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Tax-Efficient Wealth Transfer By an Elderly Couple

A growing number of elders have amassed substantial assets as a result of adopting frugal lifestyles or making fortunate investments. This article proposes detailed plans for managing these individuals' taxes as their wealth is transferred.

By Allen F. Ross

In today's world, people are living longer, more active lives. Given these circumstances, it has become much more difficult for older couples to consider when they might be interested in beginning a wealth-transfer program for the benefit of children and/or grandchildren.

Presently, substantial gifting programs can create potential income, estate, and generation-skipping taxes. This means substantial due diligence must be undertaken before a well-crafted program should be initiated. In this analysis, we will consider a gifting program that will begin with five years of accumulations followed by a transfer of these assets to an irrevocable trust or related family limited partnership.

The objectives of the gifting program include providing the beneficiaries with the largest after-tax asset value and, simultaneously, providing the givers an opportunity to gift with the least amount of tax responsibility.

The clearest way to demonstrate this situation is to create an example of a seventy-five-year-old couple that has a desire to transfer some assets. The fundamental strategy here is to absorb substantial accumulations into a specific program and then undertake a capital transfer of the funds to the partnership or trust in the most appropriate, tax-efficient manner.

Presently, the most tax-efficient method for accomplishing these goals is to introduce a unique, custom-designed life insurance vehicle that can absorb these assets. Then the contract can be gifted to the beneficiaries at a time when the effective gift or generation-skipping taxes may be only a fraction of what a direct transfer might be.

The real valuation, or the actual level of taxation, will be determined by reviewing the surrender value, the account value, and the interpolated terminal reserve. Whichever is highest would be the taxable value of the contract at transfer.[1] The IRS considers gross income to include the "entire cash value," and for certain circumstances the interpolated terminal reserve may be the most accurate parameter.[2] Furthermore, the abusive use of "springing cash value" contracts that show little or no value at transfer reiterates the need for considering reserves as a more appropriate value for such contracts.[3]

The programs and policies discussed within utilize the interpolated terminal reserve as the basic

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TABLE 1.

JT AGE	ANNUAL PREMIUM OUTLAY	GIFT TAX PAYABLE	CURRENT ACCOUNT VALUE	GROSS DEATH BENEFIT[1]
70	$ 1,000,000			$ 14,890,778
71	$ 1,000,000		$ 327,597	$ 14,890,778
72	$ 1,000,000		$ 707,312	$ 14,890,778
73	$ 1,000,000		$ 1,079,581	$ 14,890,778
74	$ 1,000,000		$ 1,451,851*	$ 14,890,778
75		$ 798,518	$ 1,712,820	$ 14,890,778
76			$ 1,980,969	$ 14,890,778
77			$ 2,637,585	$ 14,890,778[2]
78			$ 4,426,024	$ 14,890,778
79			$ 6,220,900	$ 14,890,778
80			$ 6,577,128	$ 14,890,778
81			$ 6,946,983	$ 14,890,778
82			$ 7,330,822	$ 14,890,778
83			$ 7,729,129	$ 14,890,778
84			$ 8,143,126	$ 14,890,778
85			$ 8,574,701	$ 14,890,778
86			$ 9,026,736	$ 14,890,778
87			$ 9,502,920	$ 14,890,778
88			$ 10,008,187	$ 14,890,778
89			$ 10,548,291	$ 14,890,778
90			$ 11,126,027	$ 14,890,778
91			$ 11,750,520	$ 14,890,778
92			$ 12,432,780	$ 14,890,778
93			$ 13,186,206	$ 14,890,778
94			$ 14,023,782	$ 15,284,520
95			$ 14,928,901	$ 16,070,962
96			$ 15,895,733	$ 16,889,216
97			$ 16,929,293	$ 17,740,206
98			$ 18,036,197	$ 18,638,606
99			$ 19,229,174	$ 19,607,989

[1] Policy owned as an estate includable asset for the first five years.
[2] After expiration of three year contemplation of death provision, value is not estate includable for estate tax purposes.
* Interpolated terminal reserve may be higher than account value illustrated.

valuation of the insurance contract and fall within the allowable guidelines established by I.R.S. Notice 89-25, etc. This solidifies the concept as an ideal method for providing tax-compliant, tax-efficient transfers to future generations.

Example

Table One presents the scenario in a straightforward manner. The couple has a joint insurance age of seventy years (Column One). Because two lives are being considered and death benefits are not paid until the

surviving spouse dies, the actual cost of insurance would be similar to that of an individual at the lower age.

Column Two states that the couple will make contributions to the custom-designed contract at a rate of one million dollars annually for five years. Column Four provides the current account value of the contract. The contract has been designed to have large surrender charges in the initial five years. Furthermore, the cash account and the interpolated terminal reserve will be similar and relatively low at the end of the fifth year. The value of the contract at the time of transfer will be approximately $1,451,851 and the gift tax payable on that amount will be $798,518 (Column Three). The gross death benefit of $14,890,778 is in Column Five.

Thus, in this situation, there is a tremendous increase in the valuation net of taxes both before and after transfer. The family can receive almost fifteen million dollars, which can be income-tax and estate-tax free three years after the gift is completed.

The three-year contemplation of death period above would be eliminated if the trust or partnership purchased the contract directly from the couple at the end of the fifth year for its full value (interpolated reserve value). If the trustees of the future irrevocable trust want to access the funds in the contract after it is transferred to them, it can access these funds (numbers in Column Four) as income-tax-free policy loans. As long as the integrity of the policy remains intact, these funds can be used to provide benefits to the beneficiaries (education, house down payments, etc.) while one or both of the gift givers are still alive.

This contrasts with the normal method of transfer to future generations. A transfer of five million dollars would result in a gift tax and generation-skipping tax totaling in excess of two million dollars and all future growth would be fully taxable to the beneficiaries. Thus, the real after-tax value to the beneficiaries would not be able to reach the scenario discussed above.

Advanced Example

A more intricate and more tax-efficient example is shown in Table Two. The presentation begins in the same manner as the original example. We still have a joint-age-seventy situation regarding the mortality charges, and the contract will embrace five annual payments of one million dollars as shown in Column Two. The gross death benefit still remains $14,890,778.

However, in this scenario the couple will make only four of the five payments specified in the example above. Suppose the couple's financial affairs deteriorate and they cannot make the last payment they would have liked to make. Or perhaps they planned to contribute only four million dollars, but wanted to do it in the most tax-efficient manner. Either way, the transfers to the beneficiaries are still quite extraordinary.

Returning to the example, the contributions to the contract by the couple are shown in Column Seven. In the fifth year they borrow the one million dollars from the contract, to pay the premium, using an internal policy loan. Similarly, they must pay interest on the loan for the duration of the program, although the growth in the cash value of the contract will be able to pay the outstanding interest on the loan.

Column Five displays the outstanding loan for that year. Column Six shows the total loan outstanding. Column Eight shows the interest cost annually (matching Column Five after the policy loan is taken in year five). The key columns are numbers Nine, Ten and Eleven. Column Nine displays the net cash value of the contract which is similar to Example One until the policy loan in year five. Column Ten shows the gross death benefit (similar to the earlier example) and Column Eleven shows the net death benefit for the beneficiaries after all loans are repaid.

In this scenario, the couple will transfer only four million dollars over four years and still secure an initial death benefit of almost fifteen million dollars. However, due to the policy loan in year five and corresponding decrease in the interpolated terminal reserve,[4] two things will occur. First, the net cash value is reduced to $377,851 (and can be made even lower) and will significantly reduce the gift taxes payable on transfer or reduce the cost of purchasing the contract from the couple directly (to avoid the contemplation of death three year wait for estate tax freedom). Second, as the size of the policy loans and interest increase the net amount of death benefit shown in Column Eleven will slowly decrease.

From a long-term perspective, either of our examples will be significantly more advantageous for the beneficiaries than the direct transfer of four or five million dollars. Furthermore, the grantor couple will be responsible for a much lower level of gift tax and, where applicable, generation-skipping tax. In

TABLE 2.

1	2	3	4	5	6	7	8	9	10	11
JT AGE	ANNUAL PREMIUM PAYABLE	CURRENT ACCUM. VALUE	CURRENT ACCOUNT VALUE	ANNUAL POLICY LOAN	TOTAL LOAN OUTSTNDG	ANNUAL OUTLAY	INTEREST AT 7.4% ADV	NET CASH VALUE	GROSS DEATH BENEFIT	NET DEATH BENEFIT
70	$1,000,000	$ 869,022				$1,000,000			$14,890,778	$14,890,778
71	$1,000,000	$ 1,785,537	$ 327,597			$1,000,000		$ 327,597	$14,890,778	$14,890,778
72	$1,000,000	$ 2,752,174	$ 707,312			$1,000,000		$ 707,312	$14,890,778	$14,890,778
73	$1,000,000	$ 3,771,603	$ 1,079,581			$1,000,000		$ 1,079,581	$14,890,778	$14,890,778
74	$1,000,000	$ 4,847,057	$ 1,451,851	$1,074,000	$1,074,000		$ 74,000	$ 377,851	$14,890,778	$13,816,778
75		$ 5,108,026	$ 1,712,820	$ 79,476	$1,153,476		$ 79,476	$ 559,344	$14,890,778	$13,737,302
76		$ 5,276,175	$ 1,980,969	$ 85,357	$1,238,833		$ 85,357	$ 742,136	$14,890,778	$13,651,945
77		$ 5,641,180	$ 2,637,585	$ 91,674	$1,330,507		$ 91,674	$ 1,307,078	$14,890,778	$13,560,271
78		$ 5,932,822	$ 4,426,024	$ 98,458	$1,428,964		$ 98,458	$ 2,997,060	$14,890,778	$13,461,814
79		$ 6,220,900	$ 6,220,900	$ 105,743	$1,534,708		$105,743	$ 4,686,192	$14,890,778	$13,356,070
80		$ 6,577,128	$ 6,577,128	$ 113,568	$1,648,276		$113,568	$ 4,928,852	$14,890,778	$13,242,502
81		$ 6,946,983	$ 6,946,983	$ 121,972	$1,770,249		$121,972	$ 5,176,734	$14,890,778	$13,120,529
82		$ 7,330,822	$ 7,330,822	$ 130,998	$1,901,247		$130,998	$ 5,429,575	$14,890,778	$12,989,531
83		$ 7,729,129	$ 7,729,129	$ 140,692	$2,041,939		$140,692	$ 5,687,190	$14,890,778	$12,848,839
84		$ 8,143,126	$ 8,143,126	$ 151,104	$2,193,043		$151,104	$ 5,950,083	$14,890,778	$12,697,735
85		$ 8,574,701	$ 8,574,701	$ 162,285	$2,355,328		$162,285	$ 6,219,373	$14,890,778	$12,535,450
86		$ 9,026,736	$ 9,026,736	$ 174,294	$2,529,622		$174,294	$ 6,497,114	$14,890,778	$12,361,156
87		$ 9,502,920	$ 9,502,920	$ 187,192	$2,716,814		$187,192	$ 6,786,106	$14,890,778	$12,173,964
88		$10,008,187	$10,008,187	$ 201,044	$2,917,858		$201,044	$ 7,090,329	$14,890,778	$11,972,920
89		$10,548,291	$10,548,291	$ 215,922	$3,133,780		$215,922	$ 7,414,511	$14,890,778	$11,756,998
90		$11,126,027	$11,126,027	$ 231,900	$3,365,680		$231,900	$ 7,760,347	$14,890,778	$11,525,098
91		$11,750,520	$11,750,520	$ 249,060	$3,614,740		$249,060	$ 8,135,780	$14,890,778	$11,276,038
92		$12,432,780	$12,432,780	$ 267,491	$3,882,231		$267,491	$ 8,550,549	$14,890,778	$11,008,547
93		$13,186,206	$13,186,206	$ 287,285	$4,169,516		$287,285	$ 9,016,690	$14,890,778	$10,721,262
94		$14,023,782	$14,023,782	$ 308,544	$4,478,060		$308,544	$ 9,545,722	$15,284,520	$10,806,460
95		$14,928,901	$14,928,901	$ 331,376	$4,809,436		$331,376	$10,119,465	$16,070,962	$11,261,526
96		$15,895,733	$15,895,733	$ 355,898	$5,165,335		$355,898	$10,730,398	$16,889,216	$11,723,881
97		$16,929,293	$16,929,293	$ 382,235	$5,547,570		$382,235	$11,381,723	$17,740,206	$12,192,636
98		$18,036,197	$18,036,197	$ 410,520	$5,598,090		$410,520	$12,078,107	$18,638,606	$12,680,516
99		$19,229,174	$19,229,174	$ 440,899	$6,398,988		$440,899	$12,830,186	$19,607,989	$13,209,001

reality, the final decision can be made initially or can be delayed until the fifth year.

The key element in any of these situations is to understand the objectives of the client. Then, the structure must be created by using a custom-designed contract that will fit these objectives.

Using Qualified Plan Assets for Transfer

If the couple wanted to accomplish the wealth transfer using funds presently sitting in a qualified plan or IRA, a similar scenario to the above advance example could be created. However, because of the rules and regulations in the qualified arena, it is imperative that it is done with a great deal of care.

First, we must determine what type of plan assets are available. In general, up to fifty percent of the total plan assets in a defined contribution plan may be used.[5] Defined-benefit plans will usually allow one hundred times the benefit, but they can exceed that level.[6] Profit-sharing plans can be amended to use up to one hundred percent of the plan assets.[7]

An individual traditional retirement account (IRA) cannot be used because the IRS does not allow insurance contracts in the account.[8] However, if the client has a corporate rollover IRA, there are still substantial opportunities. The requirements for establishing a profit-sharing plan include the need to have taxable earned income. If the client with the rollover IRA creates a viable business (consulting, fees, etc.), a qualified plan can be established and the client can transfer the corporate rollover IRA to the new profit-sharing plan.

Another consideration is that putting an insurance plan inside a qualified plan automatically creates a new taxable economic benefit. This benefit, known as the PS-58 costs, is taxable to the client.[9] The amount of tax is calculated using a special IRS table.

Returning to Table Two, the program is as follows: Now the client makes a transfer from the stock and bond account to the custom-designed contract, but the contract is still owned by the qualified plan. Then, at the end of the fifth year, the client takes a distribution of the contract from the plan (or the contract is purchased by a trust or partnership). The client is responsible for paying income tax on the interpolated terminal reserve value, or taxable value of the contract (when properly designed the amount will be even smaller than shown in the table). In addition, the client will be responsible for paying the gift taxes upon transferring the contract to the trust. Again, substantial assets have been transferred out of the estate and a dramatically lower amount of gift, income, estate, and generation-skipping taxes will have to be paid.

The Financial Advisor

The financial advisor must make a comprehensive assessment of each client's needs and objectives to determine the viability of this program. There are certain situations where using one or another aspect of this program would be quite advantageous for the elder couple. For those with substantial assets, either inside or outside a qualified plan, the program can be used to provide significant estate enhancements.

For those with small estates, or those who need their existing assets to live on, this program would be most inappropriate. Each case must be custom designed to fit the needs and circumstances of the couple.

Conclusion

This well-designed strategy can be an important component of any comprehensive financial or estate plan. The program can substantially reduce those assets subject to a heavy tax load. It can create millions of dollars, income-tax and estate-tax free, for the couple's beneficiaries upon their death. Finally, the trustees of the irrevocable trust can access funds during the remaining life of the couple to provide for the beneficiaries. A properly designed program will be able to provide a wealth of benefits.

Endnotes

1. I.R.S. Notice 89-25, C.B. 1989-1.
2. I.R.C. § 25.2512-6.
3. I.R.S. Notice 89-25, C.B. 1989-1; I.R.S. Announcement 94-101, I.R.B. 1994-35.
4. I.R.C. § 25.2512-6; I.R.S. Form 712, Part II.
5. *See* I.R.C. § 1-401-1(b)(1)(ii).
6. *See* Rev. Rul. 74-307, 1974-2 C.B. 126; Rev. Rul. 68-453, 1968 C.B. 163.
7. *See* Rev. Rul. 60-83, 1960-1 C.B. 157; Rev. Rul. 68-24, 1968-1 C.B. 150.
8. I.R.C. § 408(a)(3).
9. I.R.C. § 72(m)(3)(B).