Planning for clients who won’t jump through the Gift Tax window of opportunity … for fear they won’t be able to get back in (part 1)

For many years we listened to our wealthier clients express their frustration over the meager amount they could gift to family members, free of gift taxes. In the 1990s, while their wealth was growing at double-digit rates, they were limited to a gift tax exemption between $600,000 and $675,000. Oh, the strategies they would implement “if only” the gift tax exemption were higher. Then came the unexpected “gift” from the IRS – a $5,000,000 gift tax exemption for at least two years.

Cancel your vacation plans ladies and gentlemen; we’re going to need all hands on deck to manage the wave of wealth transfer requests coming our way. And, while some families did decide to take advantage of the opportunity, many more waited on the sidelines. It may be possible that some of these affluent families have not heard the news, but after a year and a half, that’s hard to believe. So we dusted off the presentation we made to them five or 10 years ago, the one they said they would move forward with “if only” the gift tax exemption were higher. Then came the unexpected “gift” from the IRS – a $5,000,000 gift tax exemption for at least two years.

While every client’s situation is different, in our experience, there are three main reasons why these clients are hesitating:

1) Desires to retain sufficient income to continue their standard of living – yes, even wealthy people have concerns over income.

2) Desires to retain control over assets – a lot of wealthy clients have control issues, an attribute that helped them get wealthy in the first place.

3) Uncertainty regarding tax laws – they have a trusted friend, associate or advisor whispering in their ear that the estate tax will be repealed so they don’t need to make a gift. What that trusted relationship forgot to tell them is that gifting isn’t all about estate taxes.

In this article we will explore strategies we have found to be effective in obviating the number one reason clients are hesitating to take advantage of the current opportunity – their desire to retain access to income to continue their standard of living. In the next two Professional Advisor Updates we will address objections number two and three.

The downturn in the economy and slow recovery has spooked a lot of clients who you wouldn’t typically think have concerns over their financial stability. But, that is often the objection that makes affluent clients decide not to make substantial gifts. That has been our experience, and the more advisors we speak with the more we hear the same story. When life insurance is a vital part of the client’s overall estate plan, their lack of planning may not only cause them to miss an opportunity to make a gift-tax-free gift, it may cost them the ability to obtain life insurance at all.

Fortunately, there are numerous ways to take advantage of the higher gift tax exemption while retaining a level of access to the required cash flow. Some are very common planning tools, some require a little more creativity and depend on the makeup of the clients assets. The following are a few concepts to consider for these families:

I. The Survivorship SLAT

A strategy supported by two private letter rulings (PLR 9451053 and PLR 9748029) in which a trust is established by a husband and wife to own a joint-survivor
life insurance policy; one spouse is the grantor of the
trust and the other spouse is the primary beneficiary.
In each of the two PLRs the non-grantor spouse’s
beneficial interest was sufficiently restricted so as
not to be considered an incident of ownership. The
non-grantor spouse can be given the right to receive
distributions subject to an “ascertainable standard”
without causing estate tax inclusion. Another way to
provide income to the beneficiary/spouse is to make
distributions solely within the discretion of an inde-
pendent trustee. Finally, the trustee may be given the
right to lend money to the non-grantor spouse (at the
AFR). The trust should be the applicant, owner and
beneficiary of all life insurance policies. If the policy
is applied for, and owned by, the trust from incep-
tion, the death proceeds should be excluded from the
gross estate.

II. Gift to a trust which allows loans back
to the grantor

A very simple way to mitigate a client’s concerns over
making an irrevocable gift is to make the gift to a
trust, which grants the trustee the right to make loans
to the grantor. As long as loans are required to be
made with adequate interest and the terms are similar
to what a commercial lender would include (in other
words there is an expectation of repayment), there
should be no issues with gift taxes. With interest rates
at historical lows, this simple provision provides a
rather high level of flexibility. If the trust was designed
to acquire life insurance, and you are aware that the
clients are concerned with access to cash, choosing
a product type that has higher cash values would
be appropriate. The trustee will have access to cash
values through withdrawals or loans, which they may
then loan to the grantor, if needed. Withdrawals and
loans from a life insurance policy will have an effect
on the policy’s death benefit, so care should be taken
prior to taking any values out of a policy.

III. Gift a business interest but retain
employment compensation

For families that own an interest in a closely held busi-
ness, a gift of their ownership interests is often the
most effective way to reduce their exposure to estate
taxes. Additionally, it is often the one asset they truly
wish to keep in the family and protect from credi-
tors. Gifting an income-producing asset to a trust is
also very effective when the trust requires ongoing
income to pay life insurance premiums. For tax pur-
poses, it may have made sense for the owners of the
business to keep their compensation levels low and
take a higher distribution of profits. One simple way
to make a gift of their ownership while retaining a
level of income/cash flow they desire is to start taking
higher compensation (keeping it within reasonable
limits based on duties performed for the business)
and let the trust receive the profits. If the clients reach
a financial comfort level in the future they can always
have their compensation reduced.

IV. Gift of business interest with a deferred
compensation plan

If a gift of a business interest is appropriate, and the
owner/client is currently an employee of the business,
they can establish a deferred compensation plan prior
to gifting the business interest. This has two advan-
tages: 1) the client retains access to income from the
asset gifted even after they terminate their employ-
ment, and 2) establishing the plan will create a liabil-
ity on the books of the business thereby reducing its
value for gifting purposes (allowing them to make a
larger gift). The amount of the deferred compensation
must obviously be reasonable. The trust may then
freely use business profits to acquire the needed life
insurance coverage.

V. Splitting a business entity

Many businesses may be split into separate entities.
For example, if the family business is commercial real
estate the owners may create one entity to own the
real estate and a separate real estate management
company. A client who wants to take advantage of the
higher gift tax exemption levels, but wants to retain
access to income, may gift the real estate and retain
ownership of the management company. As the real
estate values grow, the appreciation will be out of the
client’s estate. This type of planning may be applied
to any number of different types of businesses. For
example, a family could split their business into an
entity that owns the plant, equipment, inventory, etc.
and a separate entity that owns the land the business
sits on. They could then gift an ownership interest
in the business and have the business lease the land
thereby providing income to the family.

VI. Capped GRAT

One of the most common techniques for transferring
wealth is a grantor-retained annuity trust. The best
asset to contribute to a GRAT is one that is expected
to appreciate greatly. But, if the client is concerned about future income, they may not want to transfer all the growth in the asset contributed. The grantor may place a cap on the amount that will pass to the remainder beneficiary, either by stating a specific dollar amount or a percentage of the remaining balance, with any excess returning to the grantor. This will not affect the value of the remainder for gift tax purposes and may provide assurances to the grantor that if the asset really does appreciate greatly they will be rewarded financially.

VII. Premium financing/GRAT combination

One way for a client to acquire life insurance coverage without reducing their income is through a third-party premium financing arrangement. A critical design factor in implementing a premium financing arrangement is determining how the trust that owns the policy and takes out the loan will repay the loan. By naming the life insurance trust as the remainder beneficiary of a GRAT, the client may effectively provide the life insurance trust with the funds necessary to repay the loan. With this combination of strategies the client retains their desired level of income, uses third-party dollars to pay the premium, and uses the growth in the asset contributed to the GRAT to repay the loan. The result is the retention of adequate income and estate-tax-free life insurance benefits for their heirs.

The strategies listed above are only a few of the many ways in which clients may take advantage of the higher exemption levels while retaining flexibility and access to income. Many of the ideas are simple, but with only a few months remaining until 2013, simple may be the best way to go as there may not be sufficient time to introduce and implement complex strategies.