trust
  - Charitable deduction is approx. 97%*
- CLAT will pay $5000 each year to charity and a $1.5 million balloon payment when the CLAT terminates
- $100,000 is used to purchase muni-bonds to pay the $5000 annually
- $900,000 is used to purchase a $3.8 million policy
  - Heirs will receive $2.3 million of the death proceeds

* Based upon a 2% Section 7520 rate

Testing the Water… The Shark-Fin CLAT Debate
The Nays

- Shark-fin CLATs may be abusive:
  - Potential risk of disallowance of the income, gift, or estate tax charitable deduction
- IRS procedures are only guidance and explicit approval is lacking:
  - Even though sample CLAT forms indicate that there may be increases in the annuity amount, the IRS has not provided any specific guidance or details regarding the permissibility of such increases
- Payment structure may be disregarded by the IRS as de minimis
  - Shark-fin payments do not fit the traditional concept of an annuity payment
    - Value of payments cannot be calculated using just annuity formulas
      - Doubts regarding whether the series of payments is an annuity
- IRS has never approved the shark-fin CLAT strategy, including those funding the balloon payment to charity with life insurance
  - May consider using a CLAT that purchases a life insurance policy, not with an upfront single premium, but with annual premium payment by the CLAT

Testing the Water… The Shark-Fin CLAT Debate

The Yays

- IRS procedures *clearly* allow varying CLT annuity payments
  - This is sufficient evidence that a balloon payment at the end of the lead period is valid
    - Rev. Proc. 2007-45 states that CLATs are not subject to minimum payout requirements
  - PLR 201216045 (April 20, 2012): IRS approved of an annuity formula that would allow a testamentary CLAT to make increase the annuity payments by 20% each year
- Concern re: *de minimis* payments not applicable to CLTs
  - Applies to CRTs not CLTS because CLTs are subject to taxation
- If the CLAT pays the annual premiums, the charitable split-dollar rules of may apply to disallow a charitable income tax deduction

Generational Split Dollar (GSD)

What is GSD?

- GSD, also referred to as "intergenerational split dollar," "discount private split-dollar" and "three generation split dollar," generally is:
  - A private, non-equity collateral assignment split dollar or loan arrangement;
  - Between a grandparent ("G1") and an irrevocable life insurance trust ("ILIT") created by G1;
    - G1 is generally age 80 or older
  - Insured is a child of G1 ("G2")
  - G1 pays all the premiums and in exchange receives a collateral interest in the policy cash value and death benefit
  - Agreement contains special provision that stipulates that G1 is not entitled to be repaid his or her collateral interest until the death of G2

What is GSD? (cont.)

- Policy is designed to have a large single premium with a high early cash value
  - Cash value in the first year may exceed 100% of the premium
- G1's collateral interest is transferred to the ILIT either upon G1's death or via a gift
- Upon transfer of G1's collateral interest, a mortality discount is taken
  - Valuation discount is often as much as 90%-95%
  - Reflects the fact that the "receivable" won't be repaid until the death of G2, who may have a remaining life expectancy of 25-30 years
- Policy is typically surrendered for its cash value soon after the transfer
  - Unprofitable for insurance companies

GSD Example

- Wealthy parent (G1), age 85, creates an ILIT for the benefit of his child (G2)
- ILIT acquires a $20 million policy on the life of child, age 55
- Parent enters into a split dollar loan arrangement with ILIT agrees to pay a single premium of $10 million
    - Parent receives collateral interest in the policy equal to the loaned premium but isn't entitled to be repaid until the death of the insured child
    - Policy has a high early cash value of approximately $10 million

GSD Example (cont.)

- Parent's $10 million collateral interest is subsequently transferred to the ILIT
- At the time of the transfer a mortality discount of 90% is applied
  - Resulting gift/bequest after the discount is $1 million
- ILIT subsequently surrenders the policy, which now has a cash surrender value of $11.5 million, and distributes the proceeds to the child

End Result : A $1 million gift/bequest effectively removes $11.5 million from G1's estate

Possible IRS Attacks

- Section 2703*
  - Restriction disregarded - no discount
- Step transaction doctrine
  - Transfer is deemed to be policy itself – no discount
- Sham transaction
  - Especially applies to the gift variation where the policy is surrendered within 3 years – no discount

* Must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

Possible IRS Attacks (cont.)

- Amount of the discount
  - 90%-95% discount is excessive – more reasonable discount applies
- Gain is annually taxable
  - Single premium policy is a Modified Endowment Contract (MEC)
  - IRC § 72(e)(10) applies IRC § 72(e)(4) to MECs
  - IRC § 72(e)(4) triggers gain upon a pledge or assignment

IRS has audited several GSD cases and several are purportedly headed to Tax Court

Is There a Right Way to Do GSD?

- Make sure there is a genuine death benefit need by G2
  - Any potential discount should be viewed as “gravy”
- Have G1 retain his or her collateral interest until death
- Use a reasonable discount
- Keep the insurance in force after the transfer