LIFE INSURANCE PLANNING OPPORTUNITIES

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Dallas Estate Planning Council

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Mr. Blum founded The Blum Firm, P.C. over 40 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine. He is Treasurer for the Texas Cultural Trust.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

Spousal Lifetime Access Trusts with Life Insurance

- The most popular way for married couples to use each spouse's gift/estate tax exemption before the doubled exemption amount cuts back in half in 2026 is for each spouse to create a SLAT (Spousal Lifetime Access Trust) for the benefit of the other. Each spouse's gift would use part or all of their lifetime exemption amount, depending on the amount of assets transferred.
- Assets held in the SLAT would not be included in either spouse's estate at death. Think of it as a "lifetime bypass trust" for the benefit of a spouse.
- This locks in the higher lifetime gift and estate tax exemption before it sunsets in half, yet the spouses continue to benefit from the assets removed from their estates.
- The two SLATs must be substantially different to avoid the Reciprocal Trust Doctrine.

- For example, Husband and Wife enter into a marital property agreement in which they agree to convert a portion of their community property into two separate property halves.
- Husband creates a trust for the benefit of Wife and funds it with $12,000,000 of his separate property. Wife has access to her SLAT for her needs during her lifetime. After her death, the remaining assets are split into separate trusts for the children.
- At a later date (the more time, the better), Wife creates a separate trust for the benefit of Husband and funds it with $12,000,000 of her separate property. Husband has access to his SLAT for his needs during his lifetime. After his death, the remaining assets are split into separate trusts for the children.

- While both Husband and Wife are alive, the married couple retains access to the full $24,000,000. However, after the first death, the survivor only has access to $12,000,000.
- To replace the lost assets, each SLAT could buy a $12,000,000 life insurance policy on the life of the other spouse.
- If Husband dies first, at his death, Wife continues to benefit from her SLAT, plus her SLAT collects $12,000,000 on Husband's life, so her access to the full $24,000,000 isn't diminished when Husband dies.
- If Wife dies first, at her death, Husband continues to benefit from his SLAT, plus his SLAT collects $12,000,000 on Wife's life, so his access to the full $24,000,000 isn't diminished when Wife dies.

"Tax Fence" with SLAT Planning

ASSETS INSIDE ESTATE
Subject to 40% Estate Tax and Creditor Claims

PERSONAL ASSETS
(HOUSEHOLD ITEMS, BANK ACCTS, ETC.)

RETIREMENT ASSETS
(PROTECTED FROM CREDITORS)

PERSONAL RESIDENCE
(PROTECTED FROM CREDITORS)

TAX FENCE

ASSETS OUTSIDE ESTATE
Protected from 40% Estate Tax and Creditor Claims

HUSBAND'S SLAT

WIFE'S SLAT

Husband's SLAT

- Created by Wife to benefit Husband
- Holds $12m of assets which Husband has access to for his lifetime
- Owns $12m life insurance policy on Wife's life

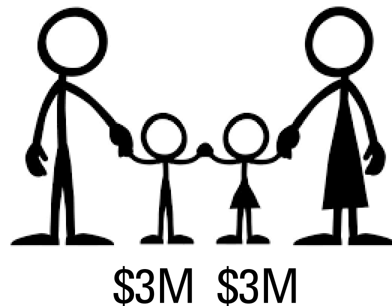
Wife's SLAT

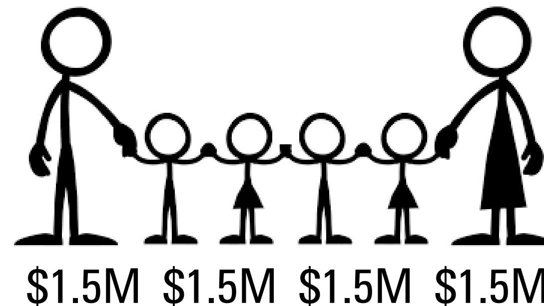
- Created by Husband to benefit Wife
- Holds $12m of assets which Wife has access to for her lifetime
- Owns $12m life insurance policy on Husband's life

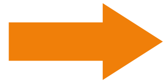
Do You Love Your Grandchildren Equally?

- Do you love your grandchildren equally? With a traditional per stirpes inheritance, grandchildren with more siblings will receive less than grandchildren with fewer siblings.

- Assume G-1 has a son with 2 children, a daughter with 4 children, and a $12 million estate. After G-1 dies, the son and daughter each receive $6 million. However, after G-2 dies, the son's children each receive $3 million while the daughter's children each receive $1.5 million.







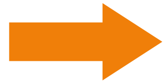
- To lessen this blow on the cousins, consider taking out a life insurance policy that goes to all the grandchildren per capita.
    - The policy can be on G-1's life for the benefit of G-3 per capita, paid to G-3 at G-1's death.
    - Or, the policy can be on G-2's life for the benefit of G-3 per capita, paid to G-3 at G-2's death. Doing a policy on G-2 instead of G-1 would provide more coverage since G-2 is younger. With this scenario, G-1 can either pay the premiums as a gift or can lend money to G-2 to pay the premiums.
- Consider a second-to-die policy on G-1 for the benefit of G-3 per capita which will be paid at the death of the surviving G-1 grandparent.
- The rest of the estate plan remains intact. This creates new assets to use for gifting to G-3 without disrupting G-2's inheritance.

Blended Families Require Extra Considerations

Don’t Pit Stepchild Vs Stepparent

- Assume Husband has children from a prior marriage.
- Husband dies, leaving his estate in trust for Wife with the remainder at the time of Wife’s death going to Husband’s children.
- Husband’s children will not receive any inheritance while Wife is still living. They have to wait for their stepmother to die in order to receive their inheritance.
- This is particularly problematic if the surviving spouse is significantly younger than the predeceasing spouse. This waiting period may stretch into decades.

- Also, Husband's children may constantly challenge Wife's entitlement to distributions from the bypass trust. As remainder beneficiaries, they want the highest amount possible of trust assets to be remaining in the trust when Wife dies.



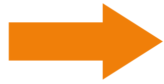
- Utilize life insurance to provide an inheritance for Husband's children from his prior marriage.
    - If life insurance is sufficient to provide for the children's entire inheritance, Husband's entire estate can pass to Wife outright.
    - Even if the life insurance covers only a portion of the children's inheritance with the rest paid to them at Wife's death, the life insurance provides some upfront inheritance, so the children don't have to wait until their stepmother dies to receive something.

My Spouse Would Never Cut Out My Kids (Right?)

- Assume Husband and Wife both have children from prior marriages. They want their estates to benefit the surviving spouse for the spouse's lifetime and then all of their children equally.

- Both of their estate plans provide that, at the first death, assets pass to a trust for the survivor. The trust gives the survivor a global special power of appointment (SPOA) among anyone other than the survivor or creditors. If the SPOA is not exercised, the second-to-die's estate will pass to all of their children, divided equally.

- The possibility exists that, when Husband dies first, Wife could change her estate plan and exercise the power of appointment over the trust to cut out Husband's children.



- Instead, Husband and Wife could establish an ILIT (Irrevocable Life Insurance Trust) for the benefit of all of their children and provide for the ILIT to purchase a joint and survivor policy.
  - The children could be given Crummey withdrawal rights exercisable over Husband's and Wife's contributions to the ILIT to minimize the use of Husband's and Wife's gift tax exemptions on contributions.
  - The insurance proceeds payable at the surviving spouse's death would be divided equally among separate dynasty trusts for the children.
  - To the extent Husband and Wife allocate their GST tax exemption amounts to their contributions to the ILIT, a child's dynasty trust created thereunder (and subsequent trusts created for the next generations) would be forever exempt from transfer taxes.
  - The ILIT locks in an inheritance that benefits all the children equally, even if the surviving spouse disrupts a separate portion of the estate.

Equal or Equitable Between Sets of Children?

- What if some of your children are significantly older than others and have already received substantial financial support from you, such as you've already paid for them to attend college or set aside money in a 529 Plan.
- For example, Husband has adult children from his first marriage and young children from his second marriage. He wants the inheritances his children will receive at Wife's death to be "equitable," which is different from equal.
- Husband can purchase a life insurance policy to benefit his children from his second marriage as an "equalization" gift to account for college expenses or other financial support previously given to the children from his prior marriage..
- The ILIT can convert to equal distributions among all the children if the younger children are fully educated by the time Husband dies.
- Husband's Will can divide the non-ILIT assets equally among all the children.

Use of Life Insurance in Prenup Planning

- Husband enters marriage with substantial separate property, such as a legacy asset like a family business he received from his parents. Husband's family wishes to preserve that legacy asset for the parents' descendants.
- The couple enters into a prenup to preserve that separate property, along with any future income on such property, as Husband's separate property.
- To provide Wife with assurance she'll have financial security upon Husband's death, Husband agrees in the prenup to provide life insurance on his life benefitting Wife.

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Quandary Over IRA Beneficiary

- Wife has children from a prior marriage and marries her new Husband.
- The bulk of Wife's assets are in an IRA.
- Wife would like to provide an inheritance for both Husband and her children. She is considering designating a trust as beneficiary of the IRA.
- Designating a trust as beneficiary would deprive Husband (as a potential "Eligible Designated Beneficiary") of the ability to stretch out the IRA distributions over his life expectancy.
- Wife names Husband as IRA beneficiary and takes out a life insurance policy on her life to benefit her children.

Utilizing Intergenerational Loans to Reduce Estate Taxes and Preserve Basis Step-Up

- For clients who own highly-appreciated assets, the problem with traditional techniques (such as gifts/sales of the assets to defective grantor trusts) is that by removing the assets from the estate, you sacrifice a basis step-up when the client dies.
- The trade-off for getting assets out of the estate is to expose the family to a 23.8% tax on the capital gain when the asset is sold after the client dies.
- Intergenerational loan planning can reduce estate tax without having to forego a stepped-up basis.

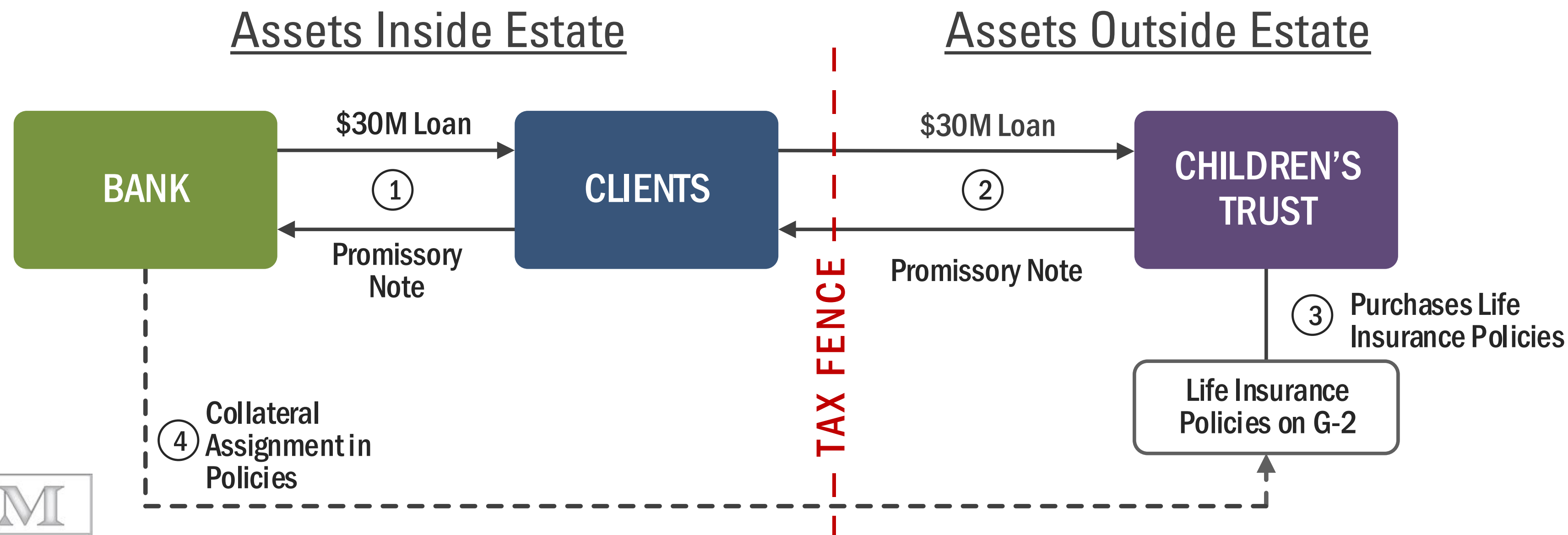
- For example, clients own a $30 million ranch with a $10 million basis and approximately $5 million of other assets (house, etc.).

  (1) Clients borrow $30 million from their bank.

  (2) They loan the $30 million to their Children's Trust (non-grantor trust) in exchange for promissory note (at the long-term Section 7872 rate) due at the death of G-2.

  (3) Using the $30 million, Children's Trust purchases life insurance policies on G-2.

  (4) The bank takes a collateral assignment in the policies.



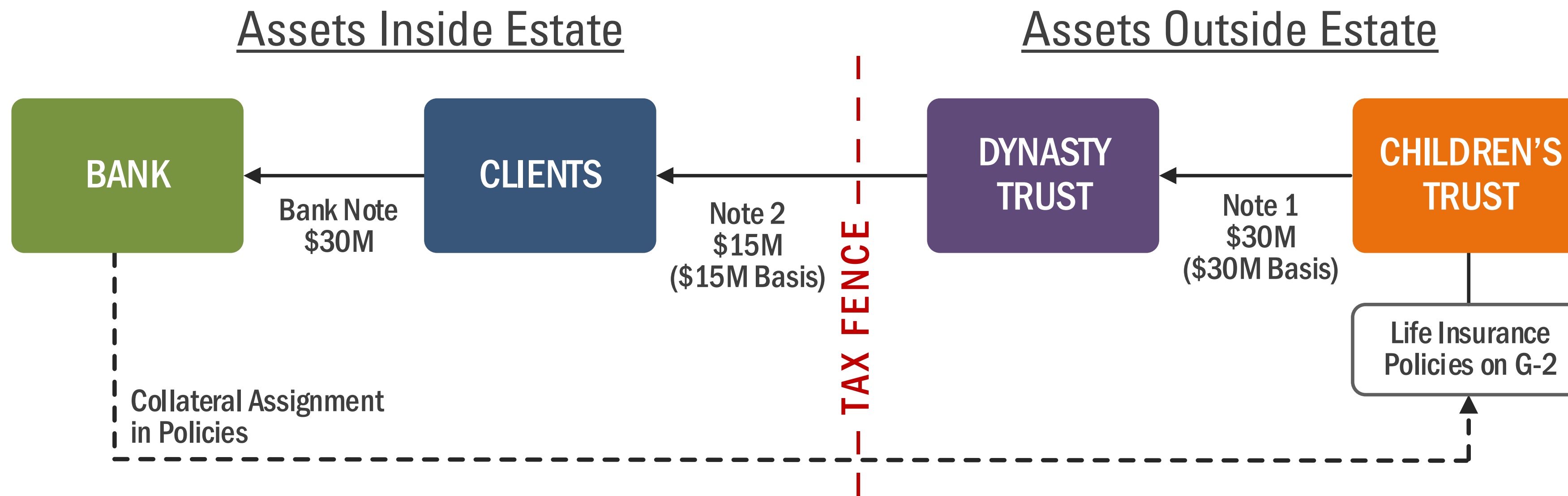
- The bank is able to charge a lower LIBOR-based interest rate on the note owing from the clients because of the collateral assignment.
- The insurance policies will be unusually structured in that they will have a very high cash surrender value while also having the least amount of death benefit possible without violating IRS life insurance corridor rates.
- The estate holds the $30 million note owing from the Children's Trust. Because of the locked-in low rate and long but uncertain duration, the note receivable would be highly discounted (assume 50%).

- At the clients' deaths, their taxable estate will be zero.

	Before	After
Assets		
Ranch	$30,000,000	$30,000,000
$30M Note Receivable (discounted)		15,000,000
Other Assets	5,000,000	5,000,000
Liabilities		
Note Payable to Bank		(30,000,000)
Net Worth of Estate	35,000,000	20,000,000
Less Lifetime Exemptions	(25,840,000)	(25,840,000)
Taxable Estate	$9,160,000	$0

- G-2 will receive a step-up in basis in the ranch to $30 million. If G-2 sells the ranch, no income tax will be due following the sale.
- We've reduced the taxable estate, and we've received a basis bump for the ranch. BUT, at the clients' deaths, the note receivable will receive a step-down in basis to $15 million. When the note is later repaid, the estate will owe income tax on the $15 million capital gain.
- Is there a way to avoid this?
- Instead of the clients retaining the note until death, two to three years after the loans are made, the clients will want to sell the note ("Note 1") to a new grantor trust for the benefit of G-2 and G-3 (the Dynasty Trust").

- The clients sell Note 1 (the $30 million note receivable owing from the Children's Trust to the clients) to the Dynasty Trust in exchange for a $15 million promissory note ("Note 2").
- Note 2 would have an adjustable rate and different terms than Note 1 and would not be valued at a discount.



- Since the clients sell Note 1 while the clients are still alive, Note 1 still has a $30 million basis. The clients avoid a basis step-down on Note 1 by getting it out of their estate before either of them dies.
- Since the sale is to a Dynasty Trust that is a grantor trust as to the clients, the sale is ignored for income tax purposes.
- The Dynasty Trust now owns Note 1 with a basis of $30 million.
- The clients own Note 2 with a fair market value of $15 million.

- At the clients' deaths, their taxable estate will still be zero.

Assets	
Ranch	$30,000,000
$15M Note Receivable (no discount)	15,000,000
Other Assets	5,000,000
Liabilities	
Note Payable to Bank	(30,000,000)
Net Worth of Estate	20,000,000
Less Lifetime Exemptions	(25,840,000)
Taxable Estate	$0

- The ranch will still receive a basis step-up so no income tax will be due following a sale.

- After the clients' deaths, the Children's Trust can cash in the life insurance policy and pay off the $30 million Note 1 it owes to the Dynasty Trust.
- Since Note 1 is out of the clients' estate, there is no basis step-down and the basis of Note 1 remains $30 million. Therefore, there is no gain when Note 1 is repaid.
- The Dynasty Trust uses $15 million to pay off Note 2 owing to the clients' estate.
- Note 2 had a $15 million fair market value at the clients' deaths, so it now has a $15 million basis. Therefore, there is no gain when Note 2 is repaid.
- The Dynasty Trust uses the extra $15 million it received to buy assets from the clients' estate, providing the estate with liquidity to pay back the bank. There is no tax since the assets in the estate have a stepped-up basis.

Mixing Bowl Partnership Planning to Use Appreciated Asset to Buy PPLI with No Taxable Gain

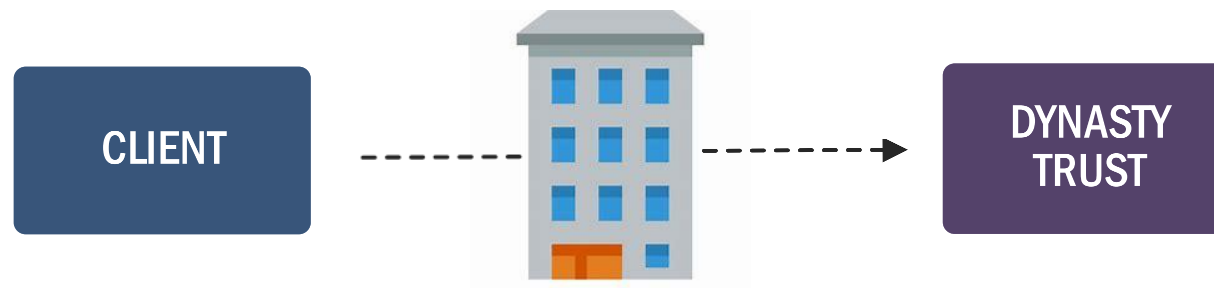
- "Mixing Bowl Planning" occurs when a partnership distributes property in a way that increases or decreases the basis of one partnership asset and triggers a corresponding decrease or increase in the basis of another partnership asset.
- Assume a client is interested in the income tax benefits of owning Private Placement Life Insurance ("PPLI") and wants to sell an appreciated asset to purchase PPLI, but he doesn't want to pay any capital gains tax on the sale of the asset.
- Example: The client owns a commercial building with a fair market value of $1,000,000 and a basis of $100,000.

Step 1: Loan From Bank

- The client borrows $1,000,000, secured by the building.

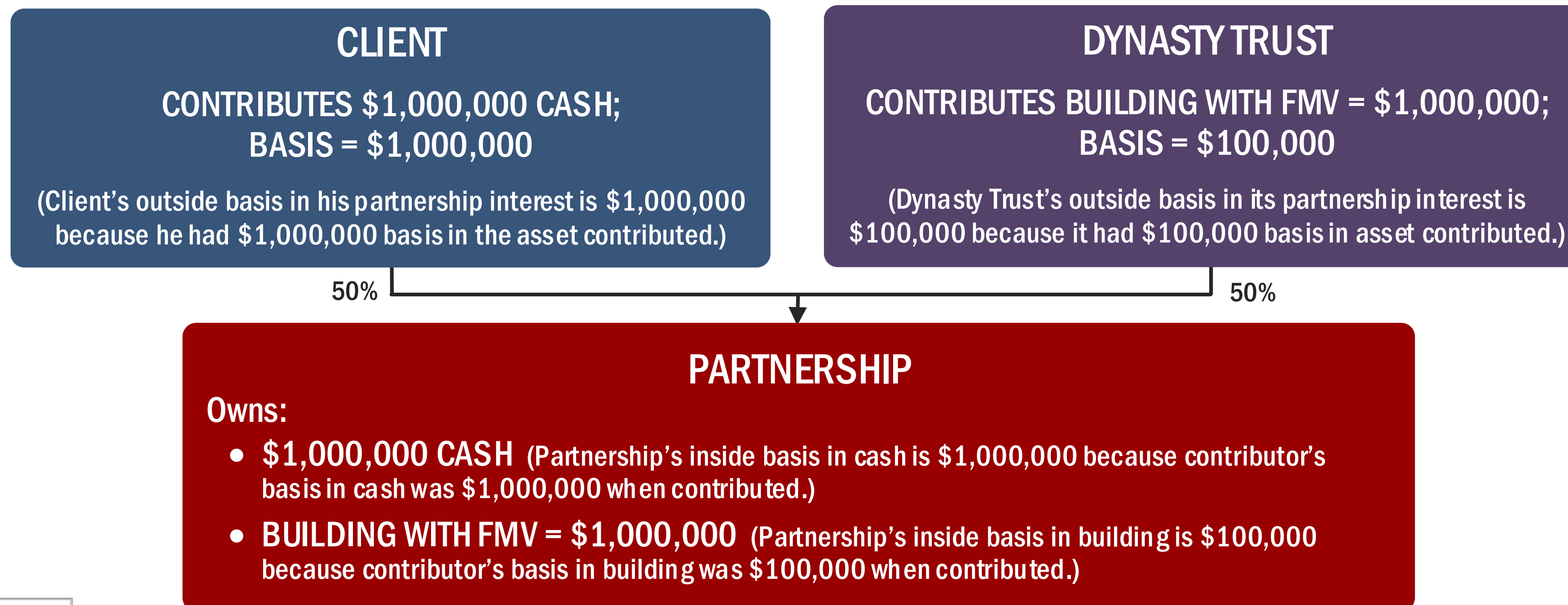
Step 2: Gift Asset to Complex Dynasty Trust

- The client gifts the commercial building (with a fair market value of $1,000,000 and a basis of $100,000) to a complex dynasty trust, which retains the $100,000 basis. (Note: The dynasty trust is a non-grantor trust, so it can later join with the client in creating a partnership that will be a true partnership for tax purposes.)
- The client agrees to remain responsible for paying off the loan, so the trust isn't burdened with the obligation to pay off the loan.
- The client files a gift tax return to report the gift of the building, eating up $1,000,000 of his lifetime exemption.



Step 3: Form Partnership

- The client and dynasty trust enter into a partnership agreement.
- The client contributes the $1,000,000 cash to the partnership in exchange for a 50% partnership interest.
- The dynasty trust contributes the building to the partnership in exchange for a 50% partnership interest.



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Step 4: Buy PPLI

- The partnership uses the $1,000,000 cash to buy PPLI on the life of the client with an assumed $2,500,000 death benefit.
- Note: The purchase should be structured where premiums are paid over time, so that the policy is not a modified endowment contract—a “non-MEC” policy.
- Note: Draft the partnership agreement and the trust so that the insured has no incidents of ownership over the policy.

PARTNERSHIP

Owns:

- PPLI WITH FMV = $1,000,000 (Partnership’s inside basis in PPLI is $1,000,000.)
- BUILDING WITH FMV = $1,000,000 (Partnership’s inside basis in building is still $100,000.)

Step 5: Liquidate After at Least 7 Years

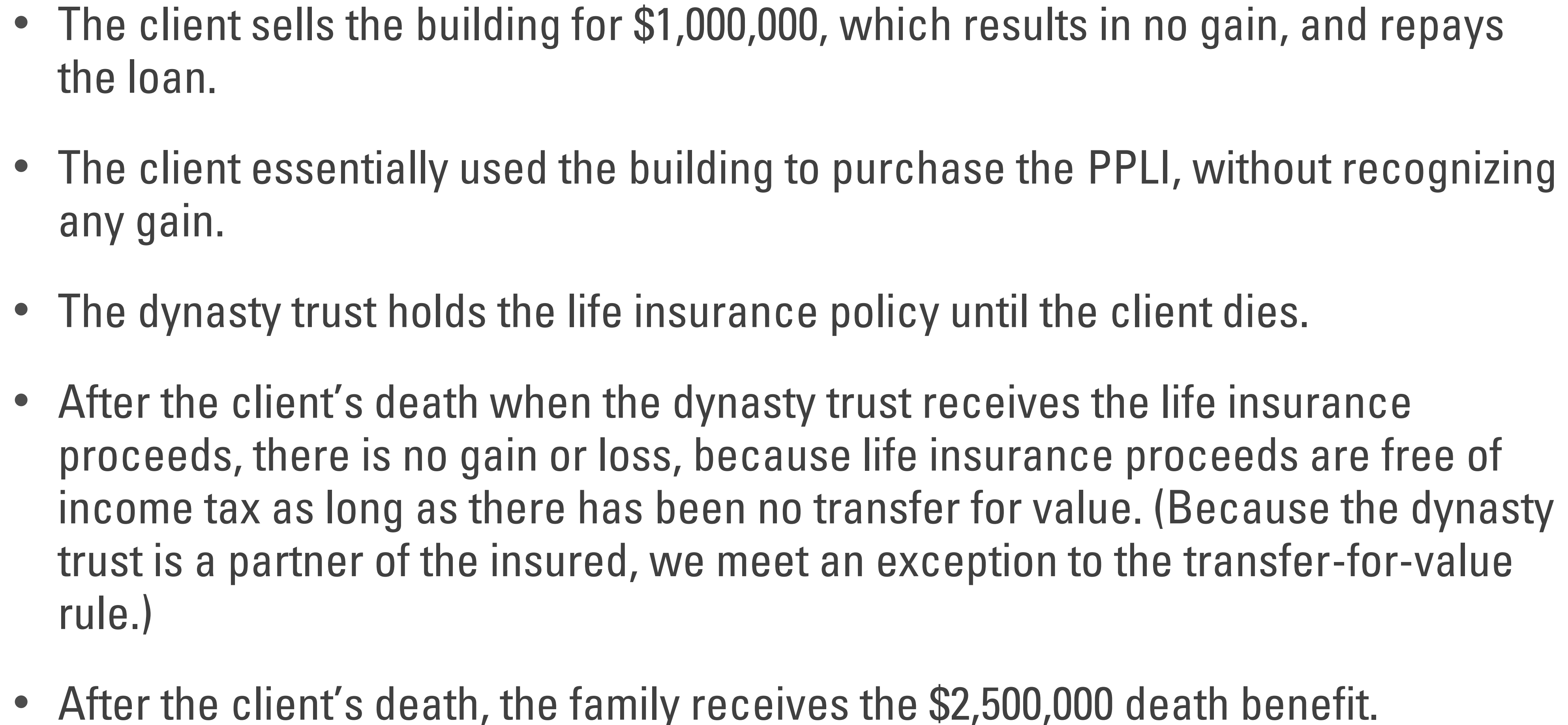
- Seven years later, the partnership is liquidated.
- The building is distributed to the client in liquidation of his partnership interest. When the client receives a liquidating distribution, the non-cash assets he receives take the basis of his partnership interest, reduced by any cash received. In this case, the building's basis becomes equal to the client's $1,000,000 outside basis.
- The PPLI distributed to the dynasty trust takes the trust's outside basis in the partnership of $100,000.

CLIENT

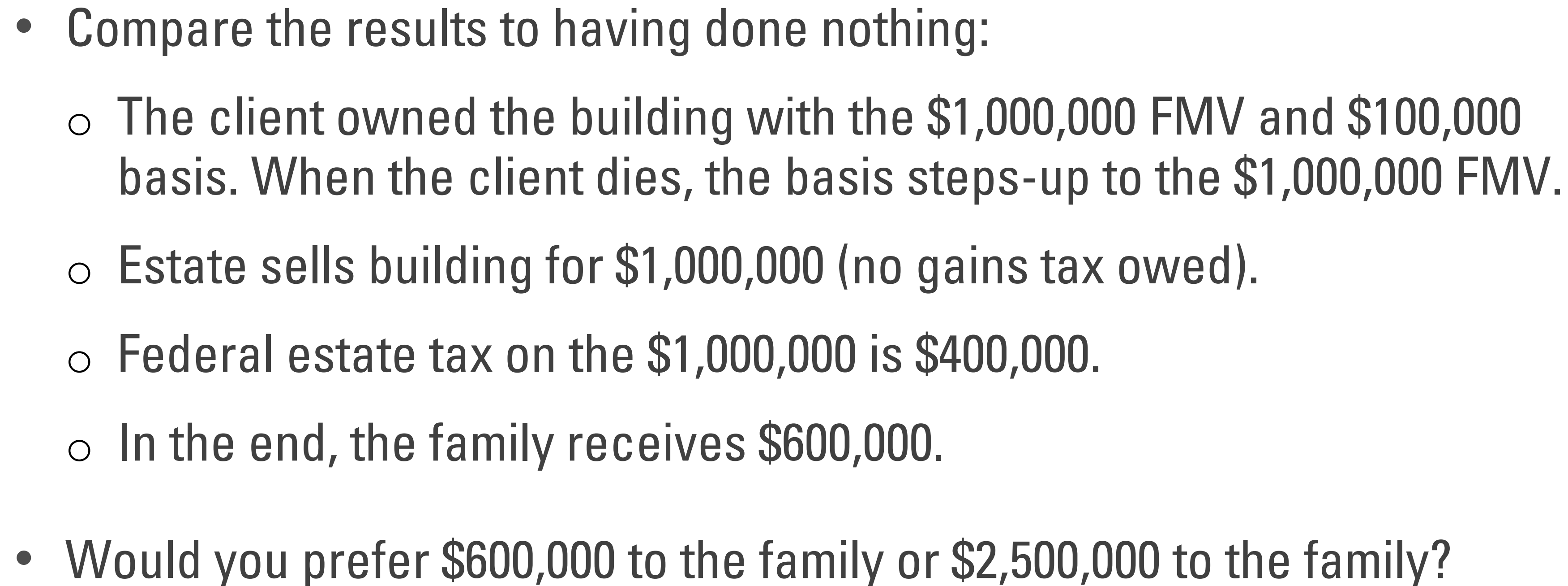
BUILDING
WITH FMV = $1,000,000 CASH
AND BASIS = $1,000,000

DYNASTY TRUST

PPLI
WITH FMV = $1,000,000
AND BASIS = $100,000


Step 6: Sell Asset
The client sells the building for $1,000,000, which results in no gain, and repays the loan.
The client essentially used the building to purchase the PPLI, without recognizing any gain.
The dynasty trust holds the life insurance policy until the client dies.
After the client's death when the dynasty trust receives the life insurance proceeds, there is no gain or loss, because life insurance proceeds are free of income tax as long as there has been no transfer for value. (Because the dynasty trust is a partner of the insured, we meet an exception to the transfer-for-value rule.)
After the client's death, the family receives the $2,500,000 death benefit.

- Why the seven-year period? Section 704(c) of the partnership contribution rules works to prevent contributing partners from shifting built-in gains to another partner.
  - Under the mixing bowl rules at §704(c)(1)(B), if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.
  - Similarly, Section 737 imposes a tax on net pre-contribution gain where any partner contributes appreciated property to any partnership and, within seven (7) years, receives a distribution in excess of the basis of his partnership interest.



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Before Cancelling Policy, Consider Life Settlement

- A life insurance policy is an asset that can be sold. Under certain conditions, the policy may sell for significantly more than its cash surrender value ("CSV").

- Example 1:
  - $10,000,000 Survivorship Policy
  - Male age 82 & female age 79
  - $69,000 CSV
  - $2,800,000 life settlement value

- Example 2:
  - $7,500,000 Guaranteed Universal Life Policy
  - Female age 78 insured
  - $0 CSV
  - $1,300,000 life settlement value

Optimizing a Life Insurance Policy's Value

- Most life settlements are on insureds age 71 or older (or under age 71 with health impairment).
- Most policies sold are Universal Life, enabling the buyer to fund the policies with flexibility.
- Term policies can also have value, especially if it's a convertible term.
- PPLI and traditional whole life are not candidates for settlement.
- Avoid taking offers from the insurer or brokers who represent the buyer of the policy. Especially watch out for TV ads providing a 1-800 phone number.
- Engage a broker who represents the seller. Options include:
  - Ashar Group (Jamie Mendelsohn)
  - Treyled Life Settlements LLC (Tama Klosek)
- Ideally, begin the process at least six months before the next premium is due, to give the broker time to create the auction.

Income Tax Consequences of Life Settlement

- **No Tax** – On amount received up to policy's basis (sum of premiums paid without reduction for costs of insurance).
- **Ordinary Income Tax** – On amount received above basis to the extent CSV exceeds basis.
- **Long Term Capital Gain Tax** – On amounts received above basis and in excess of CSV.
- **No Tax on a "Viatical" Settlement** – Sale of a policy on terminally ill insured (requires physician's certification of life expectancy of 24 months or less). Purchase must be a viatical settlement provider as in IRC Section 101(g)(2)(B).
- Example: Policy with $40,000 basis/$60,000 CSV sells for $100,000 (non-viatical sale)

First $40,000	No tax
Next $20,000	Ordinary income
Next $40,000	Long term capital gain

Warning to ILIT Trustees

- Trustees have a fiduciary duty to monitor policies owned by the trust.
- Surrendering a policy or allowing a policy to lapse that could have been sold in a life settlement could give rise to liability exposure.
- Trustees need to recognize life insurance as an asset to be managed like any other asset in a trust.
- Trustees of trusts owning life insurance need to be educated on life settlements in order to preserve trust value, especially before they ever cancel a policy.

Utilizing Life Insurance to Fund a "FAST" (Family Advancement Sustainability Trust)

- The estate planning world is shifting to include qualitative goals such as having a "successful" family—one that's physically and emotionally healthy, productive, and connected for generations to come.
- Baby Boomers are asking: "To what end have I created this wealth?"
- While the process of estate planning continues to focus on technical factors (tax, asset protection, etc.), there is an evolving call to add to that planning model a focus on clients' qualitative goals and the need to not only prepare the estate for the heirs but to also prepare the heirs to responsibly receive, manage, maintain, and pass on the estate.

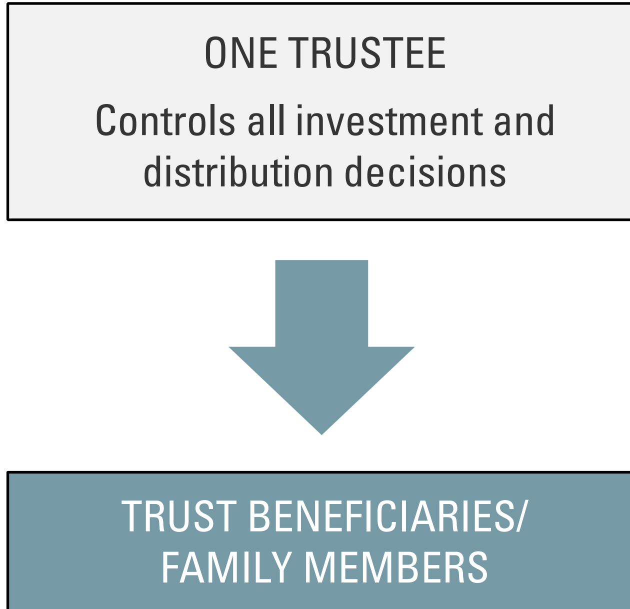
- Historically, most wealthy families squander away their fortune—70% by the second generation and 90% by the time it's passing to the fourth generation. Hence, the "Shirtsleeves to shirtsleeves in three generations" proverb.
- The most common reasons for wealth transfer efforts to fail:
  - Lack of communication and trust
  - Unprepared heirs
- Study successful families to identify common best practices:
  - Hold family meetings and family retreats
  - Work to preserve the family's history and heritage
  - Have a system of family governance (such as how family decisions are made)
  - Set up an advisory board of the family's "go to" advisors
  - Have a process to educate the heirs

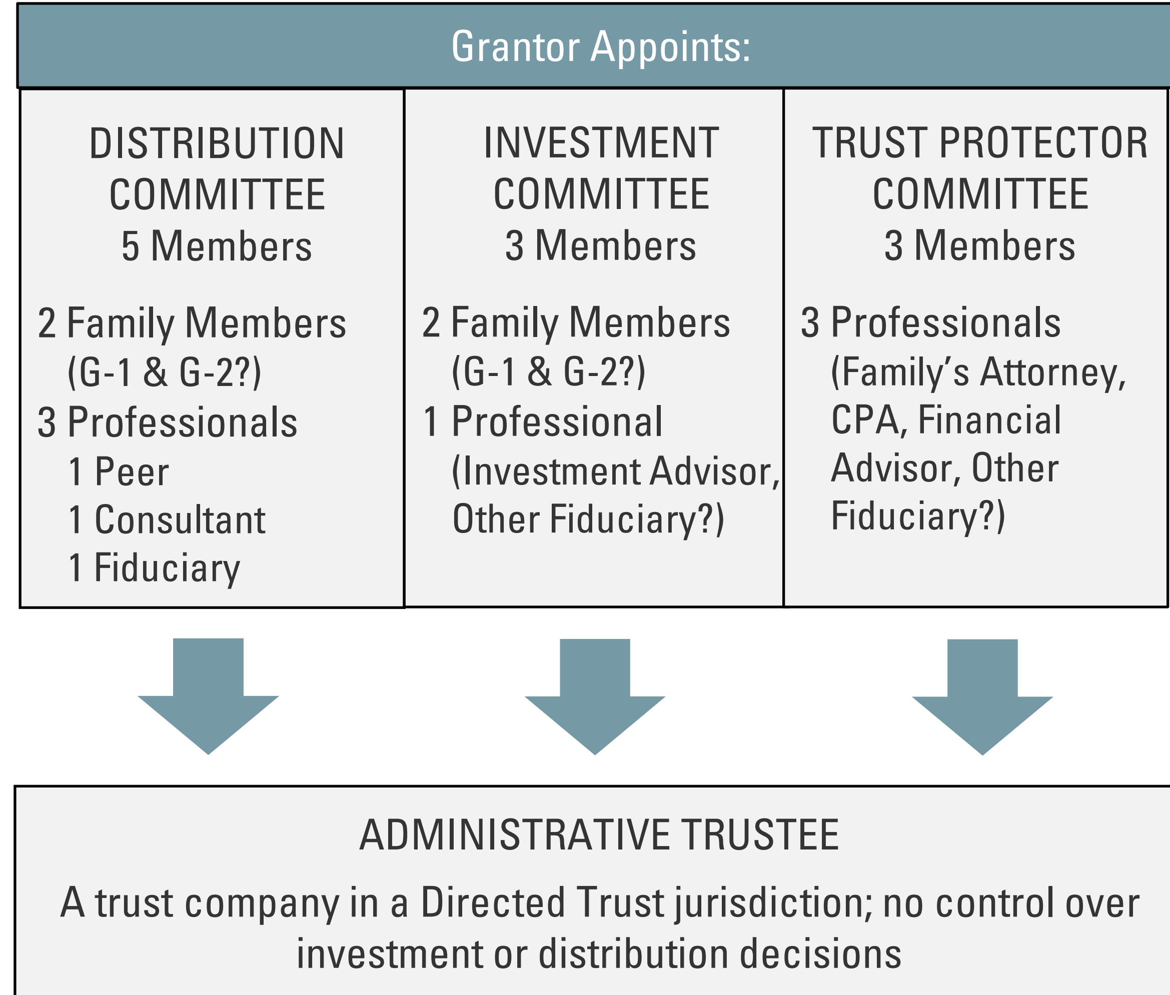
- Often the patriarch and matriarch of a family begin these best practices, pay for them, and make them happen. A problem is that after the patriarch and matriarch are gone, the children drop the ball and don’t want to pay for these activities or take the time to do them.
- It takes more than G-1’s hopes and dreams for future generations to succeed. Don’t leave it to chance. Hope is not a strategy.
- G-1 needs to be intentional and implement a practical solution.
- A Family Advancement Sustainability Trust (FAST) is a type of trust dedicated to saving the family.

- A FAST **provides FUNDS**
  - Funds for future generations to use to prepare heirs to be able to successfully manage an inheritance
  - Funds for family endeavors to keep the family together after the elder generation dies, such as family retreats and family meetings
  - Funds to train future generations on concepts like philanthropy and being responsible stewards
- A FAST **provides LEADERSHIP**
  - Creates a leadership structure to ensure these activities happen, using a system of trustees and committees who are paid to run the FAST and charged with the responsibility for carrying out these tasks

Structure of a FAST

- A Dynasty Trust created in a state with Directed Trust laws which allows decision-making authority to be split up among separate co-trustees, advisors, or trust protectors.
- This allows family members and trusted advisors to directly participate in the governance of trust.
- A FAST contains four separate decision-making bodies:
  - Administrative Trustee
  - Distribution Committee
  - Investment Committee
  - Trust Protector Committee





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Funding the FAST

- A FAST should be created during the patriarch's and matriarch's lifetimes to allow G-1 to mold the trust.
- While G-1 is alive, G-1 usually pays for FAST activities out of their pocket.
- The funding amount will vary from family to family according to their means and their agenda.
- A FAST can work for a family of any size. This is not just for the mega-wealthy.
- It may be minimally funded with lifetime gifts, with additional funding pouring over upon the death of G-1 (either a fixed amount or a percentage of the estate). This funding amount at G-1's death could be designed to be enough to last forever or could be only enough for a generation with the plan to replenish at each generation.

- New Life Insurance Policy is Efficient Way to Fund a FAST
  - A stand-alone, special-purpose ILIT could hold a life insurance policy on the patriarch, the matriarch, or the second-to-die and funnel additional funds into the FAST at G-1's death.
  - Using life insurance preserves the rest of the family's assets for distributions (traditional inheritance).
  - It also leverages lifetime estate/gift tax exemption so there's no estate tax cost and leverages GST exemption, so the FAST is fully GST-exempt.
  - The FAST could also be drafted to own the life insurance policy rather than using a separate ILIT.
  - For the life insurance portion, you'd want to be sure none of the insureds have incidents of ownership, so draft it to keep the life insurance in a separate trust pocket managed entirely by non-family trustee(s).
  - If the FAST were to be funded with only enough to last one generation, the FAST could also own life insurance policies on the lives of G-2 and G-3. Each policy could provide enough funds for the next generation.

- Funding with Legacy Real Estate Assets
  - In addition to funding the FAST with liquid assets, the FAST can also be the ideal owner of a family's legacy real estate asset such as a family ranch or lake house.
  - Use life insurance to generate sufficient funds to maintain the property.
  - The FAST establishes rules for shared use.
  - This keeps the asset in the family.
  - Note: Segregate real estate in a separate entity (such as an LLC owned by the FAST) to insulate other FAST assets from liability exposure related to the real estate asset.

- James Grubman (Family Legacy expert) uses a football analogy to perfectly illustrate the issue:

  > Think of a football game. The focus is on the quarterback. The quarterback has perfect throwing skills. The football (the inheritance) is perfectly thrown to receivers at the other end of the field. But, no one has prepared the receivers. In fact, they don't even tell them the ball is coming. As the ball comes their way, the receivers don't know how to catch it or what to do next if they do catch it. What are the odds the receiving team will catch the ball and carry it down the field to score a touchdown?

- The Family Advancement Sustainability Trust is the vehicle to make sure the heirs are prepared when the football comes their way.

Questions?

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