# Funding Grantor Trusts Without Paying Gift Taxes

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## To eliminate gift taxes, irrevocable trust planning should precede life insurance options analysis.

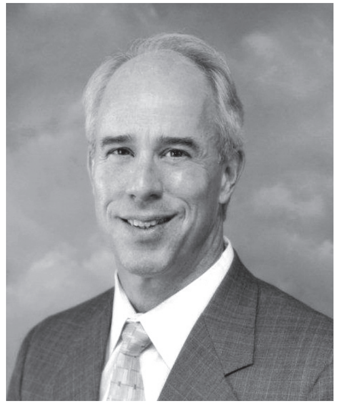
Have you ever had the uncomfortable experience of hurrying to create an irrevocable trust after qualifying for a new life insurance policy? Too often planning takes a back seat to sales deadlines. The results can be disappointing. There is a better way.

In our best experiences with high net worth clients and their other professional advisers, values-based planning takes place first and the insurance option is analyzed later in conjunction with the client's unique objectives, assets, and beliefs. This article introduces one aspect of the planning process—funding a Grantor Trust without gift taxes and without any additional income tax.

Technically, a Grantor Trust is an irrevocable trust for estate tax purposes and a grantor trust for income tax purposes. Let's look at the benefits. Assets owned by an irrevocable trust are intended to be estate tax-free (and usually generation skipping transfer tax-free, too). Loans and sales transactions between the grantor and a grantor trust are normally income tax-free. Income generated by the trust's assets is taxable to the grantor and grows estate tax-free in the trust.

Let's see how this works with life insurance. Assume you want your trust to pay $100,000 annually for a $10,000,000 permanent insurance policy. At death the $10 million benefit will be both income tax-free and estate tax-free. Here's the problem: you don't want to file a gift tax return for $100,000 every year. In addition, you prefer to continue using your $14,000 per year annual exclusion for gifts to your children and grandchildren.

Let's look at three of the many options available. Option 1 is a gift equal to your available lifetime gift tax exemption. In 2012, you could gift $5,120,000 during your lifetime without paying gift tax. Option 2 is the use of a non-taxable loan or sale to the trust. Future appreciation compounds estate tax-free in the trust and the grantor can be repaid in whole or in part during life or at death. Option 3 is the use of a special Split Dollar Arrangement (SDA) to pay premiums without gift tax and without loan interest. With all three options, the grantor pays the same income tax as if the Grantor Trust was never funded. This can reduce your taxable estate while your estate tax-free trust increases in value.



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**Option 1:** Fund the trust with your $5,120,000 lifetime gift tax exemption amount. The trust pays $100,000 to purchase the $10 million policy and invests the remaining $5,020,000 for the benefit of your family. Next year, assuming a minimum 2 percent yield, the trust will have more than $100,000 to pay the annual premium. The grantor pays no gift tax. The trust pays no income tax. At death, the trust will have $15 million plus any compounded trust earnings.

**Option 2:** Loan or sell $4,200,000 to your trust at 2.5 percent interest (the assumed annual Applicable Federal Rate for a long-term grantor note) with the principal due after 30 years or when the $10 million insurance benefit is paid, if sooner. The trust pays the $100,000 premium each year, earns an average of 5 percent annually on the remaining $4,100,000, and pays $105,000 of non-taxable interest each year income tax-free to the grantor. The grantor pays no gift tax. The grantor pays no capital gains tax on the transaction. At all times, the trust will have at least $10 million after repaying the $4.2 million grantor note. Additional leverage can be obtained by selling an asset at a discount that is expected to appreciate greatly inside the trust.

**Option 3:** Pay the $100,000 premium with a Split Dollar Arrangement (SDA) and develop a reduced or deferred gift, loan or sale arrangement. The grantor makes a modest gift to fund the trust. The trust purchases the policy and pays approximately $1,500 of the premium. The grantor pays the balance of the premium as a split dollar advance. The $1,500 is the Economic Benefit portion of the premium. It will increase annually. The trust assigns the policy to the grantor as collateral for repayment of the premium advances. The grantor pays no gift tax. The trust pays no interest on the split dollar advances. If the grantor does not gift or bequest the split dollar note to the trust, careful planning is required for the trust to repay the split dollar advances in cash or with a note before the Economic Benefit allocation becomes too high.

The benefits of income tax-free life insurance can be maximized by utilizing the many creative gift tax-free funding techniques available with estate tax-free Grantor Trusts. By including your insurance adviser on your planning team at the right time, you can accomplish great things for your family and your community. ■

*R. Marshall Jones is a founding principal of Jones Lowry, an independent firm specializing in the innovative use of life insurance to help solve the unique financial planning needs of ultra-high net worth families working in conjunction with their other professional advisers. Jones Lowry is an M Financial Member Firm.*