The Estate Planner

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Pondering your policy

Watch out for a little-known tax trap – the transfer-for-value rule

For many people, life insurance is an essential building block in an estate plan. It creates an additional source of wealth and provides instant liquidity to pay estate taxes and other expenses. Best of all, with proper planning, your beneficiaries can receive life insurance proceeds free of estate and income taxes.

But it's important to handle life insurance policies carefully. The beneficiaries typically are exempt from income taxes on death benefit proceeds. But if you transfer a policy — or an interest in a policy — for "valuable consideration," you risk triggering income taxes at rates as high as 35%. Why? Because of a little-known, yet lethal, provision of the Internal Revenue Code called the transfer-for-value rule.

The transfer-for-value rule

When the rule applies, the transferee — the person receiving the policy or interest therein — is subject to ordinary income taxes on the proceeds, excluding the consideration paid for the policy and any premiums or other charges he or she pays after the transfer.

The transfer-for-value rule is intended to discourage speculation in insurance policies by people who lack an insurable interest.

The transfer-for-value rule is intended to discourage speculation in insurance policies by people who lack an insurable interest. An insurable interest is a legitimate reason for someone to be insured against your death — typically, someone who would suffer a financial hardship. Examples of people with an insurable interest on you could include your spouse, child and business partner. Unfortunately, the rule's design doesn't necessarily jibe with its underlying rationale. For example, though the rule contains several exceptions, there isn't one for transfers to children or other family members who typically have an insurable interest.

For example, let's say Dave transfers a $1 million life insurance policy (with a $5,000 tax basis) to his daughter,

Julia, in exchange for $15,000 and her promise to take over the premium payments. Julia pays a total of $35,000 in premiums before Dave dies. Under the transfer-for-value rule, Julia is subject to ordinary income taxes on $950,000 ($1 million in proceeds less the $50,000 she paid), increasing her tax bill by more than $300,000.

Exceptions to the rule

A transfer otherwise subject to the rule won't cause the policy proceeds to lose their tax exemption if the transfer is made to:

- The insured,
- A partner of the insured,
- A partnership in which the insured is a partner, or
- A corporation in which the insured is a shareholder or officer. (But, notably, this exception doesn't apply in reverse, where the transfer is to an officer or shareholder.)

Why it's so dangerous

One reason the transfer-for-value rule is so dangerous is that the term "transfer" goes well beyond an outright sale or physical transfer of a policy. A transfer can occur, for example, when you name a beneficiary or assign someone an interest in the policy.

A transfer won't trigger income taxes unless the transferee provides "valuable consideration," but this aspect of the rule can be treacherous as well. Valuable consideration isn't limited to money. It can be virtually anything of value to the transferor — the person transferring the policy or interest.

For example, Sam and Bill are shareholders in a small corporation. In connection with a buy-sell agreement, they exchange $1 million life insurance policies. The exchange triggers the transfer-for-value rule, making the insurance proceeds taxable. By giving each other the policies, they have given consideration. (Be aware that, if Sam and Bill had been partners, the transfers would have fallen within an exception to the rule. But, oddly, the exception doesn't apply to co-shareholders.)

It's logical to assume that the transfer-for-value rule won't apply to a gift of a policy or an interest in a policy. In most cases, that's true, but even gift transfers should be examined closely to avoid the transfer-for-value trap.

If you transfer a policy subject to a loan, for example, the transferee's assumption of the loan is valuable consideration. If the loan amount exceeds your basis in the policy, the policy proceeds will become taxable.

Sidestepping the rule

In some cases, it may be possible to avoid the transfer-for-value by establishing a partnership with the transferee to qualify for the exception for transfers between partners. For this strategy to work, however, the partnership must have a legitimate business purpose apart from circumventing the transfer-for-value rule.

For example, Sam and Bill — from the previous example — form a partnership to hold and manage their corporation's investments and real estate holdings. When they exchange life insurance policies, the partnership exception applies, preserving the tax-free status of the insurance proceeds.

Be skeptical

There are many ways in which a seemingly innocent transaction involving life insurance can trigger the transfer-for-value rule. Logic isn't a reliable guide to the rule's application. To avoid a costly tax trap, therefore, you must meticulously follow the language of the tax code and regulations. The safest approach is to treat any transfer (including changing or adding a beneficiary) with skepticism and to consult a tax advisor before you proceed. ✤

Keeping life insurance out of your estate

The key to avoiding estate taxes on life insurance proceeds is to keep the policy out of your estate. In addition, forgo any "incidents of ownership," such as the power to change or add beneficiaries or borrow against the policy.

The simplest way to achieve this is to have your children or other beneficiaries purchase a policy on your life. You can even gift them the money to pay the insurance premiums. These gifts are taxable, of course, but if they fall within your annual $12,000 gift tax exclusion — available only if the gifts qualify as present interest gifts, and direct payments of premiums to a policy owned jointly by your children may not — or your $1 million lifetime gift tax exemption, there will not be a gift tax due as a result of the gift.

This approach has its disadvantages, though. The proceeds will be subject to claims by your beneficiary's creditors and included in his or her taxable estate. And, if your beneficiary dies before you, the policy may end up in the hands of someone you didn't intend to benefit.

The most effective way to preserve the value of life insurance may be to set up an irrevocable life insurance trust (ILIT) to purchase and hold the policy. A properly designed ILIT keeps the proceeds out of your estate and provides for your family without exposing the trust assets to creditors' claims.

If you already own an insurance policy on your life, you can transfer it to an ILIT or to a beneficiary. Keep in mind, however, that if you die within three years of the transfer, the proceeds will be drawn back into your estate. You may be able to circumvent the three-year rule by structuring the transfer as a bona fide sale to a beneficiary or to an ILIT. But beware of the transfer-for-value rule.

6 POSTMORTEM STRATEGIES FOR REVITALIZING AN ESTATE PLAN

Estate planning is an inexact science. No matter how much time and thought you put into a plan, changing tax laws and personal circumstances can hamper its ability to achieve your objectives. Fortunately, there are postmortem strategies your spouse, executors and beneficiaries can use to reduce estate taxes and accomplish your goals. Here are six of the most useful.

1. Create a qualified disclaimer

A qualified disclaimer is an irrevocable refusal to accept an interest in property from a will or living trust. Under the right circumstances, a qualified disclaimer can be used to redirect property to other beneficiaries in a tax-efficient manner.

For example, your will leaves your entire estate to your daughter or, if she predeceases you, to your grandchildren. If at your death your daughter doesn't need all of the money, she can file a qualified disclaimer with respect to a portion of it, which will then pass directly to your grandchildren. Assuming that the disclaimed property is protected by your generation-skipping transfer (GST) tax exemption, the disclaimer allows your family to avoid the estate or gift taxes that would have been owed had your daughter received the property first.

To qualify, a disclaimer must be in writing and delivered to the appropriate representative within nine months after the transfer is made (or, if the disclaimant is a minor, after turning 21) and before the disclaimant accepts the property or any of its benefits. Keep in mind that the disclaimant has no power to determine who will receive the property. Rather, it must pass to the transferor's spouse or to someone other than the disclaimant, according to the terms of the underlying document making the transfer — such as a will or living or testamentary trust or beneficiary form.

2. Make a spouse's right of election

To discourage people from disinheriting their spouses, most states' laws give surviving spouses a right of election that allows them to circumvent the will and take an elective share of certain property. The share varies from state to state: It may be a set portion of the property, such as one-third or one-half, or the percentage may increase with the length of the marriage.

Because a spouse's elective share of property qualifies for the marital deduction, exercising the election can be an effective way to reduce estate taxes. Keep in mind, however, that this strategy can have a negative effect on any charitable remainder trusts (CRTs) established as part of the estate plan.

A few years ago, the IRS ruled that all CRTs created on or after June 28, 2005, would be disqualified unless the donor's spouse waived his or her right of election. In 2006, the IRS suspended that ruling indefinitely, stating that it would disqualify CRTs only if the surviving spouse actually exercises the right.

3. Use (or forgo) a QTIP election

A qualified terminable interest property (QTIP) trust can be an effective way to use the marital deduction to minimize estate tax at

the first spouse's death and limit the surviving spouse's access to the trust principal. For the transfer of property to the trust to qualify for the marital deduction, several requirements must be met. For example, the trust assets must be invested in income-producing property, and all of the trust income must be distributed to the surviving spouse at least annually. In addition, a QTIP election must be made on the estate tax return.

QTIP assets ultimately are subject to tax as part of the surviving spouse's estate. In some cases, though, including more assets in the estate of the first spouse to die can minimize the overall estate tax. This might be the case if the first spouse has fewer assets than his or her available lifetime exemption. In such a situation, the deceased spouse's personal representative may decide not to make the QTIP election or to make a partial QTIP election.

4. Perform a special-use valuation

If a significant portion of the estate consists of real property used in a family business or farm, it may be possible to reduce estate taxes with a special-use valuation. The executor can elect to value the property based on its actual use, rather than its "highest and best use," subject to certain limitations. Several strict requirements must be met to qualify for a special-use valuation. For example, "qualified heirs" must materially participate in the operation of the business or farm for at least 10 years after the decedent's death.

A qualified disclaimer can be used to redirect property to other beneficiaries in a tax-efficient manner.

5. Defer payment of estate taxes

If the decedent's interest in a qualifying closely held business exceeds 35% of his or her adjusted gross estate, the executor can elect to defer estate taxes attributable to that business for five years (paying interest for only the first four years) and then pay the tax in 10 annual installments. To qualify, the estate must, in general, meet several requirements, including furnishing a surety bond or consenting to a tax lien on the property.

6. Use the alternate valuation date

Property typically is valued as of the date of death for estate tax purposes. But an executor may elect to use the alternate valuation date, which is six months later. This date can be used only when it results in a lower estate tax bill and, therefore, is typically elected when the value of property has declined.

But keep in mind that the election is irrevocable and can't be applied selectively to certain property. Once the election is made, it applies to all of the estate's property (except for property disposed of during the six-month period).

Build flexibility into your estate plan

As you plan your own estate, talk with your advisor about techniques you can use to provide your executor and beneficiaries with the flexibility they need to effectively implement these and other postmortem estate planning strategies. ✤

GRAT EXPECTATIONS

A ZEROED-OUT GRAT CAN TRANSFER WEALTH TAX-FREE

If you have a large estate and you've already used up your $1 million lifetime gift tax exemption (or you wish to preserve the exemption for other purposes), a "zeroed-out" grantor retained annuity trust (GRAT) may be an attractive addition to your estate plan.

A zeroed-out GRAT can make it possible to transfer large amounts of wealth to your family tax-free.

HOW IT WORKS

To set up a GRAT, you make a one-time contribution of assets to an irrevocable trust. The trust pays you an annuity during the trust term, after which the remaining assets are transferred gift- and estate-tax-free to your children or other beneficiaries.

To calculate the GRAT's gift tax value, first the actuarial value of your annuity interest is determined. This value is based on IRS tables, which incorporate an assumed rate of return (the Section 7520 rate).

You select an annuity payment that's high enough so the actuarial value of your annuity interest is approximately equal to the initial value of the trust assets, resulting in a gift tax value of zero.

Next, the annuity value is subtracted from the value of the assets you contribute to the trust to arrive at the present value of your beneficiaries' expected remainder interest. In a zeroed-out GRAT, you select an annuity payment that's high enough so the actuarial value of your annuity interest is approximately equal to the initial value of the trust assets, resulting in a gift tax value of zero. This is easier to do if the annuity is not only payable to the grantor, but also payable to the grantor's estate if the grantor dies during the retained annuity term. If the GRAT grantor dies during the retained annuity term and has a surviving spouse, special care must be taken in

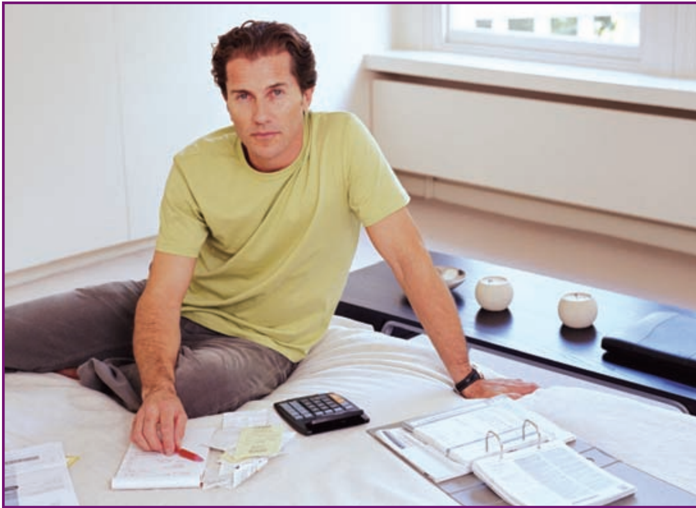
qualifying such annuity payments for the estate tax marital deduction.

The disadvantage of a zeroed-out GRAT in comparison to an ordinary GRAT is that, by increasing the annuity payments, you also increase the amount of wealth that's returned to your taxable estate. Essentially, you're trading a reduced gift tax value for an increased estate tax value.

SECRETS OF SUCCESS

Two things must happen for a zeroed-out GRAT to be effective. First, you must survive the term; otherwise, all of the trust assets will be drawn back into your taxable estate. (But even if you don't survive the term, your family will be no worse off than if you had never created the GRAT.) Second, the GRAT assets must outperform the Sec. 7520 rate. If they don't, the annuity payments will consume the entire trust, and your beneficiaries won't receive any assets from the trust.

For example, Steve contributes $1 million in assets to a 10-year GRAT for the benefit of his son, Noah. The applicable Sec. 7520 rate is 5.8%. Steve sets the annuity payments at $134,584, which, according to IRS tables, is the amount needed to zero-out the GRAT. If the GRAT's earnings



match the Sec. 7520 rate, the annuity payments will deplete the trust assets, leaving Noah with nothing. If, on the other hand, the trust assets earn an 8% return, Noah will end up with $209,265 without Steve having made a taxable gift.

Find the right answer

Which type of GRAT is right for you depends on whether you'll benefit more by keeping assets out of your estate or by reducing current gift taxes. If your lifetime gift tax exemption is unavailable, a zeroed-out GRAT may be the answer. Your estate planning advisors can help you do the math. ✤

Estate Planning Red Flag

Your estate plan benefits your grandchildren or other "skip" persons

If you've recently become a grandparent, congratulations! You may be thinking about making a gift to the new arrival, but before doing so consider the effects of the generation-skipping transfer (GST) tax on your estate plan.

The federal GST tax is one of the harshest in the tax code. It's a flat tax (currently 45%) — in *addition* to gift or estate taxes — on transfers to a "skip person," defined as a grandchild (or more remote descendant) or a nonfamily member more than 37½ years younger than you. The tax applies to "direct skips" — that is, outright gifts to a grandchild or other skip person — as well as to certain trust distributions.

The key to avoiding or minimizing GST tax is to carefully allocate your GST tax exemption (currently $2 million). Unfortunately, the rules regarding allocation of the exemption are complex. For example, if you allocate the exemption to certain trusts, it shields the trust assets against GST tax even if they appreciate in value. But that rule doesn't apply if you retain certain rights or interests in the trust assets that would cause them to be included in your taxable estate.

Another potential trap involves the automatic allocation rules. These rules are designed to help you avoid unintended tax consequences if you neglect to allocate your GST tax exemption to direct skips as well as to certain GST trusts.

In most cases, the automatic allocation rules will prevent you from making costly mistakes. But in some cases, they can cause you to waste your exemption by allocating it to trusts that are unlikely to benefit a skip person. To avoid this result, it's important to identify trusts that may be considered GST trusts and opt out of the automatic allocation rules if appropriate.

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Ellis Painter Ratterree & Adams LLP's Wealth Transfer Planning and Estate Practice Group is comprised of attorneys with over sixty years of experience in representing clients in the areas of estate planning and taxation. The team is equipped to create and implement a wide variety of estate plans utilizing groundbreaking yet tested strategies to meet the goals of each client in passing wealth to successive generations. At all times the personal goals unique to each client are of the utmost importance.

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