Advanced Markets Blog

Three insurance opportunities for charitably inclined clients in 2020

Contributor: Caroline McKay

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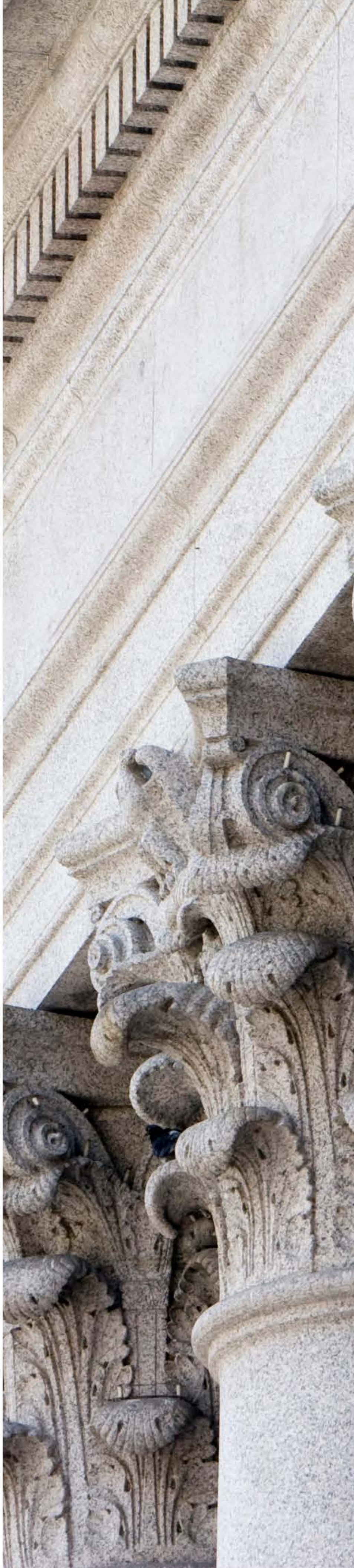
If you were looking for a silver lining in all the uncertainty and turmoil that 2020 has brought thus far, one could be found in the significant estate planning opportunities afforded by the high gift and estate tax exemption, historically low interest rates and depressed asset values. For clients who are also charitably inclined, now may be the best time to be discussing planning opportunities that can benefit both the client's family and their favorite charities.

Let's look at three opportunities in particular:

1. Outright charitable gifts to accelerate income tax deductions

If you have clients who have expressed an interest in making a large gift to their favorite public charity or educational institution, or have previously made gifts and likely would do so again, doing so this year can produce an acceleration of income-tax benefits associated with making a charitable gift. As part of the Corona Aid, Relief and Economic Security Act (commonly referred to as the CARES Act), donors can get a federal income-tax deduction on their charitable contributions of up to 100% of their Adjusted Gross Income (AGI), but only for 2020. If the value of the charitable gift exceeds the client's AGI for 2020, the excess amount can be carried forward for up to five years but will be deductible based on the general rule which limits cash gifts to public charities at 60% of AGI. This opportunity to deduct up to 100% of AGI is limited to cash gifts to public charities; asset transfers or transfers to private foundations will be subject to the typical income-tax deduction limits that apply in other tax years. **Click here** to see our Charitable Planning Client Guide that discusses the typical AGI limitations and other rules associated with charitable gifts.

Example: Assume we have a couple, Patrick and Martha (ages 55 and 53), both presumed to be Preferred Non-Smokers. They are interested is making a $1.5M cash gift to their alma mater, the University of Virginia (a §501(c)(3) public charity).



Their expected AGI for 2020 will be approximately $833,000. If Patrick and Martha make the gift in 2020, they will be able to take an income-tax deduction on their 2020 return of $833,000, which will save them approximately $308,000 in taxes (assuming a combined federal and state tax bracket of 37%). The excess value of the gift over the amount deductible in 2020, which is $667k, can be deducted over the following two years based on a 60% of AGI limitation. This works out to approximately $499,800 in 2021 and $167,200 in 2022 (assuming their AGI remains consistent), providing additional tax savings of roughly $246,790.

Their financial professional also suggests that Patrick and Martha leverage these tax savings to secure a $5M survivorship life insurance policy to address potential tax liabilities that might be due at their death and help secure the inheritance for their four children. Using an indexed survivorship policy, Patrick and Martha's irrevocable life insurance trust (ILIT) will purchase $5M of death benefit with a three-pay planned premium of approximately $153,000. Given the current $22M+ of lifetime gift/estate exemption available to Martha and Pat, gifting $153k for three years is of little consequence, and the illustrated premiums align closely with the income-tax deductions associated with the gift to UVA, helping them get comfortable with the purchase knowing exactly how they will pay for it.

Why now?

AGI limitation for income-tax deductions on cash gifts to public charities is increased from 60% to 100% of AGI for 2020 only. This offers the opportunity to accelerate income-tax deductions based upon a higher AGI limitation and can be combined with other planning strategies that increase AGI — like asset sales or IRA to Roth IRA conversions — to provide additional offset.

2. Using a charitable lead trust as an exit strategy for insurance financing strategies

The current historically low interest rate environment presents a significant opportunity for clients to fund large life insurance premiums while minimizing the use of their lifetime gift exemption and potentially increasing the rates of return on the policy. Techniques such as sales to defective trusts, private financing, premium financing and dual loan are all getting second and third looks given how low interest rates have gone recently. For example, the AFR rates for July 2020 are at or near historic lows: – 0.18% (short-term), 0.45% (mid-term) and 1.17% (long-term). In addition, the §7520 rate, commonly referred to as the "hurdle rate," is also at a historical all-time low of 0.60% as of July, which means that clients can commit less assets to common financing exit strategies such as grantor retained annuity trusts (GRATs) and charitable lead trusts (CLTs). For your charitably inclined clients, let's examine how a CLT can help minimize the client's tax outlay when purchasing a large life insurance policy.

Example: Consider Patrick and Martha from our previous example. Instead of making an outright gift to UVA of $1.5M of cash, they are going to contribute $1.5M of publicly traded stock to a grantor* charitable lead annuity trust that will provide yearly payments to UVA over a period of 10 years. Designing the trust to produce a de minimis gift at the end of the annuity term and scheduling the charitable annuity payments to increase by 20% each year, UVA will receive approximately $1.56M over the 10-year period (based on the §7520 hurdle rate of 0.6%) and will provide a remainder interest of approximately $794k (assuming 6% growth), which they will leave to their ILIT that benefits their kids. Because the present value of the annuity interest payable to UVA is approximately equal to the $1.5M value contributed, Patrick and Martha also can receive an income tax deduction of up to 30% of their AGI each year for up to six years. Assuming their AGI remains consistent at $833k, they can deduct up to $250k a year for six years (30% of $833k), which equates to yearly tax savings of approximately $92k (assuming 37% combined federal/state tax liabilities).

Leveraging those tax savings once again, Patrick and Martha decide to purchase a $5M indexed survivorship policy inside their ILIT, designed as a six-pay design to correspond with their charitable income tax deduction. The six-pay premium is approximately $87,000. Rather than gifting directly to the ILIT to pay the premium, the couple decides to do a private split-dollar arrangement where they will pay the premiums directly to the carrier and the trust will be required to repay them the greater of premiums paid or cash value when the arrangement terminates. The cost associated with the private split-dollar arrangement is equal to the economic benefit costs of the survivorship policy, which is treated as a gift from the clients to their trust. If the arrangement remains outstanding for 10 years, the total economic benefit cost is less than $2,500. In Year 10, the remainder from the CLAT will pour into the ILIT (estimated to be $794k), thus providing a source of funds to repay Patrick and Martha the totals premiums paid - $522,000. The remainder of the CLAT can be invested by the ILIT trustee and held for the benefit of the kids, thus further increasing their legacies and reducing Patrick's and Martha's estate.

Why now?

Historically low §7520 rate used for GRATs and CLTs allows clients to transfer less assets to produce remainder interest necessary for exit strategy. For example, if the §7520 rate was 2.0% instead of 0.60%, which it was only a few months ago in January 2020, client would have had to transfer closer to $2M to produce the same remainder interest as provided in the example above.

Additionally, contributing assets with a depressed value could create even higher remainder interests for heirs as those assets rebound in value. For example, if the $1.5M of stock contributed to the CLT produced an average return of 11% instead of the 6% assumed, the remainder interest payable to the ILIT would grow from $794k to just over $2M. Given that the Dow Jones averaged 11.8% returns during the 11-year period following the last market correction in 2008, there is great potential for higher returns on assets with depressed values.**

3. Minimizing taxes on asset sale with charitable remainder trust (CRT)

Although charitable remainder trusts are typically considered more advantageous in a higher interest rate environment (exactly the opposite of a CLT), creating a CRT today can still provide several benefits for charitably inclined clients looking to sell assets with a low basis. Because a charitable remainder trust is a tax-exempt trust, the sale of a low-basis asset inside that trust does not produce immediate income-tax realization to the client. The client only recognizes income as annuity payments are made and gets an income tax deduction associated with the present value of the remainder interest that will be paid to charity based on the current §7520 rate (or, if higher, the §7520 rate for up to three months prior). The after-tax value of the annuity payments can be leveraged by the client to purchase life insurance to replace the value of the property gifted to the CRT and then some. Let's look at an example.

Example: Patrick and Martha have a $5M stock portfolio that is heavily concentrated in a few stocks with very low basis. Their financial professional has suggested that they diversify with life insurance, but they are concerned about the tax liability associated with selling. They have also expressed interest in making a substantial gift to their alma mater, UVA. With that in mind, their financial professional asks them to consider transferring $1.5M of the low basis stock to a charitable remainder annuity trust (CRAT) with a term of 15 years. Based on the §7520 rate in April 2020 (three months prior), which was 1.2%, and optimizing the annuity to create the largest possible payment while respecting CRT qualification rules (e.g. minimum 5% annuity, 10% remainder to charity), the CRAT would make annual payments to the clients of approximately $94,000 year for 15 years, totaling $1,415,000 in payments. Patrick and Martha can also take an income tax deduction equal to the present value of the remainder interest, which is calculated to be roughly $211,000. Assuming the assets produce 6% over the 15-year period, their charity, UVA, stands to receive close to $1.4M in benefit at the termination of the CRAT.

To help replace the $1.5M gift to the CRAT and provide protection over the value of their remaining stock portfolio of $3.5M, they purchase a $5M indexed survivorship policy inside their ILIT using the after-tax annuity payments received over 15 years. The premiums illustrated are roughly $44k over that 15-year period and the $5M policy death benefit produces a rate of return of 6.43% at life expectancy (Ages 94, 92)***, which translates to a competitive 9.89% pre-tax return. The policy also has cash value that Patrick and Martha can withdraw or borrow from to help cover unexpected or additional expenses in retirement.

Why now?

For clients who are looking to diversify or sell low-basis assets but are worried about the impact of taxes, creating a CRT can help more efficiently manage taxes while also creating charitable gifting opportunities.

If you are interested in learning more about any of these opportunities or would like to see sample illustrations, please reach out to us at *advancedmarkets@jhancock.com* or call us at *1-888-266-7498, Option 3 (consultant)* or *Option 4 (attorney).*

* note that a grantor CLT requires the grantor to be responsible for the income taxes produced by the trust each year.

** see https://tradingninvestment.com/stock-market-historical-returns/

*** Life expectancies shown in this presentation are based on Valuation Basic Table 2015.

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