The Power of Gifting

Annual gift exclusions in a properly structured policy that is held in an irrevocable life insurance trust offer many benefits.

By David E. Appel and David B. Shannon

With the uncertainty of future tax brackets, along with the turmoil that the stock market has experienced over the past number of years, many clients and financial professionals are eager to seek out alternative plans for successful people who desire to leave money or assets to the generations that follow.

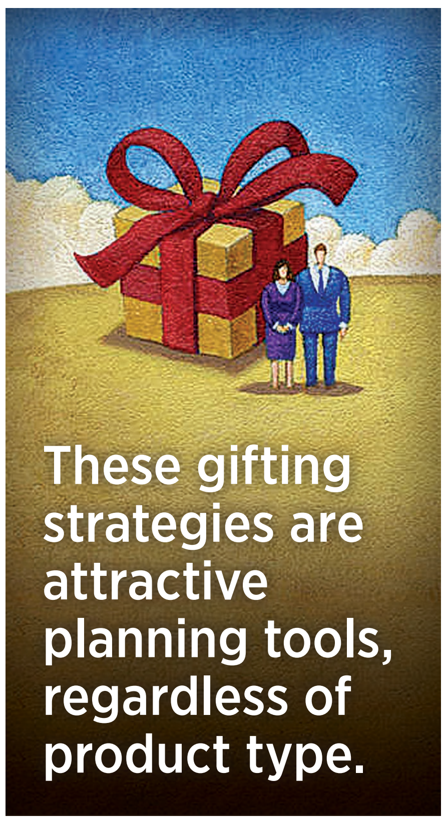
Most of our affluent clients get to a point in their life when they start to think about the next generations of their families, and the strategies and products that they can implement to take care of their children and grandchildren when they are no longer around. Often when clients get to this stage in life the conversation gravitates towards annual gifting, and how these annual gift exclusions can benefit the heirs of these successful families.

Under current federal law, our clients who are U.S. citizens can gift up to $14,000 ($28,000 for married couples) annually to an individual. When these gifts are considered present interest gifts, there are no gift tax consequences on either end of the transaction. When utilized to the maximum levels, these gifts can create a significant amount of money for the recipients.

Life Insurance in an ILIT

When the recipient is not using the gift immediately for living expenses, the question then becomes: What is the most efficient way to invest these annual exclusions? In other words, over the course of 20 years, where can the recipient of these annual exclusions experience the highest rates of return on their gifts? We are going to focus on using these gifts to create a legacy for the next generation through the use of life insurance held in an Irrevocable Life Insurance Trust (ILIT).

In the past, many clients have earmarked their grandchildren's annual exclusions to an investment account for the benefit of each designated child. Say a married couple, both age 75, gift their grandson Tom $28,000 annually to an irrevocable trust that invests the money in mutual funds. The trust is subject to paying taxes annually, and as the account balance grows over the years, the tax brackets will continue to rise, as will the annual income taxes that will be paid on this account.



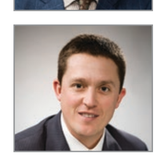
Juxtaposed to that is a properly structured life insurance policy that is owned by an irrevocable life insurance trust. Here, your clients' heirs not only will see solid rates of returns on their premiums at age 100, but will have no exposure to market losses or taxes. Life Insurance death benefits are paid out to beneficiaries tax-free and, when held in trust, estate tax-free as well.

A Case in Point

Now back to our example about Tom. If we assume that the annual exclusion level remains at $28,000 per year going forward, and the top income tax bracket for an irrevocable trust remains at 35 percent, then we can extrapolate the average rate of return the investment account would have to yield in order to outperform the life insurance death benefit in 20 years. In year 20 (Age 95 for this couple), the internal rate of return in terms of premiums paid in ($28,000 per year) to the death benefit paid out (approximately $1.3 million) is roughly 7.95 percent. In order for the investment account to generate a larger pool of money for the intended beneficiaries, the after-tax rate of return required to outperform the life insurance death benefit would have to be greater than 12 percent.

This gifting strategy is not just limited to annual exclusions. Families that took advantage of the large lifetime gifting amounts over the past couple years are also benefiting from these rates of return, in regard to life insurance. There are many funded irrevocable trusts with multiple millions of dollars allocated to them, and depositing some percentage of this lifetime gift in a single-premium life insurance policy generates the same type of leverage and similar internal rates of returns. These gifting strategies are attractive planning tools regardless of product type. Typically, you will see higher rates of return on the survivorship universal life policies versus the individual universal life policies.

When you are working with successful individuals and families who are looking to create some type of "legacy" account for the heirs, explore the use of annual gift exclusions into a properly structured life insurance policy held in an irrevocable life insurance trust. Not only does the life insurance immediately establish a large death benefit in the event of an early passing, but it reduces the risk associated with market returns and tax exposure in the future.



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