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PLATINUM ADVICE SERIES

How to Protect Your Legacy with Wealth Transfer Planning

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When you have accumulated a significant estate, you want to make sure your wealth is ultimately protected. This paper focuses on how wealth transfer strategies can preserve your wealth for future generations, and/or ensure the continuation of a family business.

IT CAN HAPPEN TO ANYONE

In 1983, Paul Brown sold all but one of his shares in the Cincinnati Bengals pro football team to the president of the team at that time, John Sawyer. The deal stipulated that Brown's two sons could buy back his shares in 10 years at $25,000 a share. They did so years later when their father passed away, buying back Sawyer's shares for a total of $8.2 million.

Everything was fine until 1994, when a bill arrived from the Internal Revenue Service for $29.8 million. Although the shares weren't technically handed down directly from Paul Brown to his sons, the IRS claimed the process was intended to avoid estate taxes. The IRS claimed millions in back taxes, based on the appreciated value of the team.[1]

After a lengthy court battle, Brown's sons avoided the penalty. This story illustrates how judicious wealth transfer planning can benefit a large estate.

THE IMPACT OF ESTATE TAXES ON YOUR WEALTH

Like most Americans, every spring you go through the annual ritual of preparing your income tax returns. You have likely been diligent about minimizing the impact of income tax on your earnings. This often requires creative strategies and long-term planning.

But while the top federal income tax rate in the U.S. is around 34 percent, the top federal estate tax rate is 46 percent.[2] This means that estate taxes could have a much bigger impact on your wealth.

Federal estate tax is only part of the challenge. There is also a gift tax structure and the federal generation-skipping transfer tax (GSTT), and in some cases state estate, gift and GSST. Someone with an estate of $10 million, for example, trying to transfer that entire amount directly to a grandchild outright, could face a federal tax liability of nearly $7 million. That's a 70 percent bite out of your wealth!

[1] ESPN.com, April 14, 2006.

[2] As of 2006.

IT'S ALL ABOUT MINIMIZING RISK

Wealth Transfer Planning addresses personal and financial goals, as well as transferring assets to the next generation, minimizing taxes at death, and other risks such as health risks, business succession and capital gains on appreciated assets.

It is often referred to as "repositioning" assets from one generation to another, in a way that minimizes taxes and maximizes wealth.

Wealth Transfer Planning is part of the third phase of the financial planning cycle. Phase one involves growing assets during your prime earning years. Phase two enables you to preserve and live off that wealth in your retirement years. Phase three includes transferring assets to the next, or future, generations in a tax-efficient way.

SOME OPTIONS FOR SATISFYING A LIABILITY

Whether it's a health, business or estate tax liability, your goal is to provide future funds, so your descendants or heirs do not have to sell valuable assets to settle a debt.

For illustrative purposes, let's say you leave a $5 million estate tax liability — over and above your exclusions. Here are some ways your heirs could neutralize this liability:

Cash on hand: Your heirs could take $5 million dollars out of the bank and send it to the IRS to satisfy the tax liability. However, employing this option will diminish family assets.

Liquidate assets: Your heirs could sell real estate, artwork, stocks, bonds, and collectibles. However, items sold in a hurry may not demand the highest price. Closely held businesses or real estate assets may be even more difficult to sell.

Your heirs could liquidate qualified retirement plans (IRAs, 401ks, etc.). But, any money pulled out of qualified plans will be taxed as ordinary income at their current income tax rate. We have seen qualified plans significantly reduced by having to go through this unfortunate exercise.

Borrow against assets: Financial institutions may lend money to satisfy the estate tax liability.

Use life insurance inside an Irrevocable Life Insurance Trust (ILIT): Using this method, you can arrange for an insurance policy, at your death, to fund a trust. The trust (an ILIT) can then buy assets from the estate, so the estate has cash to pay the estate tax liability, since it is the estate that owes the money.

WHY LIFE INSURANCE IS SUCH A POWERFUL TOOL

Life insurance is a very versatile tool and can be used in many different situations to protect assets, including:

- To pay a future tax bill;
- To replace wealth given to charity;
- To ensure the continuation of a business.

Life insurance can be the most efficient way to fund a liability. If you have a million dollar life insurance policy, you may be able to fund the policy with far less than that amount in premiums, spread over time. If you happen to die before the policy is paid, the insurance company will still honor the agreement and pay out the full amount.

Insurance has other benefits as well. Certain types of policies accumulate a cash value, which grows tax-free. Mutual fund investments within a policy grow tax-free. Further many policies have loan provisions, which let you borrow from the policy at preferred rates and pay no income tax on the money you borrow if certain conditions are met. And as long as a certain percentage of cash value is left intact, the policy will not lapse.

"TAX-FREE" DOES NOT MEAN ESTATE TAX-FREE

While life insurance is generally inherited income tax-free by the beneficiaries — it is NOT free of estate taxes. This means the value of a life insurance policy owned by you at death is *actually calculated as part of the overall gross value of your estate*. This fact causes some people to inadvertently add to their estate and increase their estate tax liability.

An ILIT may help you to avoid this problem by placing the ownership in an insurance policy within a trust. Since you are no longer the owner of the policy, it is not included in your estate. Nor does it factor into the estate tax. The trust itself is the owner, beneficiary and payee of the policy proceeds.

After the proceeds of the life insurance policy are paid into the trust, the trust then pays out a sum to satisfy the estate tax liability, as per the wishes and instructions of the individual who created the trust.

TRUSTS + INSURANCE = A POTENT COMBINATION

As previously discussed, trusts are a powerful financial tool, especially when combined with insurance. One of the most effective ways to minimize estate taxes is to give assets to charity. You can make direct bequests to a charity or use a Charitable Remainder Trust (CRT), which is a popular estate planning tool. The downside to both direct charitable bequests and CRTs is that those assets are no longer available for your family and heirs. However, you can use CRTs in combination with irrevocable insurance trusts to *replace* the wealth you've given to charity, in order to meet your heir's needs. The CRT can provide lifetime benefits to you, and at your death, to charity. The life insurance policy proceeds that are paid to the irrevocable insurance trust can replace the amount that you gave the charity and benefit your heirs.

At the end of the day, however, you still want the liquidity element provided by life insurance. You may need it to help fulfill an estate tax liability or, in the case of a Charitable Remainder Trust, to generate replacement dollars so your heirs will be pleased with the arrangement, as well.

GIVING AND REPLACING $2 MILLION

One affluent couple wanted to give a $2 million charitable contribution to a major university. They set up a Charitable Remainder Trust. The university was notified that they were to become the beneficiary of the $2 million trust. However, the donors were the income beneficiaries of the trust during their lifetimes. They received an annual income of approximately $100,000 from the trust.

They took $66,000 of that annual income and gifted it to their three children ($11,000 annual tax-exempt gift exclusion in 2006, per parent, per child) into a wealth replacement trust, or ILIT. The trust paid the premiums on a $2 million life insurance policy.

Net result: Upon their death, the donors' estate receives the tax benefit of the $2 million charitable gift. Their children get back everything given to charity in the form of life insurance benefits. And there will be extra liquidity to minimize the impact of estate taxes.

WEALTH TRANSFER PLANNING FOR BUSINESS OWNERS

Business owners can use Wealth Transfer strategies in many beneficial ways, too.

1. Ensure the continuation of your business.
A major concern for family-owned businesses is succession. Some family businesses are quite dependent on the owner, so when an unexpected health event occurs, it threatens the survival of the business.

One tool that can help is called Key Person Protection. The company purchases an insurance policy on the life of the founder or owner, or any other person deemed critical to the success of the company. In the event of that person's premature death, proceeds from the policy can be used to support his family, as well as address the orderly disposition of the business.

A Key Person policy may build up cash value as well. This cash value can help fund retirement or deferred compensation plans for employees, or be carried as an asset on the company's books.

2. Protect a partnership.
When there are two or more owners of a closely held business, if one owner were to die prematurely, that deceased partner's stock in the company would automatically go to his or her surviving spouse. This spouse may not be qualified, or interested, in taking a major role in the company.

A buy-sell agreement solves this problem. Both partners agree to take out an insurance policy on each other's life. If either dies prematurely, they agree to buy out the other partner's stock from the deceased's spouse. The spouse and family benefit from the financial stability provided by the insurance. The surviving partner gains full ownership of the business

3. Retain and reward key people.
Finally, a business owner can purchase a variable life insurance policy for an employee and use it as a non-qualified Supplemental Executive Retirement Plan (SERP) or Deferred Compensation Plan.

This is a smart way to show key people that you appreciate them and to provide a value-added perk that few other employees get.

There are fewer government reporting or approval requirements for a SERP than for a regular retirement plan. It is simple to administer and can be structured to recover 100% of the costs. Deferred compensation paid to an executive at retirement may even be tax deductible to the company.

TAKE THE TIME TO PLAN AHEAD

Not only do tax laws change constantly but your own personal or business situation may change as well. For years, the annual federal estate tax exclusion was $600,000 per person. In 2006, it's $2 million and will increase to $3.5 million in 2009, but it will revert back to $1,000,000 in 2011 unless Congress passes new legislation.

In addition, the federal gift tax rate is currently $1 million and is scheduled to stay at that amount. The federal GSTT exemption is currently $2 million and is schedule to increase to $3.5 million in 2009. It will be repealed in 2009 and will revert to $1,120,000 in 2011 unless Congress passes new legislation (this amount will be indexed for inflation.)

ESTATE TAX EXEMPTION RATES – 2002-2011		
YEAR	MAX. ESTATE TAX CREDIT	MARGINAL TAX RATE
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	repealed	N/A
2011	reinstated at 2002 level	N/A

(Source: http://en.wikipedia.org/wiki/Inheritance_tax)

Given that the estate tax on your assets is likely to be much higher than your annual income taxes, it is important to plan ahead to minimize your exposure.

Wealth Transfer Planning — especially using life insurance — can provide the liquidity to satisfy nearly any financial liability in the most cost and tax-efficient way possible.

"Not only do tax laws change constantly but your own personal or business situation may change as well."

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