CHURCHLEY FINANCIAL GROUP LLC

ESTATE PLAN DESIGN

ADDRESSING WEALTH TRANSFER TAXES

USING THE SALE OF LIFE INSURANCE TO A GRANTOR TRUST

THE CONCERN

Your client has been financially successful during their lifetime and want to use their assets to provide for their family after they are gone. However, estate taxes can consume a significant portion of the wealth they have worked so hard to accumulate, especially if they have rapidly appreciating, income-producing assets.

Making lifetime gifts to an Irrevocable Life Insurance Trust (ILIT) can help, but may involve gift or generation-skipping transfer taxes. Also, trust income tax rates can be significantly higher than individual income tax rates and can further reduce the amount ultimately transferred to your heirs. Is there a way to transfer assets to an ILIT in a tax-efficient manner?

THE SOLUTION

By establishing an ILIT that is a grantor trust for income tax purposes, your client, as grantor of the trust, will be responsible for the trust's income taxes, leaving all the trust assets intact for the benefit of their heirs.[1]

Rather than making a gift to the trust, the client can then sell an asset to the trust. This will freeze the size of their taxable estate immediately, as the asset's future growth and income will be removed from the estate. In addition, certain assets may be valued at a discount, allowing the client to transfer even more in a shorter period of time.

In some cases, the client may be able to give away or sell an interest in an asset such as a privately held company, Family Limited Partnerships (FLP) or Limited Liability Company (LLC) without giving up control of it. The income from the asset sale can then be leveraged significantly when the client's trust invests in life insurance. And, if the ILIT is properly drafted by their attorney to comply with the applicable state and federal laws, the life insurance proceeds are generally not subject to income and estate taxes.

[1] See IRC Sec. 671-678. The grantor ILIT takes advantage of the difference between how the trust will be taxed for estate tax purposes and income tax purposes.

HOW DOES THIS STRATEGY WORK AT INCEPTION?

Create the ILIT. Client creates a grantor ILIT to keep trust assets outside of their taxable estate. The trust is drafted so that the client is considered the trust owner for income tax purposes, but not for gift and estate tax purposes.

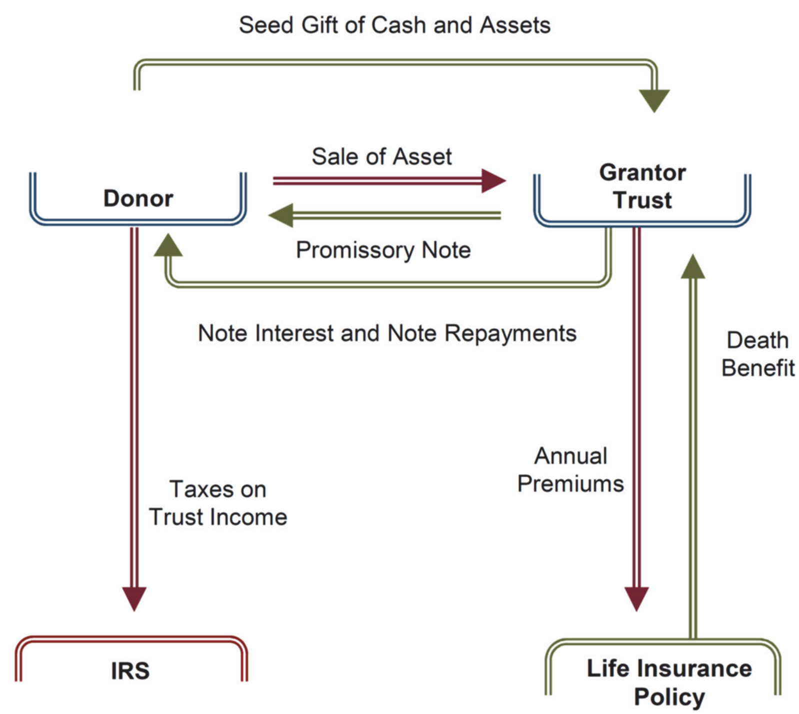
Fund the ILIT. Client will make a gift of cash, assets, or both to the trust. This gift can be covered by any available applicable exemption amount or annual exclusion gifts to avoid gift taxes. This gift is also referred to as “seed” money and should be at least 10% of the value of the sale amount. If the client wants to have a multi-generational trust that is exempt from generation-skipping transfer taxes (GSTT), they can allocate the GSTT exemption to the initial gift.

Sell the Asset. After making the gift, the client may enter into a sales agreement with the trust. In this arrangement, the client will sell an income-producing asset, such as a partnership interests or corporate stock, to the trust. An appraiser may apply valuation discounts to the assets, particularly if the assets are closely-held or if they are interests in a partnership or a limited liability company (discounts can be applied for assets used in the sale and the gift). The promissory note is usually structured for a term of years and interest should be charged at or above the applicable federal rate (AFR). And, there is no capital gains tax due on the sale because the sale is from a grantor to a grantor trust.

Trust Pays Interest from Trust Income. Assets transferred to the trust may earn income each year, which may accumulate inside the trust and can be used to make note and interest payments.

Purchase the Life Insurance. The trust may use cash and income from the asset to purchase a life insurance policy. The death proceeds from the life insurance policy may be used to increase the overall amount left to the client’s heirs or to pay any principal balance remaining on the note.

Grantor Pays Taxes. The client will pay the trust’s income tax due each year at their personal income tax rate. However, any note interest paid to the client by the trust annually will not be taxable because the client and the trust are considered to be the same person for income tax purposes (see Revenue Ruling 85-13). By paying the trust income tax, the client is making the equivalent of an additional tax-free gift to the trust.



HOW DOES THIS STRATEGY WORK AT DEATH?

Repayment of the Note. At death, the trust will repay the client's estate the remaining note balance, which may have already been reduced by scheduled note repayments.

Life Insurance Death Benefit. The trust will receive the death benefit from the life insurance policy. In general, life insurance policy proceeds are received free of income taxes when properly structured.

Trust Assets Pass to Heirs. The life insurance proceeds, along with any other trust assets left after the repayment of the note, will pass to the client's heirs as specified under the trust.

Estate Pays Taxes. The client's estate will pay estate taxes under the current applicable estate tax laws. The note repayment will be included in the client's estate for estate tax purposes.

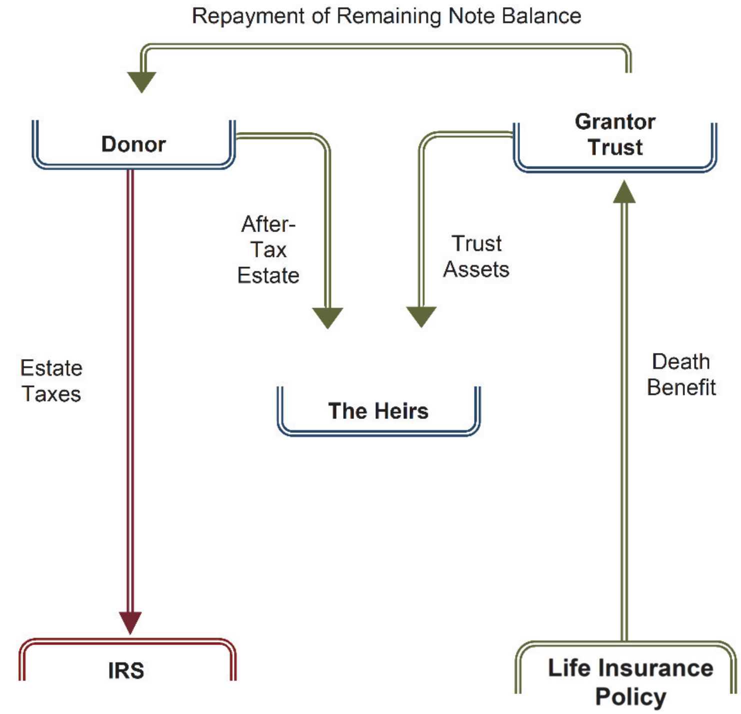
Net to Heirs. The remainder of the client's estate will then also pass to their heirs.

THE POWER OF DISCOUNTED GIFTS

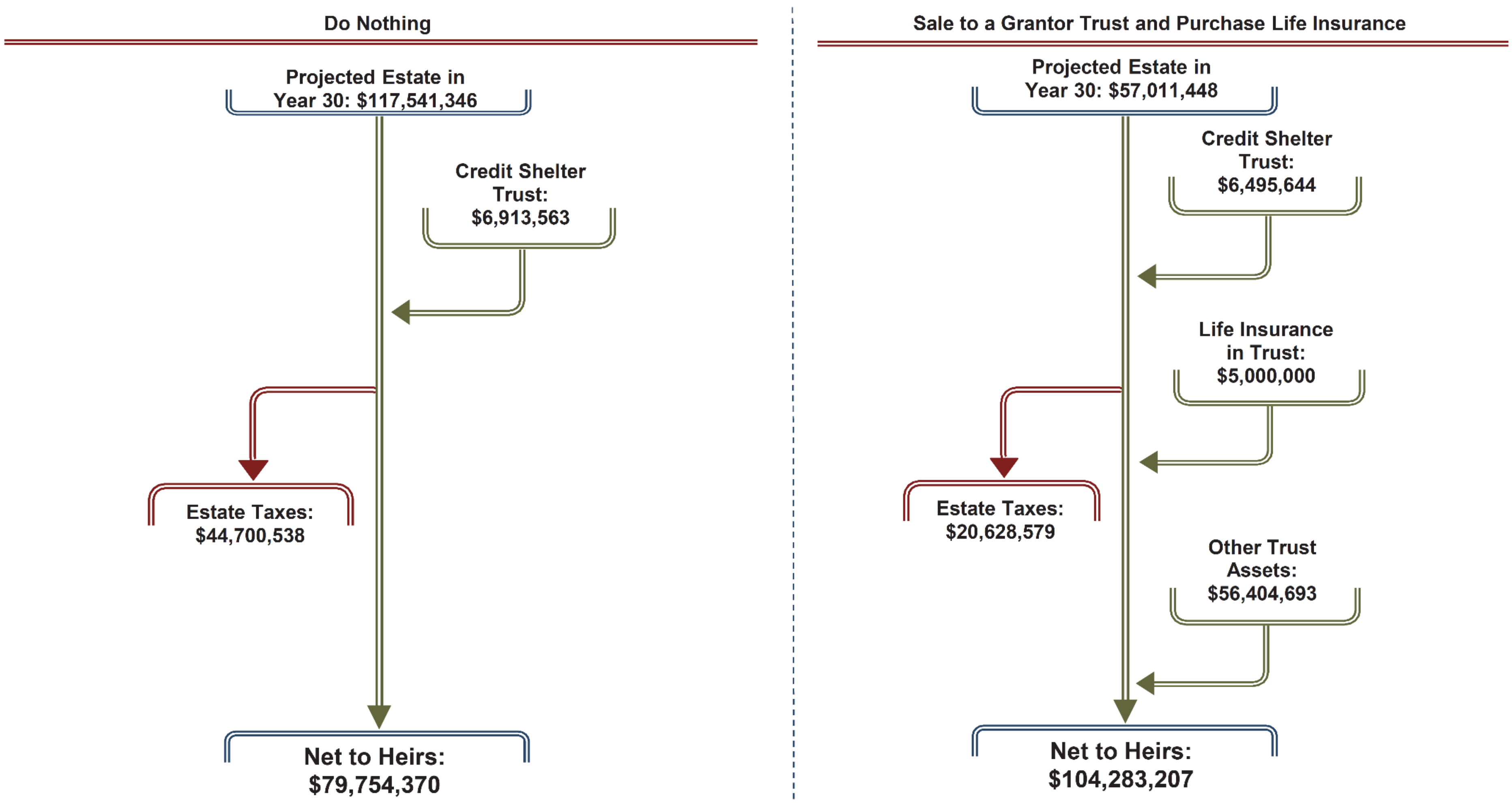
The value of an interest in a closely held corporation, a partnership, or other asset, may qualify for a valuation discount to reflect either or both a minority interest discount and a lack of marketability discount. Consequently, maximum leverage can be achieved with the transfer of such interests in a gifting program. The discounts may be considerable, ranging from 25%-40% of the underlying value of the assets, and the amount of time it takes to transfer the assets gift tax free can be minimized. The components of discounting are:

Lack of Marketability. A lack of marketability discount may be available because of the technical and practical restrictions on the owner's ability to transfer the asset.

Minority Interest. A minority interest discount may be available because the owner of an interest or asset may not have the power to manage or control the underlying net asset value.



HYPOTHETICAL COMPARISON OF $40 MILLION ESTATE IN 30 YEARS: WITH AND WITHOUT STRATEGY



This is a hypothetical illustration. Benefits and values may not be guaranteed; the assumptions on which they are based are subject to change by the insurer. Actual results may be more or less favorable. Refer to the basic illustration for guaranteed elements and other important information. This illustration is not intended to be accounting, legal, or tax advice. Clients should consult their accounting, legal, and tax advisors about their particular circumstances before implementing any recommendations. Insurance policies and/or associated riders and features may not be available in all states.