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Owens, Rodney J
Journal of Financial Service Professionals; Nov 2001; 55, 6; ProQuest Central
pg. 37

Insurance Planning

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PAINLESS PREMIUM PAYMENT PLANNING

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Our guest columnist, Rodney J. Owens, is a founding partner in the law firm of Meadows, Owens, Collier, Reed, Cousins & Blau, LLP, a Dallas-based firm dedicated principally to the practice of law in the specialized areas of personal and business tax planning, civil and criminal tax defense representation, and mergers and acquisitions. As co-chairman of the tax planning group, Mr. Owens represents family business owners throughout the country, with active planning cases currently in 28 states. He is a graduate of Southern Methodist University, receiving BBA, Accounting, and JD degrees, and is a member of the Dallas, the Texas, and the American Bar Associations. In addition to serving on the Estate and Gift Tax Committee and Real Property, Probate and Trust Committees for both the American Bar Association and the Texas Bar Association, Mr. Owens is the author of several tax and estate planning articles that have appeared in publications such as Trusts and Estates, CCH Financial and Estate Planning, Prentice-Hall, the Journal of the Institute of Financial Planners, and the National Association News of the NALU. He is noted for his prolific speaking engagements, which account for more than 500 sessions and professional conferences across the nation.

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I've never been a big believer in the adage "no pain, no gain," particularly when the exercise at hand involves strategic cash-flow planning to complement the life insurance liquidity plan which is funded with one or more life insurance products. Given the wealth transfer tax planning obstacles that typically beset your "jumbo case" engagements, any premium financing plan that requires too much post-acquisition work by or on behalf of the family will be met head on with client intolerance or, even worse, that dreaded disease called "planning paralysis."

The creative planner should therefore examine those premium payment methodologies that not only minimize post-acquisition payment procedures, but likewise create a seamless policy placement plan that is almost effortlessly woven into the tapestry of the applicable client's Family Wealth Preservation Plan. There are, of course, numerous plan design alternatives, too many to cover in this column. Therefore, let's take a look at two planning techniques that are on the cutting edge of painless premium payment planning.

Leveraged Premium Funding with Nonreversionary GRATs

Section 2702 of the Internal Revenue Code of 1996 and Treasury regulations thereunder permit us to design our grantor-retained annuity trust (GRAT) plans as either one in which the grantor retains a contingent reversionary interest in the trust or a term certain plan wherein the remainder interest is not contingent on the grantor's mortality. More important for our purposes, however, neither the Code nor the Treasury regulations thereunder limit the investment powers of the GRAT trustee with either type of design structure. Thus, the assets of any GRAT plan can be dedicated in whole or in part toward the premium financing needs of a life insurance policy, whether for life insurance policies owned directly by the GRAT or perhaps under one or more varieties of split-dollar life insurance configurations. Nevertheless, the reversionary GRAT plan does not typically represent an appropriate vehicle for the direct ownership of life insurance contracts given the fact that the grantor's premature death would operate to subject the life insurance contract and its proceeds to potential estate tax liability exposure. On the other hand, the nonreversionary GRAT plan represents a potentially ideal premium funding mechanism under the appropriate circumstances.

Case Study Example

Let's assume that our client is the owner of all of the outstanding shares of Enterprise, Inc., a very profitable S corporation with substantial annual corporate dividend distributions. We have previously implemented a stock recapitalization plan whereby the client and the client's spouse *each* own 1 share of voting stock, and the client owns

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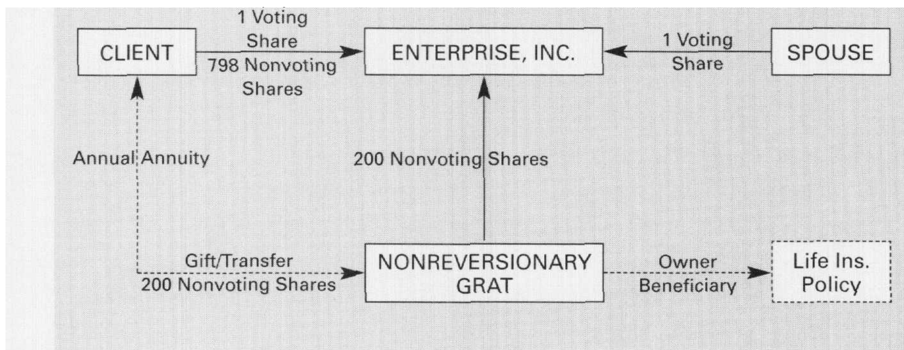
the remaining 998 shares of nonvoting stock. After carefully constructing an appropriate economic model, we conclude that we would need only 20 percent of the annual conservatively determined corporate dividend distributions to (1) provide sufficient annual cash flow to satisfy an annual annuity payment with an appropriately designed nonreversionary GRAT Plan, *and* (2) satisfy the annual cash-flow requirements for the life insurance policy(s) which we want to position as part of the family liquidity plan. Any ideas?



The client would establish the nonreversionary GRAT, endowing it with sufficient provisions to have it characterized, of course, as a grantor trust for income tax purposes. The client would then transfer ownership of the 200 shares of nonvoting stock to the GRAT (as a part gift, part deemed sale procedure), in exchange for the actuarially computed annual annuity payment obligation.

We now have locked away the 200 shares of nonvoting stock, the projected annual corporate dividend distributions which will be sufficient to underwrite the required annual annuity payment to the client and underwrite the premium payment obligation for the previously designed life insurance product. Of course, we will need to implement additional planning methods to underwrite the initial life insurance premium payment (e.g., loans to the GRAT, a split-dollar life insurance plan with Enterprise for the initial premium payment only, etc.). With such additional planning in place, the trustee of the GRAT would then have the resources to acquire the previously designed life insurance contract.

Case Study Summary

The astute planner will, of course, need to fill in the blanks, so to speak, with respect to the above case study. For example, the presence of the life insurance policy on the life of the grantor will necessitate appropriate planning to circumvent the incidents-of-ownership tax inclusion rules of Code § 2042. Nevertheless, this type of planning can be successfully implemented to facilitate the acquisition and continued premium payment requirements for life insurance programs, all without the necessity of annual gifts and other complex annual procedures that must be followed by the client for the plan to be successful. If the client/grantor dies before expiration of the retained annuity period, the inclusion amount under Code § 2033 is limited to that portion of the trust assets which, if invested at the applicable federal interest rate as of the date of death, would be sufficient to underwrite the remaining annuity payments (see, e.g., FSA 200036012 (9/14/00), and Rev. Rul. 82-105, 1982-1 C.B. 133). Assuming we avoid all of the other inclusionary rules under Chapter 11 of the Code, then the life insurance proceeds received by the GRAT will successfully escape estate taxation even if the grantor dies during the retained annuity period.

The above case study represents but one alternative to utilize the resources of a nonreversionary GRAT plan to effectively fund the life insurance premium payment obligations. The creative planner will quickly find numerous planning alternatives, particularly with short-term zeroed-out nonreversionary GRAT plans where the post-GRAT assets are continued under trust administration as an irrevocable grantor trust.

Advanced Premium Payment Methodologies with Family Limited Partnership Plans

For good reason, the planning rage in Family Wealth Preservation circles is the remarkable "defective sale" plan wherein clients are able to sell assets (usually, but not always, highly appreciated) to irrevocable grantor trusts (usually, but not always, dynastic by design) without any significant front-end taxable

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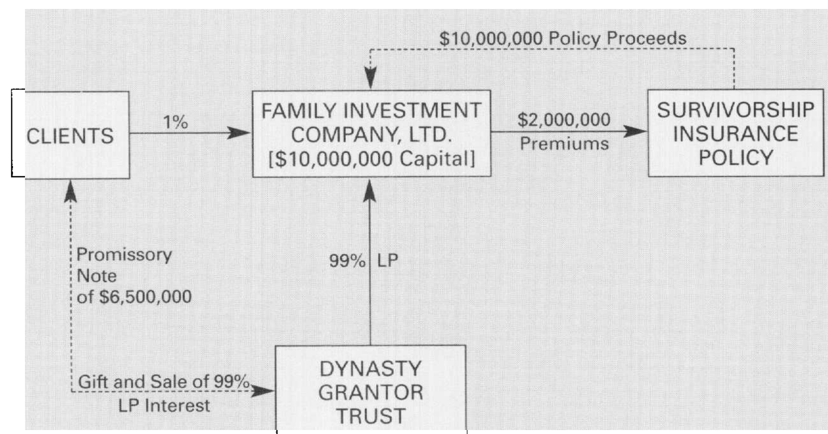
event for income tax purposes, yet fully effective for wealth transfer tax purposes. The successfully implemented defective sale plan permits the clients to shift postsale appreciation and excess income from the transferred asset(s) out of their future taxable estates without any postimplementation procedures! Much like its sibling planning technique involving the previously discussed nonreversionary term certain GRAT plan, this leveraged planning tool is an extraordinarily attractive planning technique to likewise facilitate the acquisition and painless premium payment of the annual premiums for any type of life insurance plan.

Case Study Example

Let's assume that our clients have successfully accumulated $10,000,000 of net investment assets (e.g., marketable securities, investment real estate, etc.), owned equally by the husband and wife. They have the typical Family Wealth Preservation planning objectives (i.e., continued control and financial security, enhanced confidentiality and probate avoidance, asset protection planning, and wealth transfer tax savings). You therefore recommend the implementation of a classic Family Limited Partnership (FLP) plan for purposes of owning and managing these investment assets. Assuming a conservative devaluation factor of 35 percent, our professional appraiser concludes that the 99 percent limited partner interests owned by the clients have a current fair market value (FMV) of approximately $6,500,000. Your proposed life insurance family liquidity program involves a $10,000,000 survivorship life insurance policy, with an annual premium of $200,000 per year projected over 10 years of payments. This powerful (and painless) Family Wealth Preservation Plan can be implemented to create some extraordinary planning benefits for the family.



Assuming a presale gift of 10% of the nonvoting shares (i.e., a $650,000 gift) and therefore a sale of 89% of the nonvoting shares (i.e., $5,850,000), your carefully constructed economic model reveals that the annual interest payments on the promissory note would involve around $351,000 of interest (assuming an adjusted federal rate of around 6 percent). Assuming the net annual rate of return is 12 percent for the FLP plan (i.e., $1,200,000 of minimum annual cash flow), distributions by the family partnership to the respective partners will provide the trustee with more than sufficient liquidity to underwrite such annual interest payments as well as partial principal payments. The family partnership would immediately commence the annual premium payment procedures whereby the family partnership will utilize a portion of its resources to acquire the $10,000,000 survivorship life insurance policy, leaving the family partnership with substantial annual cash flow over and above that needed to service the promissory note and life insurance premium payments.

Case Study Summary

Once again, there are several fill-in-the-blanks issues that the advanced planner must address and resolve in successfully implementing this sophisticated planning technique. You will find, however, that this planning tool will accomplish all of the planning objectives for the family while simultaneously establishing a family liquidity program that does not include anything other than a required annual premium payment check to achieve success.

Pushing the Envelope

Can we push the proverbial planning envelope further to integrate a family philanthropy plan and zero out the estate tax liability? This is where

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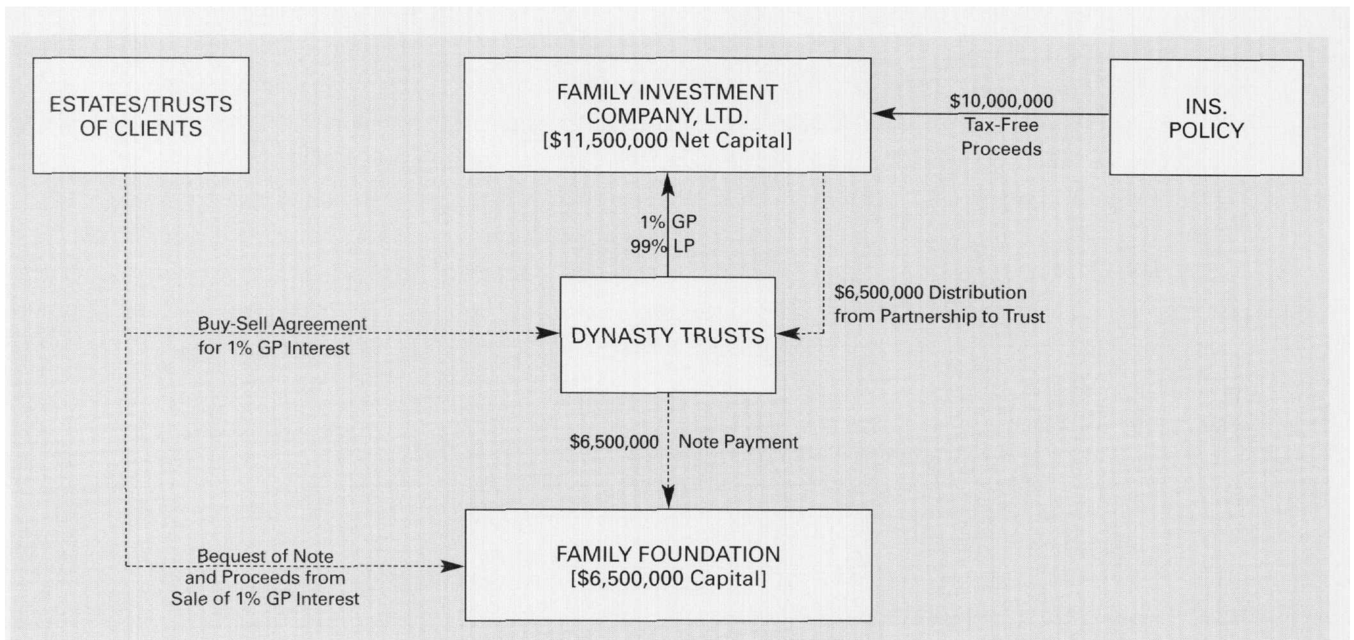

our planning really gets fun and interesting. I will supply the diagram *assuming* a zero growth/appreciation factor, and absolute zero income accumulations for the family partnership; I will let you fill in the blanks.

Utilizing the same fact pattern, we are now simply modifying the estate plan of the clients whereby the remaining balance of the promissory note (assumed here to be 100 percent) is left to qualified charitable organizations, together with the proceeds from the sale of their 1 percent general partner (GP) interest.

Concluding Observations

It is interesting to note that these powerful planning tools are even more attractive in the shadows of the recently enacted tax legislation. If the clients die before the death tax is actually repealed, they have effectively beat the system. If deaths occur during a period in which the death tax is actually repealed, their estate plans should either make tax-free bequests of the promissory note (and 1 percent GP interest) to the Dynasty Trust *or* follow through with the family philanthropy plan. Above all, however, both of these advanced planning techniques involve proven planning tools that even the most conservative family wealth planner can embrace. And for the life insurance professional, and with all due respect to the original creators of the phrase, it does not get much better than this! ■

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TABLE 1

Who Wins the Wealth Transfer Tax Game?

Description	FMV	Estimated Estate Tax*	Net to Family	Net to Foundation
Without FLP plan	$10,000,000	$5,500,000	$4,500,000	-0-
With FLP plan	$6,500,000	$3,575,000	$6,425,000	-0-
With "defective sale"—insurance and foundation plan	$6,500,000	-0-	$11,500,000	$6,500,000

*Assumes flat 55 percent tax rate.

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