

Life Insurance Planning Changes After the Big Beautiful Tax Act

Tuesday, September 23, 2025
4:00 PM to 5:30 PM EST
(90 minutes)



Barry Flagg
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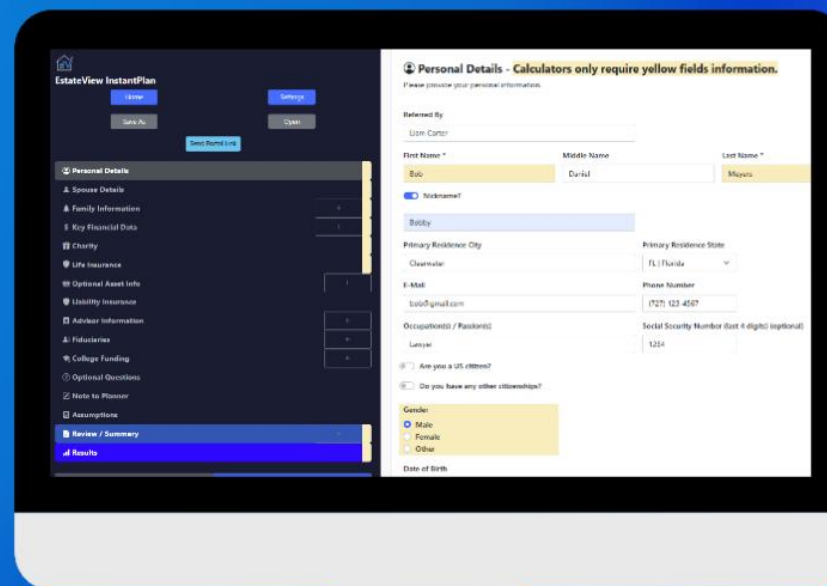
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Life Insurance Estimator	Rolling GRATs	Holding Company Valuation	
§7520 & AFR Table	Letter Writer (Under Construction)	Valuation Discount (Active Business)	



Special Thanks to Barry D. Flagg, CFP®, CLU, ChFC, GFS®, AEP®



Barry D. Flagg is the inventor and founder of Veralytic, the leading online publisher of life insurance pricing and performance research and product competitiveness ratings. Veralytic is the result of his unique background in both the fiduciary investment business where he became the now oldest, youngest Certified Financial Planner (CFP®) in history, and as a life insurance expert consistently recognized in the top 1% of the industry. He's renowned for applying Prudent Investor Principles to life insurance product selection or retention and portfolio management.

As a result, he serves as sub-advisor to thousands of irrevocable life insurance trusts (ILITs) as well as RIAs and wealth managers, is a contributing expert to CNN, Forbes, Insure.com, and USA Today among others, leads curriculum development and instruction for Applied Fiduciary Practices involving life insurance for The Center of Board Certified Fiduciaries at Wake Forest University, and serves as volunteer to the CFP Board Professional Standards and Legal Department for complaints involving life insurance. Barry has authored numerous articles for national publications on the management of life insurance as an asset according to established and proven asset management principles and frequently teaches continuing education courses about same to attorneys, CFP®, CPAs, and CTFAs.

Barry's speaking and writing includes addressing the national conferences of the AICPA Personal Financial Planners (PFP), Ernst & Young Annual Family Office Accounting & Tax Education, Fi360, Financial Planning Association (FPA), Grant Thornton, Holland & Knight, HSBC Bank/WTAS, Notre Dame Tax Institute, the Academy of Financial Services (AFS), and many of the largest independent distributors of life insurance in the U.S. He has also been published by the ABA, AICPA, CCH, Fiduciary & Investment Risk Management Association (FIRMA) and Trust & Estates, cited by ALI/ABA reference text, guest lectured at Leadership Bootcamp for Life Insurance Stewards at West Point, Stetson Law, Texas Tech University and the Wall Street Academy, and appeared on national internet radio shows for a number of the largest insurers in the U.S.

Barry is also a Chartered Life Underwriter (CLU), Chartered Financial Consultant (ChFC) and Cum Laude graduate of the W. Paul Stillman School of Business at Seton Hall University. Barry has been on the CFP Board's Disciplinary and Ethics Commission, an adjunct faculty member of the College for Financial Planning, and is a member of the Financial Planning Association (FPA), and the Million Dollar Round Table (MDRT) Top of the Table continuously since 1993.

Pre-2025 One Big Beautiful Bill Act

The most common way for an estate-taxable person or family to hold life insurance under a thorough plan was to have the policy owned under an **Irrevocable Life Insurance Trust**.

Typically, the policy on the higher earner or wealthier spouse would be owned under an **Irrevocable Life Insurance Trust**, which would benefit the surviving spouse and descendants after the death of the insured spouse.

Insured spouse would gift the premium dollars needed to keep the policy current to the trustee of the trust or would pay the premiums directly and consider that payment to be a gift to the trust.

Descendants are given a short period of time to withdraw the gifted amounts from the trust, dictated under the Crummey power rules, which allow the gifts to be considered present interest gifts to the child, therefore qualifying them for the \$19,000 annual gift exclusion.

It was common for one spouse to fund an irrevocable trust for descendants that would not benefit the other spouse because of something called the "Reciprocal Trust Doctrine."

Many couples also established "second-to-die life insurance trusts," which would purchase one or more of these policies that would pay a death benefit only after the death of the surviving spouse. These policies are less expensive than a policy on a single life, for obvious reasons.



PARTIAL CHECKLIST FOR LIFE INSURANCE AND ASSOCIATED PLANNING AFTER BBB 2025

1. **The Super Wealthy - Well Over \$15,000,000 for an Individual or \$30,000,000 for a Married Couple.**

- A. Have they been waiting to see whether they should do more (or any) estate tax planning, in hopes that the Estate Tax would be abolished? No such luck!

Get going with a plan while they are still insurable.

B. Non-insurance related Estate Tax planning opportunities.

- I. Annual gifting.
- II. Making large gifts.
- III. Qualified Personal Residence Trusts.
- IV. Installment sales.
- V. Life Insurance Trusts.
- VI. Charitable Lead Annuity Trusts to zero out estate tax on death to the extent needed.
- VII. Synergism between a CLAT to avoid estate tax and an ILIT to assure a significant benefit upon death.

Common themes:

- I. Is there enough life insurance and is it properly structured?
 - A. Add coverage and/or secure sufficient cash value.
 1. Consider a 1035 exchange to a more appropriate policy.
 2. Consider split dollar funding.



PARTIAL CHECKLIST FOR LIFE INSURANCE AND ASSOCIATED PLANNING AFTER BBB 2025

2. **The Mid-Wealthy – not well above \$15,000,000 for an individual or \$30,000,000 for a married couple, but may certainly be heading there, and what if the Estate Tax Exemption comes down in 2030 or thereafter?**

- A. What is the savings rate? - - What are the prospects of growth to become super wealthy?
 - I. Review anticipated savings, rates of return on investments, and any possibly exploding assets such as a family business.
 - II. Don't forget inheritance planning--what are their parents going to leave for them? Can it be put into a Trust before they receive it?
 - III. Encourage consideration of whether the client should do extensive estate tax planning, or perhaps less estate tax planning, with one or more ILITs funded by life insurance - perhaps convertible term “just in case”.

Possible middle ground considerations:

- A. Keep any life insurance in place and be ready to push it into an ILIT more than three years before death. Calendar all conversion deadlines for term life policies.
- B. Is there a Buy/Sell Agreement relating to a family business or other entity that has suppressed values for estate tax purposes? - Liberate the values and update buy/sell coverage.
- C. The heck with Connolly.. - Increase the redemption price to take the life insurance into account so that the deceased member's family gets full monies. - Perhaps an ILIT will handle any estate tax that might be owed as a result of this.
- D. Consider re purposing ILITs and other estate tax planning Trusts. - See below.



PARTIAL CHECKLIST FOR LIFE INSURANCE AND ASSOCIATED PLANNING AFTER BBB 2025

3. The No Longer Estate Taxable Family (They Hope).

Keep in mind that estate and inheritance taxes and the possible reduction of the estate tax exemption as soon as the year 2030 (where there could be a Democrat rally elect the President and regain control of the House and Senate) - stress test showing possible present arrangements to allow client to decide whether to completely disband and revamp planning structures.

- A. Are there elderly, family members or even close friends that can be given powers of appointment to increase the basis of assets on death?
- B. Does the client want to continue to pay income tax on the income of Irrevocable Grantor Trusts?
- C. Are there installment sales in place where a note is owed to the client at below market rates?
- Should the note be repaid (and if so, at a discount?).
- D. Are there homes in Qualified Personal Residence Trusts that will not get a step up or the \$250,000 for a single person/\$500,000 for a married person income tax exemption on sale after the death of the grantor.

Should another family Trust purchase the home from the QPRT and be considered as owned by the client to get an income tax step up on death and access to the \$250,000/\$500,000 exemption on sale (sometimes hard to predict what will come first).

Should the client buy life insurance from the ILIT and allow the ILIT to purchase the homestead and be restructured?

Should the life insurance that was intended to be for payment of death taxes be repurposed as savings of vehicle or should there be a 1035 exchange to a more suitable vehicle?

More to come!



PARTIAL CHECKLIST FOR LIFE INSURANCE AND ASSOCIATED PLANNING AFTER BBB 2025

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**Should the life insurance that was intended to be for payment of death taxes be repurposed as savings vehicle or should there be a 1035 exchange to a more suitable vehicle?

More to come!



Comprehensive Estate Planning

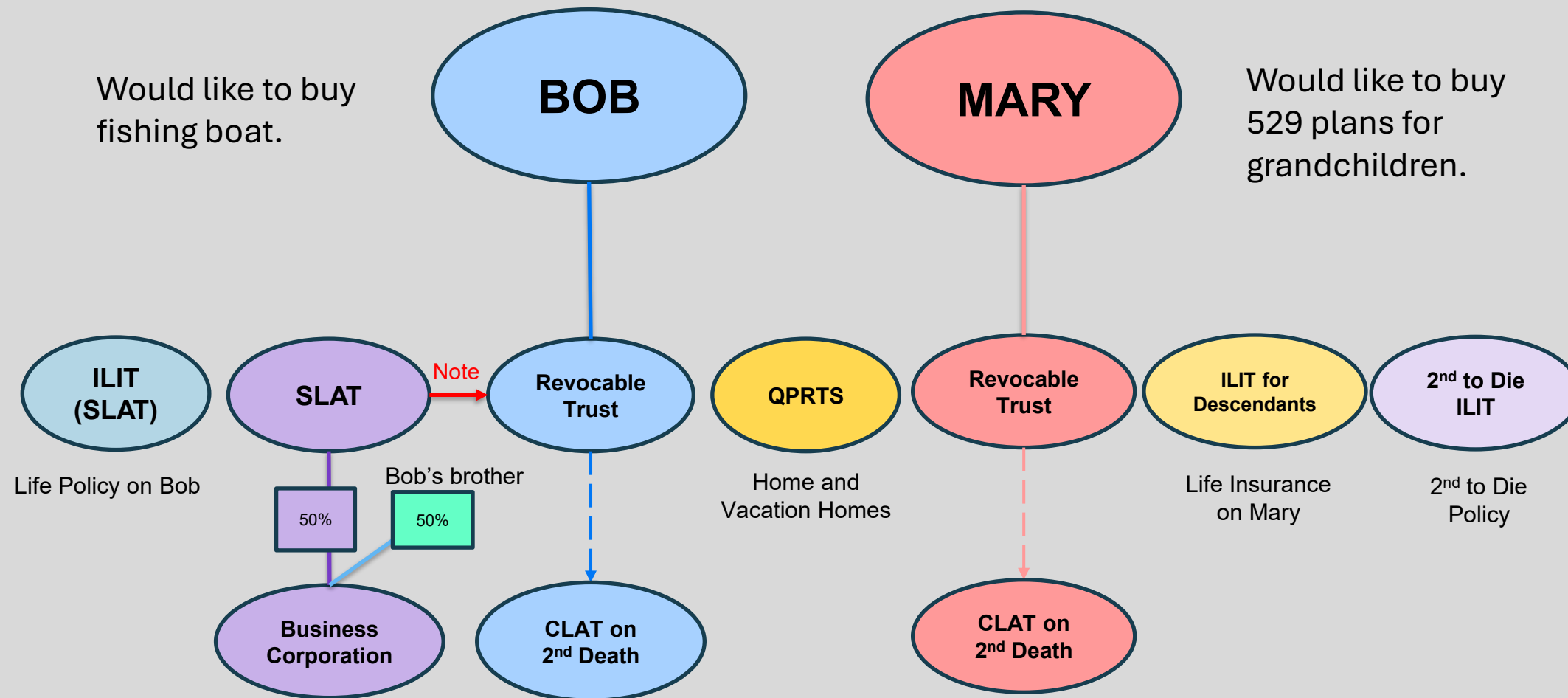
Prepared For: Bob and Mary Sample

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1

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Sample Letter to Married Couple Concerning Life Insurance Planning, If Permanent No Longer Threatened by Federal Estate Tax.

Dear Bob and Angie:

This letter is to discuss possible planning opportunities for you in view of the permanence of a \$15,000,000 per person estate tax exemption that becomes effective on January 1, 2026. Please note that despite the exemption being “permanent,” it could be changed by a future administration. There is no way to quantify that risk, but you should nonetheless take it into account in any decisions you make.

As you know, some aspects of your planning were based upon the premise that assets should be moved outside your estates for federal estate tax purposes.

Unless you believe that the estate tax exemption may be reduced significantly when the political situation next changes in the future, it may be appropriate to reconsider your planning. For example, it may be possible to repurpose some existing estate planning to save income taxes. Also, when you evaluate your existing life insurance planning, consider that life insurance can provide income tax advantages in that the growth inside the policy accrues free of income tax (whereas, realized gains on an investment portfolio outside a life insurance wrapper cannot do so).

You may recall that the federal estate tax exemption was \$5,000,000 in 2012, was expected to decrease to \$1,000,000 in 2013 (which did not happen), and increased with inflation thereafter. The exemption was doubled in 2017 to \$10,000,000. That increase was on a temporary basis, and was to have declined to \$5,000,000, inflation adjusted, in 2026. The One Big Beautiful Bill Act (“OBBBA”) made the exemption a permanent \$15,000,000 exemption as of January 1, 2026 that will be inflation adjusted.

You have a number of Irrevocable Trusts in place that were intended to provide both estate tax avoidance and creditor protection.

There are a number of different things that you can do with these trusts and the investments thereunder, including the life insurance policies that we have been involved with.



Taking the attached chart from left to right, the following is derived from a conference that I recently attended:

First, we have John's Irrevocable Life Insurance Trust (John's ILIT).

John's ILIT has been funded by annual Crummey withdrawal power gifting using the \$19,000 per person/per year gift tax exclusion. Besides federal estate tax avoidance, another reason for this policy was to make sure that Mary and your descendants would have sufficient resources upon John's death. Mary is the lifetime beneficiary of the trust and may be able to redirect how the trust assets pass upon your death. Subject to certain limitations, you may want to keep this trust and the life insurance policy in place, or you may wish to make changes, which could include the following:

1. John could stop giving premium monies and start loaning monies at an arm's-length interest rate, so that John could receive the first monies back from the trust, if the policy is ever cashed in, borrowed upon or sold to you or someone else.
2. You may wish to reduce the death benefit of the policy, now or in the future, to reduce or eliminate John's need to make payments.
3. You may wish to maintain the arrangement but have the trust swap the policy for one that can provide nursing benefits for Mary in a tax efficient manner.

Alternatively, John could buy the policy from the Life Insurance Trust by putting cash or other assets in the trust and receiving the policy. Then the trust would not have as much value, if John were to die in the next few years, and John could continue paying premiums to have the income tax and investment benefits of the policy or even "fatten the policy" or exchange it for a policy that might have better investment features.

4. Also, John's ILIT could be repurposed to save income taxes by doing one or more of the following:
 - A. If John's ILIT is converted to what is called non-grant or trust, then it could "spray income" to your descendants and save income taxes if they are in a lower tax bracket.



- B. John has assets that are not protected from creditors, but if John owns the life insurance policy on his life, it will be creditor protected. John can swap non-creditor protected assets for the life insurance policy on his life so that his creditor protection is enhanced, and the assets that are not otherwise creditor protected are held safely under John's ILIT.
- C. John could buy the life insurance policy from the Trust based upon its value, and the Trust might be converted to what is known as a "Non-Grantor Trust" for income tax purposes to possibly save some income taxes for you.

For example, a Non-Grantor trust can make payments to charity and get a 100% (or close to 100%) tax deduction, as opposed to how your personal tax deductions may be limited because of the standard deduction and other aspects of the income tax rules. I can provide you with further information on this if you like.

- D. In addition, under the new income tax law, a trust can deduct up to \$40,000 in property taxes that it may pay on residential properties.

If John's ILIT converts to a non-grantor trust and owns income producing assets such as bonds, and also recreational property, then it may be possible for all of the bond income to be spent charity and the taxes on the recreational property, so that no taxes are imposed on bond income that you would have otherwise been taxable on.

Mary's Irrevocable Life Insurance Trust (Mary's ILIT) has the same possibilities.

The policy in Mary's ILIT could be repurposed or the policy might be purchased from the trust.

You mentioned that you plan to pay all college and other educational expenses for your grandchildren.

One idea is that Mary might give the trust money in exchange for receiving the life insurance policy on her life, and the trust might use the money to buy 529 College savings plans for your grandchildren.



Based upon our analysis, you may want to put away approximately \$_____ into 529 plans for the grandchildren. Any amounts not used for one grandchild could be transferred to be used for another grandchild or for great-grandchildren or certain other family members. You do not have to purchase the 529 plan accounts from your own money. A new or existing irrevocable trust that may benefit multiple family members can purchase and make use of a 529 plan or plans.

For example, you could purchase one of the life insurance policies from the existing life insurance trusts and have that life insurance trust use the money paid by you to the trust for the policy to purchase a 529 college savings plan that can then pay for up to \$10,000 per year of tuition from kindergarten through 12th grade, for college and college living expenses and graduate school and graduate school living expenses and/or trade school or similar arrangements and certain internships.

Please note that these Trusts are “irrevocable,” so that you cannot change them yourselves, but there may be other ways to change them.

For example, there may be a Trust Protector provision whereby trusted individuals may be able to change the Trust, or such a provision might be installed into the Trust, and then actions can be taken to modify the Trust if it needs to be changed.

Also, depending upon the Trust language and state law, it may be possible for the trustee or trustees and all beneficiaries to amend the trust with the consent of the grantor or grantors, or it may be possible for the trust assets to be transferred into one or more other trusts that benefit one or more of the beneficiaries, but no individual who is not a beneficiary. This is called decanting.

Another alternative is to get a court order from a judge, after the judge confirms that everyone is properly represented and that the change makes good sense. The judge might appoint a special lawyer called an ad litem to represent the interests of minors and unborn beneficiaries. This can be a relatively simple and inexpensive way to make sure that family resources are best used in an appropriate manner. An ad litem may require that a certain portion of the value of the Trust be set aside for minor or unborn beneficiaries, and allow the rest of the trust assets to be used as requested by the adult beneficiaries.

You also have a second-to-die life insurance trust with a second-to-die life insurance coverage. The same opportunities generally apply.

Please note that when a life insurance policy is purchased from a trust, it is extremely important to make sure that certain transfer for value rules are followed. If these rules are not followed, then the entire death benefit from the policy may be subject to income tax!



I also recall that you have a Buy-Sell Agreement with respect to _____, LLC with your partner, Tim. Is there enough life insurance in place for this?

You could use the life insurance coverage on John, or get new coverage to handle the Buy-Sell arrangement.

In addition, you may have been using a suppressed purchase price for the company to avoid estate tax, which may no longer be an issue. You may now want to have a higher purchase price and more life insurance to cover the purchase, in order to get a higher income tax basis on the ownership interests in the company in the event of death, so that there would be less capital gains tax when the company is eventually sold.

With respect to your IRA and pension account planning, typically the non-Roth benefits will come out and be subject to ordinary income tax within 10 years of the death of the surviving spouse. This could instead come out over the lifetime of each child or other beneficiary, or over 20 years using a Charitable Remainder Uni-Trust (CRUT).

A relatively small portion of what goes into a CRUT needs to be allocated to a charitable remainder interest, so that what is left in the trust after the lifetime of a child or up to a 20 year term, if selected, will pass to charity. Generally, the portion expected to pass to charity will be approximately 10% of the initial value, and it is not unusual to have a life insurance policy set up to make a payment on the death of a lifetime beneficiary in order to offset the portion that will go to charity.

We could put life insurance policies on each of your children using term life that can be converted into a permanent policy on each child at the time of the death of the survivor of you to make up for the remainder interest that may go to charity on the death of a child.

Do you know whether each of your children has put away enough in personal assets or has sufficient life insurance for the support of each of your daughters-in-law, the parents of their spouses or significant others besides your descendants? This could be important if your descendants are the only beneficiaries of the trusts that you are leaving. We would be glad to meet with each of your descendants to see if they have sufficient resources or could benefit from planning.

There is also something called multi-generational split dollar where the parents help to finance a life insurance policy on a child in an efficient manner.

Obviously, this letter cannot cover all of the planning opportunities that are available to you ,or describe them in any significant detail. I nevertheless hope that this letter has been helpful to help you see why it may be a good idea for us to get together to determine how we might advance your planning and possibly save you premium dollars and taxes for you and your descendants. I hope that we can involve _____ CPA and _____ Esquire to review your situation in an efficient and effective manner.

Best personal regards.



ASSUMPTIONS

Clients			
Name	Bob Sample	Mary Sample	
Age	70	64	
Sex	Male	Female	
Tobacco User?	No	No	
Lifetime Gift Exclusion Used	\$0	\$0	
Projected Year of Death	2035	2045	
Net Annual Savings/Outgo	\$250,000 per year	\$300,000 per year	
Savings Transition Age	78	78	
Rest of Life	\$100,000 per year	\$100,000 per year	
Portability			
Assume no portability?	No		
Exemption Adjustment			
Exemption Adjustment Option:	CPI adjustments only		
Business and Investments			
Current Value	\$30,500,000		
Annual Growth Rate	7.50%		
Annual Investment Costs Rate	0.40%		
Annual Investment Tax Rate (as % of assets)	2.00%		
Personal Residence and Property			
Current Value	\$3,000,000		
Annual Growth Rate	3.75%		
Bypass Trust			
Bypass Trust Value	\$20,800,000		
Gifting			
Initial Gifting Trust Value	\$0		
Exempt Gifts per year	2 Donees		
Number of Years	10		
Subsequent Gifts per year	6 Donees		
Percentage of Gifts to Gifting Trust	100.00%		
Life Insurance - Pre-planning			
Insured	Bob Sample	Mary Sample	Second To Die
Policy 1			
Held in ILIT?	No	No	No
Policy Type	Permanent	Permanent	Permanent
Number of Years	35	35	35
Annual Premium	\$58,000	\$19,000	\$104,000
Number of Additional Years	15	0	0



Additional Years Annual Premium	\$58,000	\$19,000	\$0
Initial Death Benefit	\$2,000,000	\$2,000,000	\$8,000,000
Death Benefit Term	35	35	35
Subsequent Death Benefit	\$2,000,000	\$2,000,000	\$8,000,000
Life Insurance - Post-planning			
Insured	Bob Sample	Mary Sample	Second To Die
Policy 1			
Held in ILIT?	Yes	Yes	Yes
Policy Type	Permanent	Permanent	Permanent
Number of Years	35	35	35
Annual Premium	\$58,000	\$19,000	\$104,000
Number of Additional Years	15	0	0
Additional Years Annual Premium	\$58,000	\$19,000	\$0
Initial Death Benefit	\$2,000,000	\$2,000,000	\$8,000,000
Death Benefit Term	35	35	35
Subsequent Death Benefit	\$2,000,000	\$2,000,000	\$8,000,000
Large Gift To Trust			
Value Gifted	\$5,000,000		
Large Gift Discount Rate	0.00%		
Large Gift Value After Discount	\$5,000,000		
Split Large Gift	No		
Year to Toggle Off Grantor Status	Never		
Rates			
Consumer Price Index Growth Rate	3.71%		
Real Inflation	4.01%		
Estate Tax Rate	40.00%		
Adjust for Real Inflation	No		
Charity			
Charity, CLAT, or CRT?	CLAT		
Charity Name			
Percent of Residue to CLAT	100.00%		
Percent of CLAT to Charity	50.00%		
Number of Years	20		

EstateView InstantPlan Comprehensive Planning Strategies - Continued



ILLUSTRATION - DIES IN 2026 (NO PLANNING)

Both spouses die in one year

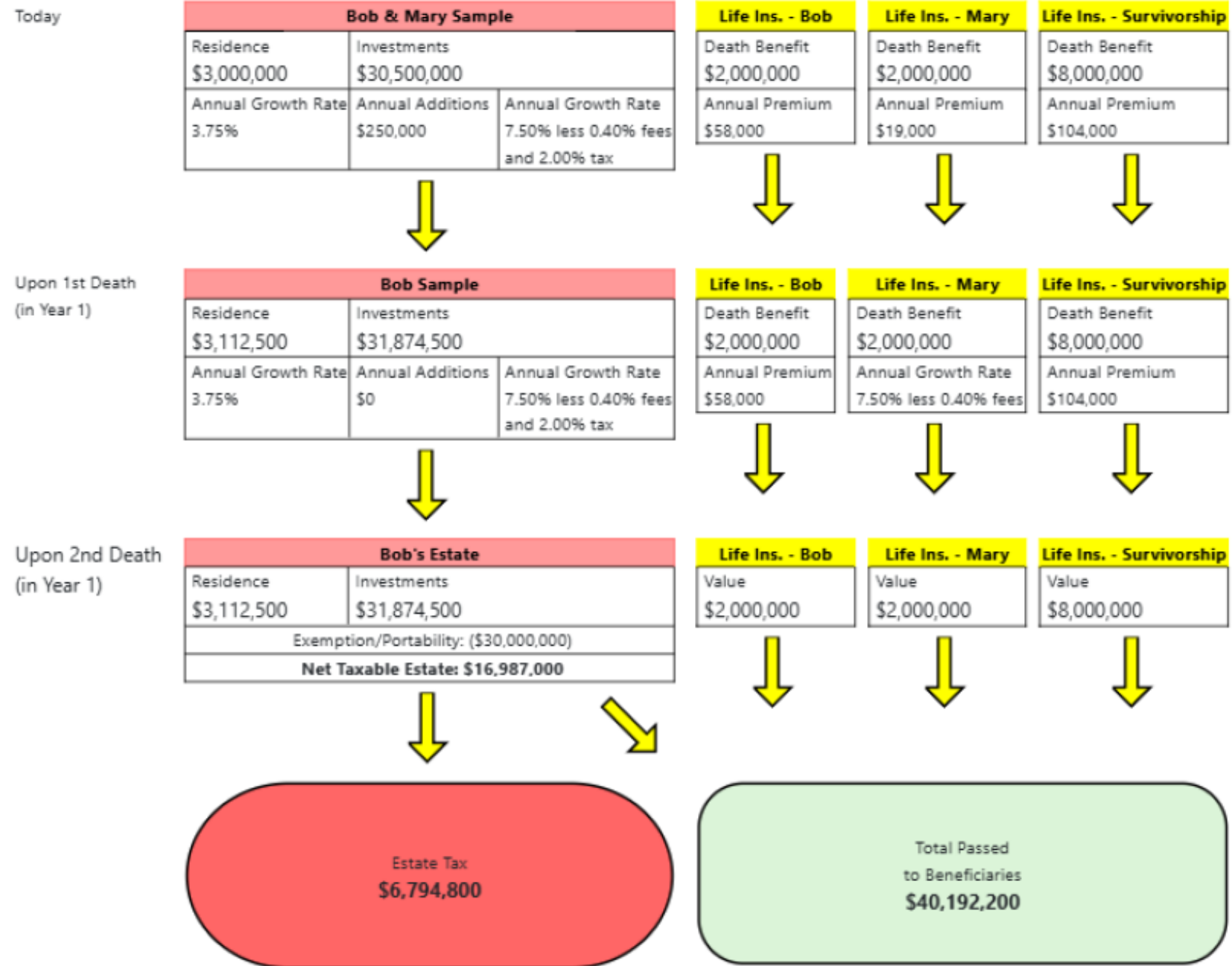


ILLUSTRATION - DIES IN 2026 (WITH PLANNING)

Both spouses die in one year

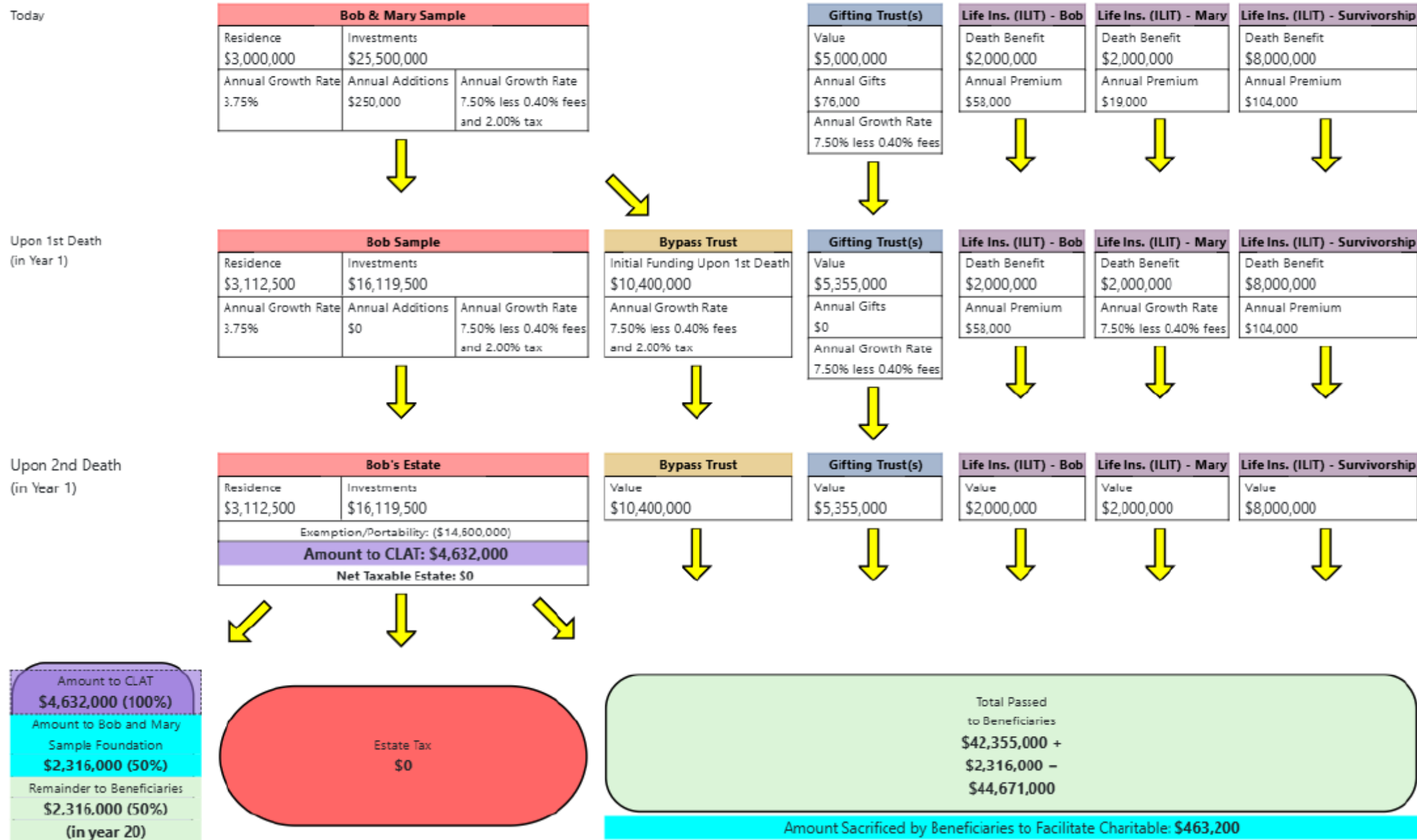


ILLUSTRATION 1 - NO PLANNING
(20 YEARS)

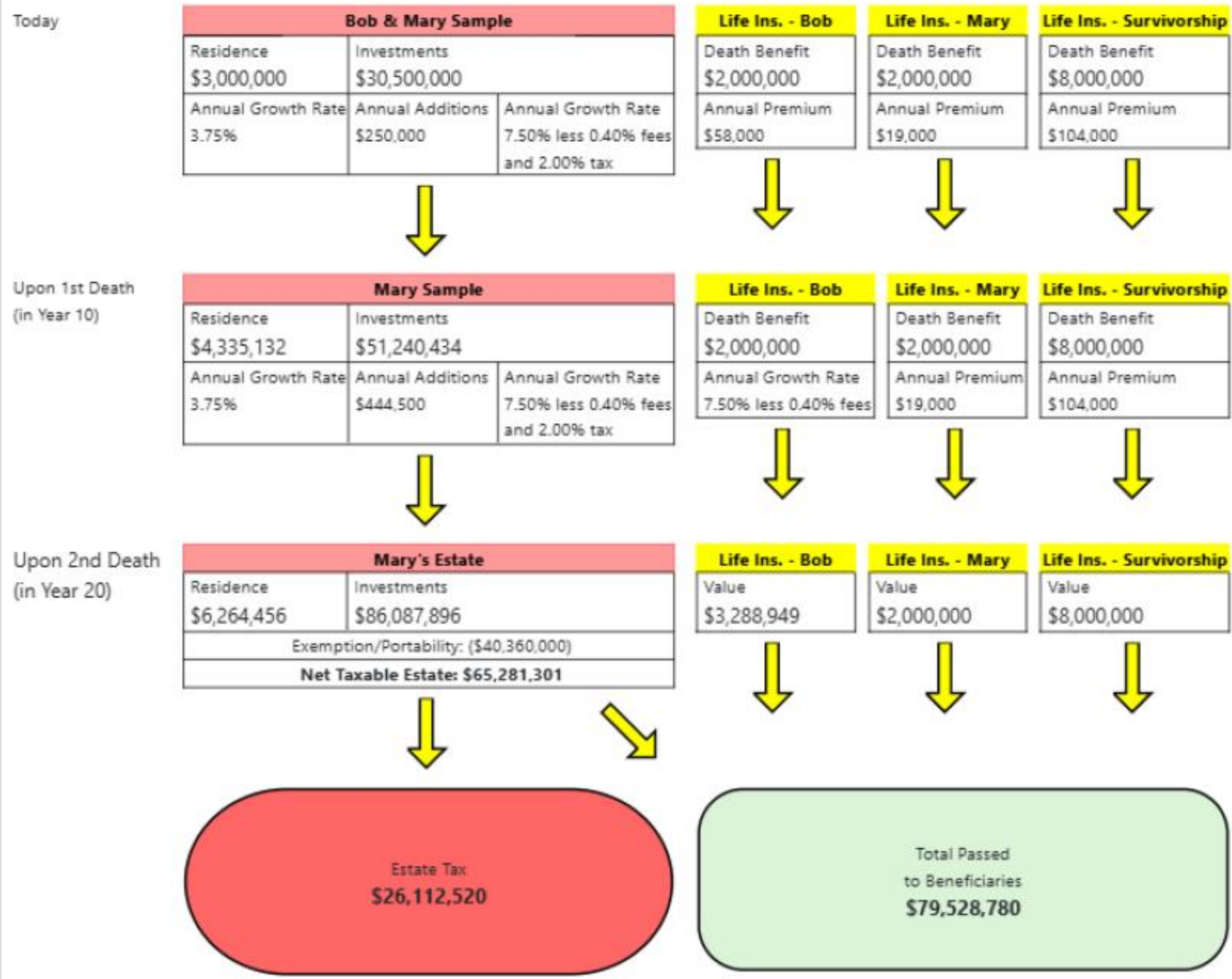


ILLUSTRATION 2 - BYPASS TRUST
(FUNDED YEAR 10)

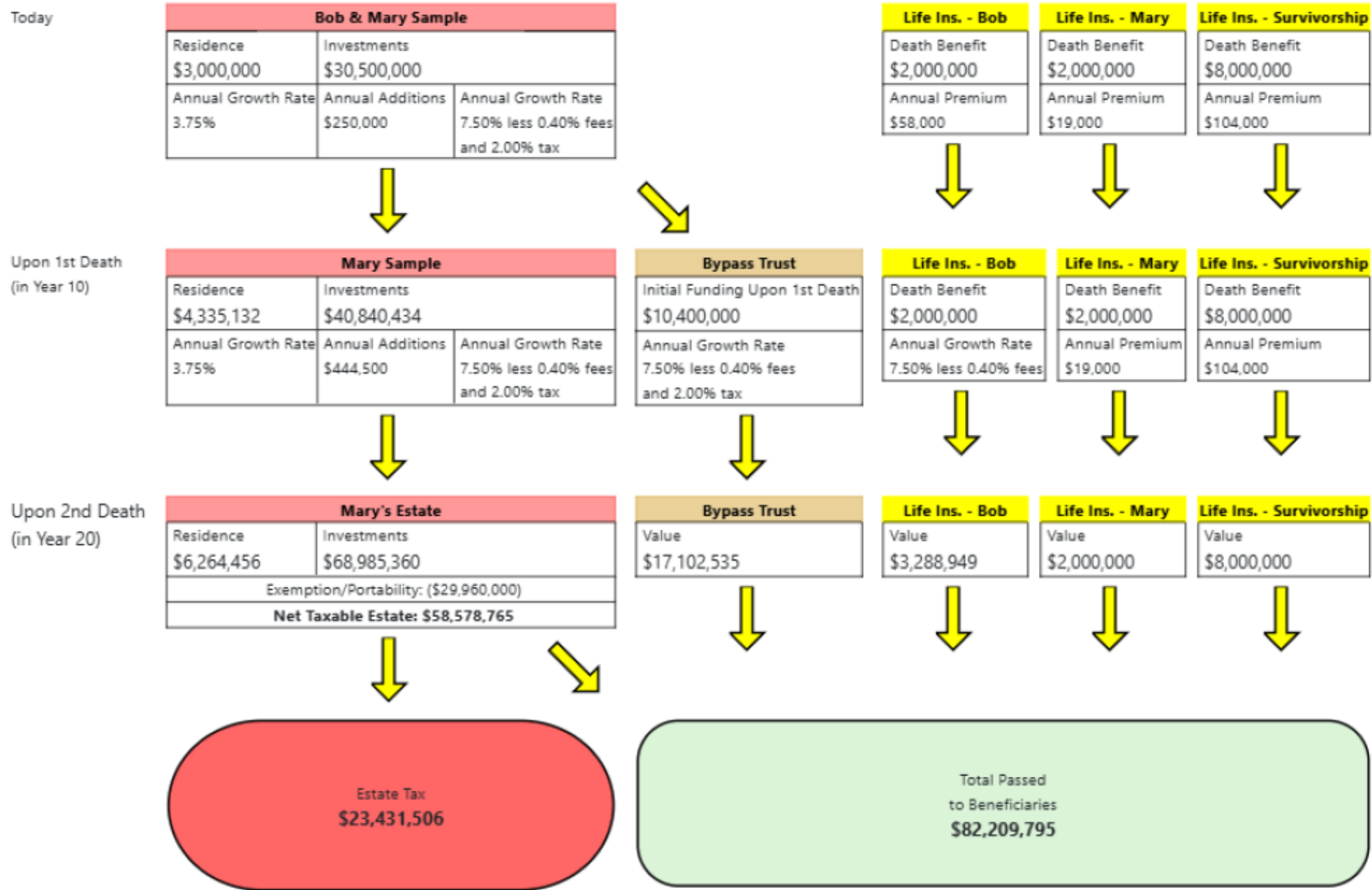


ILLUSTRATION 3 - ANNUAL GIFTING
(2 DONEES)

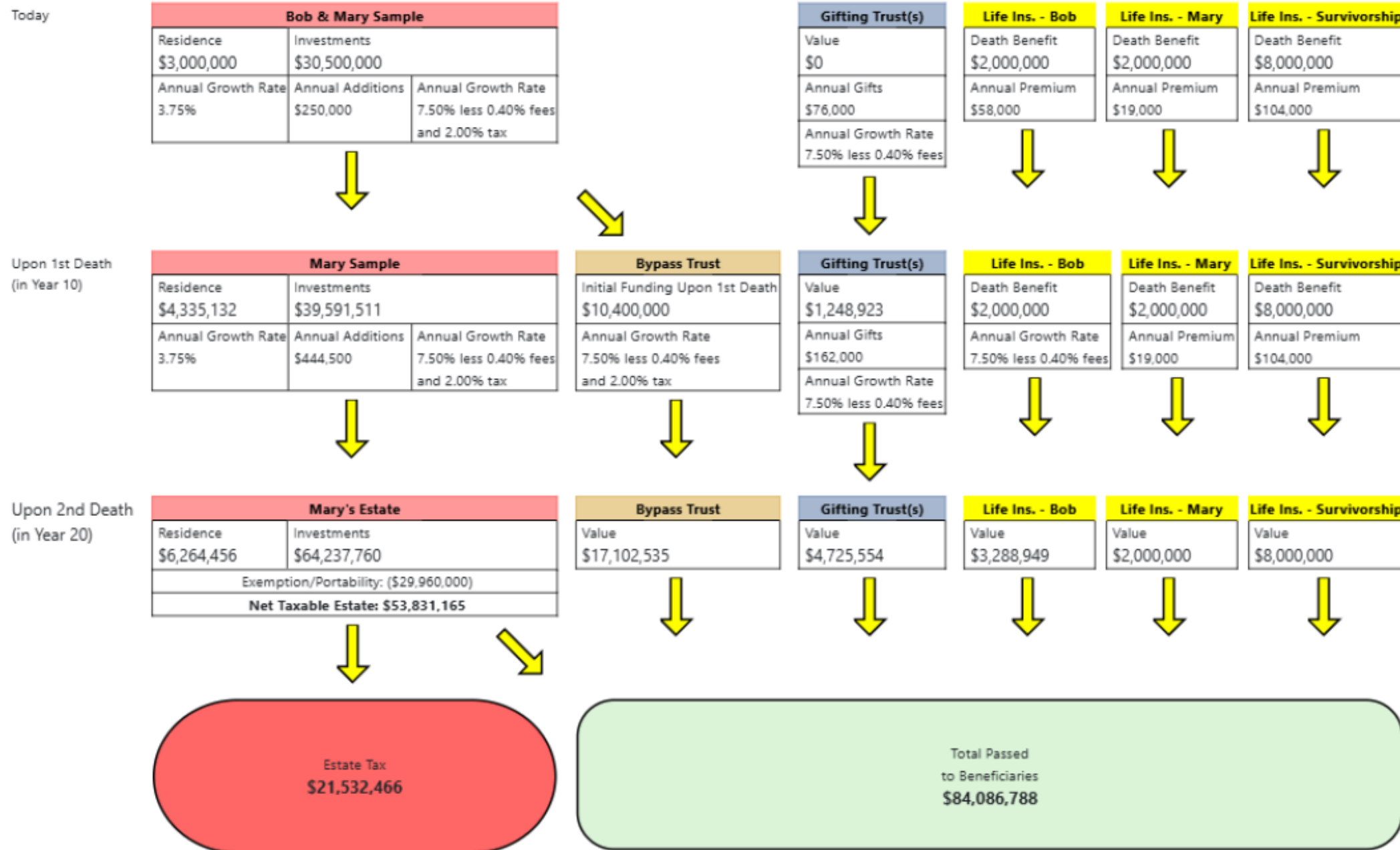


ILLUSTRATION 4 - LIFE INSURANCE TRUST PLANNING
(20 YEARS)

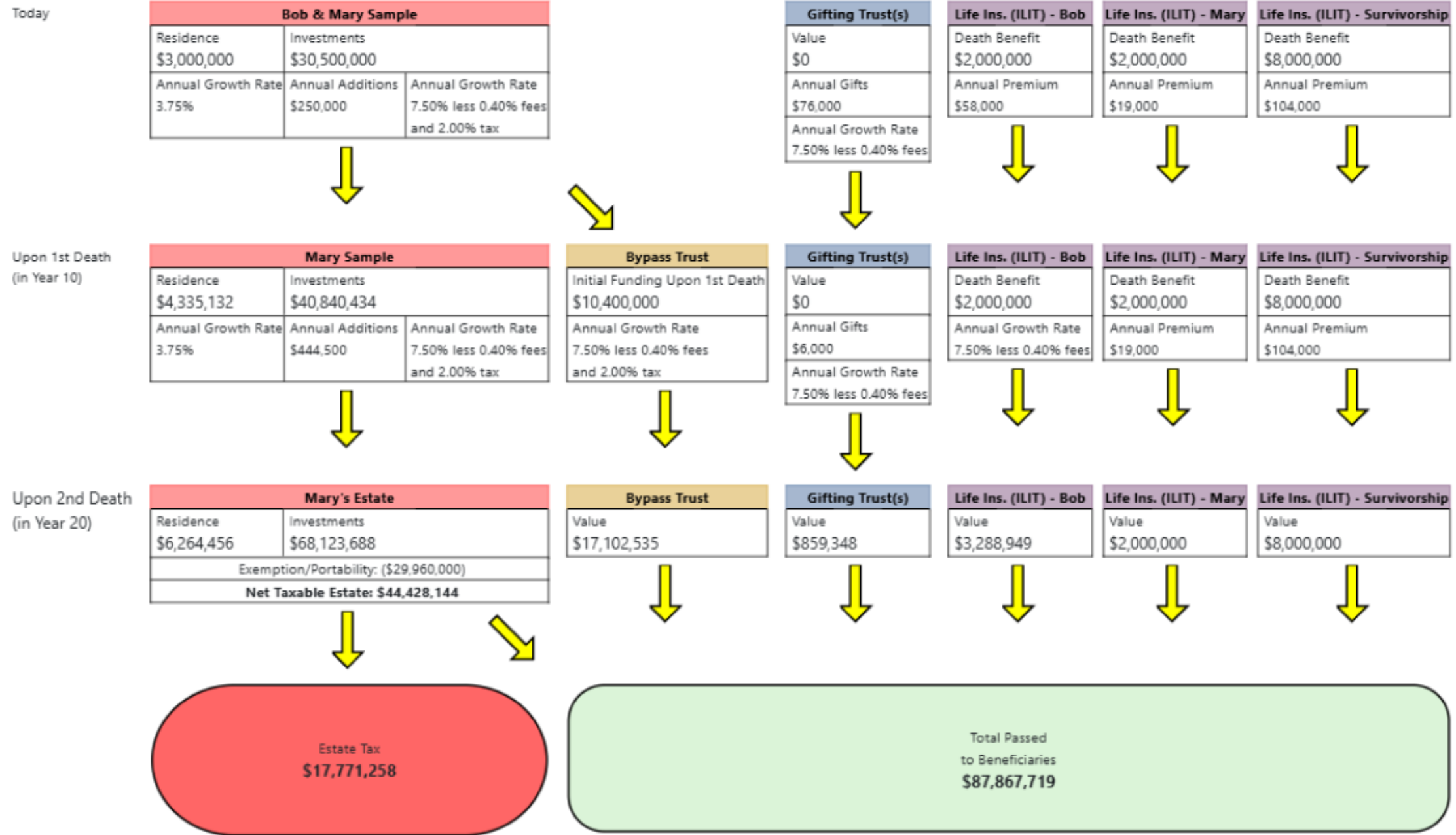


ILLUSTRATION 5 - LARGE GIFT
(20 YEARS)

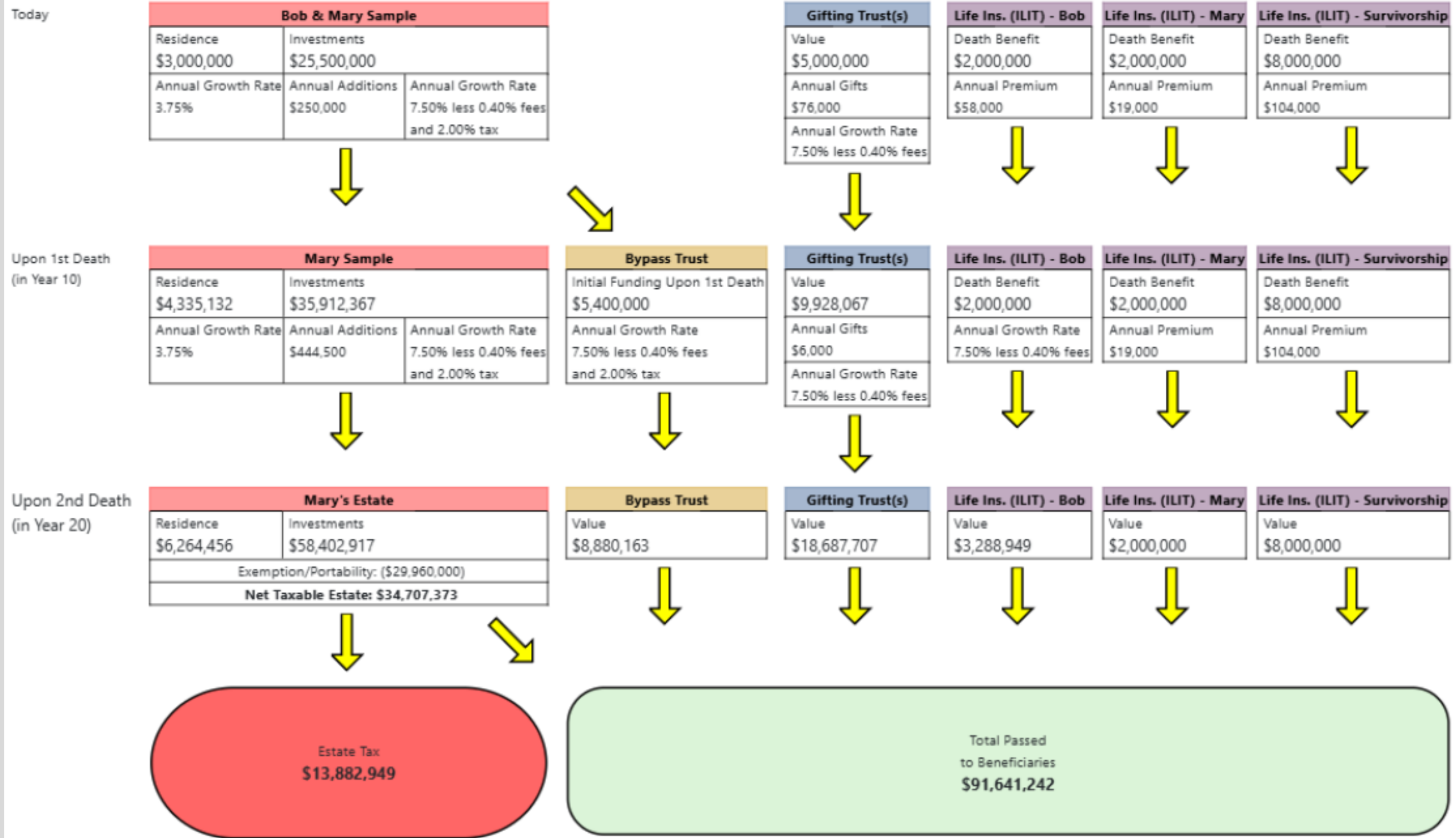


ILLUSTRATION 5 - LARGE GIFT (20 YEARS)

Bob Sample & Mary Sample
Effective Estate Tax Rate: 15.052%

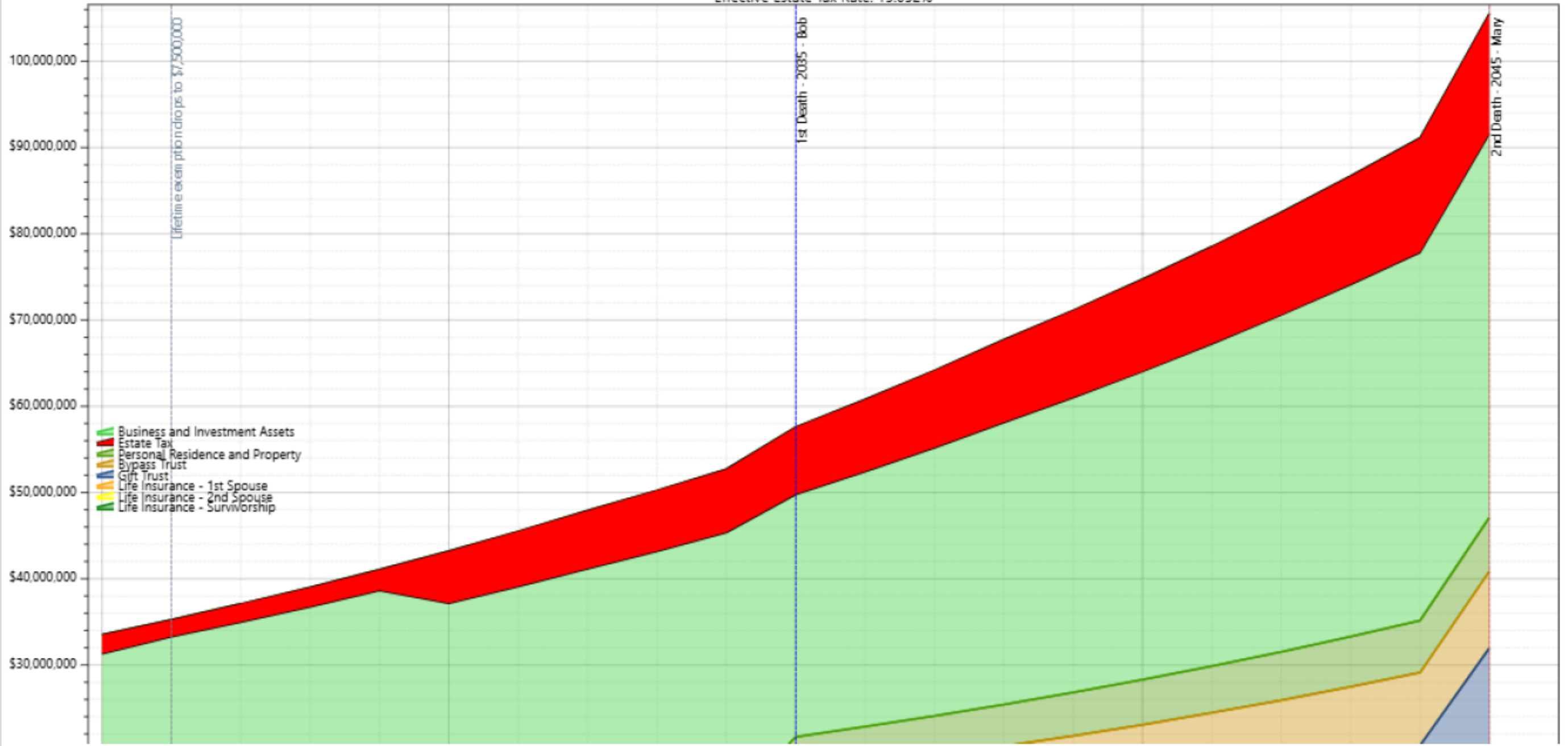


ILLUSTRATION 6 - TESTAMENTARY CHARITY

Today

Bob & Mary Sample		
Residence	Investments	
\$3,000,000	\$25,500,000	
Annual Growth Rate	Annual Additions	Annual Growth Rate
3.75%	\$250,000	7.50% less 0.40% fees and 2.00% tax

Gift(s) Trust(s)
Value
\$5,000,000
Annual Gifts
\$76,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Bob
Death Benefit
\$2,000,000
Annual Premium
\$58,000

Life Ins. (ILIT) - Mary
Death Benefit
\$2,000,000
Annual Premium
\$19,000

Life Ins. (ILIT) - Survivorship
Death Benefit
\$8,000,000
Annual Premium
\$104,000

Upon 1st Death
(in Year 10)

Mary Sample		
Residence	Investments	
\$4,335,132	\$35,912,367	
Annual Growth Rate	Annual Additions	Annual Growth Rate
3.75%	\$444,500	7.50% less 0.40% fees and 2.00% tax

Bypass Trust
Initial Funding Upon 1st Death
\$5,400,000
Annual Growth Rate
7.50% less 0.40% fees and 2.00% tax

Gift(s) Trust(s)
Value
\$9,928,067
Annual Gifts
\$6,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Bob
Death Benefit
\$2,000,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Mary
Death Benefit
\$2,000,000
Annual Premium
\$19,000

Life Ins. (ILIT) - Survivorship
Death Benefit
\$8,000,000
Annual Premium
\$104,000

Upon 2nd Death
(in Year 20)

Mary's Estate	
Residence	Investments
\$6,264,456	\$58,402,917
Exemption/Portability: (\$29,960,000)	
Amount to CLAT: \$34,707,373	
Net Taxable Estate: \$0	

Bypass Trust
Value
\$8,880,163

Gift(s) Trust(s)
Value
\$18,687,707

Life Ins. (ILIT) - Bob
Value
\$3,288,949

Life Ins. (ILIT) - Mary
Value
\$2,000,000

Life Ins. (ILIT) - Survivorship
Value
\$8,000,000

Amount to CLAT	\$34,707,373 (100%)
Amount to Bob and Mary Sample Foundation	\$17,353,687 (50%)
Remainder to Beneficiaries	\$17,353,687 (50%)
	(in year 20)

Estate Tax	\$0
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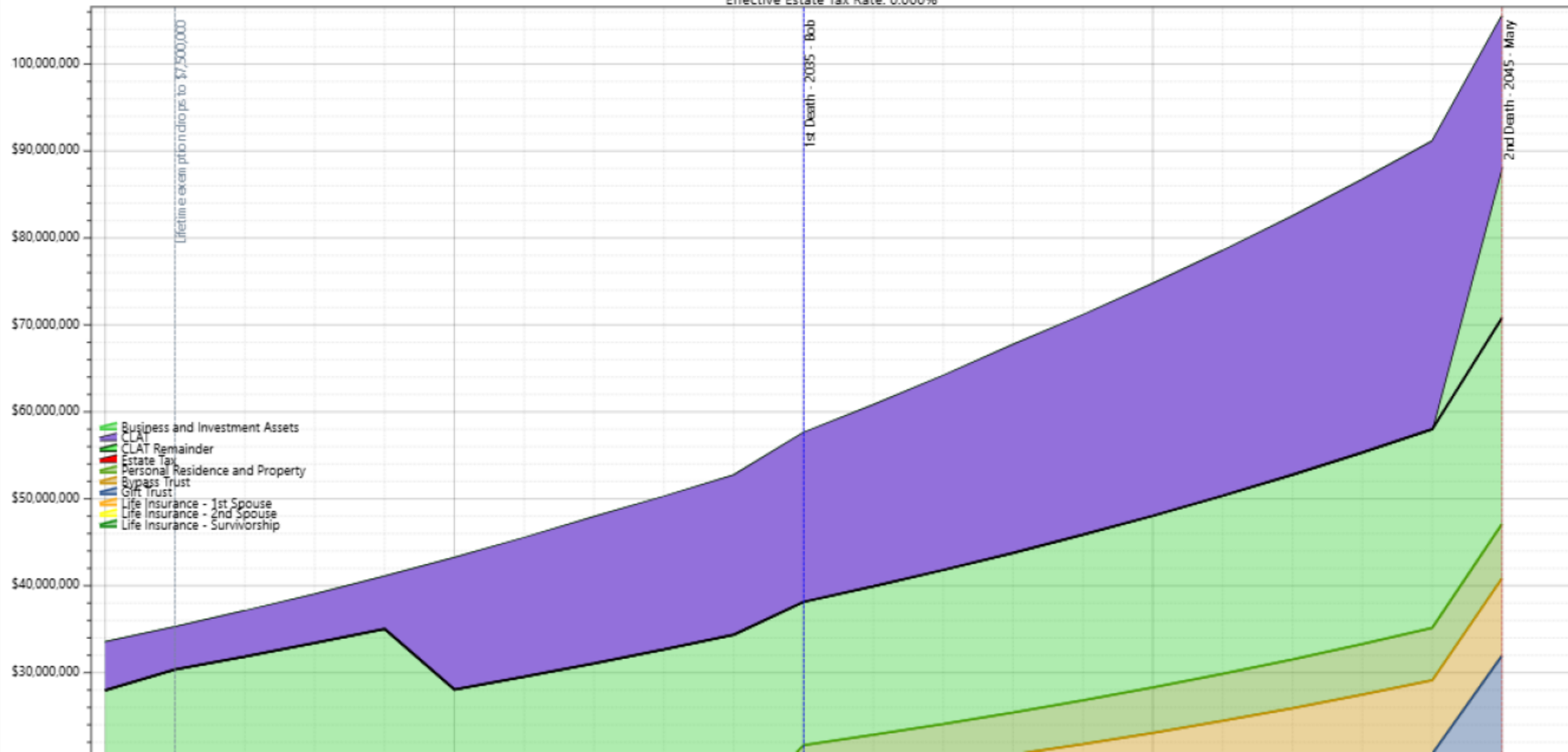
Total Passed to Beneficiaries	\$70,816,819 +
	\$17,353,687 =
	\$88,170,505

Amount Sacrificed by Beneficiaries to Facilitate Charitable: \$3,470,737



ILLUSTRATION 6 - TESTAMENTARY CHARITY

Bob Sample & Mary Sample
Effective Estate Tax Rate: 0.000%



WHAT IF THE EXEMPTION GOES DOWN BY ONE-HALF IN 2030?



ILLUSTRATION 1 - NO PLANNING
(20 YEARS)

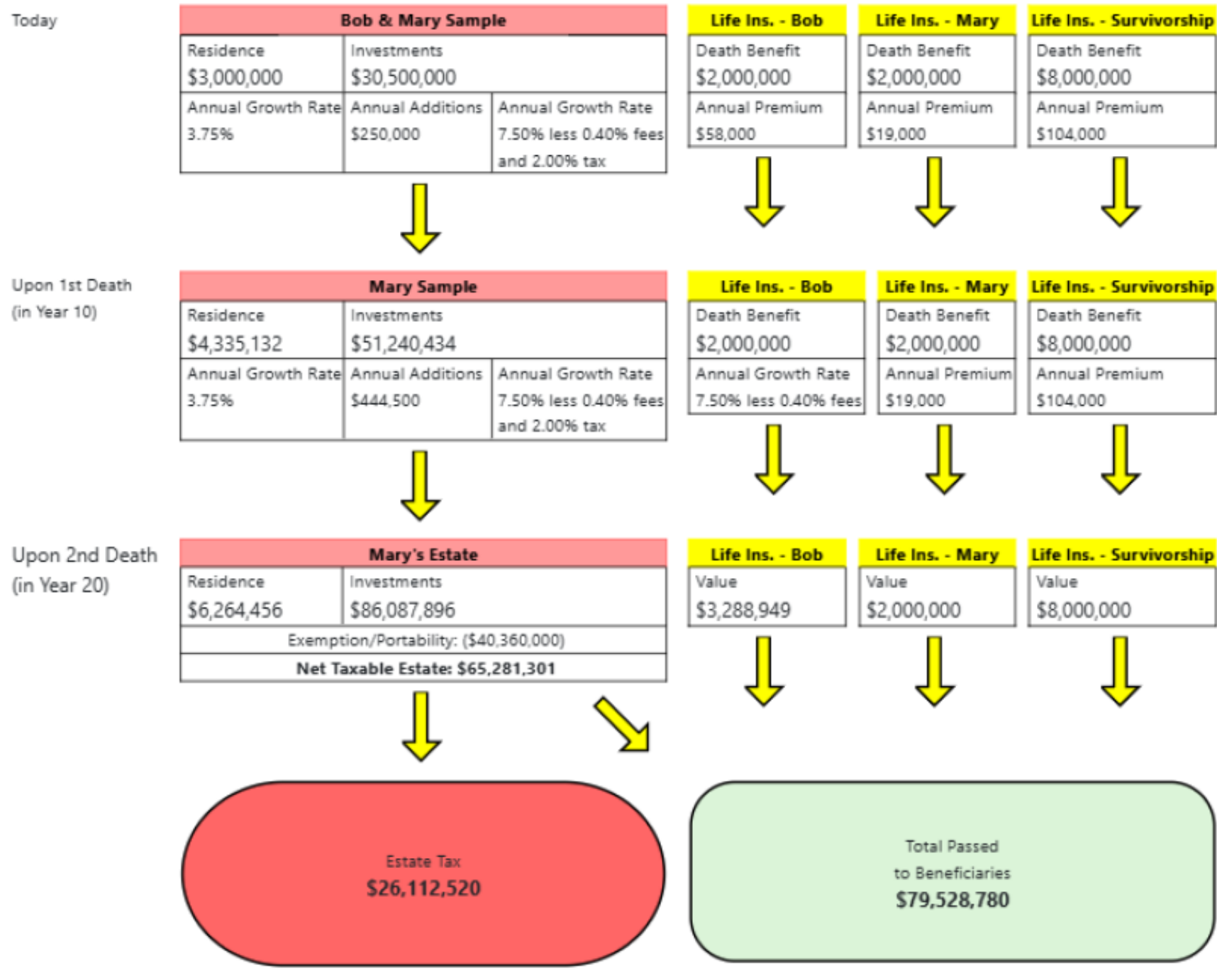


ILLUSTRATION 2 - BYPASS TRUST
(FUNDED YEAR 10)

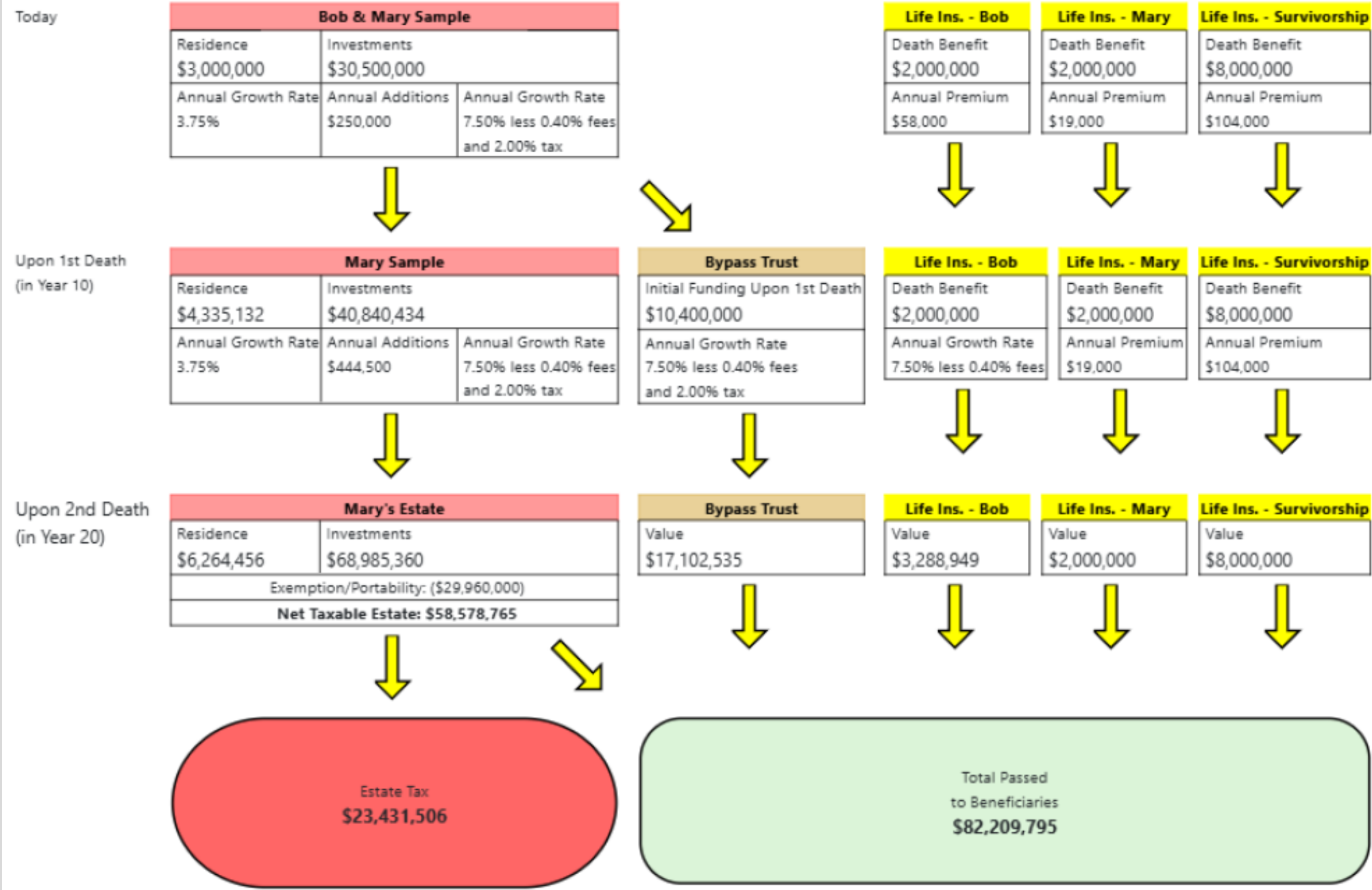


ILLUSTRATION 3 - ANNUAL GIFTING
(2 DONEES)

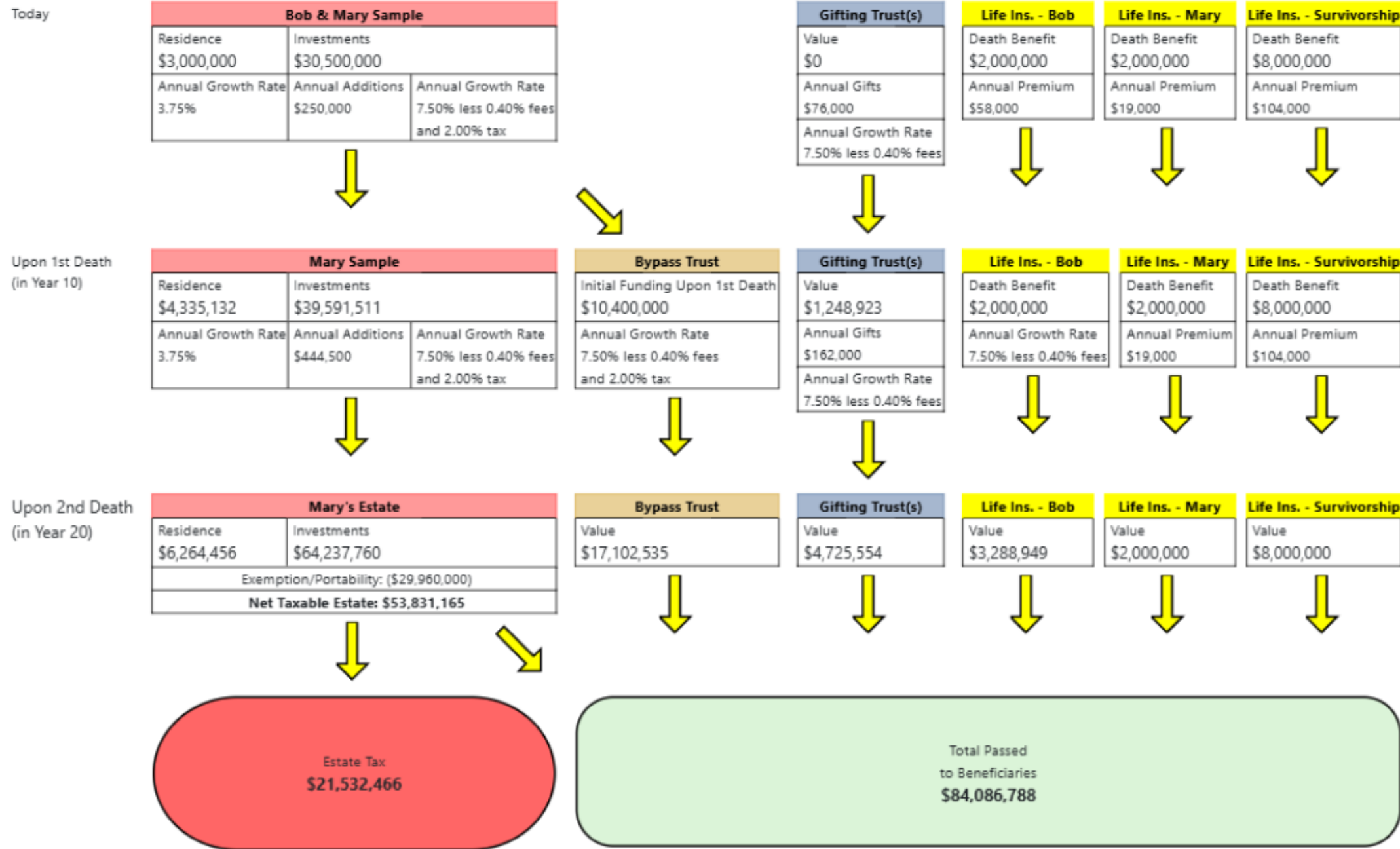


ILLUSTRATION 4 - LIFE INSURANCE TRUST PLANNING
(20 YEARS)

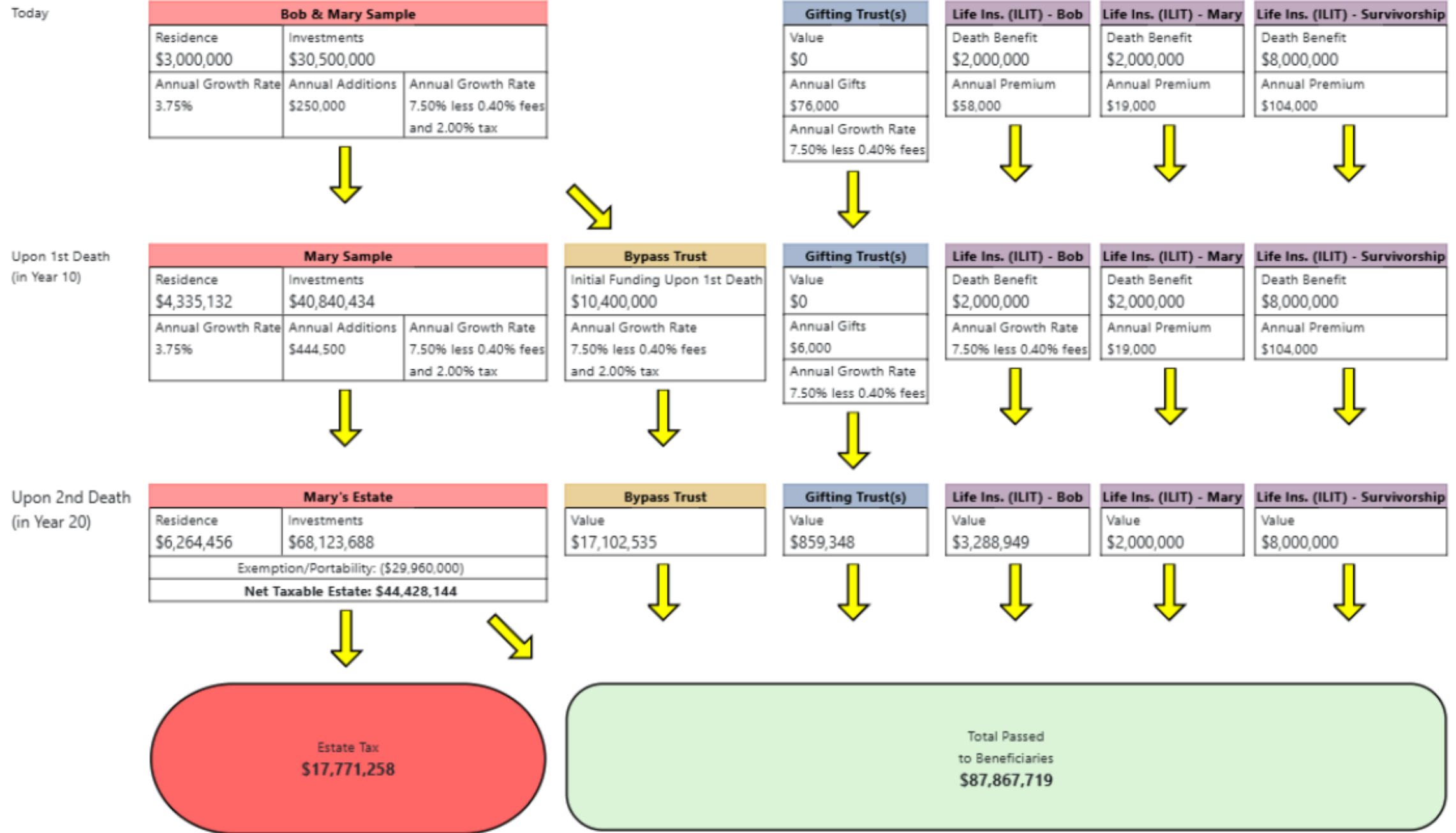


ILLUSTRATION 5 - LARGE GIFT
(20 YEARS)

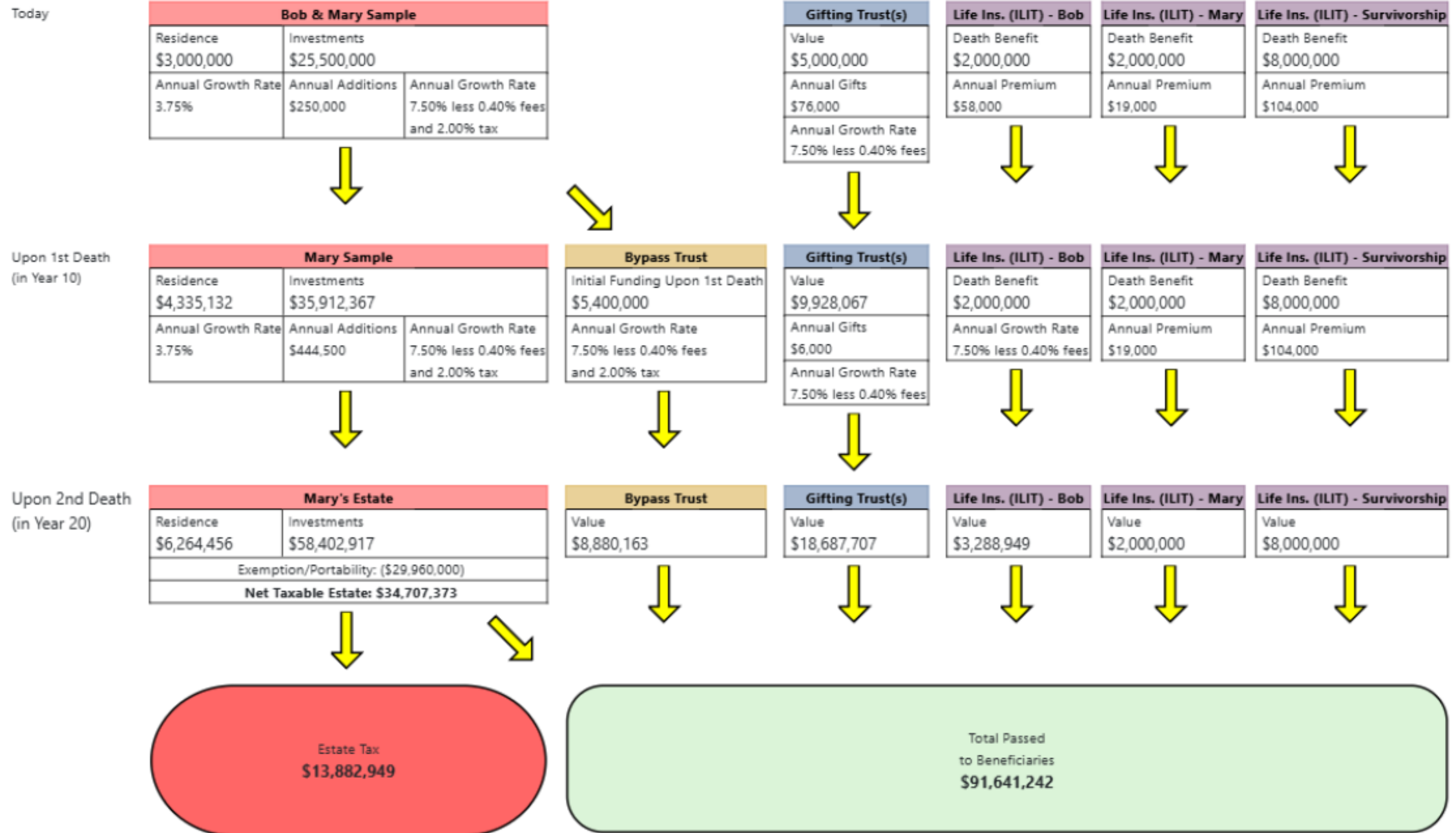


ILLUSTRATION 5 - LARGE GIFT (20 YEARS)

Bob Sample & Mary Sample
Effective Estate Tax Rate: 15.052%

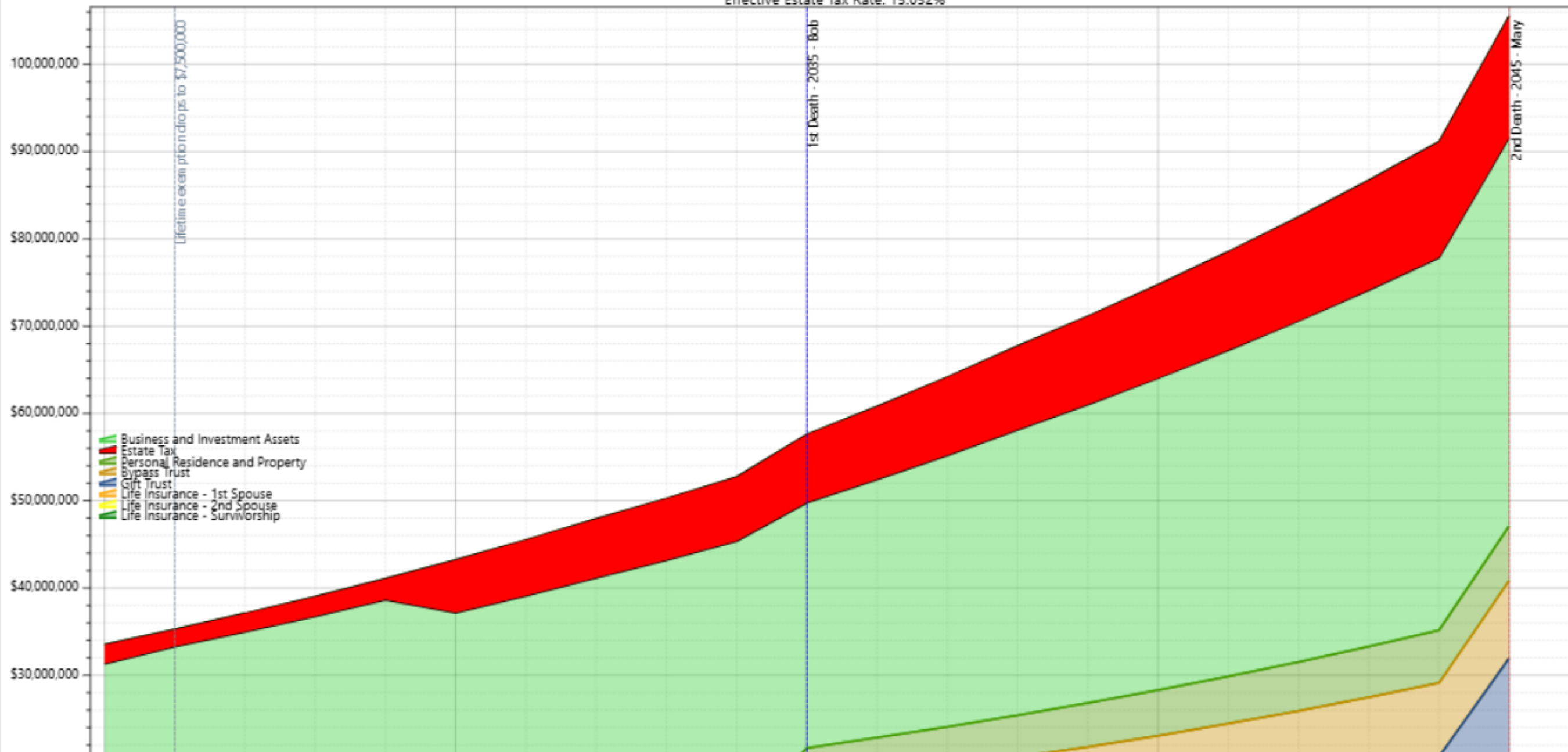


ILLUSTRATION 6 - TESTAMENTARY CHARITY

Today

Bob & Mary Sample		
Residence	Investments	
\$3,000,000	\$25,500,000	
Annual Growth Rate	Annual Additions	Annual Growth Rate
3.75%	\$250,000	7.50% less 0.40% fees and 2.00% tax

Gift(s) Trust(s)
Value
\$5,000,000
Annual Gifts
\$76,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Bob
Death Benefit
\$2,000,000
Annual Premium
\$58,000

Life Ins. (ILIT) - Mary
Death Benefit
\$2,000,000
Annual Premium
\$19,000

Life Ins. (ILIT) - Survivorship
Death Benefit
\$8,000,000
Annual Premium
\$104,000

Upon 1st Death
(in Year 10)

Mary Sample		
Residence	Investments	
\$4,335,132	\$35,912,367	
Annual Growth Rate	Annual Additions	Annual Growth Rate
3.75%	\$444,500	7.50% less 0.40% fees and 2.00% tax

Bypass Trust
Initial Funding Upon 1st Death
\$5,400,000
Annual Growth Rate
7.50% less 0.40% fees and 2.00% tax

Gift(s) Trust(s)
Value
\$9,928,067
Annual Gifts
\$6,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Bob
Death Benefit
\$2,000,000
Annual Growth Rate
7.50% less 0.40% fees

Life Ins. (ILIT) - Mary
Death Benefit
\$2,000,000
Annual Premium
\$19,000

Life Ins. (ILIT) - Survivorship
Death Benefit
\$8,000,000
Annual Premium
\$104,000

Upon 2nd Death
(in Year 20)

Mary's Estate	
Residence	Investments
\$6,264,456	\$58,402,917
Exemption/Portability: (\$29,960,000)	
Amount to CLAT: \$34,707,373	
Net Taxable Estate: \$0	

Bypass Trust
Value
\$8,880,163

Gift(s) Trust(s)
Value
\$18,687,707

Life Ins. (ILIT) - Bob
Value
\$3,288,949

Life Ins. (ILIT) - Mary
Value
\$2,000,000

Life Ins. (ILIT) - Survivorship
Value
\$8,000,000

Amount to CLAT	\$34,707,373 (100%)
Amount to Bob and Mary Sample Foundation	\$17,353,687 (50%)
Remainder to Beneficiaries	\$17,353,687 (50%)
	(in year 20)

Estate Tax	\$0
------------	-----

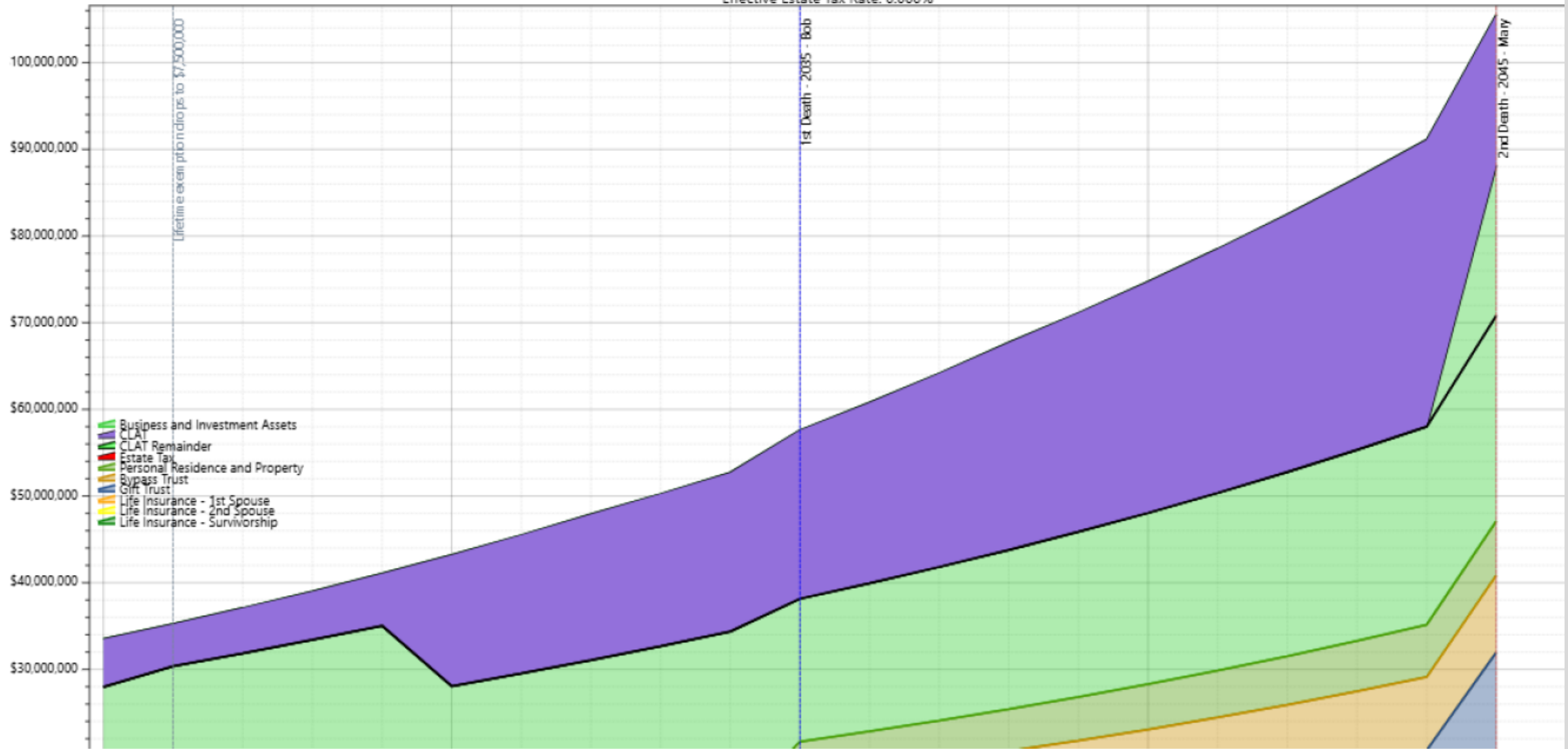
Total Passed to Beneficiaries	\$70,816,819 +
	\$17,353,687 =
	\$88,170,505

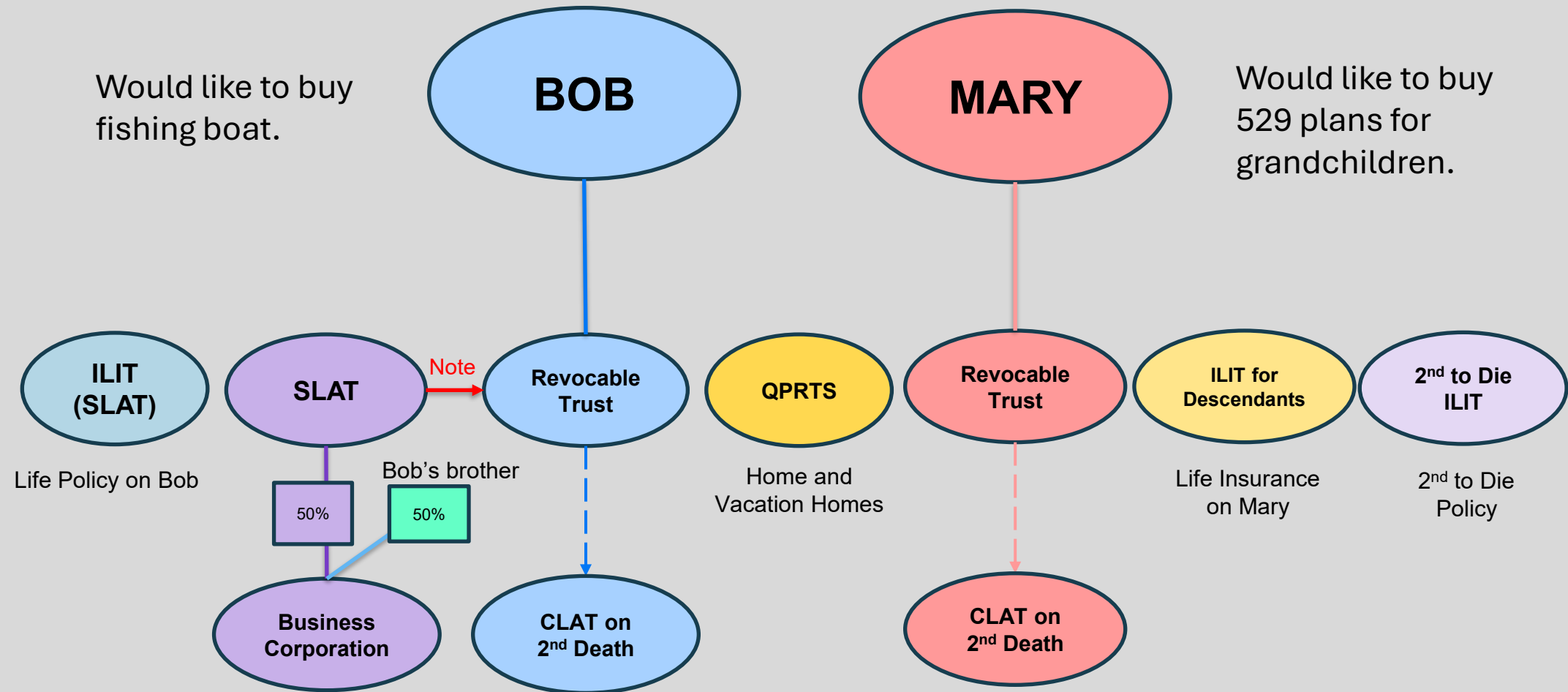
Amount Sacrificed by Beneficiaries to Facilitate Charitable: \$3,470,737



ILLUSTRATION 6 - TESTAMENTARY CHARITY

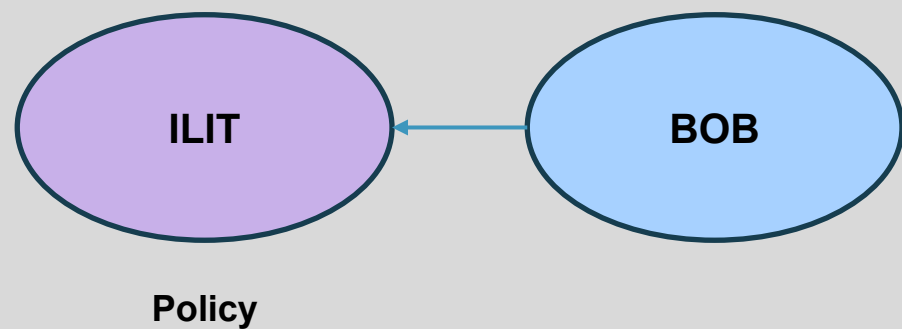
Bob Sample & Mary Sample
Effective Estate Tax Rate: 0.000%





BOB AND HIS ILIT

Keep Policy in ILIT

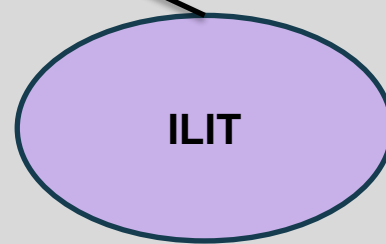


1. Status Quo - Keep gifting premiums.
2. Reduce Death Benefit - Stop gifting.
3. Loan instead of Gift at Arm's-Length (8% interest?)
4. Use Split Dollar Loan or Economic Benefit Regime
- Smaller gifts.
5. Consider Premium Financing.

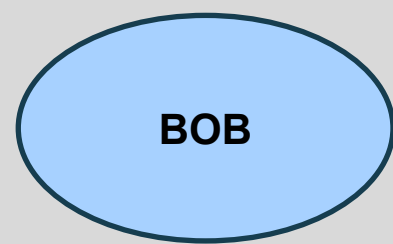
BOB AND HIS ILIT (HELD FOR MARY AND DESCENDANTS)

Buy Policy from ILIT

Give Power of Appointment to older relatives to obtain step-up on death.



Other Assets



Life Insurance Policy

1. Buy policy and fatten it up - Maybe to MEC
2. Buy policy out and convert to a better vehicle
 - A. With long-term care
 - B. PPLI [?]
 - C. Variable contract [?]
 - D. Equity index [?]
 - E. Possible premium financing [?]

ILIT may buy 529 Plan Accounts:

ILIT may become Non-Grantor Trust

- A. Sprinkle income to lower bracket beneficiaries
- B. Pay property taxes
- C. Pay income to charity



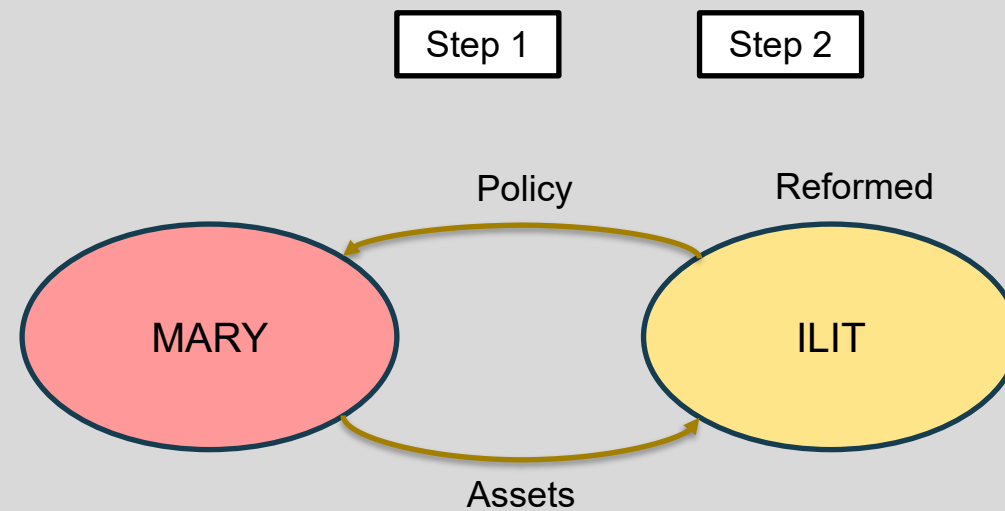
Creditor Proof Life Insurance States (Limits on amount protected will vary)

By Population	Alphabetical Order
Texas	Alabama
Florida	Arizona
New York	Arkansas
Pennsylvania	Delaware
Illinois	District of Columbia
Ohio	Florida
Georgia	Georgia
North Carolina	Hawaii
Michigan	Idaho
Virginia	Illinois
Arizona	Indiana
Tennessee	Iowa*
Massachusetts	Kansas
Indiana	Kentucky
Missouri	Louisiana
Maryland	Maryland
South Carolina	Massachusetts
Alabama	Michigan
Louisiana	Mississippi*
Kentucky	Missouri
Oregon	Montana
Oklahoma	Nevada
Utah	New Mexico
Iowa*	New York
Nevada	North Carolina
Arkansas	Ohio
Kansas	Oklahoma
Mississippi*	Oregon
New Mexico	Pennsylvania
Idaho	South Carolina
Hawaii	South Dakota
Montana	Tennessee
Delaware	Texas
South Dakota	Utah
Vermont	Vermont
District of Columbia	Virginia
Wyoming	Wyoming

None of these states, to the knowledge of the authors, provide protection for the ownership of term life insurance, although term life insurance policies typically are considered to have a negligible value unless the insured is in poor health and not able to replace the policy.



MARY'S ILIT FOR DESCENDANTS (OR DID RECIPROCAL TRUST RULE APPLY AND THEY DID NOT KNOW THIS?)

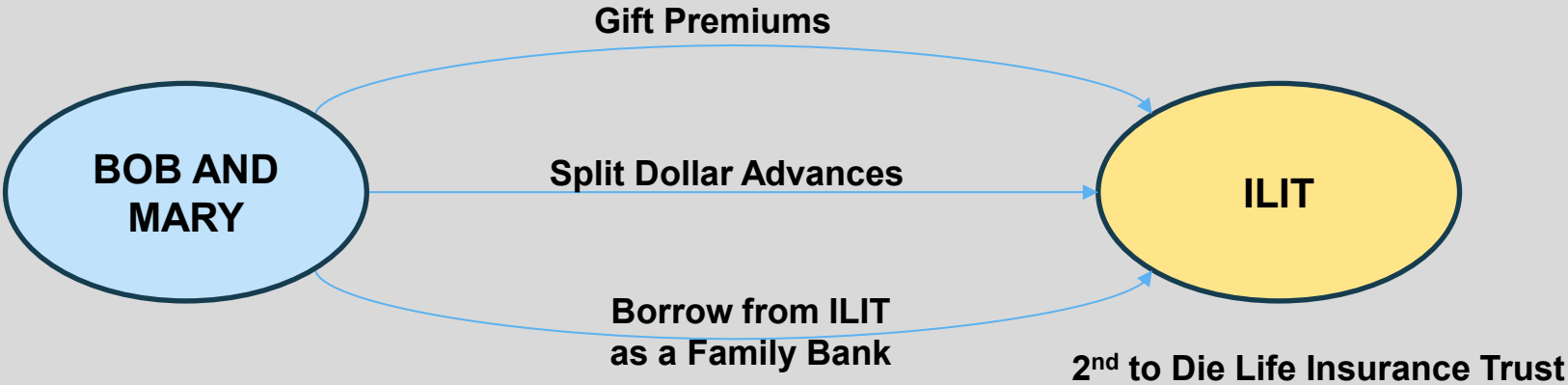


Mary may exchange policy for a policy that has lifetime nursing/care benefits.

1. May spray income to lower bracket family members.
2. May spray income to charity.
3. May receive vacation home and pay vacation home taxes (up to \$40,000 per year).
4. May become 678 Trust for a child and buy a home for the child.
5. May become 678 Trust and own part of family business to get 199a income tax deduction.
6. May buy 529 college savings plan .



BOB AND MARY AND 2ND TO DIE LIFE INSURANCE TRUST

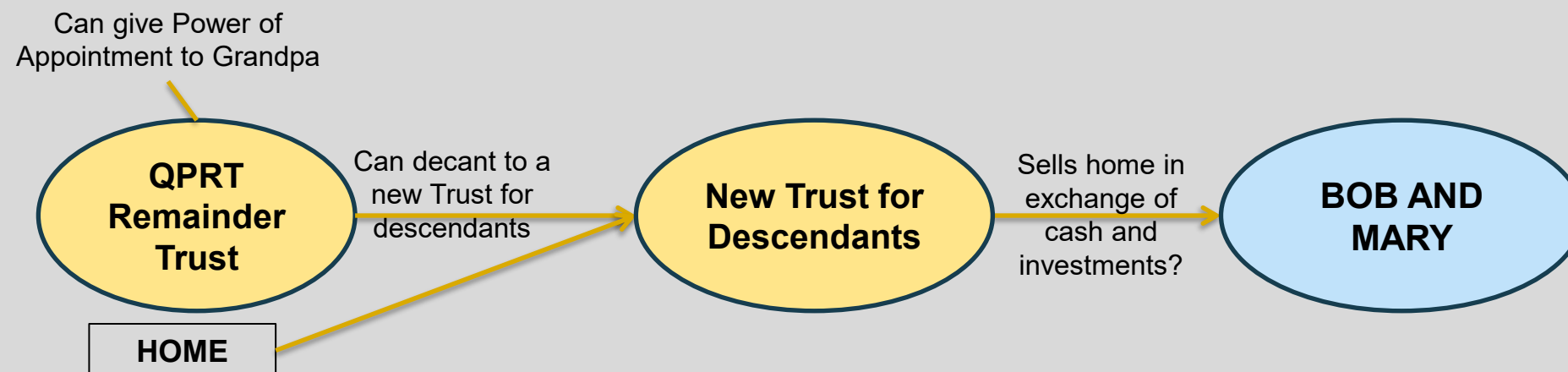


Keep Policy in ILIT until 2030?
 Buy policy from ILIT and use it as a savings vehicle.
 Let ILIT then be a non-life insurance trust and do one or more of the things described in past slides.

May repurpose second to die coverage or make partial withdrawal to purchase other coverages or investments.



BOB AND MARY AND QPRT



Considerations:

1. No step up in basis on death of Bob or Mary.
2. Possibly no \$250,000/\$500,000 exemption on sale after the death of one spouse.
3. IRC Section 2703 requires a QPRT to not allow a transfer or sale of the home to the Grantor or spouse thereof. – If this happens, then the transfer of the home to the QPRT will be considered to be the gift of the entire value of the home – retroactive to the date of funding.

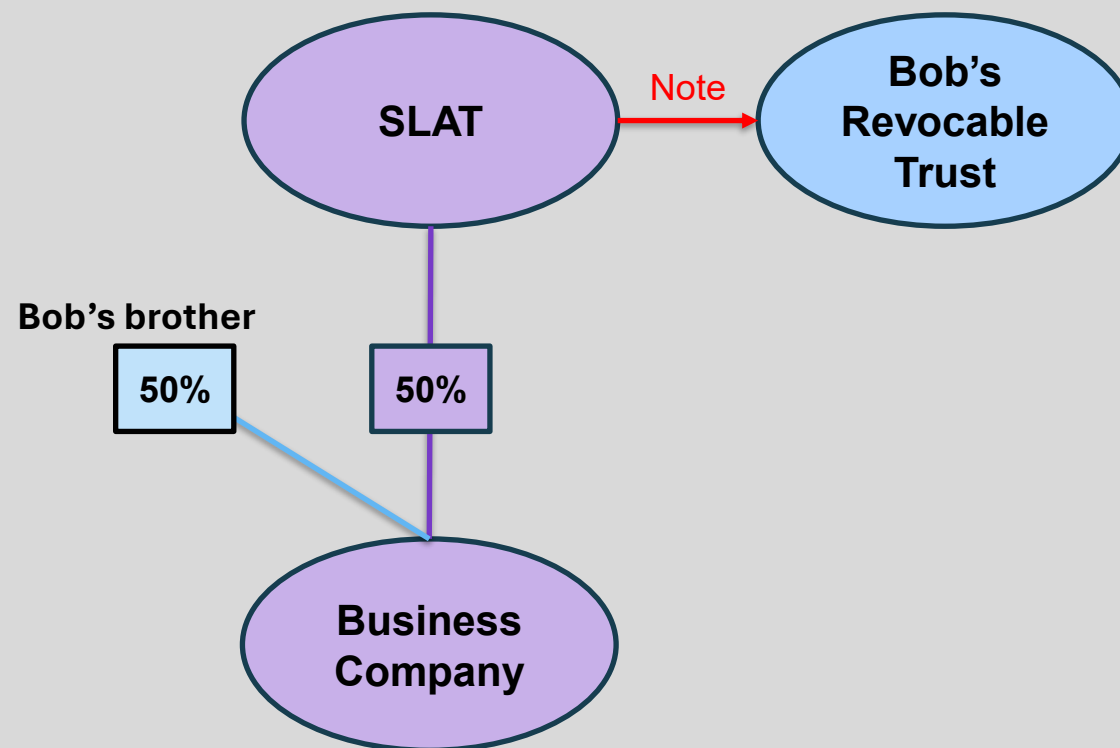
May receive a life insurance policy in exchange for home or other investments used for family.

May require court approval after notice to all beneficiaries and appointment by court of an ad litem to represent minor and unborn beneficiaries.

Home is owned by Bob and Mary again to qualify for \$500,000 exemption on sale and get new fair market value income tax basis on death. No more rent payable to QPRT.



BOB AND MARY PLANNING



Buy-Sell Agreement with Bob's brother suppressed purchase price:

Present formula - \$6,000,000 for half.

Updated formula - \$9,000,000 for half.



WHAT CAN THE SLAT BECOME---POSSIBLE IRREVOCABLE TRUSTS TO CONSIDER

Make SLAT complex to be separately taxed.

1. Spray income to lower bracket beneficiaries.
2. Spray income to charity.
3. Add property and pay property taxes.

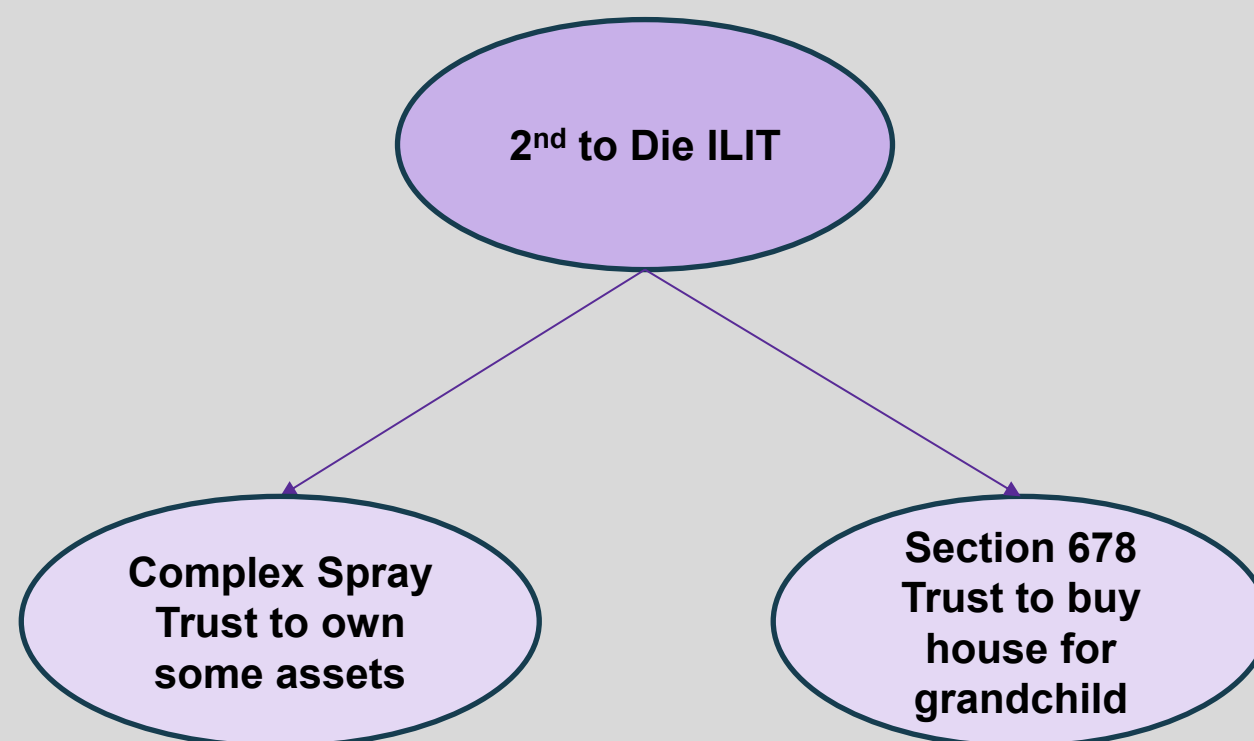
Keep as disregarded (Grantor pays income tax and may exchange assets)

Section 678 Trust

May own child's homestead to obtain \$250,000/\$500,000 exemption and let child deduct property taxes.

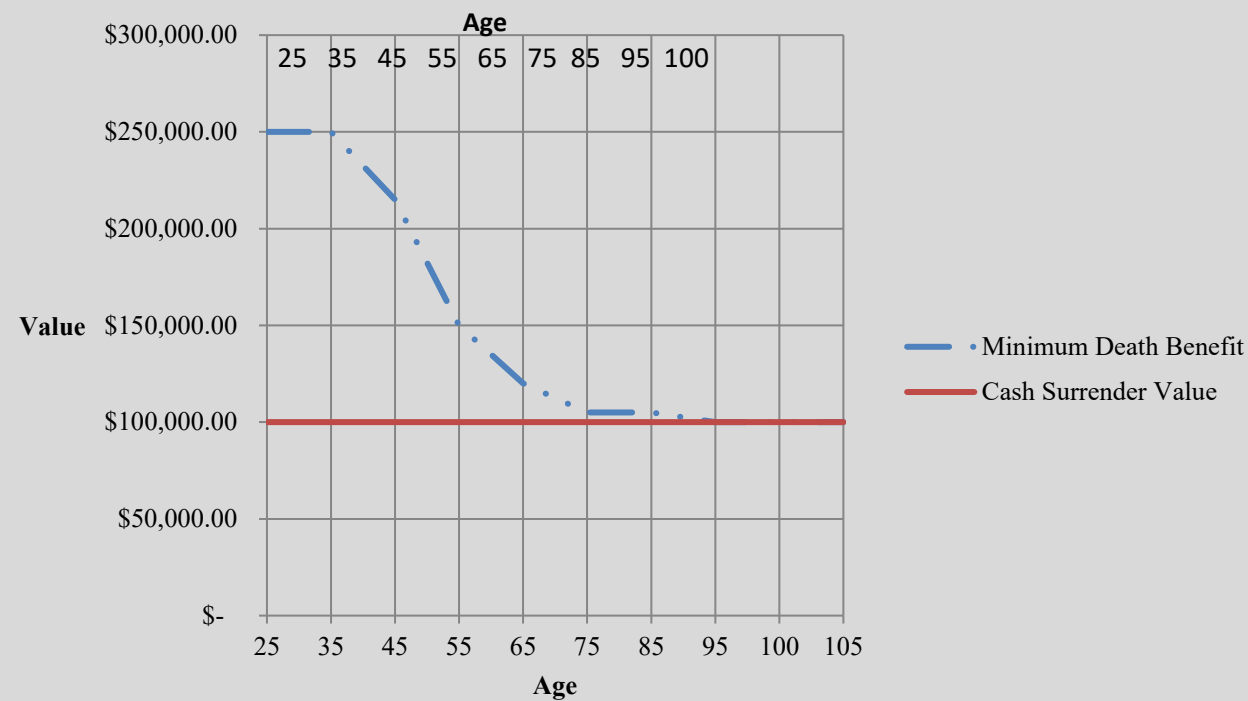


WHAT CAN A SECOND TO DIE ILIT DECANT INTO?



Tax Talk

Minimum Corridor Test Illustration \$100,000 Cash Surrender Value Minimum Death Benefit

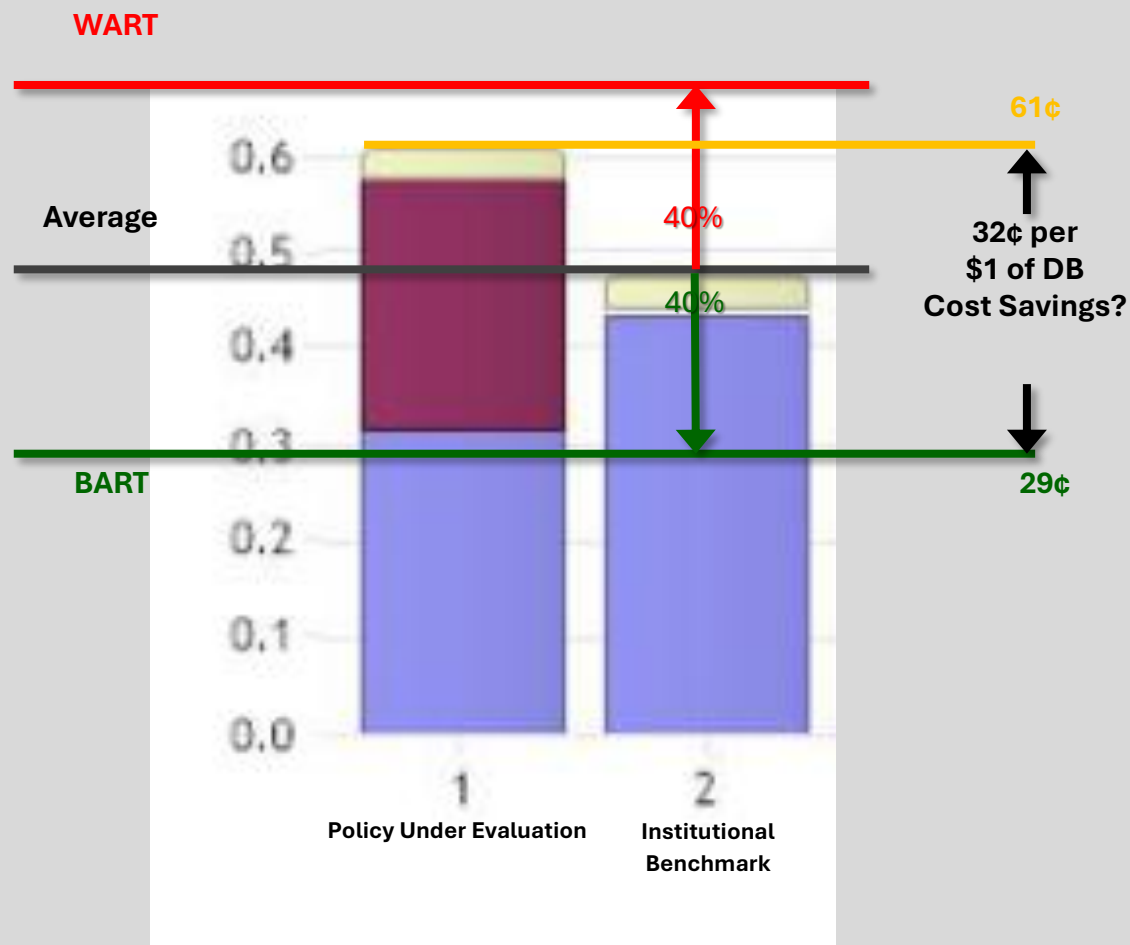


Insured's Age	Percentage
40 or less	250%
45	215%
50	185%
55	150%
60	130%
65	120%
70	115%
75	105%
80	105%
85	105%
90	105%
95 or more	100%

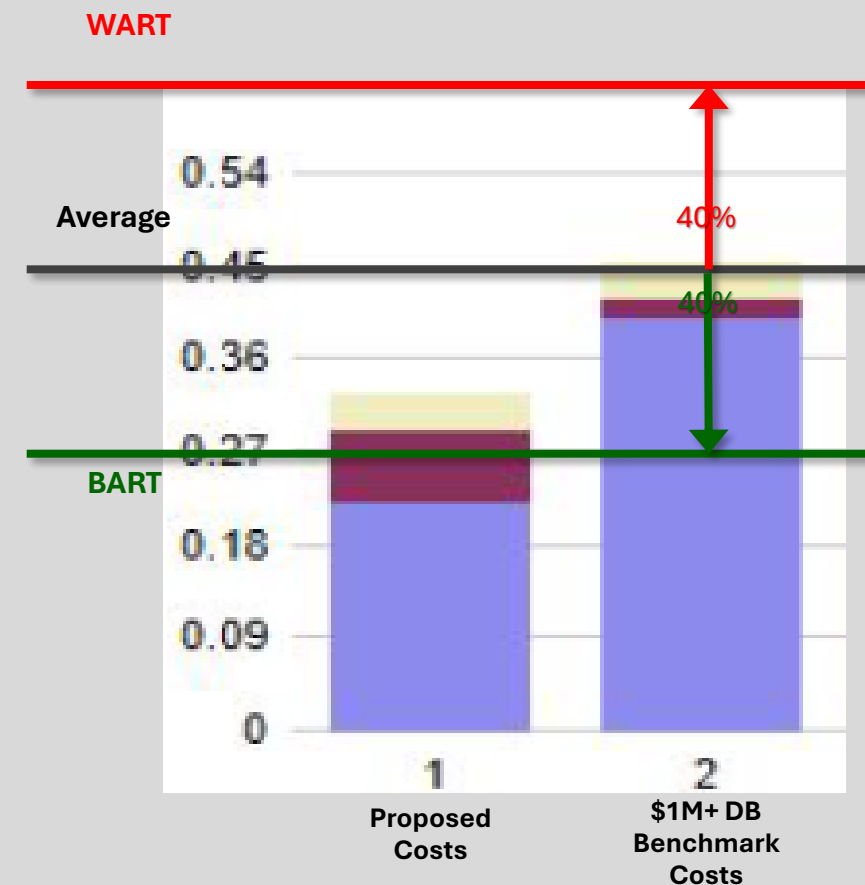


Policy Exchanges Under Internal Revenue Code Section 1035

Cost analysis from Veralytic report of an **inforce policy** indicating internal policy costs of 61¢ per \$1 of death benefit were as much as 32¢ higher than benchmarks for best-available rates and terms (e.g., as much as \$320,000 in potential over-charging for a \$1,000,000 policy)



Cost analysis from Veralytic report of the **1035 Exchange policy** showing actual cost savings were \$300,000 (i.e., 61¢ for the inforce policy less 31¢ for the proposed 1035 exchange below equals 30¢ in actual cost savings per \$1 of death benefit, times \$1,000,000 death benefit equals \$300,000 in cost savings, almost exactly as the above Veralytic report predicted).



Varieties of Life Insurance Policies

Distinguishing Characteristics

	Term Life	Guaranteed Universal Life (GUL)	Whole Life (WL)	Current Assumption Universal Life (CAUL)	(Equity) Index Universal Life (IUL)	Variable Universal Life (VUL)
Distinguishing Characteristics	Lowest cost protection for a specific term of years less than life expectancy.	Premium & death benefit guaranteed for a specified period with the flexibility to change coverage duration and/or death benefit for a corresponding change in the guaranteed premium.	Fixed death benefits for a fixed premium as long as premiums are paid in cash or by dividends, but if dividends not sufficient to pay premiums, then premiums are borrowed against cash values at additional interest cost (see Policy Loan Interest Rate/Spread below).	Flexible death benefits for a flexible premium as long as Policy Cash Values are sufficient to cover cost of insurance charges (COIs) and policy expenses. Account Values are credited with interest at a rate periodically declared by the insurer commensurate with prevailing interest rates subject to a minimum guaranteed rate (e.g., 2% - 4%).	Account Values CAN BE credited with interest at a rate equal to a % of performance from an equity index (e.g., S&P500) EXCLUDING dividends subject to a minimum guaranteed rate (e.g., 0% - 2%)	Account Values either increase/decrease based on performance of self-directed mutual-fund-like Separate Accounts OR are credited with interest at a rate periodically declared by the insurer subject to a minimum guaranteed rate (e.g., 2% - 4%).
Death Benefit	Face Amount	Face Amount	Face Amount + Paid Up Additions (PUAs) if Dividends are used to buy PUAs & PUAs not used to pay premiums.	Option A: Face Amount Option B: Face Amount + Policy Account Value Option C: Face Amount + Cumulative Premiums Paid		
Coverage Duration	1, 5, 10, 15, 20 or 30 years - fixed & guaranteed at issue, but NOT longer than life expectancy.	Guaranteed but dependent on the amount & timing of premium payments.	Dependent on amount & timing of premium payments AND the amount & use of dividends.	Dependent on the sufficiency of policy account values needed to cover cost of insurance (COI) charges and policy expenses.		
Premiums	Fixed & guaranteed for the initial coverage duration.	Fixed & guaranteed until changed by policyowner.	Fixed in amount, but not in the number of years.	Flexible, but must be sufficient to cover COIs & policy expenses over the intended coverage duration.		

This slide is courtesy of Barry Flagg - Veralytic



Varieties of Life Insurance Policies

Distinguishing Characteristics

	Term Life	Guaranteed Universal Life (GUL)	Whole Life (WL)	Current Assumption Universal Life (CAUL)	(Equity) Index Universal Life (IUL)	Variable Universal Life (VUL)
"Premium Call" Risk	None	None, provided premiums are paid when due.	Moderate or Higher if premiums paid by automatic premium loans (APL).	Moderate	Higher	Depends on cash value asset allocation.
Cash Value	None	None or nominal.	Guaranteed to equal the Face Amount at policy maturity plus Dividends used to buy PUAs.	Account Values = Premiums - COIs & Expenses + Interest/Earnings		
				Surrender Value = Account Value - Surrender Charges		
Invested Assets Underlying Policy Account Values	N/A	High-grade bonds & gov't-backed mortgages.	High-grade bonds & gov't-backed mortgages.	High-grade bonds & gov't-backed mortgages.	High-grade bonds & gov't-backed mortgages.	Self-directed from among a family of mutual-fund-like Separate Accounts.
Crediting/Earnings Rates	N/A	N/A	Based on performance of the insurer's General Account over the long-term as declared annually to be generally commensurate with prevailing long(er)-term interest rates.	Based on performance of the insurer's General Account over the long-term as periodically declared to be generally commensurate with prevailing mid-term interest rates.	Based on the performance of an equity index (e.g., S&P500) EXCLUDING dividends subject to a max cap, a participation rate, a spread and/or a minimum guaranteed rate (e.g., 0% - 2%)	Based on the gains or losses in the selected mutual-fund-like Separate Accounts.
Can Borrow Against Cash Value	N/A	May lose death benefit and/or premium guarantees.	Yes	Yes	Yes	50%; Subject to Regulation U
Policy Loan Interest Rate/Spread (i.e., net cost of borrowing)	N/A	N/A	6%-8% or less if "direct recognition" type product.	0%-2%	0%-2%	0%-2%

This slide is courtesy of Barry Flagg - Veralytic



Varieties of Life Insurance Policies

Distinguishing Characteristics

	Term Life	Guaranteed Universal Life (GUL)	Whole Life (WL)	Current Assumption Universal Life (CAUL)	(Equity) Index Universal Life (IUL)	Variable Universal Life (VUL)
Cash Value at Risk if Insurer Fails	N/A	Yes	Yes	Yes	Yes	No
Death Benefit at Risk if Insurer Fails	Yes	Yes	Yes	Yes	Yes	Yes
Can be Sold Without Series 6 License	Yes	Yes	Maybe	Yes	Yes	No
Commission Concessions	No	Sometimes	Yes	Yes	Yes	Yes
Life Settlement	Yes, if convertible.	Yes	Maybe	Yes	Yes	Yes, but with only through B/Ds supervised by FINRA.
Regulated By	State	State	State	State	State	FINRA and State
Common Riders	N/A	Maturity Extension Rider (MER) to prevent loss of coverage and/or taxable gain otherwise triggered between age 95 - 100.				
		Accelerated Death Benefit (ADB) rider for terminal illness (i.e., life expectancy of 6-12 months).				
		Long-Term-Care (LTC) or Chronic Illness Riders (e.g., for loss of 2 or more Activities of Daily Living or Cognitive Impairment).				
		N/A	N/A	Over-Loan Protection (OLP) Rider to prevent policy loans from causing policy lapse and the corresponding phantom-taxable-income on the "forgiveness" of accumulated policy loans and accumulated interest.		

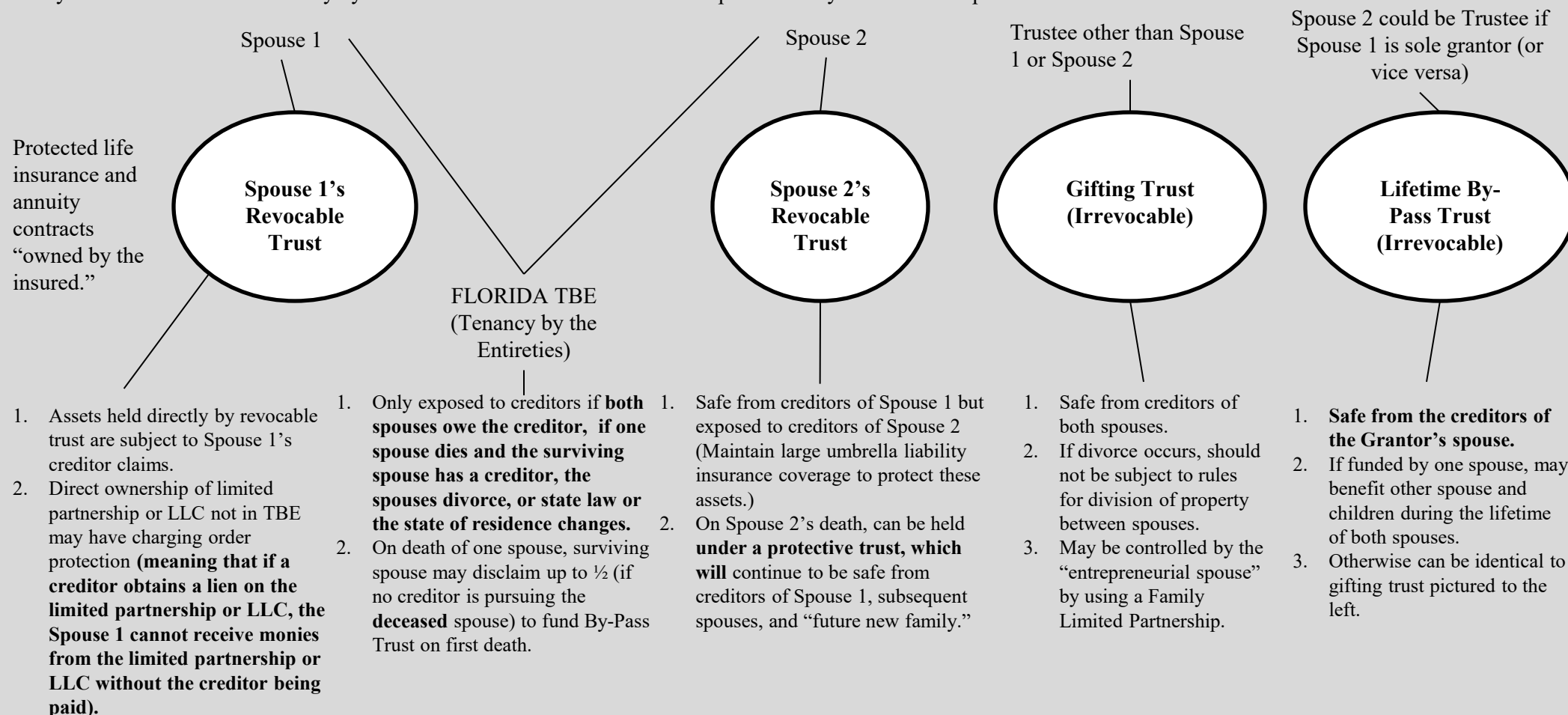
This slide is courtesy of Barry Flagg - Veralytic



DETERMINING HOW TO BEST ALLOCATE ASSETS AS BETWEEN A MARRIED COUPLE - PART I

General Rules:

- Typically want each trust funded with at least \$11,200,000 worth of assets on death for estate tax planning.
- May be funded from ½ of tenancy by the entireties assets via disclaimer and probate or by life insurance/pension/IRA assets.



SEE NEXT PAGE FOR SECOND TIER PLANNING

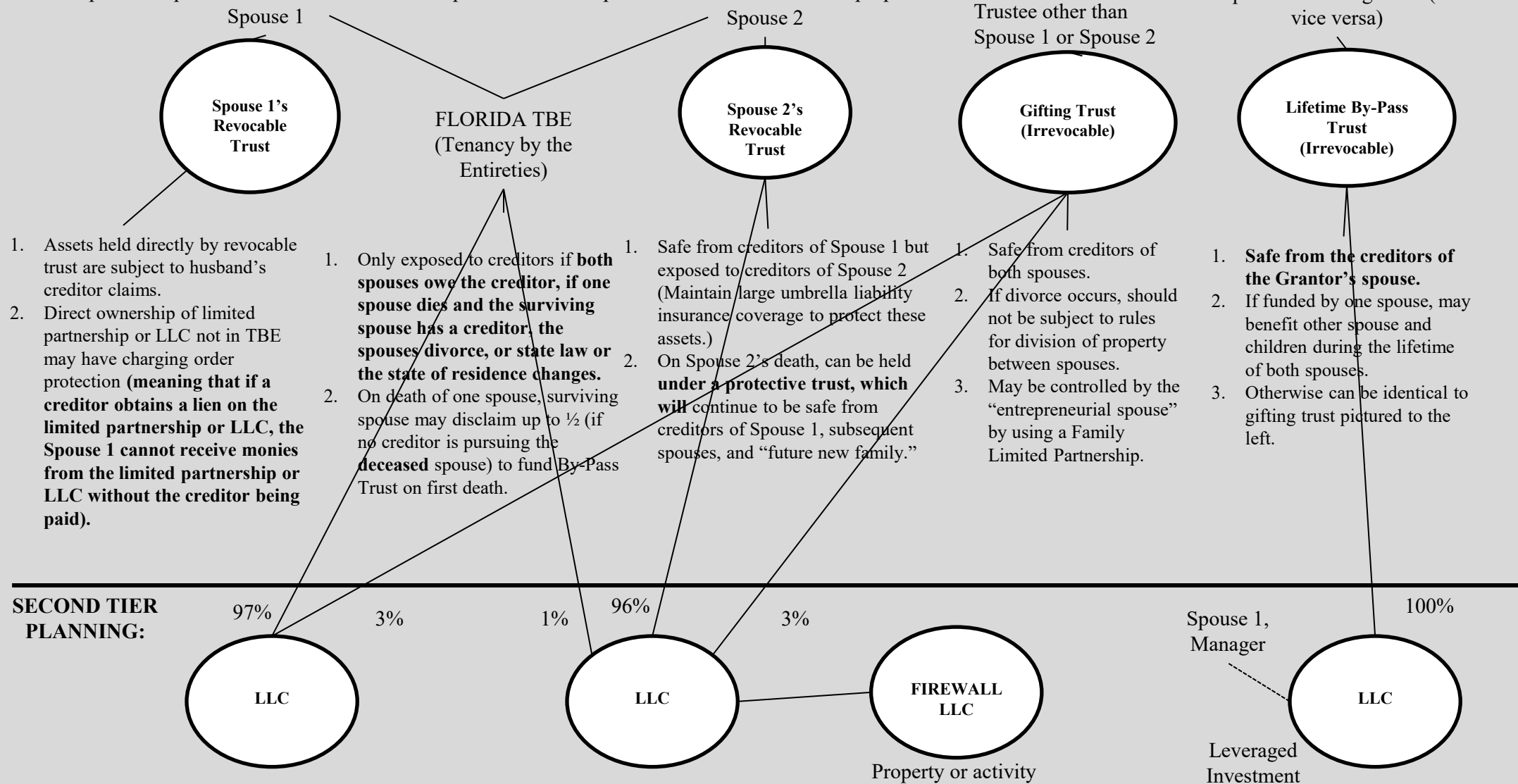
A COMMON SOLUTION - to use a limited partnership or similar mechanisms and have no assets directly in the "high risk" spouse's trust, half to two-thirds of the assets held as tenants by the entireties, and half to two-thirds of the assets directly in the "low risk" spouse's trust.



DETERMINING HOW TO BEST ALLOCATE ASSETS AS BETWEEN A MARRIED COUPLE - PART II

Subsidiary Entity Techniques:

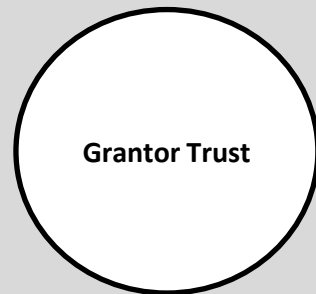
- Limited partnerships and LLCs can be used to facilitate discounts, for estate tax purposes, and for charging order protection.
- Limited partnerships and LLCs can also be used to provide “firewall protection” from activities or properties owned.



A COMMON SOLUTION - to use a limited partnership or similar mechanisms and have no assets directly in the “high risk” spouse’s trust, half to two-thirds of the assets held as tenants by the entireties, and half to two-thirds of the assets directly in the “low risk” spouse’s trust.



Basic Income Tax Operation of Each Type of Trust

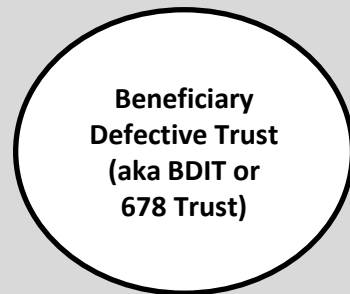


Grantor Trust

Grantor treated as the owner for federal income tax purposes.

Can make protective ESBT election.

If anyone but the Grantor makes a contribution, it is no longer a Grantor Trust!



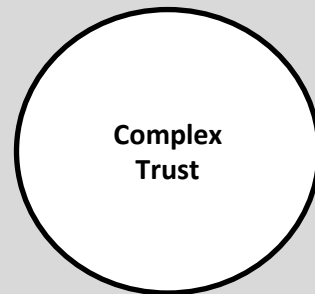
Beneficiary Defective Trust (aka BDIT or 678 Trust)

Beneficiary treated as owner for federal income tax purposes.



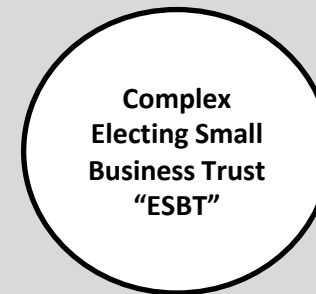
678 Income Trust

If beneficiary has the right to withdraw all income then all income will pass by K-1 to beneficiary regardless of whether it is distributed.



Complex Trust

1. Taxed as a separate entity to the extent that income is not distributed
2. "Distributable Net Income" paid out can carry the income to lower bracket taxpayers
3. The trust has an effective tax rate of 24.1% on the first \$12,500 of income and 37% above that.
4. Distributions made within 65 days of the next tax year can be considered to have been made in the previous tax year.
5. Distributions made to charity can carry income to the charity to in effect give a tax deduction without a 60% adjusted gross income limitation or itemized deduction considerations.
6. 3.8% Medicare tax begins to apply at \$12,500+ of AGI.
7. Unlike a C Corporation - No tax upon liquidation of the trust.
8. Can shield Trustee and Beneficiaries from operational liability similar to a corporation depending upon state law.
9. No 179 Deduction
10. Separate \$10,000 SALT deduction.



Complex Electing Small Business Trust "ESBT"

1. Can be owner of an S-Corporation.
2. Can allow a non-resident alien beneficiary to effectively be a member of an S-Corporation.
3. S-Corporation income taxed at the highest rate bracket, regardless of whether income is distributed to beneficiaries.
4. ESBTs may have multiple beneficiaries, and mandatory distributions of income are not required.
5. Distributions made to charity will be subject to the same rules that apply to individuals.
6. 3.8% Medicare tax begins to apply at \$12,500+ of AGI.



Qualified Subchapter S Trust "QSST"

1. Can be owner of an S-Corporation.
2. Can have only one named beneficiary.
3. Must pay all "fiduciary accounting income" to trust beneficiary each year.
4. All S-Corporation K-1 income taxed to beneficiary of trust.

Married Couples Trust Decision Chart

	JEST (Joint Exempt Step-Up Trust)	Tenants by the Entireties Trust	Joint Trust – Not TBE, JEST, or CPT	Florida Community Property Trust	Tennessee Community Property Trust	South Dakota Community Property Trust	Alaska Community Property Trust	Kentucky Community Property Trust
Step-Up in Basis After First Death	Probably Yes	Only Half of a Step-Up	Depends Upon Drafting and Logistics	Probably Yes	Probably Yes	Probably Yes	Probably Yes	Probably Yes
Creditors of One Spouse Can Reach Trust Assets	Yes – the Debtor Spouse’s Share	Protected from Either Spouse’s Creditors	Depends Upon Trust Drafting	One-Half of Trust Assets Exposed to One Spouse’s Creditors	One-Half of Trust Assets Exposed to One Spouse’s Creditors	All of Trust Assets Exposed to One Spouse’s Creditors	All of Trust Assets Exposed to One Spouse’s Creditors	One-Half of Trust Assets Exposed to One Spouse’s Creditors
Can Create Credit Shelter Trust With More Than Half of the Trust Assets	Yes, All Trust Assets May Go Into Credit Shelter Trusts	Up to Half, But Only by Disclaimer or Surviving Spouse Will Not Have a Power of Appointment	Depends Upon Drafting – Be Careful!	Only as to One-Half	Only as to One-Half	Only as to One-Half	Only as to One-Half	Only as to One-Half
May Share Upon Divorce as Set Forth in Pre- or Post- Nuptial Agreement	Yes	Probably Not	Yes	Yes – Spouses can agree on the dissolution of property Fla Stat. 736.1508	Yes – Spouses can agree on the dissolution of property	Yes – Spouses can agree on the dissolution of property	Yes – Spouses can agree on the dissolution of property	Yes – Spouses can agree on the dissolution of property

***Chart continued on next slide**



Married Couples Trust Decision Chart, Cont'd

	JEST (Joint Exempt Step-Up Trust)	Tenants by the Entireties Trust	Joint Trust – Not TBE, JEST, or CPT	Florida Community Property Trust	Tennessee Community Property Trust	South Dakota Community Property Trust	Alaska Community Property Trust	Kentucky Community Property Trust
May Be Converted from Former Joint or Individual Trust	Yes	Yes	N/A	No – Must Be Created On or After July 1, 2021 as a new Florida Community Property Trust	N/A	Yes	Yes	Yes
Complicated to Draft?	Yes	Simpler than JEST	Will Depend Upon Specifics	Simple to Draft if the Statute is Followed	Simple to Draft if the Statute is Followed	Simple to Draft if the Statute is Followed	Simple to Draft if the Statute is Followed	Simple to Draft if the Statute is Followed
Requires a “Qualified” Trustee	No	No	No	Yes	Requires a Tennessee Trustee	Requires a South Dakota Trustee	Requires an Alaska Trustee	Requires a Kentucky Trustee



Community Property Trust Features- Florida

State	Requirements	Creditor Protection	Property Included	U.S.C. s. 1014(b)(6)
Florida	<p>(1) Expressly declares that the trust is a community property trust within the meaning of this part</p> <p>(2) Has at least one trustee who is a qualified trustee, provided that both spouses or either spouse also may be a trustee</p> <p>(3) Is signed by both settlor spouses consistent with the formalities required for the execution of a trust under this chapter.</p> <p>(4) Contains substantially the following language in capital letters at the beginning of the community property trust agreement: THE CONSEQUENCES OF THIS COMMUNITY PROPERTY TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND UPON THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD BE SIGNED ONLY AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK COMPETENT AND INDEPENDENT LEGAL ADVICE.</p>	<p>(1) An obligation incurred by only one spouse before or during the marriage may be satisfied from that spouse's one-half share of a community property trust.</p> <p>(2) An obligation incurred by both spouses during the marriage may be satisfied from a community property trust of the settlor spouses.</p>	All property owned by a community property trust is community property under the laws of the state during the marriage of the settlor spouses.	<p>36.1511 Application of Internal Revenue Code; community property classified by another jurisdiction.--For purposes of the application of s. 1014(b)(6) of the Internal Revenue Code of 1986, 26 U.S.C. s. 1014(b)(6), as of January 1, 2021, a community property trust is considered a trust established under the community property laws of the state. Community property, as classified by a jurisdiction other than this state, which is transferred to a community property trust retains its character as community property while in the trust. If the trust is revoked and property is transferred on revocation of the trust, the community property as classified by a jurisdiction other than the state retains its character as community property to the extent otherwise provided by ss. 732.216-732.228.</p>

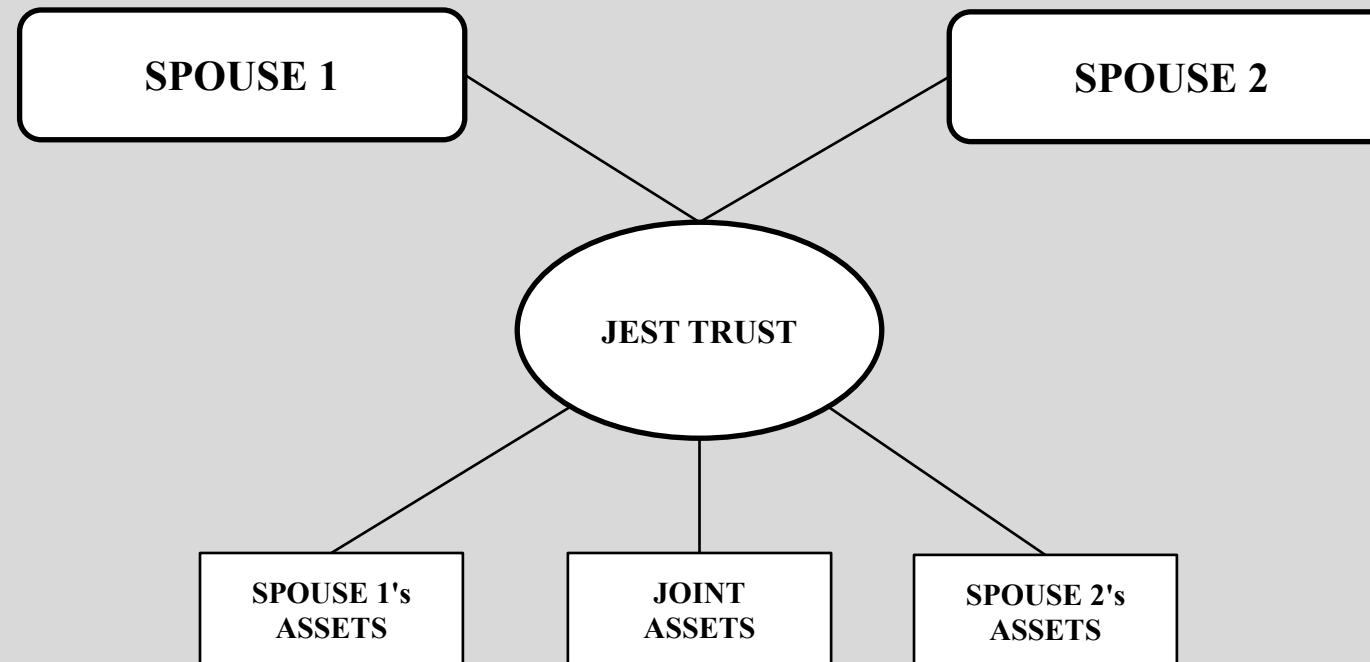


The JEST Trust

(JEST means Joint Exempt Step Up Trust and allows for full step up and full funding of the credit shelter amount on first death)



JEST Trust



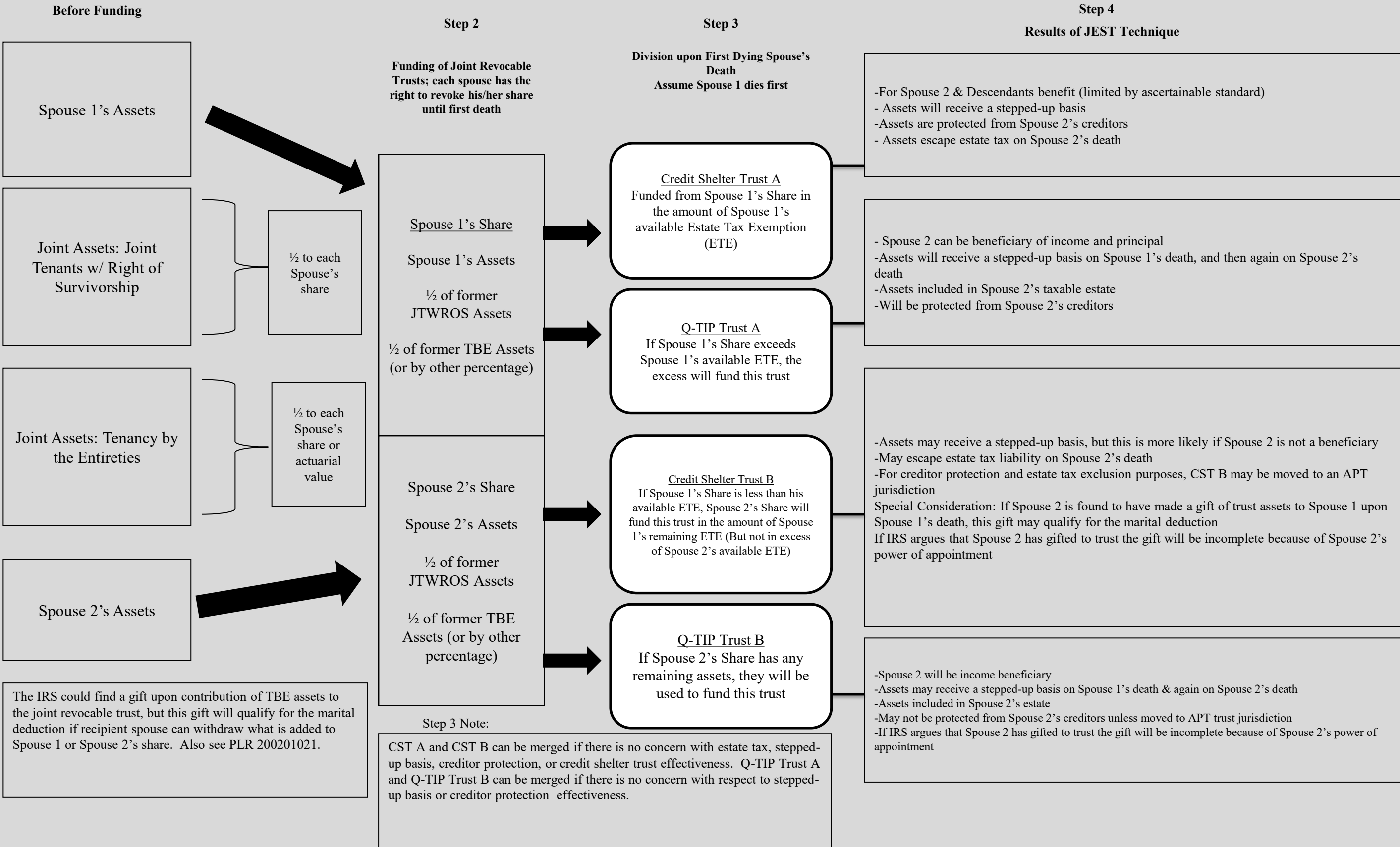
On first death, up to exemption amount of first dying spouse (as much as \$13,990,000), may pass to Credit Shelter Trust or Trusts to benefit surviving spouse and descendants, with a possible full step-up of all assets - excess assets going into QTIP Trusts, which may also qualify for full step-up.



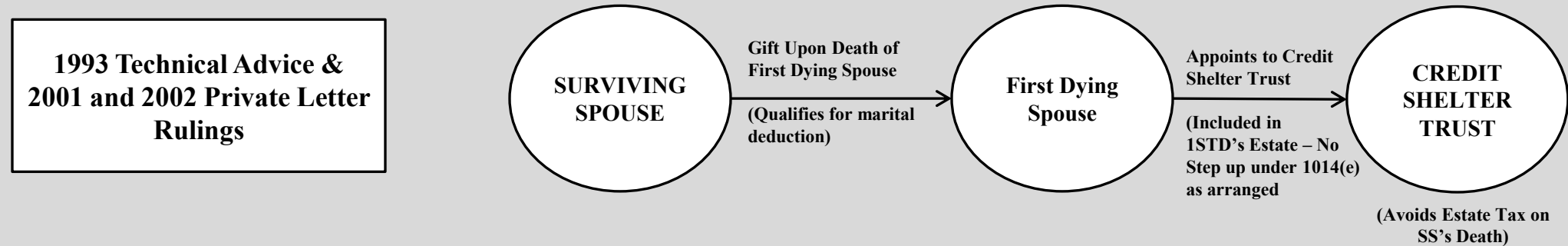
Joint Exempt Step-Up Trust (JEST) Chronology - The 4 Steps from Drafting to Implementing

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Derived from articles that can be found on Leimberg Information Services (Estate Planning Newsletter #2086) and Estate Planning Magazine October and November 2013 Editions



Basic JEST Anatomy



Blattmachr Article

Credit Shelter Trust could be found to be funded by surviving spouse under step transaction doctrine so creditor may invade the trust in most states.

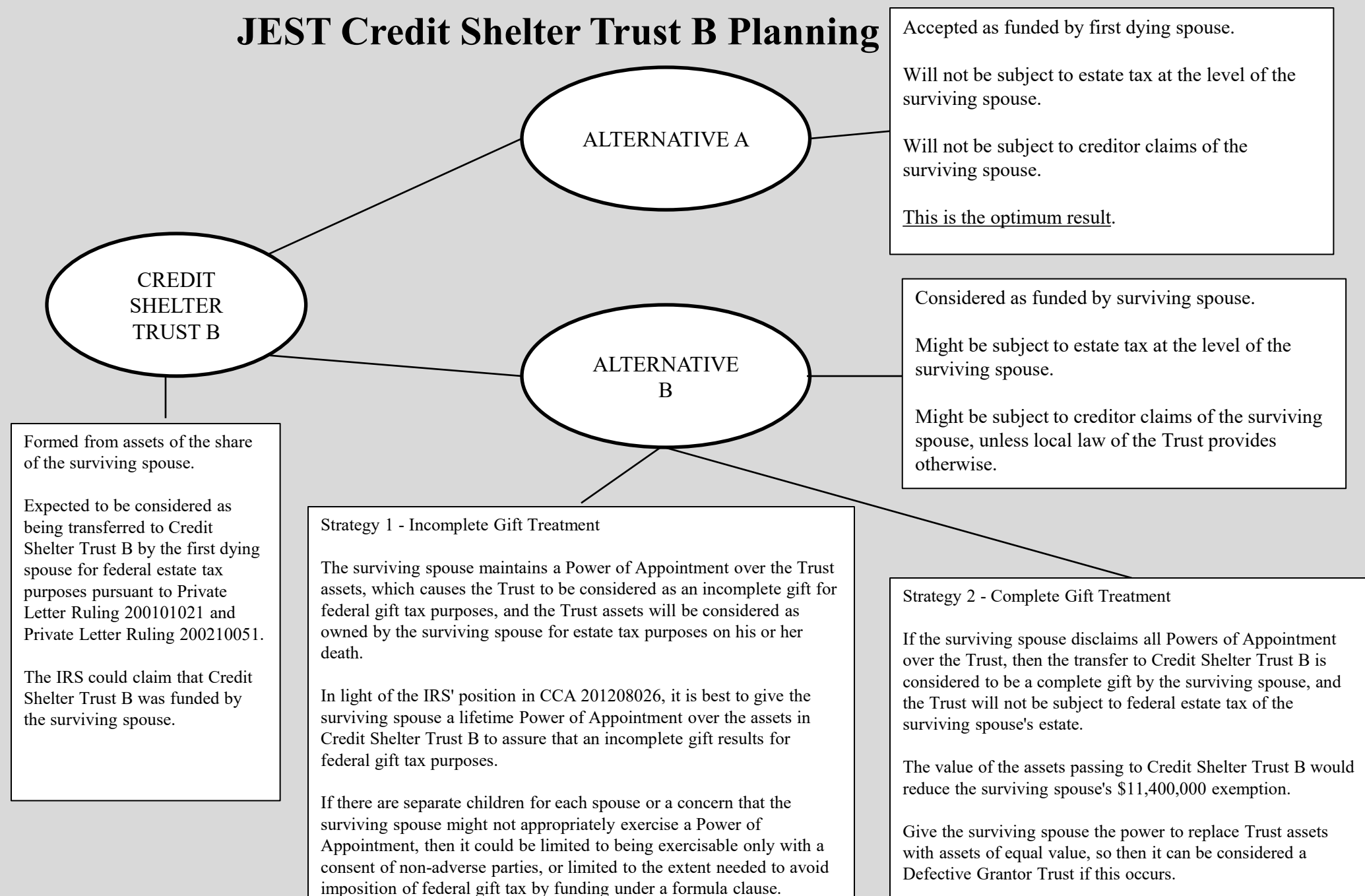
Mulligan

If first dying spouse needs approval of surviving spouse to appoint then 2041 may not apply, could be considered as a gift of ½ by the surviving spouse – but 1933 Johnston case held otherwise in a similar situation.

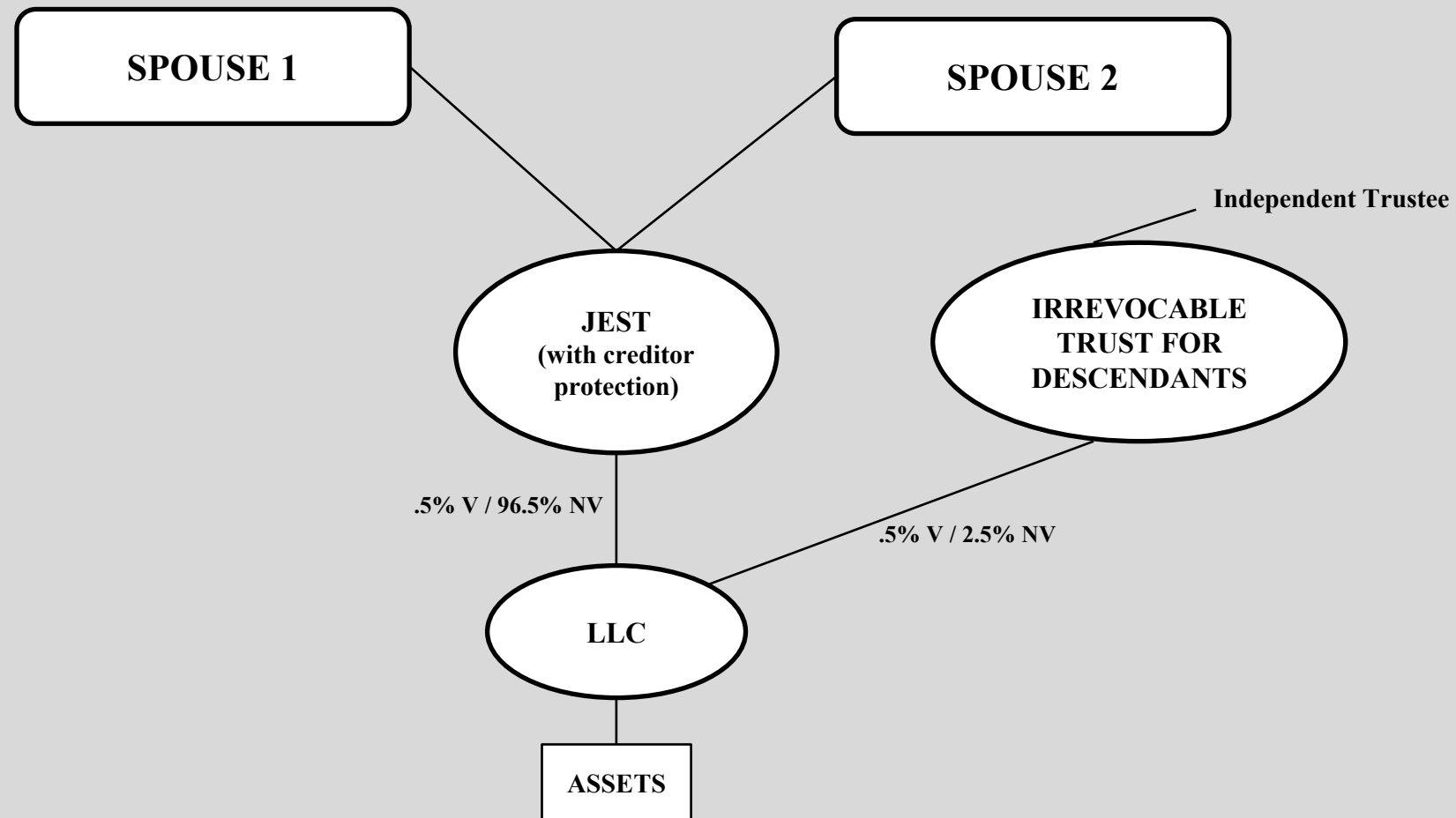
Zaritsky 2015 Heckerling Presentation.

Will the service consider the surviving spouse to have funded the credit shelter trust or trusts by reason of the step transaction doctrine?

JEST Credit Shelter Trust B Planning



JEST with Some Creditor Protection



Modernization/Conversion of Irrevocable Life Insurance Trusts and Taxation of Life Insurance Trust

Income Taxation of Life Insurance Trust

Most life insurance trusts are disregarded grantor trusts for federal income tax purposes because the IRC Section 677 considers a trust to be a grantor trust if the grantor is the insured, at least as to the life insurance policy itself.

Transactions between an individual and a grantor trust and/or the spouse of the Grantor will normally be disregarded for federal income tax purposes as if they never occurred. However, interest paid or accrued as between spouses (or between one spouse and a grantor trust considered as owned by the other spouse) will be taxable as the interest is paid or accrued each year. (See Northern Trust. (2022).

Understanding grantor trusts: Tax implications and planning strategies. Retrieved from <https://www.northerntrust.com>. See also The Tax Adviser. (2020). *Planning with irrevocable life insurance trusts.* AICPA. Retrieved from <https://www.thetaxadviser.com>.)



Modernization/Conversion of Irrevocable Life Insurance Trusts and Taxation of Life Insurance Trust

Avoiding Income Tax on Investment Income

Many grantors will prefer not to pay income tax on the income of a grantor trust, and many trustees and beneficiaries will prefer not to have a non-grantor trust pay income tax.

One solution to this will be to invest the trust assets into an economically efficient, investment-based life insurance policy or policies. These policies can in turn be invested in any nu96

mber of stocks, bonds, real estate, or other underlying asset classes. The policies will still provide a death benefit, if one or more of the insured individuals die, and tax-free income during the life of the insureds, as further described herein.



Varieties of Life Insurance Policies

The primary varieties of life insurance are **term** and **permanent** policies.

Term life insurance policies are sold to provide a death benefit for a set number of years based upon preset premiums. Most term policies provide a stable death benefit for 10, 20, or 30 years, and after the stated term the premiums become very high and basically unaffordable. Most term policies can be converted into permanent policies based upon pricing that reflects the assumption that anyone who would convert a term policy must have health issues. Nevertheless, when a term policyholder has a medical condition or circumstance that significantly reduces life expectancy, converting the term policy to a permanent policy can result in an economic windfall to the family. Many term policies have convertibility option periods that expire well before the term policy premiums increase.

It is best to calendar the convertibility option dates and to seriously consider whether to replace the term policy or convert it before the convertibility option expires.

Permanent life insurance policies are designed to provide a death benefit up through some age beyond life expectancy, such as 99, 103, or 123. For an additional cost, this coverage duration can be guaranteed. For obvious reasons, the premiums needed to cover the costs of coverage beyond life expectancy (which increases the likelihood of the insurance paying a death claim) are significantly higher than the premiums that would apply under the term life insurance policy (where insurers know by experience they will pay less than half of all death claims).

In addition, almost all permanent policies have open “cash value” that builds up during the life of the policy in order to generate internal dividends, interest or investment earnings that can be reinvested or used to pay for the death benefit. The asset classes into which these cash values are invested is a distinguishing characteristic of the different types of permanent policies. For instance, cash values of whole life and traditional universal life are required by regulation to be allocated predominantly to high-grade bonds and government-backed mortgages, from which a fixed-income-type rate of return is reasonable to expect.



Varieties of Life Insurance Policies, Cont'd

Equity-indexed universal life are also required by regulation to be allocated predominantly to high-grade bonds and government-backed mortgages, but the interest from those bonds and mortgages can be allocated to the purchase of options on an equity-index like the S&P500, so that the rate of return is reasonable to expect is somewhat greater-than fixed-income-type asset classes, but could be less than fixed-income-type returns if those options expire out-of-the-money.

Variable universal life policies permit allocation of account values to a family of mutual-fund-like Separate Accounts, typically for a wide range of asset classes. See Distinguishing Characteristics Matrix courtesy of Veralytic for more distinguishing characteristics for each product type.

A MEC is a form of life insurance policy that does not have all the tax benefits of a non-MEC policy, but many have a lower death benefit, and therefore lower internal costs, and higher rates of return. The primary difference between a MEC and a non-MEC is that any withdrawal from a MEC during the lifetime of the insured will carry out taxable income to the extent of appreciation within the policy, and any loan from the policy, and interest thereon not paid in cash, will be considered to be a taxable withdrawal.

Many families have life insurance policies that they will never need to withdraw from during the lifetime of the insured. Such policies might be “skinnied down” by reducing the death benefit, which reduces cost of insurance charges, and in turn increases the cash value growth to make the policy a more economically effective savings vehicle, notwithstanding that the ability to make tax withdrawals or loans would no longer exist. As mentioned earlier, unlike a non-MEC, withdrawals or loans against a MEC are taxable income on a worst first basis and come with early withdrawal penalties based upon 10% of the income withdrawn (worst first) if the policy owner is under the age of 59 ½.



Varieties of Life Insurance Policies, Cont'd)

The owner of a policy may wish to gift it to a lower bracket taxpayer or a trust that is taxed at the bracket of a lower bracket taxpayer to reduce the income tax incurred in the event of a partial or full liquidation of a policy or the sale thereof. If a MEC is pledged as collateral then the income of the MEC is considered to be transferred to the policy owner. (See Investopedia. (n.d.). Modified endowment contract (MEC). In Investopedia. Retrieved July 15, 2025, from <https://www.investopedia.com/terms/m/modified-endowment-contract.asp>.)

While the vast majority of life insurance policies are considered to be “registered products”, Private Placement Life Insurance (“PPLI”) policies may be customized and established without the regulatory oversight and restraints that apply to “registered” policies. PPLI is further discussed below in Section 11.



Private Placement Life Insurance Policies

Private placement life insurance (PPLI) allows for a wider range of investment options, but the IRS requires that the policyholder not have direct control over investments and that the investments be diversified. It is possible to have business entities and individualized investments, including investment real estate and even artwork and collectibles, held under a private placement life insurance policy. However, many very strict rules apply and must be adhered to in order to maintain the tax advantages of income and appreciation in value within the policy never being subject to income tax.

For example, a wealthy client might use a PPLI to invest in hedge funds and private equity. An independent investment advisor, rather than the client, manages the policy's investment choices. This structure complies with the investor control rules and ensures sufficient diversification.

It may be possible to sell an appreciated asset to a PPLI in exchange for a promissory note owed by the PPLI to defer income tax under the installment sale rules. The PPLI may then sell the asset shortly after purchasing it, and would not pay income tax on the gain. At a later time the promissory note may be paid in full, and the income tax on the sale of the asset to the PPLI may be recognized at that time. The income tax on the sale will not be avoided, but it will be deferred, perhaps to a year when the taxpayer, or the successors to the taxpayer, are in a lower tax bracket or better able to pay the tax.



Private Placement Life Insurance Policies

Frozen Mortality Accounts

Part of the reason that permanent life insurance is as expensive as it is, is that the death benefit must be maintained until the death of the insured. It may be possible to have a portion of the assets held under a PPLI policy set aside and earmarked to be used solely as the death benefit under what is called a frozen mortality account, which can replace the need to have reinsurance and a separate death benefit paid into the policy upon the death of the insured. This can dramatically lower the cost of maintaining a life insurance policy until the death of the insured person or persons, and may also eliminate the risk of a policy expiring before the death of the insured.

This is commonly referred to as a Hampton Freeze.

As an example, the Roberts family uses a frozen mortality account within their PPLI policy. By allocating \$1 million to this account, they reduce annual mortality charges from \$30,000 to \$8,000 and ensure the policy will not lapse at age 100.



Creditor Protection and State Law

Creditor protection is a key consideration, and now more important for a great many individuals and families who no longer have significant estate tax planning concerns. Anyone who drives in the United States or has errands run for them by an employee has a potential creditor protection problem. It is important to remind and educate clients with respect to the need for appropriate limits of liability, umbrella coverage, and recognizing other liability risks such as recreational property ownership, hunting, and professional or business liability. These often make creditor protection the most important thing on the asset protection list.

According to one source, the states that provide for full creditor protection for permanent life insurance policies on the lives of those who reside there, with unlimited cash value and death benefit creditor protection, are as follows:



Alternatives for Funding Life Insurance Policies

There are other alternatives besides gifting for funding a life insurance policy under an irrevocable trust. These consist primarily of:

- Split-dollar funding.
- Having income-producing assets in the life insurance trust.
- Merging or decanting other trusts that have significant assets or income, such as a remainder trust resulting from a successful “Grantor Retained Annuity Trust” (GRAT) that might have been established for the primary purpose of being able to provide premium dollars in a tax-efficient manner.



Alternatives for Funding Life Insurance Policies

Split-Dollar Loans and Arrangements

Under split-dollar life insurance arrangements, the insured or another family member or entity can make premium payments and consider the payments to be loans or beneficial interest advances. This entitles the contributing party to be repaid at a rate with little to no interest, depending upon the type of split-dollar arrangements selected, when the policy is cashed in or upon the death of the insured. Therefore, many families have family limited partnerships or LLCs.

Alternatively, individuals who will receive split-dollar advance repayments upon the death of an insured or upon the liquidation of a life insurance policy may renegotiate for a higher interest rate to apply with respect to the payments to be received when the policy is cashed in or “matures” upon the death of the insured.

Multi-generational split dollar is the name given to an arrangement whereby a senior family member, or entity owned in large part by a senior family member, advances money to an individual or an irrevocable life insurance trust to pay the premium(s) on a policy owned by a junior family member or a life insurance trust holding life insurance on a junior family member.

The loan can be at the long term Applicable Federal Rate, which is a below fair market value rate, and provide that the advancing party/lender will not be repaid until the policy matures (upon the death of the insured individual).

While the below fair market loan does not constitute a gift under the gift tax laws, the value of the right to be repaid may be worth less than half of the amount advanced, depending upon the life expectancy of the insured. (Internal Revenue Section 7872 and Treasury Regulation 1.7872-15, under the split-dollar rules, indicate that no gift is considered to be made as long as the applicable federal rate is used.)



Alternatives for Funding Life Insurance Policies

Split-Dollar Loans and Arrangements

There are many arrangements such as this in place, which essentially put the senior family member into an unfortunate position, specifically from a financial standpoint, because they may not be repaid until the junior family member or trustee dies or voluntarily unwinds the situation, which could be decades in the future.

Taxpayers who still hold taxable estates may consider making split-dollar loans to fund policies for younger family members. Taxpayers who have made these loans and are no longer concerned about the federal estate tax may want to renegotiate to receive the right to call the loan in or the right to increase the interest rate. This way the senior family member can sleep better at night knowing that they can receive payment on the loan well before the death of the junior family member if they need it.



Alternatives for Funding Life Insurance Policies

How Much Interest Can Be Charged on Split Dollar and Other Loans?

Including the 5% Guideline:

When setting the interest rate for split-dollar life insurance loans, the Internal Revenue Code establishes that for federal estate tax purposes, the minimum rate must be at least the Applicable Federal Rate (AFR). (IRC § 7872.)

The AFR is published monthly by the IRS and varies depending on whether the loan is short, mid, or long-term. Charging at least the AFR is essential to ensure the loan is not classified as a below-market loan, which would otherwise result in imputed interest and possible gift or compensation tax consequences.

There is no explicit federal maximum interest rate for interfamily loans, the five percent above the applicable federal rate seems to be safe for a gift tax standpoint. (Generally, instruments that mature after five years can bear a maximum interest at 5% above the mid-term applicable Federal Rate. Jerry M. Hesch, Esq. et al., *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 Tax Mgmt. Est., Gifts, Tr. J. 1, 6 (2011). “Regs. § 1.1274-3(b)(3) states that ‘interest on a debt instrument excessive if the interest. . . is clearly greater than [an] arms-length transaction amount.’” *Id.*)



What Maximum Interest Rate Can Be Used in a Related-Party Loan? (Cont.d)

Assuming that usury laws are complied with, §163(i) provides that a debt instrument with a maturity five years or greater from the date of issue can bear interest, at maximum, at 5% above the mid-term Applicable Federal Rate. This appears to be a safe harbor for federal income tax purposes.

Regs. §1.1274-3(b)(3) states that “interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm’s-length amount of interest that would have been charged in a cash lending transaction between the same two parties.” This regulation is far from clear, and uses terms, such as “clearly excessive” and “clearly greater than the arm’s-length amount of interest that would have been charged,” upon which reasonable minds may easily differ. That being said, as a practical rule, it may be preferable to not stray too far from the prevailing market interest rates that are used in similar type transactions when determining the maximum interest rate that can be applied to a transaction.

Additionally, Regs. §1.707-4(a)(3)(ii) can be used by analogy. It provides a safe harbor maximum interest rate of 150% of the long-term AFR then in effect in the context of preferred returns or guaranteed payments made to a partner of the partnership. (Tax Management Estates, Gifts and Trusts Journal, Vol. 36, No. 2, 3/10/2011, Jerry M. Hesch, Esq., Alan S. Gassman, Esq., Christopher J. Denicolo, Esq., *Interesting Interest Questions: Interest Rates for Intra-Family Transactions.*)

If a trust is the lender, the trustee has a fiduciary duty to act in the best interests of all beneficiaries.

The interest rate should be fair and reasonable, reflecting market conditions and the risk profile of the loan. Excessively high rates could be challenged as unfair or as a breach of fiduciary duty. It is important for the trustee to document the rationale for the chosen rate, taking into account market rates, the trust’s investment policy, and the interests of all parties.



What Maximum Interest Rate Can Be Used in a Related-Party Loan? (Cont.d)

Estate planning literature and tax commentary often reference a "safe harbor" for interest rates up to 5% above the AFR. If the stated interest rate is no more than 5% higher than the AFR, the note will generally be valued at its issue price for gift tax purposes. This means that, at or below 5% above the AFR, the loan is considered to have adequate stated interest and is not subject to recharacterization or adverse valuation for gift tax purposes. However, if the interest rate exceeds the AFR by more than 5%, the IRS may recharacterize the loan as a high-yield debt obligation (HYDO), and the excess interest could be treated as disguised principal, potentially leading to adverse tax consequences.

If a trust is the lender, the trustee has a fiduciary duty to act in the best interests of all beneficiaries. The interest rate should be fair and reasonable, reflecting market conditions and the risk profile of the loan. Excessively high rates could be challenged as unfair or as a breach of fiduciary duty. It is important for the trustee to document the rationale for the chosen rate, taking into account market rates, the trust's investment policy, and the interests of all parties.



The following table summarizes the guidelines for setting interest rates on loans:

I.R.C. § 163(j).

Interest Rate Charged	Tax / Legal Treatment
At least AFR	No imputed interest; not treated as a gift; safe from below-market loan rules
Up to 5% above AFR	Tax Safe harbor — valued at issue price for gift tax purposes
More than 5% above AFR	May be treated as HYDO; excess interest could be disguised principal — adverse gift/tax impact
Above state usury cap	Potentially void or unenforceable under state law



Alternatives for Funding Life Insurance Policies

Excluding Policy Cash Value From Estate Inclusion, the *Levine* Case

The IRS vigorously contests situations where multi-generational split-dollar has been used to generate significant discounts on federal estate tax returns, but the case law has generally been favorable to taxpayers. (See *Levine* discussion *infra*.)

The holding in the Tax Court case of *Estate of Marion Levine v. Commissioner* demonstrates that split-dollar arrangements can successfully exclude policy cash values from estate inclusion, but only if structured with strict separation of powers and ownership. (158 T.C. 58 (T.C. 2022)).

In *Levine*, an Insurance Trust purchased life insurance policies on the lives of decedent's relative and their spouse, which a Revocable Trust owned by the decedent paid \$6.5 million in premiums for under a split-dollar arrangement. (*Id.* at 74.)

The Insurance Trust assigned the insurance to the Revocable Trust as collateral, and the Insurance Trust agreed to pay the total premiums paid and either the cash-surrender value upon death of the insured or the cash surrender value of the policies when terminated by the Insurance Trust, which ever was greater. (*Id.*)

The Tax Court ruled in favor of the estate, finding that the properly designed and implemented split-dollar arrangement did not result in the inclusion of the insurance policy's cash value in the donor's gross estate under IRC §§ 2036 or 2038. *Id.* at 96. I.R.C. §§ 2036(a)(2) and 2038 do not require inclusion of the policies' cash-surrender values. The court ruled in favor of deceased's estate because deceased did not have any right, whether by herself or in conjunction with anyone else, to terminate the policies. Only the irrevocable trust had that right. (*Id.*)

The reasons for the court were, first, that there had been no transfer of the insurance policy because the Insurance Trust, which the decedent never owned, always owned the life insurance policy. (*Id.* at 84-86.)

Second, while there was a "transfer" of the \$6.5 million for the premiums, the decedent did not retain an interest in the policies because she did not have immediate rights to the cash-surrender value and could not terminate the policies unilaterally, only the Insurance Trust had that ability. (*Id.*)

Therefore, the cash surrender value of the policies was not to be included in the gross estate. (*Id.*)



Alternatives for Funding Life Insurance Policies

Repurposing for Buy-Sell Agreements

A policy on an individual, a married couple, or two individuals who were a married couple may be repurposed from paying estate taxes to use in a buy-sell agreement. It could also be used for key person coverage where there is a multiple-owner business or investment company and it would be useful to have an individual's ownership interests purchased in the event of death.

An Irrevocable Life Insurance Trust could become the purchaser of stock on the death of the insured, thus remaining intact and providing a benefit for the beneficiaries of the trust, by:

- Purchasing the stock LLC interests or other rights or assets owned by the insured on the death of the insured or
- Selling or loaning the policy to the other owners so that they can purchase the ownership interests from the insured on the death of the insured or
- Selling or loaning the policy to the other owners so that they can purchase the ownership interests from the insurer on the death of the insured.

The other owners, the entity itself, or an entity taxed as a partnership and owned in some part by the other owners, could either purchase the policy from the life insurance trust (which would no longer thereafter be a life insurance trust) or agree to buy the right to the death benefit to be generated under the life insurance trust by using "reverse split dollar." In this arrangement, the life insurance trust would receive annual amount equal to the PS58 cost, while shareholders cover the difference.

This structure differs from the arrangement in *Levine*, where the split-dollar agreement followed an economic benefit regime but was structured more favorably toward the shareholder, who retained rights to the policy's cash value and sought repayment of its contributions. In contrast, the reverse split-dollar approach gives the employee greater economic interest from the outset, particularly in the cash value and future death benefits. The tax implications of a reverse split dollar approach include annual taxation to the shareholder based on the value of the PS58 costs, which is generally treated as imputed income. Unlike the *Levine* arrangement, the reverse structure may reduce or eliminate the need for repayment or employer recovery, shifting tax burdens and benefits earlier to the shareholder. (See *Levine* 158 T.C. at 85.)



Alternatives for Funding Life Insurance Policies

The Connelly Question – Maybe We Now Want a Higher Value Included For Basis Step-Up Purposes

Connelly Facts:

- Many life insurance buy-sell arrangements are still being reviewed because of the *Connelly v. United States* case. (See *Connelly v. United States*, 602 U.S. 257 (2024).)
- In *Connelly*, the decedent and his brother were sole shareholders in a valuable and closely held corporation. (*Id.* at 261.)
- The brothers entered into a contract that gave the surviving brother the option to buy the shares of the first brother to die, with the corporation then obligated to repurchase the shares of the first-to-die brother in the event that the surviving brother declined to purchase them. (*Id.*)
- The agreement stated that an outside appraiser would determine the fair market value of the shares. (*Id.*)
- The corporation purchased life insurance on the lives of both brothers to ensure that it would have sufficient funds to purchase the shares. (*Id.*)
- Upon the decedent's death, who owned 77.18% of the company, the decedent's son and brother, rather than using an outside appraisal, independently reached an agreement on the value of the shares at \$3 million. (*Id.*)
- The life insurance proceeds were then used to purchase the shares. (*Id.*)

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

The Connelly Question – Maybe We Now Want a Higher Value Included For Basis Step-Up Purposes

Connelly Holding and Reasoning:

- The U.S. Supreme Court held that fair market value determined the value of the shares for estate tax purposes and that the life insurance proceeds should not be excluded from the valuation. (*Id.* at 267.)
- The court reasoned that “no real-world buyer or seller would have viewed the redemption obligation as an offsetting liability” because a “share redemption at fair market value would not affect shareholder economic interests.” (*Id.* at 263.)
- The Court stated that the focus of estate evaluation was on the fair market value at the time of the decedent’s death, not what it would be valued after death. (*Id.*)
- Therefore, the total value of the corporation was equal to its \$3.86 million in assets plus the \$3 million in potential life insurance proceeds earmarked for redemption, totaling \$6.86 million. (*Id.*)
- This meant a willing buyer would have paid up to \$5.3 million for all of the decedent's shares. (*Id.* at 264.)

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

The Connelly Question – Maybe We Now Want a Higher Value Included For Basis Step-Up Purposes

Take Away:

- For this and other reasons, many tax and financial advisors prefer to use a cross-purchase agreement or have the life insurance placed into an entity, taxed as a partnership under the arrangement described in Private Letter Ruling PLR 96-51017. This is to, first; assure that the policy death benefit will not be considered included in the value of the estate of the deceased owner. Second, it will assure that the death benefit does not go into a company that may have liabilities exceeding the value of its assets (to ensure that the death benefit is not lost to creditors). Finally, this enables the purchasing owners to receive an income tax basis in the purchased interests equal to the amount paid, assuming that this is also equal to the fair market value of the ownership interest.

Courtesy of James Magner



Common Mistakes in Drafting Buy-Sell Agreements

Lack of a clearly defined valuation method

Failure to fund the agreement (e.g., no insurance)

Inadequate coverage of triggering events

Unclear or incomplete buyout terms

Conflicts with wills or operating agreements

Improper use or titling of life insurance

Ignoring tax implications

No plan for involuntary transfers (e.g., divorce, bankruptcy)

Using generic templates not tailored to the business

Failure to review and update the agreement regularly



VALUATION METHODS

FIXED PRICE (REVIEWED
PERIODICALLY)

BOOK VALUE OR ADJUSTED
BOOK VALUE

FORMULA (E.G., EBITDA
MULTIPLE)

INDEPENDENT THIRD-PARTY
VALUATION



BENEFITS OF A WELL-STRUCTURED BUY-SELL AGREEMENT

MAINTAINS BUSINESS CONTINUITY
AND STABILITY.

REASSURES CLIENTS, EMPLOYEES, AND
CREDITORS.

PROVIDES LIQUIDITY FOR THE
DEPARTING OWNER OR THEIR FAMILY.

PREVENTS FORCED SALES OR
OWNERSHIP BY UNWANTED PARTIES.



KEY TAKEAWAYS

Buy-sell agreements are essential for every closely held business.

They should be customized to the business and reviewed regularly.

Funding, valuation, and trigger event clauses are critical to success.



Cross-Purchase Agreement with Life Insurance

Each owner purchases a policy on every other owner.

Proceeds are used to buy deceased owner's share directly from estate.

Ownership and beneficiary designations are held individually.

Best for businesses with 2–3 owners due to complexity as partners increase.



A Logical Guide to Selecting Buy/Sell Agreement Arrangements- Traditional Choices are Not Always the Best

By Alan S. Gassman, J.D., LL.M.

A. Entity Redemption Arrangements. The company owns the life insurance policy and is the beneficiary thereof. Upon receipt of the life insurance proceeds, the company is to use such proceeds to buy out the deceased owner.

Will there be enough money to (A) buy out the deceased owner and (B) have the deceased owner released from any and all guarantees and obligations associated with the business?

1. If it is not practical to have the deceased owner released for contractual or other reasons, should the part of the life insurance proceeds that would otherwise be kept by the company as key man insurance be escrowed pending satisfaction of all releases that the deceased owner may have responsibility for.
2. How can the deceased owner's family be sure that the monies received from the life insurance policy will actually be used to satisfy contractual buy-out agreements?
3. What if the company claims that for some reason the agreement is not enforceable or that there are claims against the deceased owner that offset what would be paid to him or her.
4. What if the company has a major creditor claim against it (what if the deceased owner died in a car accident that he or she caused while driving a company vehicle and the company is now being sued by others who died in the accident?)
5. What if the company goes into bankruptcy and the family of the deceased owner becomes just another creditor in a bankruptcy proceeding?
6. For income tax purposes the remaining shareholders do not get a stepped up basis for the stock purchased.. The stock simply becomes treasury stock.



A Logical Guide to Selecting Buy/Sell Agreement Arrangements- Traditional Choices are Not Always the Best

By Alan S. Gassman, J.D., LL.M.

B. To avoid the above potential problems consider a cross-purchase agreement?

Each owner may own the policy or policies on the other owners. Thus the policy proceeds should be protected from creditors of the company.

Also, each purchasing shareholder will get a tax basis in the purchased stock equal to the purchase price thereof.

1. However, policy proceeds will not be protected from creditors of the surviving owner who would receive policy proceeds.
2. Also, contractual disputes could result in the surviving owner using the funds for other purposes while litigating over the obligation to pay and becoming insolvent.
3. Further if there are more than 2 shareholders, then on the death of one the policies owned on the others would need to be transferred to rebalance between them, thus causing issues under the transfer for value rules. For example, if there are 4 equal shareholders there have to be 4 policies each owned 1/3rd each by each 3 shareholders on the fourth, and if one leaves the company the remaining 3 policies have to be readjusted as to ownership.



A Logical Guide to Selecting Buy/Sell Agreement Arrangements- Traditional Choices are Not Always the Best

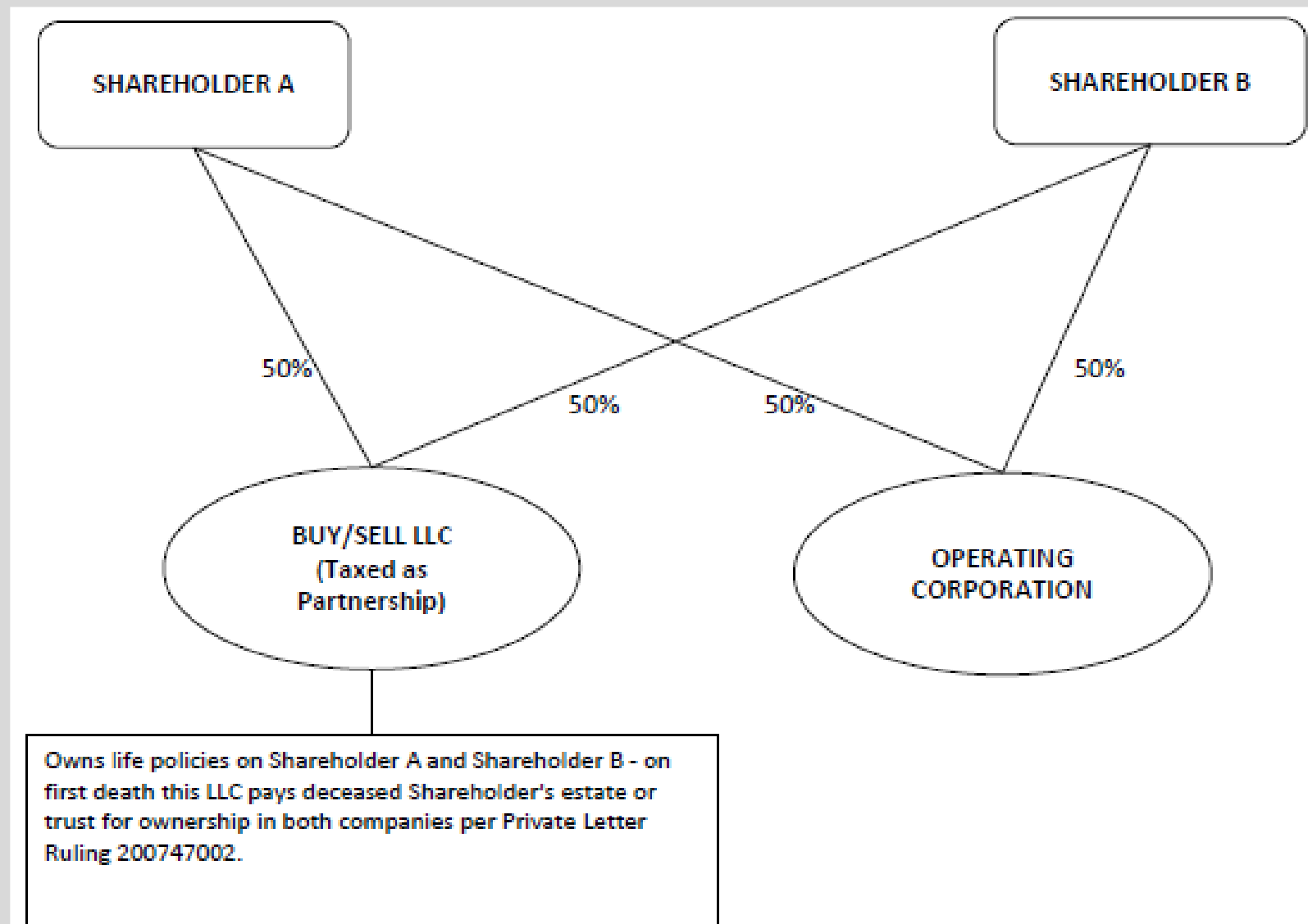
By Alan S. Gassman, J.D., LL.M.

C. Hybrids of the Above:

1. Consider a Trusteed Corporate or Cross-Purchase Agreement. Under these arrangements the owner and beneficiary of the policy can be a trust company, a law firm, or another trusted institution as trustee for the benefit of the company in a Trusteed Redemption arrangement, or for the benefit of the other shareholder or shareholders in a Trusteed Cross Purchase arrangement. . The trust agreement can require that the policy proceeds be held safely until sale and used solely for redemption or cross-purchase purposes.
2. This at least assures the surviving family that the life insurance proceeds will not be absconded with.
3. Generally for tax purposes the policy needs to be considered as owned and payable to the company in a redemption arrangement or the surviving owner or owners in a cross-purchase agreement. Could a state court or a bankruptcy court override the trust agreement where there are creditors of the entity in a redemption arrangement or creditors of the remaining shareholders in a cross-purchase arrangement?
4. There would be a purchase price tax basis for the other shareholders if the Trustee appropriately characterized as an agent for the other shareholders.



Cross-Purchase Arrangement



Buy-Sell Agreements and Estate Tax Planning

Many buy-sell agreements have provided for the value of ownership interests to be as low as is reasonably possible under the estate tax rules, which require that a value be commensurate with the amount that similarly situated, unrelated parties would pay for an applicable ownership interest pursuant to Internal Revenue Code § 2703, which reads as follows:

(a) General rule

For purposes of this subtitle, the value of any property shall be determined without regard to—

- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.

(b) Exceptions

Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction [emphasis added].



Buy-Sell Agreements and Estate Tax Planning

Family members and close friends who have essentially played Russian roulette in order to reduce federal estate tax exposure may wish to revise their agreements and/or agreed values to a higher “fair market value”.

When there is no longer an estate tax threat existing, those individuals and companies may want to increase death benefit coverage and key person coverage to reflect the amounts to be paid for the stock or membership interests of a deceased owner without regard for federal estate tax implications, if the applicable owner is well below the estate tax thresholds.



Entity Redemption Agreement with Life Insurance

Business owns life insurance on each owner.

Upon death, the business uses proceeds to redeem the deceased owner's interest.

Simplifies policy administration—one policy per owner.

May have less favorable tax basis outcomes for surviving owners.



Key Person Insurance in Estate and Business Continuity Planning

Safeguarding Value and
Stability in Business
Transitions



Why Key Person Insurance Matters



The loss of a key executive or owner can cause major disruption.



Revenue can decline sharply during the transition period.



Business value may fall without strong leadership in place.



Helps preserve continuity while estate or succession plans are executed.



Alternatives for Funding Life Insurance Policies

How Does Connelly Impact Insurance-Only LLCs

Over the past decade, the Insurance-Only LLC has become a popular vehicle for structuring life insurance-funded buy-sell agreements. *Connelly* clearly impacts Insurance-Only LLCs because the agreement typically requires the deceased member's interest in the Insurance-Only LLC to be redeemed before the death claim is made with the carrier.

It is precisely at this point in the transaction that advisors will need to be creative, and one planning technique that advisors have pointed to is whether it is possible to “specially allocate” the death benefits to the surviving owners' capital accounts so a deceased member's interest is bought out for a value not inclusive of the death proceeds. (Citation *infra*)

(See generally Treas. Reg. § 1.704-1(b). Special allocations in partnership and LLC agreements must have “substantial economic effect,” meaning the allocation must reflect the partners' actual economic arrangement and not be solely tax-driven. To satisfy the economic effect prong under Treas. Reg. § 1.704-1(b)(2), (i) capital accounts must be maintained under § 1.704-1(b)(2)(iv), (ii) liquidating distributions must follow positive capital account balances, and (iii) the agreement must include either a deficit restoration obligation (DRO) or a qualified income offset (QIO). The substantiality prong under § 1.704-1(b)(2)(iii)(a) requires a reasonable possibility that the allocation will materially affect partners' dollar returns, independent of tax consequences. For example, in an Insurance-Only LLC, insured members may cross-pay premiums to support economic effect, with special allocations of death benefit proceeds to non-insured surviving members. This can reduce the decedent's ownership value for estate tax purposes while increasing the basis of the survivors. Capital accounts must be carefully tracked. Suppose five equal shareholders (A through E) in an S corporation form an Insurance LLC, each insured for \$2 million. Premium costs differ, with A's premium at \$50,000 and E's at \$20,000. Cross-payments are allocated across members, and if A dies, the \$2 million death benefit is allocated equally among B through E. For the allocation to hold under § 704(b), documentation must reflect the economic burden and benefit consistently and meet all regulatory requirements.)

The special purpose buy-sell insurance LLC has largely started to replace the trusted buy-sell agreement as the go-to planning technique. The Special Purpose Buy-Sell Insurance LLC (BSILLC) can solve many of the issues with both cross-purchase and entity redemption arrangements.



Alternatives for Funding Life Insurance Policies, Cont.d

How Does Connelly Impact Insurance-Only LLCs

For example, entity redemption arrangements may result in the loss of a basis increase for the remaining owners, the exposure of the life insurance policies to the business's creditors, and potential income taxation on the change of ownership of the life insurance policy from the business to the insured at retirement. But the need for a lot of life insurance policies makes the cross-purchase agreement less desirable when there are many owners, which may cause advisors to consider the Insurance-Only LLC. The Insurance-Only LLC is a separate legal entity that owns the life insurance policies on the business owners' lives to fund a separate buy-sell agreement amongst the business owners. The business owners are members of the Insurance-Only LLC, and the centralized ownership of the life insurance policies in the LLC may make the premium payments easier to administer and allocate between the business owners, ensure all the policies are kept in force and that a business owner does not drop the policy insuring another business owner, and assists in paying the life insurance proceeds to a decedent's estate for the purchase of the decedent's ownership interest in the operating business as required by the separate buy-sell agreement.

With the holding in *Connelly*, entity redemption arrangements funded with company owned life insurance will generally result in the value of the company plus a pro-rata portion of the insurance proceeds being included in the deceased's gross estate. This is a change from prior case law that held that a redemption agreement created an obligation that offsets the life insurance proceeds received by a business that is used to redeem a deceased's interest in the business. (See *Blount* and *Cartwright*.)

The planning implications from the *Connelly* decision as well as some of the many workarounds that advisors have devised are discussed below.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

What if the Deceased Business Owner Did Not Have a Taxable Estate?

Shortly after the *Connelly* decision was announced, some advisors asserted that if a business owner does not have a taxable estate, *Connelly* does not present a problem.

The inclusion of life insurance proceeds in the business value for estate tax purposes may not result in additional estate taxes for those who do not have taxable estates, but increasing the value of a business for estate tax purposes has other ramifications. There are step-up in basis issues, capital loss issues, and redemption price issues that may arise from the decision in *Connelly*.

Business owners who do not have an estate tax concern still need to be mindful of *Connelly*. Under *Connelly*, the fair market value and thus the estate tax value of the shares includes life insurance proceeds received by the corporation. For example, let's say Michael and Jim equally own MGJM, Inc., which is worth \$10M. MGJM, Inc. purchases two \$5M policies insuring Michael and Jim. A stock redemption agreement states MGJM, Inc. will redeem a deceased shareholder's shares for \$5M. Michael passes away and the corporation receives the \$5M death benefit.

Under *Connelly*, the fair market value of the corporation is \$15M and the estate's share is \$7.5M. As that is the fair market value, Michael's estate obtains a step-up in basis equal to that value under IRC § 1014(a)(1). But per the terms of the stock redemption agreement, his estate only receives \$5M as the purchase price on the stock redemption. His estate realizes a \$2.5M capital loss on the redemption. Michael's estate should be able to use that capital loss to offset any capital gains the estate may recognize. In the estate's final tax year, unused capital losses may be passed through to the estate beneficiaries.

Redemption agreements may include a price adjustment clause, so if the estate tax value of a business is higher than the purchase price listed in the agreement, the business agrees to pay an additional amount to the seller to cover the shortfall. However, there are many redemption agreements that do not currently have such a clause. Business owners should review their agreements and make adjustments accordingly.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

Connelly Can Impact All Estates and Business Owners

Connelly will certainly impact business owners who have taxable estates by increasing the estate tax value of a business for the death benefit received on company owned life insurance. This will further increase the deceased's gross estate. Business owners who do not have a taxable estate based just on the value of the business may be pushed into a taxable estate when the insurance proceeds are added to the business value. Note that if a decedent's business interest passes to a U.S. citizen spouse, the estate can claim the unlimited marital estate tax deduction, however, whatever is left at the time of the surviving spouse's death would be included in his or her taxable estate.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

Connelly's Impact on Basis Consistency

Regarding step-up in basis rules, for taxable estates, "basis consistency" rules also come into play. IRC § 1014(f) states the basis of property acquired from a decedent may not exceed its final value for estate tax purposes or, if not finally determined, the value of that property as reported on a statement made under IRC § 6035. The concept of "basis consistency" is that the value of assets reported on a Form 706 becomes the asset's basis in the hands of its new owner. An executor of an estate that is required to file Form 706 is required to file Form 8971 with attached Schedule(s) A and must also provide each beneficiary listed on Form 8971 with that beneficiary's Schedule A. Form 8971 requires the following information be provided to beneficiaries:

A description of the property acquired from the decedent;

Whether the asset increased estate tax liability;

The valuation date; and

The estate tax value in U.S. dollars.

Form 8971 isn't required when:

The gross estate plus adjusted taxable gifts is less than the basic exclusion amount;

The estate tax return is filed solely to make an allocation or election respecting the generation-skipping transfer tax; or

The estate tax return is filed solely to elect portability of the deceased spousal exclusion amount.

Under *Connelly*, the fair market value of a decedent's business interest would include a pro-rata portion of the insurance proceeds received by the business. That fair market value would be reported on the estate tax return and Form 8971 (unless Form 8971 is not required as stated above). That fair market value would provide the estate/heirs with a stepped-up basis in the business. If the buyout price is less than the stepped-up basis, the estate/heirs have a loss on the sale. This step-up in basis and loss issue is present in both taxable and non-taxable estates.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

Redemption Price Issues

Business appraisers have historically relied on *Blount* and *Cartwright* to exclude life insurance proceeds from a business valuation, but that now contradicts *Connelly* so appraisers may include the death benefit in the business valuation going forward. The result is an underfunded arrangement.

For example, MGJM, Inc.'s stock redemption agreement states the purchase price is fair market value as determined at the time of death. MGJM, Inc. was worth \$10M before the death benefit but is worth \$15M after the death benefit. That would result in a \$7.5M value for Michael's estate's shares and that would be the purchase price per the stock redemption agreement. However, MGJM, Inc. only received \$5M in death benefits, leaving it liable to pay \$2.5M using other corporate assets and/or a promissory note.

A company could have an entity redemption agreement but keep the life insurance outside the business. Death benefits received by the owners outside of the business could be used by the owners to make a capital contribution or loan to the business so it can redeem the deceased's ownership interest. (See *Connelly supra*. *Connelly* raises a larger issue, which is why use redemption-type buy-sell agreements in the first place? Stock redemptions themselves result in "wasted basis" because the surviving shareholders don't purchase the decedent's shares, the corporation does, so the surviving shareholders' cost basis in their shares isn't increased after the redemption. For S corporations, the shareholders may obtain an increase in basis only because of the corporation's receipt of life insurance proceeds. Shareholders of C corporations would not obtain an increase in basis in their shares. In addition, with life insurance funded redemption plans, the insurance is owned by the business, so judgment creditors of the business can attach the policy's cash surrender value and the death proceeds because there is no creditor exemption for business-owned life insurance.)

Courtesy of James Magner

Alternatives for Funding Life Insurance Policies

Move the Business Interest to Trusts

Another *Connelly* work-around is to move the business interests into irrevocable trusts as there should be no estate inclusion if the interests in the operating business are owned outside of a decedent's estate. But this approach has complexities. First, there could be significant gift tax exposure if the valuations of the business interests are high. Second, from an administrative standpoint, clients may find it impractical to have their business interests owned in trust.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

Creating Multiple LLCs

Creating multiple LLCs where each policy is owned in a separate LLC so the decedent does not have an ownership interest in the LLC that owns the policy on the decedent's life is another option some advisors have considered. That said, some clients may look at this and conclude that the expense of creating and maintaining multiple LLCs is simply not worth it.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

Resurgence of the Trusteed Buy-Sell Approach?

Trusteed buy-sell agreements have a number of features that on first blush make them attractive, the most prominent of which is the fact that the trustee is required to purchase only one policy per business owner. In addition, centralized management of a large block of policies is often preferable to each insured owning and maintaining multiple policies on multiple insureds. Finally, there may be a degree of creditor protection afforded to the insureds from trust-owned life insurance where a spendthrift provision is utilized.

Trusteed buy-sell agreements come in two flavors: business-sponsored where the entity establishes the trust for the benefit of the business owners, and individual-sponsored where the insured/business owners establish the trust. Note that entity-sponsored trusts can pose difficult income tax issues.

Perhaps the most troubling aspect associated with trusteed buy-sell agreements for corporations is the fact that the transfer-for-value (TFV) issue at the first death has forced planners to either find a partnership exception to the transfer for value rule, or simply unwind the agreement after the first owner's death and start over again. Although there is no physical transfer of the policies owned by the trustee at the first death, the deceased owner's interest in the policies on the other owners' lives shifts to the surviving owners pro rata, and most advisors think this creates a TFV problem. In fact, some planners refuse to utilize the arrangement if they are unable to find or create a partnership exception to the TFV rule.

The degree of control trust beneficiaries have over the trustee can impact the estate tax inclusion/exclusion of the life insurance proceeds. In cases where the trustee looks too "directed" by the beneficiaries, the Service has found the proceeds to be estate tax includible. On the other hand, where the trustee is truly independent, the Service has ruled against inclusion.

Courtesy of James Magner



Alternatives for Funding Life Insurance Policies

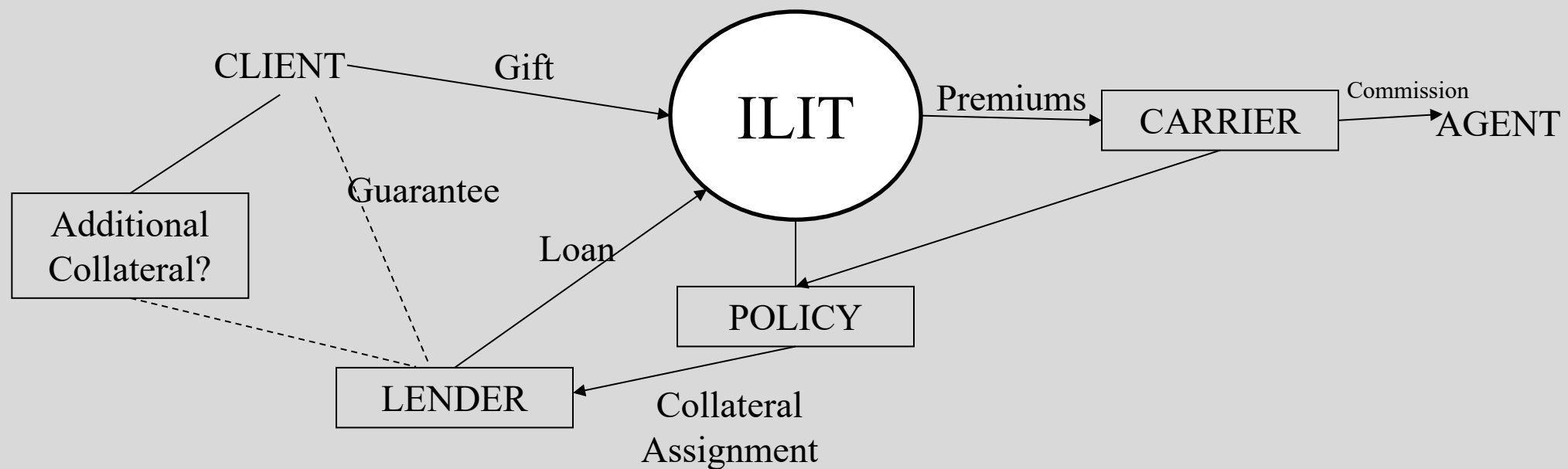
Ownership and Beneficiary Designation

Traditionally, it was best to have an irrevocable life insurance policy owned by the wealthier or primary earning spouse, or by an **Irrevocable Life Insurance Trust** established and funded by that spouse for the benefit of any surviving spouse and descendants. If the life insurance policy was held individually, then it would commonly be payable to a credit shelter trust established under the last will and testament or revocable trust of the insured spouse to assure that the policy proceeds would be protected from federal estate tax, creditor claims, and possible divorce scenarios that might be experienced by the surviving spouse. Alternatively, the policy could be paid outright to the surviving spouse, and there would be no estate tax protection or creditor protection once the spouse has received the policy proceeds or built-in subsequent marriage/divorce protection. It may now be more popular to have life insurance proceeds under policies owned individually by the insured payable to a Qualified Terminable Interest Property Trust (QTIP) marital deduction trust. This way, the assets in the trust on the death of the surviving spouse may receive a new fair market value income tax basis if the surviving spouse is not expected to be estate taxable upon his or her death. Many considerations apply with respect to what kind of trust should receive life insurance proceeds upon the death of an insured.

Courtesy of James Magner



Premium Financing is as Simple as it Looks



The policy may be cashed in with amounts of value exceeding the loan owned by the ILIT or will pay loan and provide remaining death benefit to ILIT on death of client.



Transfer for Value Rules

The “transfer for value rules” under Internal Revenue Code Section 101 can be very treacherous. A transfer for value of an insurance policy will cause the death benefit of the policy to be subject to federal income tax on the death of the insured. After a violation of the transfer for value rules, a policy may be cleansed by making a transfer of the policy to the insured. Exceptions to the transfer for value rules may be narrowly construed by the IRS, but may include a transfer of the policy to the person whose life is insured, to a joint ownership policy by the persons insured under a second-to-die policy, or when there is a transfer to a person or entity who is a partner in a partnership with the insured.



The most pertinent part of Section 101 of the Internal Revenue Code reads as follows:

(a) Proceeds of life insurance contracts payable by reason of death

(1) General rule

Except as otherwise provided in paragraphs (2) and (3), subsection (d), subsection (f), and subsection (j), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

(2) Transfer for valuable consideration

In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

The term “other amounts” in the first sentence of this paragraph includes interest paid or accrued by the transferee on indebtedness with respect to such contract or any interest therein if such interest paid or accrued is not allowable as a deduction by reason of section 264(a)(4).

IRC § 101.



Transfer for Value Rules

Sale of a Life Insurance Policy

Some life insurance policies can be sold for significantly more than the cash value. The viatical industry is active and thousands of taxpayers sell life insurance policies to investors every year. Taxpayers will generally have to pay income tax when a policy is sold for more than the “investment in the policy” amount. Unfortunately, many tax advisors are not aware or intimately familiar with how “the tax basis” of a life insurance policy is calculated.

The term of art under the Internal Revenue Code is the “investment in the contract”, which is usually the exact amount of premiums that have been paid for a permanent life insurance policy, subject to the following primary rules:

The investment in the contract is generally the total premiums or consideration actually paid, reduced by any previously excluded amounts. (IRC § 72 (c)(1).)

To qualify as life insurance for tax purposes, a policy must meet certain statutory standards; if it fails, the policyholder must report as income the increase in surrender value plus the cost of insurance, minus premiums paid that year. (IRC § 7702(g); 7702(a).)

For policies sold after 2009, only the portion of premiums not attributable to the cost of insurance counts toward the investment in the contract. (*Annuities; Certain Proceeds of Endowment and Life Insurance Contracts*, Rev. Rul. 2009-13 at 8.)

Premiums paid via policy loans or dividends typically do not count unless repaid with out-of-pocket funds. In a transfer, the recipient’s basis includes the amount paid to acquire the policy plus any premiums paid thereafter. (26 CFR §1.101-1(b)(1).)



Policy Withdrawals, Loans, and Taxation

Withdrawals of up to basis (total premiums paid – also known as the policy investment in the contract) are tax-free.

Loans taken from a life insurance policy can also be tax-free as marked from the policy if properly structured, but if the policy lapses or is surrendered with a loan outstanding, the loan is treated as a taxable distribution to the extent of gain. The owner may therefore withdraw an amount up to the total premiums paid, income tax free, and may borrow monies from the policy without triggering income tax as long as the loan is satisfied by the death proceeds or is repaid before then

If, for example, Mrs. Thompson pays \$400,000 in premiums, she can withdraw \$400,000 tax-free. Then, Mrs. Thompson borrows \$100,000 from the policy. Mrs. Thompson passes away and the death benefit repays the loan. Income tax is not owed in this situation.

An alternative is to borrow from a bank or other lender and pledge the policy as collateral. This will not trigger income tax unless the policy is a MEC.

Policy Exchanges and Types of Policies

The exchange of one life insurance policy for another should be carefully considered because there will typically be surrender charges or loss of cash value depending upon the terms and nature of the policy being exchanged. Policy exchanges can also trigger unintended financial consequences, including loss of guarantees, new contestability periods, and higher costs. The compensation to be received by an individual or agency recommending an exchange may make the exchange important to the agent or carrier, but not quite as beneficial to the person or Irrevocable Life Insurance Trust making the exchange. There are many different kinds of life insurance policies that may be considered when an individual or individuals are procuring a new policy or exchanging for a substitute policy. One such example is the private placement life insurance policies, which may have lower costs and higher and more flexibility than conventional policies.



Policy Exchanges Under Internal Revenue Code Section 1035

The exchange of one life insurance policy for another should be carefully considered for several reasons, including the fact that there may be significant surrender charges (a.k.a. contingent deferred sales charges) on the “premature” termination of the inforce policy triggering a loss of cash value depending upon the age of the inforce policy, the number of years that surrender charges apply (e.g., between 0 years for policies with no surrender charges, to 10 +/- years in most policies, to 20 or 25 years in some policies), terms and nature of the policy being exchanged and sales and potential surrender charges that will apply to a replacement property.

In addition, an exchange of one life insurance policy for another policy issued by a different insurer almost always triggers additional State Premium Taxes (of 2.35% on average but can be lower depending on the applicable State of jurisdiction, Federal DAC Taxes of 1.50%), and Sales Loads of between 0% on no-load policies and as much as 30%. In that the policy owner has already paid State Premium Taxes, Federal DAC Taxes, and Sales Loads on the inforce policy, incurring these costs again on the cash surrender values of the inforce policy needs to be justified. For instance, the cost of insurance charges (COIs), fixed administration expenses (FAEs) and account-value-based fees (e.g., VUL M&E) in the new policy may be significantly less than those costs in the enforced policy, so that incurring premium taxes and new sales and surrender charges may be justified.

However, extra care is needed when considering whether cost savings in a new policy justifies incurring premium loads again and/or triggering a surrender charge because current regulations in most states permit insurers to “quote” low illustrated premiums, giving the appearance of low-costs, while instead charging high-costs, without disclosing either those high costs, nor the risks of future “premium calls” to cover those high costs.



Policy Exchanges Under Internal Revenue Code Section 1035

As such, considering an exchange of one life insurance policy for another policy must include analysis of year-by-year cost disclosures in both policies. Unfortunately, regulations in most states don't require such disclosures, so year-by-year cost disclosures typically must be requested.

Policy exchanges can also trigger unintended financial consequences, including loss of guarantees, new contestability periods, and higher costs. The compensation to be received by an individual or agency recommending an exchange may make the exchange important to the agent or carrier, but not quite as beneficial to the person or Irrevocable Life Insurance Trust making the exchange. There are many different kinds of life insurance policies that may be considered when an individual or individuals are procuring a new policy or exchanging for a substitute policy.

One example is the private placement of life insurance policies, which may have lower costs and more flexibility. An advantage of the tax-free exchange statute is that a policy with no long term care benefits may be exchanged income tax-free for a policy that may permit a large portion, or even more than the cash value of the policy to be used for long term care expenses incurred by the insured.

The question of whether such a policy is more efficient or effective than a traditional monthly or annual premium long-term care contract can be a complicated mathematical exercise, but the ability to have "tax-free" income within a life insurance policy, purchase long term care coverage that would otherwise not be tax deductible is certainly a factor to be considered.



Policy Exchanges Under Internal Revenue Code Section 1035

Current regulations in most states permit agents, brokers and insurers to “quote” low premiums, giving the appearance of low costs, while instead actually charging HIGH costs, withOUT disclosing either those HIGH costs, nor the HIGHer "bait-and-switch" risks of additional “premium calls” in the future to cover those HIGH costs and/or TOTAL loss due to policy lapse.

Decision-Support in the Client’s Best Interest

- ▶ Do NOT compare HYPOTHETICAL premiums, cash values or death benefits as decision-support for 1035-Exchanges
- ▶ Do NOT accept the rate of return shown in illustrations withOUT independent verification
- ▶ Do NOT presume that exchanges permissible under NAIC Illustrations Model Regulations are in your Client’s Best Interest
- ▶ DO compare internal policy costs being charged in the inforce policy to internal policy costs to be charged in the proposed policy
- ▶ DO consider whether the rate of return required to achieve illustrated expectations is consistent with the client's risk tolerance
- ▶ If costs savings in a proposed policy are greater than any surrender charge (i.e., contingent deferred sales charge) in the inforce policy, and the rate of return required to achieve illustrated expectations is consistent with historical returns for the asset allocation corresponding to the client’s risk tolerance, then DO proceed with the 1035-Exchange

This slide is courtesy of Barry Flagg - Veralytic



Policy Exchanges Under Internal Revenue Code Section 1035

Jurisdictions providing Clients' Best Interest Rules protections:

- ▶ New York - Regulation 187
- ▶ California - Senate Bill #263 (defeated for the time being)
- ▶ SEC RegBI for Variable Products
- ▶ NAIC Model #275 for Annuities (sort of)

In all other jurisdictions/situations, fiduciary advisors are the only party responsible for ensuring that:

1. Costs are justified relative to peer-group alternatives,
2. Performance requirements are reasonable relative to asset-class benchmarks, and
3. Risks are appropriate relative to client risk tolerance.

This slide is courtesy of Barry Flagg - Veralytic



Policy Conversion and Exchange

Many life insurance policies are sold as savings vehicles, and the insured may use the cash value if and when needed by (1) borrowing on a short-term basis, (2) withdrawing up to the amount of premiums paid in tax-free on a long-term basis, or (3) pledging the policy as collateral for a loan.

Cashing a policy in or reducing the death benefit can result in financial penalties and/or surrender charges that should be navigated with caution after receiving multiple illustrations that may show the different alternatives available to a policyholder. Many times, it is best to hire an independent consultant who has expertise in the complicated calculations and contractual terms that apply within a life insurance policy.

Either way, independent benchmarking of costs and performance may be the easiest way to verify that product recommendations are in the Client's Best Interests. For instance, investment recommendations are routinely verified using independent research like Morningstar or benchmarking against relevant asset-class indexes like the S&P500. Likewise, life insurance product recommendations can and arguably should be benchmarked and verified using independent research and analysis, such as which can be provided by Veralytic or possibly by an independent fee for service or hourly paid insurance consultants.



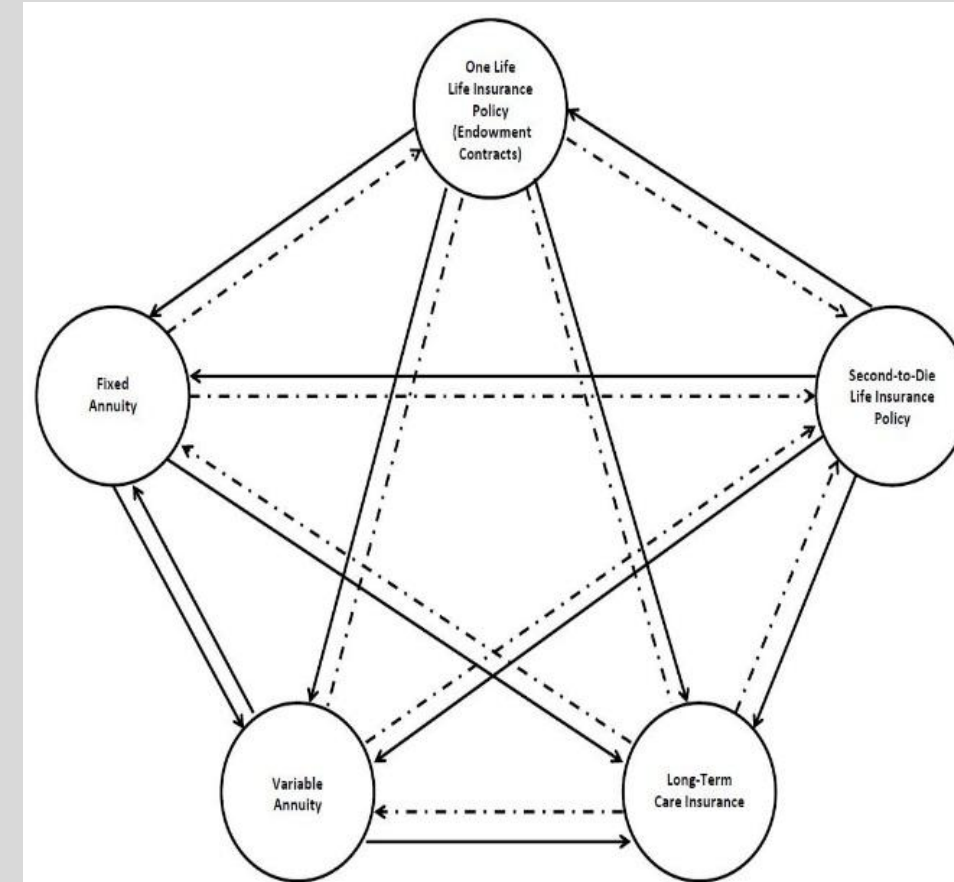
1035 Exchanges

The chart pictured provides a graphic representation of which financial products can be exchanged on a tax-free or tax-deferred basis under Section 1035. As indicated by the chart, Section 1035 allows for a life insurance contract to be exchanged into any of the other listed contracts (i.e. other life insurance policies, endowment contracts, annuity contracts, or long-term care insurance contracts). However, a life insurance policy on one life cannot be exchanged for a life insurance policy that pays on the death of the survivor of two individuals (a second-to-die life insurance policy). Furthermore, endowment contracts may only be exchanged for other endowment contracts, annuities, or long-term care insurance contracts. Long-term care contracts are the most restricted, in that they can only be exchanged for other long-term care contracts. Some variable annuity products provide that minimum annual payments may be doubled if the annuitant would qualify for long-term care benefits. These annuities presumably can be exchanged for other annuities under Section 1035, and the benefit is very limited if all payments under the contract reduce the actual cash value of the contract.

The straight lines in the chart indicate that tax-free exchange treatment under Section 1035 is permitted, while the dotted lines indicate that tax-free exchanges are not available under Section 1035.

Treasury Regulation 1.1035-1 provides that Section 1035 will not apply in situations where the contract or policies that are exchanged do not involve the same insured or obligee. However, Section 1035 allows for the exchange of multiple contracts, meaning that two life insurance policies may be exchanged for one annuity contract, or one annuity contract may be exchanged for two annuity contracts.

Finally, the IRS released Rev. Proc. 2011-38, which provided that, so long as withdrawals are not received from either contract for 180 days following a partial exchange, then the partial exchange will qualify as a tax free 1035 exchange. It reduced the 12-month period that was espoused by the IRS in Rev. Proc. 2008-24 to 180 days, and eliminated the requirement that an exception under Section 72(q)(2) must be met to obtain Section 1035 tax-free treatment. The Rev. Proc. established that a partial exchange of annuity contracts will be tax-free under Section 1035 or “the Service will apply general tax principles to determine the substance of the transfer and, therefore, its tax treatment.” Further, the original contract and the new contract are not aggregated after the 180 day period, notwithstanding whether they are issued by the same carrier.



1035 Exchanges - Caution

Current regulations in most states permit agents, brokers and insurers to “quote” low premiums, giving the appearance of low costs, while instead actually charging HIGH costs, withOUT disclosing either those HIGH costs, nor the HIGHer "bait-and-switch" risks of additional “premium calls” in the future to cover those HIGH costs and/or TOTAL loss due to policy lapse.

Decision-Support in the Client’s Best Interest

- ▶ Do NOT compare HYPOTHETICAL premiums, cash values or death benefits as decision-support for 1035-Exchanges
- ▶ Do NOT accept the rate of return shown in illustrations withOUT independent verification
- ▶ Do NOT presume that exchanges permissible under NAIC Illustrations Model Regulations are in your Client’s Best Interest
- ▶ DO compare internal policy costs being charged in the inforce policy to internal policy costs to be charged in the proposed policy
- ▶ DO consider whether the rate of return required to achieve illustrated expectations is consistent with the client's risk tolerance
- ▶ If costs savings in a proposed policy are greater than any surrender charge (i.e., contingent deferred sales charge) in the inforce policy, and the rate of return required to achieve illustrated expectations is consistent with historical returns for the asset allocation corresponding to the client’s risk tolerance, then DO proceed with the 1035-Exchange

This slide is courtesy of Barry Flagg - Veralytic



Existing Life Insurance Review

1. Request inforce ledgers to include year-by-year cost disclosures and performance requirements, premium history, and copies of existing policies for permanent coverage.
2. Term insurance policies and a carrier printout confirming ownership and beneficiary designation will also be valuable.
3. Prior policies will have application information attached, which includes full application and medical history information that can be used and updated for subsequent applications.
4. Controversial - have inforce ledger numbers placed on spreadsheets to show historical and expected rate of returns.
 - a. At same time consider requesting the following for permanent policies:
 - i. Inforce Ledger showing reduction of death benefit to minimum corridor amount, and separately to MEC amount for permanent policies, and alternatively showing maximizing death benefit if increase is possible.
 - ii. Confirmation of any payment requirements that must be maintained to keep guarantees or other policy features in place.
 - iii. Are there existing riders that can be added or switched off and costs thereof.
 - iv. Veralytic cost/performance benchmarking. or other report on the carrier and product.



Determining Basis (“Investment in the Contract”) for Life Insurance Policies

- Investment in the contract or basis is:
 - > (1) the aggregate amount of premiums or other consideration paid for the contract LESS
 - > (2) the aggregate amount received or credited under the contract that is excludable from gross income
- Payments not included in calculating the amount paid for the contract:
 - > Premium payments for (1) disability income, (2) double indemnity provisions, and (3) disability waiver provisions.
 - > Interest payments on policy loans
- What else reduces basis?
 - > Policy Dividends received in cash
 - > Dividends used to purchase policy riders not integral to the insurance policy (e.g. disability income, disability waiver provisions, accidental death insurance, term insurance riders)
 - > **Dividends used to pay policy premiums**
 - > **Dividends used to pay interest on policy loans**



Policy Conversion and Exchange

Carryover Basis Applied to Term Conversion

The Tax Cuts and Jobs Act amended IRC § 1016(a) to state there is no basis adjustment for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract. (Rev. Rul. 2020-5 amended Rev. Rul. 2009-13 and Rev. Rul. 2009-14 for the IRC § 1016 amendment.)

Therefore, an insured has basis in his term life insurance policy equal to the cumulative premiums paid.

Historically, the view was that an insured who was issued a term life insurance policy on his life had to reduce his cost basis for the cost of insurance and his basis was only the unearned premium because of the holding in Rev. Rul. 2009-13. However, IRC § 1016(a)(1)(B) and Rev. Rul. 2020-5 should put to rest the notion that an insured who takes out an insurance policy on his life must reduce his policy basis for the cost of insurance for purposes of selling the policy. The open question is whether a term conversion can provide carryover of the term policy's basis into the new permanent policy.

IRC § 1035 allows for tax-deferred exchanges of life insurance policies and provides for carryover basis into the new life insurance policy. However, insurance carriers generally will not process an exchange of a term life insurance policy for another life insurance policy as a 1035 exchange, therefore, the basis in the term life insurance policy is lost. Carriers also generally take the view that a term life insurance policy's basis will not carryover to a new policy in a term conversion. But, given that an insured's basis in his term life insurance policy equals the premiums paid and that a term conversion is essentially the 'exchange' of a term policy for a new permanent policy, should a term conversion provide the insured with carryover basis?



Creditor Protection and State Law

Parents' Ownership of Life Insurance Policies on the Lives of their Children May Not Have Creditor Protection

Many individuals have purchased life insurance on the lives of their children, both as an investment vehicle and as a means to help assure that their children will have life insurance in the future, regardless of changes to their children's health. Many parents believe that if they own a life insurance policy on the life of their child, it will be creditor-proof. This is not the case, as most states do not offer such protection when the owner of a policy is not the person whose life is insured.

It is a common misconception that simply owning a life insurance policy on another's life, such as a child, automatically confers creditor protection. In most states, the statutory protections for life insurance policies only apply when the insured is also the owner. If a parent owns a policy insuring their children and the parent is sued or files for bankruptcy, the policy's cash value may be available to the parent's creditors.



Creditor Protection and State Law

Irrevocable Life Insurance Trust Ownership of Policies on the Lives of Children May Have Creditor Protection

A policy on the life of a child may be owned by the spouse who is the least likely to lose the value to a creditor. Alternatively, the policy can be owned by an Irrevocable Life Insurance Trust for the child and the child's descendants, which may distribute the ownership of the policy to the child as a benefit when the time is right.

Using an Irrevocable Life Insurance Trust (ILIT) to own the policy can provide both creditor protection and estate tax benefits, as the policy is removed from the parent's estate and is not subject to the parent's creditors.

For example, the Johnsons (a father, mother, and son) are concerned about potential lawsuits against the father, who is a physician. The first option is to have the mother, who is not exposed to professional liability, own the policy on their son. Alternatively, they can establish an ILIT to own the policy, to assure that neither parent's creditors can reach the policy's value.



Portability Allowance and Estate Tax Exemption

When the estate tax exemption was \$600,000 from the years 1987 through 1997, and there was no **Portability Allowance**, it was often best to fund an **Irrevocable Life Insurance Trust**. This ensured that the life insurance death benefit plus up to \$600,000 of other assets could be held for the health, education, and maintenance and support of the surviving spouse in a credit shelter trust that was never subject to estate tax on the second death.

When the portability laws were passed in 2012, it became more important to place life insurance under an **Irrevocable Life Insurance Trust** in order to not reduce the **Portability Allowance** of the surviving spouse. For example, if the first dying spouse had \$2 million of investment and personal assets and a \$2 million life insurance policy and the estate tax exemption was \$5 million per spouse (which was the case in the year 2012), then the surviving spouse would receive a \$3 million **Portability Allowance**. This would occur if the life insurance was in an **Irrevocable Life Insurance Trust** and the remaining assets of the first dying spouse were \$2 million dollars, or a \$1 million dollar **Portability Allowance** if the \$3 million of assets and the life insurance were all in the estate of the first dying spouse.

This continues to be a consideration for individuals who may have large estates. For example, an individual with \$8 million worth of assets and a \$5 million life insurance policy could have the life insurance policy payable to a credit shelter trust with the rest of his or her assets in 2026, and assuming no prior use of the estate tax exemption, the credit shelter trust could be used for the health, education, maintenance, and support of the surviving spouse and pass estate tax-free on the surviving spouse's death.



Portability Allowance and Estate Tax Exemption, Cont'd

If the life insurance is held outside of an **Irrevocable Life Insurance Trust**, the surviving spouse will receive a \$2 million **Portability Allowance**. Alternatively, if the life insurance policy is held under an **Irrevocable Life Insurance Trust** that is properly structured and assuming that the policy was not transferred by gift to the trust within three years of the death of the insured, then the Life Insurance Trust and the credit shelter trust together provide the same estate tax, creditor claim, and divorce protection, but the surviving spouse will receive a \$7 million **Portability Allowance**.

Even clients who live in states that provide full protection of life insurance cash values from creditors can be well advised to implement or maintain an **Irrevocable Life Insurance Trust**.

Be careful if a client is under the federal exemptions, but would be subject to state estate or inheritance taxes if they move back to where they came from, particularly if they have children there that might be inclined to ask them to move back towards the end of their lives to have better care and for the convenience of the children.

Planners should consider that many of the northern states do not recognize portability, so it is important to fully fund a Credit Shelter Trust on the first death, in order to reduce what the surviving spouse's estate will be if he or she moves back to a state that imposes estate taxes. If the first dying spouse leaves a Q-TIP Marital Deduction Trust, the family may consider making a special election in the northern state to have the Q-TIP Trust or a part thereof be considered to be a Credit Shelter Trust in that state, even though neither spouse has recently resided there.



Valuation and Sale of Life Insurance Policies

Valuation of Life Insurance Policies is complex and depends on the insured's health, policy features, and market demand. Policies on individuals with short life expectancies may be worth far more than cash value. Note, the value of a life insurance policy for estate and gift tax purposes and fiduciary purposes is not necessarily the cash value or the surrender value thereof.

The value of a life insurance policy for estate and gift tax purposes and fiduciary purposes will normally be what a willing buyer would pay a willing seller for the policy. (See *Valuation of Life Insurance Policies*, John Hancock Insurance, <https://theasagroup.com/wp-content/uploads/JHancock-Valuation-of-Life-Insurance-Policies.pdf> (last visited July 14, 2025)).

The cash value or cash surrender value is what could be received if the policy is liquidated.

The Interpolated Terminal Reserve (ITR) value is the value that life insurance companies determine and use for calculating their regulatory reserve requirements and for producing their financial statements. Lastly, the PERC value is a market-based valuation methodology commonly used to calculate the fair market value of a life insurance policy by estimating the present value of future benefits, minus the present value of future costs, based on realistic policy assumptions — not just statutory accounting reserves like ITR — hence the name **P**remiums, **E**xpectation, **R**ealization, **C**ost or PERC method. Alternatively, if the insureds are in very poor health and have a short life expectancy, then the policy may be worth much more than the interpolated terminal reserve value.

Each such method arrives at a value that is based upon the health of the insureds when the policy was issued and what their health would be assumed to be, for example using the median health expectation. If the insured or insureds are in excellent health and expected to live well beyond their initially expected life expectancy, then the policy may be worth much less than the ITR value. (Should we capitalize the letters I, R, and T? Authorities are split on whether or not to capitalize here. Some sources on this topic, including Anderson *supra*, capitalize Interpolated Terminal Reserve. (“ . . . typically provides the Interpolated Terminal Reserve (ITR).” Others, like John Hancock *supra*, do not capitalize it (“ . . . a valuation method using an ‘interpolated terminal reserve’ value.”). See also *Interpolated Terminal Reserve Law and Legal Definition*, USLegal, <https://definitions.uslegal.com/i/interpolated-terminal-reserve/>, (accessed July 15, 2025) (“Interpolated terminal reserve refers to. . .”). It appears the generally sources do not capitalize it when used in a sentence, but others do capitalize for stylistic purposes.)



Valuation and Sale of Life Insurance Policies

Alternatively, if the insureds are in very poor health and have a short life expectancy, then the policy may be worth much more than the interpolated terminal reserve value.

A 78-year-old, for example, who is terminally ill and holds a \$2 million life insurance policy with a \$300,000 cash value, might receive a \$1.2 million offer from a life settlement company, reflecting the policy's high value due to the short life expectancy.

However, caution is again prudent when considering the sale of a life insurance policy on the secondary market because regulations for life settlement sales are even more lax than for life insurance placements and replacements or exchanges. For instance, the life settlement secondary market includes both legitimate auctioneers and brokers, and, unfortunately, also buyers that aggressively market themselves with claims like “your clients are losing money if you don’t work with us” and “but our process is proprietary so we can’t tell you how or why we can get you higher purchase offers”. As such, working with a broker that demonstrates a transparent process like the below increases the likelihood that clients actually received top-dollar when selling a life insurance policy.

Appraisal of fair market value in advance of any bids for context to determine good versus bad bids from the auction,

Life Expectancy (LE) reports from multiple LE providers again for determining good versus bad bids from the auction,

All Inclusive Auction for soliciting bids (or declines) from all buyers approved by the respective State Department of Financial Services/Insurance,

Bid History to confirm participation by all buyers and sufficient bidding activity to ensure the highest possible offer, and

Fee Disclosure to ensure fees and commissions paid to auctioneers and/or brokers are reasonable



LLC Structures and Discounting

Another possibility is to contribute the policy to a limited liability company (LLC) and to have the ILIT own a 1% voting member interest in the LLC and the 99% non-voting member interest. Then the 99% non-voting member interest could be valued with reference to discounts for lack of marketability and lack of control. This way, the 99% non-voting member interest might be purchased at least 30 days or more after the policy is placed into the LLC to avoid the step transaction doctrine at a significant discount, which may be in the area of 25 to 35%. A note may be given in exchange for the policy and might be secured by a lien against the policy. This structure allows for discounted transfers of policy interests, reducing gift or estate tax exposure. The IRS generally respects discounts if parties observe the formalities and timing.

As an example, the Blackwell ILIT contributes a \$1 million policy to an LLC. Thirty-five days later, the trust sells the 99% non-voting interest to a family member for \$700,000, reflecting a discount of approximately 30%.



Promissory Notes and Trust Administration

The promissory note should bear interest at a reasonable rate that a fiduciary would charge an arm's length borrower, which might be 2% above the prime rate, which is 7.5% as of the date of publication of this article. Approval of this type of transaction should normally be received by all adult beneficiaries of the trust and preferably by someone who is able to represent minor beneficiaries and unborn heirs. Alternatively, a certain dollar amount might be set aside to pass to the minors and unborn future heirs in exchange for not objecting to the sale at a discount based upon a court order and having had an independent ad litem appointed by the court to determine what an appropriate amount to set aside would be. Proper documentation, fair interest rates, and clear beneficiary consent can play critical roles in withstanding IRS scrutiny and avoiding fiduciary disputes.



Private and Contractual Annuities and Self-Cancelling Installment Notes

One aspect of estate tax planning is that someone who gives away a tree but retains the ability to eat the fruit of the tree will be considered to own the tree upon death. By the same token, someone who loans money and receives interest income will be subject to federal estate tax on the amounts that are still owed to that person upon his or her death, unless the note is a self-canceling installment note.

A self-canceling installment note works by having the lender charge a significantly higher interest rate than would otherwise apply to take into account that the note will cancel upon death. Most advisors use commercially available software that computes rates using the IRS actuarial tables that apply to private annuities and market interest rates, along with life expectancies to determine what the interest rate will need to be in order for the establishment of the note to be considered an arm's length agreement.

A similarly effective arrangement is for the taxpayer to buy a private or contractual lifetime annuity right. While both a self-cancelling installment note and a private annuity may appear to be similar to keeping the fruit from the tree, the estate tax laws are clear that when the payments cease upon death, there is no federal estate tax inclusion if these are properly structured.

For more information on structuring self-cancelling installment notes and private annuities sales, see Jerome M. Hesch and Elliott Manning, *Family Deferred Payment Sales Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 29 U. M. Sch. L. 1 (2009).

When a private annuity arrangement is entered into between the grantor of a trust and the trust itself, the Treasury Regulations impose what is known as the “probability of exhaustion test.” This test requires that the trust have a net worth sufficient to make the private annuity payments based upon the assumption that the grantor will live until age 110 and that the trust assets will grow only at the Internal Revenue Code Section 7520 rate that exists at the time that the annuity is put into place. This rate is generally 120% of the midterm applicable Federal Rate, which is generally equivalent to the market value of a three to nine-year Treasury Bill. The probability of exhaustion test is designed to prevent taxpayers from using underfunded trusts to avoid estate tax. The trust must be able to make payments even under conservative assumptions.



Private and Contractual Annuities and Self-Cancelling Installment Notes

Buy Life Insurance to Avoid the Risk of Premature Death

One possible arrangement is to establish an Irrevocable Life Insurance Trust that would purchase a life insurance policy to offset the risk of the annuity or self-canceling installment note holder dying prematurely.

For example, Mr. Jackson, age 65, received a \$400,000 annual private annuity from his trust. To hedge the risk of dying early, the trust purchased a \$2 million 20-year term policy via an ILIT. If he died at age 75, his family will have received a total of \$4 million in combined annuity and death benefit payments.

The private annuity or self-canceling installment note can solve the estate tax problem for many families, assuming that the payments received are spent, gifted, or donated in sufficient amounts to keep the recipient below the estate tax threshold. This may require making multiple gifts of \$19,000 per year to or for the benefit of many family members, whether directly or using Crummey Trusts. It could also entail discounted gifting of non-voting or minority interest LLC interests, and/or donating funds or assets to public charities, or a private or family foundation, in an amount sufficient to remain under the threshold.

A parent, for example, receiving \$500,000 per year from a private annuity could gift \$19,000 each to 10 grandchildren and \$50,000 to a family charity foundation annually, reducing their taxable estate while avoiding estate tax on the annuity proceeds.

As stated above, payments received under a private annuity arrangement will normally be subject to income tax on the “interest income component,” but this can be avoided if the payments are received from a grantor trust where the recipient of the payments is considered to be the owner of the trust for Federal income tax purposes.



Partnership Basis Bump Transactions – Now Reportable

Courtesy of James Magner



Certain Basis Bump Transactions with Life Insurance-Funded Mixing Bowl Partnerships Are Now Reportable Transactions

The mixing bowl partnership involves setting up a partnership with one partner contributing appreciated assets and another partner contributing a life insurance policy or the partnership purchasing a life insurance policy using a cash contribution. The partnership liquidates after seven years and the assets are distributed to the partners so that a partner's basis in the appreciated assets are increased and the other partner's basis in the life insurance policy is decreased. The appreciated assets are then sold with little to no gain due to the increased basis. The life insurance policy is held until the insured's death at which point an income tax-free death benefit is paid, which provides a de-facto step-up in basis.

Professionals should review the recently released treasury regulations on partnership basis shifting that are transactions of interest because if the basis adjustment is over \$10M the mixing bowl partnership would appear to fall under the regulations, triggering reporting obligations for the client and material advisors. Additionally, as the strategy includes the transfer of life insurance policies, the transfer for value rules must be reviewed to avoid creating a taxable death benefit. (Michael Geeraerts & Jim Magner, Will the EOLI Tax Trap Capture Life Insurance Owned by a Family LLC, LISI Bus. Entities Email Newsletter No. 254 (2023). For further discussion on the employer-owned life insurance rules applying to family partnerships.)

Courtesy of James Magner



Is the Liquidating Distribution of the Policy a Transfer for Value?

If the partnership's liquidating distribution of the policy to the non-grantor trust is a transfer for valuable consideration, the death benefit above the trust's basis in the policy is taxable ordinary income. As the policy is being distributed as a liquidating distribution from the partnership in exchange for the trust's partnership interest, that is a transfer for valuable consideration. If there is no exception to the transfer for value, the death benefit will not be entirely income tax-free. If the trust is not a grantor trust with respect to the insured, the exception for a transfer to the insured is not available.

Typically, when a partnership distributes a policy to a partner in a non-liquidating distribution, the partner takes a carryover basis in the policy equal to the partnership's basis as long as the partner has sufficient outside basis in the partnership interest, and carryover basis is an exception to the transfer for value rule. However, in this case, the trust, as the partner receiving a liquidating distribution, is not taking a carryover basis because the trust's basis is not what the partnership's basis was before the distribution.

With respect to the transfer to a partner of the insured exception, the insured and the non-grantor trust were partners. However, after the liquidation of the partnership, they are no longer partners unless there is another partnership between the insured and the trust. When the partnership liquidates and distributes all its assets in exchange for partnership interests, the partners may cease to be classified as partners after the liquidation, so it is important to review whether the insured and trust can rely on the transfer to a partner of the insured exception.

If the trust is a grantor trust with respect to the insured, the trust may need to own another entity, such as an S corporation, with the insured as a partner. Suppose the partnership makes a liquidating distribution to the S corporation. In that case, that is a transfer for value and, unless the insured is an officer or shareholder of the S corporation, there is no exception to the transfer for value rule. The carryover basis exception would not apply to a liquidating distribution where the partnership's basis in the policy is not transferred to the partner. If the S corporation distributes the policy to the grantor trust, this subsequent transfer may qualify for the transfer to the insured exception. However, if the partnership's distribution to the S corporation is a reportable policy sale, the death benefit received by the trust may still not be entirely income tax-free. Financial professionals must review the ownership of the entities to ensure there is no reportable policy sale.

Courtesy of James Magner



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