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CREATIVE LIFE INSURANCE FUNDING TECHNIQUES FOR THE LARGE POLICY

Life insurance trusts are an effective and relatively common estate planning device. Such trusts offer the benefit of excluding the proceeds from the insured's gross estate along with the secondary benefit of providing needed liquidity to pay estate taxes. Going beyond the technical issues involved in assuring that the proceeds are kept out of the estate, the question of how to fund the insurance trust brings up some intriguing alternative planning strategies. In the following interview, Steven J. Oshins of the Law Offices of Oshins & Associates, Las Vegas, Nevada shares his thoughts on the use of intentionally defective trusts and opportunity shifting to fund a life insurance trust.

CCH: Although much has been written on the subject of establishing a life insurance trust and the traps to avoid to ensure that the trust accomplishes its stated objectives, the question of how to fund the trust is often ignored. Is this a planning opportunity that practitioners are missing and, if so, what strategies exist to deal with it?

Mr. Oshins: There are a number of people who are underinsured simply because of a presumed inability to move sufficient cash flow into a life insurance trust to pay large premiums. The general belief is that the amount of the premium is limited to the amount of cash that can be gifted tax free using gifts subject to a *Crummey* withdrawal power. This problem is sometimes resolved by funding the trust using a split-dollar arrangement. However, this solution creates new problems, most notably the potential income tax issues raised in IRS Technical Advice Memorandum 9604001.

A simple technique that is often superior to funding the trust solely with *Crummey* gifts involves making a large gift of income-producing property to the trust using a portion of the grantor's gift tax exemption. The trustee of the trust can use the cash flow from the gifted assets to pay the insurance premiums without depleting the trust corpus.

Designing the trust so that it is defective for income tax purposes, but not for transfer tax purposes can enhance this strategy. In other words, the income, deductions, and credits attributable to the trust assets are reported on the grantor's income tax return each year, but the trust assets are not owned by the grantor for gift, estate, or generation-skipping transfer (GST) tax purposes. The trust should be designed so that it is defective with respect to both ordinary income and capital gains. I will refer to this type of trust as a "defective trust."

Since the trust assets accumulate income tax free, there is much more cash flow available to pay the life insurance premiums than there would be with a trust that is depleted each year by income taxes. For example, an asset earning 10 percent would only be accumulating at six percent, after a 40-percent income tax, if the trust were not defective. Under Code Sec. 677(a)(3), the trust should be defective at least to the extent its income is used to pay the insurance premiums. However, to be certain that the trust is wholly defective with respect to the grantor, and with respect to both ordinary income and capital gains, at least one other grantor trust section of the Code should be violated.

CCH: In assuring that the trust is defective for income tax purposes, but not for estate tax purposes, are there any particular Code provisions you intentionally violate in your trust agreements to accomplish this goal?

Mr. Oshins: I generally violate at least two Code provisions in case one of the "defects" has to be released or renounced sometime in the future, and in case the IRS

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issues an unexpected ruling causing one of the defects to be insufficient. In addition, as you noted in your question, it is very important to use a Code section that makes the trust defective for income tax purposes, but not for transfer tax purposes.

One of my favored Code sections to violate is Code Sec. 675(4)(C), the so-called "swap-out" power. Under Code Sec. 675(4)(C), the grantor is treated as the "owner" of the trust for income tax purposes if given the power, held in a non-fiduciary capacity, to reacquire the trust corpus by substituting assets of an equivalent value. In addition to the "swap-out" power, I also generally violate Code Sec. 674 by giving a non-adverse party the power to add additional beneficiaries, including charities.

CCH: Are there any further enhancements that you use with the defective trust strategy?

Mr. Oshins: Yes, for example the defective trust strategy can be further enhanced if the grantor makes a gift subject to a valuation discount. For example, the grantor could contribute an income-producing asset to a family limited partnership and then gift a limited partnership interest to the trust. The fair market value of the limited partnership interest is discounted for transfer tax purposes from the pro-rata value of the partnership's underlying asset since the partnership interest is not entitled to a vote and is unmarketable. Assuming that an appraisal shows that the limited partnership interest should be valued at a 40-percent discount from the value of the partnership's underlying asset, a 10-percent return on the underlying asset would equate to a 16.67-percent return on the limited partnership interest relative to its value. This enhancement creates additional cash flow that can be used to pay an even larger insurance premium.

The concepts I have discussed so far are relatively simple strategies that can be used as alternatives to the typical *Crummey* trust. Although these strategies can increase the cash flow available to pay the insurance premiums, especially if the trust has only a few legitimate *Crummey* beneficiaries, these enhancements are often not sufficient when the client needs an extremely large life insurance policy. A superior alternative is to use an installment sale to a defective trust, utilizing the same concepts already discussed.

CCH: Could you explain the installment sale technique and provide an example of a scenario in which this strategy could be used to enhance the funding process?

Mr. Oshins: The first step is for the grantor to make a gift to the defective trust of cash or other assets having a fair market value of at least 10 percent of the fair market value of the asset that will be sold to the trust. Since the trust has sufficient assets independent of the asset that will be sold to the trust, the IRS will be less likely to successfully argue that the sale was a sham, or that the sale was a disguised transfer with a retained interest under Code Sec. 2036(a)(1).

After the gift, the grantor enters into a sales agreement with the trustee of the trust to sell an asset, typically subject to a valuation discount, to the trust in exchange for an interest-only promissory note with a balloon payment due after a term of years. If the face value of the note is equal to the fair market value of the asset being sold, and the interest rate on the note is at least equal to the appropriate rate under Code Sec. 1274(d), the sale will not use any additional gift tax exemption. The sale will be income tax free under the holding of Rev. Rul. 85-13 (1985-1 CB 184) since the grantor is transacting with a trust in which the grantor is the "owner" for income tax purposes.

For example, assume that the grantor gifts an asset valued at $650,000 (the amount that can be gifted tax free as of 1999) to a defective trust and allocates $650,000 of gift tax exemption and $650,000 of GST tax exemption so that the trust is wholly exempt from transfer taxes. Further assume that the grantor is a one-percent general partner and a 98-percent limited partner of a family limited partnership that holds assets worth $10 million and that produces a 10-percent cash flow.

Assume that an independent appraisal concludes that a 98-percent limited partnership interest should be valued at a discount of 35 percent because the interests are non-voting and unmarketable. If the grantor sells the 98-percent limited partnership interest to the defective trust for a promissory note with a face value of $6.5 million, there is an immediate estate reduction of the $3.5 million difference between the value of the underlying assets and the face value of the note.

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If the partnership assets and the initial $650,000 gift are both earning 10 percent per annum, then the trust will have a cash flow of $1,065,000 during the first year of the sales transaction. Assuming the note is payable interest-only at the September 1999 Code Sec. 1274(d) long-term rate of 6.25 percent with a balloon payment due at the end of the twentieth year, the annual interest payment due from the trust to the grantor would be 6.25 percent of $6.5 million, or $406,250. Therefore, after the $406,250 interest payment is made to the grantor, the trust would have $658,750 available to pay the first year life insurance premium. Unless the annual premium is greater than $658,750, there will be an additional $658,750 (or more) available each year thereafter to pay insurance premiums.

More realistically, in most cases only a portion of the cash flow in the example above would be used to pay insurance premiums because the insurance need would not be so large as to justify a $658,750 annual premium. For example, if the client's insurance need requires a $200,000 annual premium, the additional $458,750 cash flow in the trust can be used for "opportunity shifting" (see discussion below) and to purchase additional assets from the grantor on an installment basis. If only a portion of the cash flow is used to purchase insurance, the additional cash flow available each year should increase since the additional cash flow may produce even more cash flow. Thus, the installment sale technique is used for estate reduction, as well as life insurance.

CCH: Briefly, what is "opportunity shifting" and how does it fit into the insurance trust funding equation?

Mr. Oshins: Opportunity shifting is the shifting of the opportunity to make money or generate wealth from one person to others, usually descendants or trusts for the benefit of descendants. Many of our clients are frequently presented with business and investment opportunities which, if structured properly using the opportunity shifting technique, can be protected from income and estate taxes, and from creditors, including spouses and ex-spouses.

Most advisors, in counseling their clients with respect to new opportunities to make money, concentrate primarily on the type of entity that should own and invest in the opportunity. However, by taking one additional step—examining who should be the beneficial owner of the entity that owns the business or investment opportunity—the client may be able to shift the opportunity to a defective trust to enhance the cash flow to pay insurance premiums.

CCH: Could you provide our readers with a simple example of how opportunity shifting would work in this context? What would it accomplish?

Mr. Oshins: Assume your wealthy client is a real estate developer who recently made $1 million on her last shopping center project. During your meeting with her to discuss a plan to help her fund a life insurance trust, she mentions that she wants to form a limited liability company (LLC) to own and develop another shopping center with similar investment potential.

She anticipates signing the paperwork to start the project sometime next month. The project will require an investment of $200,000. She anticipates, based on the success of her last project, that the shopping center will be 100 percent occupied with tenants within a year. She says that it should be worth approximately $1.2 million in a year and will produce $150,000 in annual cash flow from the leases.

This set of facts presents a perfect opportunity for the client to gift $200,000 to a trust to buy the land and develop the shopping center. In a year, there will be a $150,000 annual cash flow to pay future insurance premiums. Since the shopping center will not produce any income during the first year, the initial premium can be made from a low interest loan from your client to the trust.

CCH: Are there any practice pointers or cautions you would suggest to anyone contemplating this strategy?

Mr. Oshins: Because the opportunity shifting technique can produce such incredible results, there is a tendency to try to shift opportunities after the opportunities have increased in value beyond the initial cash required for the investment. For example, had the paperwork already been in place in the example above, the land arguably would have already significantly appreciated in value because the transaction may have already gone too far. Once the transaction has progressed to that point, the planning focus should shift towards obtaining an appraisal and then either gifting or selling minority interests in the asset to defective trusts.

I tell my clients to call me as soon as they have a "hot" business or investment opportunity so that I can either help them establish the appropriate trust to own the opportunity or advise them as to which of their existing trusts should own the opportunity. Unfortunately, they often tell me about the opportunity after it has already obtained some or all of its value. If I believe the transaction has already gone too far, I am careful to resist the temptation to "opportunity shift" it out of the client's estate. The best transactions are often the ones that are not made.