Pouring Old Wine into New Bottles - Using Traditional Estate Planning Tools in Untraditional Ways

Pouring Old Wine into New Bottles - Using Traditional Estate Planning Tools in Untraditional Ways

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Many estate planners have concluded that the famous proclamation from the Book of Ecclesiastes that "there is no new thing under the sun" is applicable to their planning strategies. The conventional wisdom provides that there are well known legal strategies and financial tools that have been thoroughly explored and that may be appropriate in particular, predicable circumstances. Most financial advisors, accountants and attorneys who assist clients in the estate planning process are familiar with tools such as revocable living trusts, irrevocable life insurance trusts and family limited partnerships. Those advisors understand that revocable living trusts are useful probate avoidance devices; that irrevocable life insurance trusts can keep life insurance proceeds out of the client's taxable estate and that family limited partnerships may help discount the value of assets for estate tax and gift tax purposes.

Often these strategies are viewed solely through the lens of estate tax avoidance. However, changes in the estate tax laws starting with the adoption of the Economic Growth and Recovery Tax Act of 2001 ("EGTRA") have made federal estate tax concerns less relevant than ever before. Moreover, it is possible that further legislative changes may yet increase the federal estate tax exemption significantly above its current $2,000,000 level and may reduce the federal estate tax rate below its present 45% rate. These changing circumstances suggest that estate planning professionals should take a broader view of the estate planning process and that attorneys, accountants, financial advisors and others involved in the estate planning process should work in a collaborative manner to better advance the interests of their clients.

The purpose of this article is to point out new uses for some well known estate planning strategies and to demonstrate that better results may be obtained by coupling those strategies with appropriate financial tools (such as life insurance policies and annuities) to fulfill clients' estate planning objectives. We will look at some specific examples that join one or more legal entities such as revocable and irrevocable trusts with particular financial tools that yield a better result for the client than either the legal entity or the financial tool would by itself. The legal strategies we will focus on are time tested; we are for all intents pouring old wine into new bottles by finding new uses for these strategies and coupling them with appropriate financial tools. The authors firmly believe that the best results are obtained through a team approach where the entire group of advisors (including the client's attorney, accountant, and financial advisor) are all engaged in working to achieve the client's best interests. Such a team approach requires that each member of the team have some familiarity with the tools, tactics and strategies recommended by the other members of the team. The authors have also concluded that the most satisfactory method for determining the client's best interests and planning objectives is through the use of comprehensive questionnaires addressing the client's concerns and anxieties and through conferences including the client and the other members of the planning team.

The Stand-Alone Education/Retirement Accumulation Trust ("SAAT")

Many clients have expressed the desire to fund higher education expenses for their children or grandchildren. Often those clients have used Uniform Gifts to Minors Act ("UGMA") or Uniform Transfers to Minors Act ("UTMA") accounts as a means to accumulate funds for education purposes. UGMA and UTMA accounts are less attractive today than in the past due to the compression of income tax rates and the expansion of the "kiddie tax" to persons under the age of 18 rather than merely those under the age of 14 as in prior years. Moreover, the income earned in UGMA and UTMA accounts is currently taxable. One useful alternative for funding higher education expenses is the Section 529 College Savings Plan. Section 529 plans allow the grantor to make gifts that qualify for the annual gift tax exclusion or to fund substantially in excess of the annual gift limits. Funds invested in Section 529 plans grow in a tax-free environment,are estate tax free and funds paid from Section 529 plans for qualifying education expenses are not subject to federal income tax when withdrawn.

If Section 529 plans are so useful, why hasn't every client with a family education need chosen to use one? One of the significant barriers has been the concern that designated beneficiaries of Section 529 plans might use the funds for purposes other than education. Another concern is that these plans are typically funded with after-tax dollars contributed by the grantor (who may be concerned that his or her lifestyle may be adversely affected by irrevocable commitments to fund education for younger generation family members).

The Stand-Alone Education/Retirement Accumulation Trust is a revocable trust that can hold 529 plans during the life of the grantor and can be a beneficiary of IRA proceeds at death ("SAAT") may be a means to allow clients to overcome these barriers. This type of trust is most useful when the following facts are present:

- The client wants to maintain control over assets for children or grandchildren
- The client wants to appoint a trustee to revoke or modify the terms of the trust
- The client wants flexibility to move assets among multiple beneficiaries
- The client wants to preserve asset protection for the education fund

- The client has determined that all or some of any pretax retirement funds remaining at the client's death should be directed for family education needs and enjoy the longest income tax deferral possible.

We find this type of trust most appealing to clients who agree with the following statements:

- I would like to provide for at least part of the higher education needs of my children or grandchildren.
- I want to control the timing of distributions for education and determine who among my family is most deserving of those funds (i.e., my grandchild who wants to attend medical school is likely to need far more financial support than a grandchild who will not go to a graduate school)
- I want to confer upon a trusted person the ability to make these decisions if I become disabled or upon my death
- I want to make certain that none of the funds set aside for family higher education needs are available to satisfy third-party creditors claims
- I want 529 plan education funds for my family to be free of estate tax but controlled by a trustee after my death to assure they are used for education.
- I want to enhance the educational funds available in the trust with IRA proceeds at my death.
- I want the least income tax possible assessed by employing a "stretch out" strategy for the required payments to my beneficiaries.

The SAAT is created in the same manner as a revocable stand-alone retirement accumulation trust. These trusts are similar to the trust described in Private Letter Ruling 200537044. Such a trust may give the grantor the ability to decide how distributions will be made at the grantor's death, or may confer that power on a third party acting as trustee. Unlike a typical beneficiary designation that names individual beneficiaries for the grantor's IRA or 401(k), the revocable stand-alone retirement accumulation trust creates a legally enforceable mechanism to ensure that each trust beneficiary will receive distributions of their required minimum distribution from IRA or 401(k) funds over their life expectancy and may protect the undistributed funds from the claims of third party creditors.

The SAAT enhances the planning possibilities by serving as the owner and the beneficiary of the Section 529 College Savings Plan. In addition, substantial additional funds for education will become available upon the death of the grantor, as IRA or 401(k) balances held for the grantor are then paid out. The grantor may create a separate SAAT for each beneficiary or may structure the trust with multiple beneficiaries if the beneficiary designation for the subject IRA or 401(k) account clearly describes the separate shares established under the trust for different beneficiaries. Under these circumstances, any IRA or 401(K) balances paid to the trust upon the death of the grantor may be reinvested for the benefit of the designated beneficiary of that share and the funds will be subject to withdrawal over the life expectancy of that beneficiary.

The benefits of the SAAT cannot be fully exploited by merely creating the legal documentation to establish the trust. The entire estate planning team should be involved in evaluating the structure of the trust and proper investment choices for the trust. In this regard, the client's financial advisor should build appropriate asset allocation models for the beneficiaries of the SAAT, taking the client's objectives into account. Moreover, the client's advisors should be involved in determining the appropriate 529 college savings plan and investment options based on the client's specific fact situation.

The Retirement Irrevocable Life Insurance Trust – ("RILIT")

Typically, insurance is purchased to provide liquidity to fund the payment of debts or estate taxes and in some instances to create an estate in the event of premature death. To avoid estate tax inclusion of the death proceeds, most practitioners recommend that the insurance be owned by an irrevocable life insurance trust ("ILIT"). However, all of the benefits of life insurance require that insured to die for the benefit to be realized. In many cases, a prospective insured will be more willing to fund the cost of insurance if there is also some potential benefit for him while he is living.

Many clients and their advisors believe that an ILIT is useful only to hold life insurance policies that do not need to be accessed during the client's lifetime. The conventional wisdom is that ILITs are too restrictive to ever allow the insured to gain access to accumulating cash value during the insured's lifetime. With that mindset, the only potential use of an ILIT is to hold an insurance policy so that the death benefit will not be subject to inclusion in the insured's taxable estate. The most appropriate type of life insurance policy in that scenario would be one that has little or no opportunity for cash accumulation. However, the reality is that ILITs possess other attractive attributes and they can be used in many different situations.

In many instances the primary motivation for using an ILIT may be the enhanced level of asset protection available by creating an irrevocable trust with a third party trustee. Clients who practice in high risk professions such as medicine or law may be particularly interested in an estate planning strategy that couples a relatively high level of asset protection for a cash value life insurance policy with the ability of the ILIT Trustee to loan funds from the ILIT to the insured/grantor. This strategy may be quite attractive as an adjunct to or substitute for a qualified retirement plan as a retirement savings vehicle.

Unlike a qualified retirement plan that is subject to the vesting and participation requirements mandated by the Internal Revenue Code and ERISA, the retirement ILIT ("RILIT") need not cover the client's rank and file employees. Of course, the RILIT is funded with after tax contributions rather than with pretax dollars. However, the economics of the RILIT may be quite compelling if properly structured even without the benefit of an income tax deduction for contributions. In contrast to a qualified retirement plan which is subject to stringent regulations pertaining to required minimum distributions and taxation of distributions at ordinary income tax rates, the RILIT is typically structured so that the funds that are loaned to the grantor come from tax-free loans made from the policy by the Trustee. When the insured/client borrows funds from the RILIT, the client will be creating an enforceable liability to the RILIT, thereby potentially reducing the size of the client's taxable estate to the extent of the accrued interest. In contrast, the value of the client's interest in a qualified retirement plan will inevitably be an asset of the client's estate subject to federal estate tax.

The RILIT is an estate planning strategy that works best in a team planning environment. The estate planning attorney assumes responsibility for the preparation of the RILIT documentation. There are numerous decisions that need to be made by the attorney in drafting the documents, and it is extremely useful for those decisions to be made with input by other members of the planning team. These decisions may include a determination of whether the RILIT should be structured to allow annual exclusion gifts through the use of "Crummey" powers, the definition of beneficiaries for annual exclusion gift purposes (there may be an advantage in naming contingent beneficiaries as annual exclusion gift beneficiaries to increase the amount of annual funding without using the client's lifetime gift exemption), defining the role of the Trustee (whether there should be multiple Trustees acting together or with separate defined roles for each Trustee, whether the RILIT should employ a Trust Protector to maintain oversight over the Trustees, and determining the dispositive provisions of the trust. Furthermore, the estate planning attorney must draft the RILIT so that the Trustee is authorized (but not required) to make loans to the client, without causing the insurance death proceeds to be included in the client's taxable estate.

The other members of the estate planning team have significant roles to play in making certain that the RILIT works as intended. In this regard, it is critically important that the proper type of life insurance policy is structured to achieve the client's planning objectives. The client's financial advisor should be in the best position to determine whether the life insurance policy will result in sufficient cash becoming available for policy loans when those loans are likely to be needed. In addition, it will be important to determine the effective interest rate for any policy loans. There should also be a review of the client's existing life insurance policies to see if those policies are suitable for the client's current goals and to measure the gift tax consequences of transferring any of those policies to the RILIT.

The client's financial advisor and accountant should lead the effort to determine the amount of the death benefit appropriate for the life insurance policy owned by the RILIT. The primary benefit of the RILIT from the client's perspective may be the fact that there is likely to be a very substantial death benefit that will be paid to an asset protected irrevocable trust. Those funds may be useful to help fund ongoing business needs (such as funding employee stay bonuses for key employees to assure business continuity) as well as for more typical family oriented estate planning purposes such as providing liquidity to a surviving spouse and children or creating a fund to pay estate taxes. The determination of the size of the insurance policy death benefit cannot be made in a vacuum and requires the input of all members of the planning team. The net result of this interdisciplinary planning process will be a better matching of legal strategies and financial tools to achieve the client's objectives.

IRA Annuitization

The final strategy we will review involves the annuitization of an individual retirement account ("IRA"). This strategy is more potent for clients whose estates will be subject to the estate tax, but may also be appropriate for smaller estates as well. The single largest asset for many clients is their IRA. In many instances, IRAs are comprised of substantial rollovers of retirement funds from 401(k) plans, defined benefit plans or other employer sponsored retirement plans. IRAs are among the least favorable assets from an estate planning perspective. IRA withdrawals are treated as taxable income to the recipient, and the balance remaining in a decedent's IRA at the time of his or her death is subject to federal estate tax if the client's estate is large enough to be taxable. In some instances, the combined income and estate tax cost attributable to IRA funds may exceed 70%. Moreover, successor beneficiaries of IRAs are generally subject to requirements that distributions be made over the beneficiaries' life expectancies. There are significant tax costs associated with the failure to plan for the distribution of IRAs to the client's successors.

One strategy that we have found to be worthwhile in particular circumstances for clients over the age of 59 1/2 involves acquiring a single premium immediate annuity (SPIA) within the IRA using some or all of the IRA assets. The utility of immediate annuities in retirement planning is often overlooked. Immediate annuities available from major insurance companies provide regular guaranteed payments to the annuitant, here the IRA participant, not related to stock market performance or the rise or fall of interest rates. In troubled times having a regular guaranteed payment is reassuring to many. In effect the IRA participant has converted her plan to mimic the assured retirement income pension plans of an earlier age now seen only rarely in blue ribbon pension plans of major corporations and government entities. .Because the payments are based upon the assumption that the annuity will be fully paid out over the life expectancy of the annuitant in most instances the immediate annuity will produce a substantially greater return for the IRA participant. Thus the annuity can provide a significantly increased level of distributions each year to enhance the IRA participant's lifestyle. Depending on the age and health of the IRA participant, the immediate annuity within the IRA may yield an increase of 40% or more distributable income than the previous low-yielding money market or certificate of deposit investments held by the IRA. For the conservative retiree the immediate annuity also provides a conforting guaranteed income stream for the participant's life that is unrelated to market performance. Since the immediate annuity within the IRA will typically terminate at the death of the annuitant/IRA participant, a portion of the increased IRA distribution may in turn be used to fund a life insurance policy owned by an ILIT for the benefit of the client's chosen beneficiaries. The ILIT in this instance will be utterly independent of the IRA and use traditional annual exclusion gifts or lifetime exemption gifts from the IRA participant to fund the life insurance premiums.

Assume that your client is a healthy 68 year old woman, who has an IRA of $1,000,000 that comprises the largest asset in her $1,800,000 estate. Your client has a comfortable income level without drawing on her IRA and has elected to defer taking required minimum distributions until she reaches age 70-1/2. She has a marginal income tax rate (both state and federal) of 30 percent.

Your client may be able to exchange her existing IRA portfolio (which is yielding a 5% return) for an immediate annuity that will pay her approximately $78,000 per year for the rest of her life. After income taxes, your client will have approximately $54,000 of spendable cash each year. If she decides to replace the entire $1,000,000 balance with a life insurance policy, she may spend approximately $22,000 each year on the insurance premiums that will be funded through gifts to her ILIT. The net result will be that the client's children (and/or subsequent generations of family members) will benefit from the receipt of the $1,000,000 death benefit that is free of income tax and outside your client's taxable estate. Your client could have chosen to acquire a smaller life insurance policy at less cost (taking into account that the amount of life insurance necessary to replace the IRA on an after tax basis might be $700,000 or less). Alternatively, she might have chosen to maximize the gifting to fund the ILIT and acquire a substantially larger life insurance policy that would be a windfall to her beneficiaries.

The IRA participant can elect to use all or any part of the increase in their IRA distributions to fund the ILIT. The decision will be based on the cost of life insurance and the client's desire to replace some or all of the IRA assets that no longer will be available at the participant's death (because the funds were placed in the immediate annuity). Some clients may conclude that the IRA annuitization strategy should be maximized because they want to leave the maximum amount to their beneficiaries. In those cases, particularly those where clients have taxable estates, there is little doubt that the advantage of using their entire IRA balance to fund the annuity and the life insurance policy makes good sense. There can be a real economic advantage to replacing IRA funds that would be subject to both income and estate taxes with a life insurance policy that provides an income tax-free death benefit and is structured to be outside the client's taxable estate. Moreover, the purchase of the annuity within the IRA will typically result in a more robust level of income to the client that can be structured to be level or increase over time, and reduce the risk of investment losses by shifting that risk to the issuer of the annuity.

The decision as to how much or how little of the client's IRA to annuitize is best approached by the entire estate planning team. Given the significant income tax consequences of planning IRA distributions, it is important for the client's accountant, financial advisor and attorney all to be involved in crafting a solution that keeps the client's interests and objectives in mind. The result of this planning process for the IRA annuitization strategy as for the other wealth planning strategies outlined above, is likely to be demonstrably better than going through the decision making process with only one member of the estate planning team.

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