COMMITTEE REPORT:
INSURANCE

By **Robert W. Finnegan**

The GRAT Enhancement Strategy

Use life insurance to move appreciation of successfully transferred assets to a dynasty trust

Today, successful estate planning is being hindered by three important factors: (1) many clients are currently delaying planning; (2) time introduces risks into every estate plan; and (3) many estate plans require additional planning. Taken together, these three factors are preventing many clients' estate plans from delivering optimal results.

Grantor retained annuity trusts (GRATs) have been a great wealth transfer success story, transferring assets worth many billions of dollars to or for the benefit of children. However, the shortcoming of successful GRATs is that their assets will be included in the children's taxable estates.[1]

Life insurance is self-completing on death, provides an immediate source of cash exactly when needed to pay estate taxes, helps avoid the forced or fire sale of assets and offers competitive uncorrelated internal rates of return. Yet frequently, life insurance is underrepresented in a client's estate plan.

Let's explore the three factors affecting planning today and learn about the GRAT enhancement strategy. This strategy uses life insurance to move appreciation of successfully transferred assets to a dynasty trust to build a more resilient plan. It can stand alone or be used to help address the three impediments to an optimal estate plan. Although I'll focus on assets successfully transferred to GRAT remainder trusts, this strategy can also be used with assets transferred directly to children and, in fact, with any successfully transferred assets that will be taxed in the children's estates.[2]

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Planning Reluctance

Our role as advisors is to help clients make informed decisions so they can take steps to improve their and their family's financial security and well-being. While the Dec. 31, 2025 sunsetting of gift, estate and generation-skipping transfer (GST) tax exemptions draws closer, significant planning opportunities remain.[3] Exemptions continue to increase, applicable federal rates (AFRs) continue to be favorable and, for the time being, the full range of planning strategies remains.[4]

Yet, currently, many clients are reluctant to engage in new or additional estate planning. Reasons include uneasiness in thinking about their demise, unresolved family issues, unwillingness to give up access to and control of assets and their cash flow and simply being too busy with other important matters. As if that weren't enough, political partisanship has placed estate planning in a continuous state of flux, leaving clients confused regarding the best path forward. For example, there's an ongoing effort to raise taxes and revenues by reducing exemptions and eliminating planning strategies. In contrast, there's a constant effort to reduce or eliminate the estate tax by raising exemptions, reducing tax rates and even repealing the transfer taxes. In some cases, clients may justify delaying planning because they believe that current high exemptions will be extended beyond Dec. 31, 2025.

Frequently, clients who gifted all or a substantial part of their $12.92 million exemptions ($25.84 million for married couples) and engaged in other wealth transfer strategies feel that they've done enough and may even be experiencing

planning fatigue. Some simply don't feel ready to part with access to and control of significant assets. Finally, paying substantial legal and accounting fees for additional planning further justifies clients' reluctance. In the process, many clients have become desensitized to our entreaties regarding the importance of engaging in additional planning.

Time-Related Risks

Time introduces risks into every estate plan. With few exceptions, wealth planning strategies take time to move wealth—whether gifts, GRATs, intra-family loans, the sales of discounted assets to a dynasty trust in exchange for a promissory note (note sale) or life insurance. Consider that:

- Except for annual exclusion gifts, current gifts only move future appreciation of the asset (and valuation discounts) out of the taxable estate.[5]
- With GRATs, note sales or intra-family loans, the limitation on wealth transferred is even greater because only the appreciation in excess of amounts due back to the grantor/lender moves wealth outside the estate.
- GRATs have a number of time-related drawbacks, the most important of which are: (1) the grantor must survive the term for it to succeed, and (2) even if they do, assets successfully transferred by GRATs will be taxed in the children's estates.[6]
- A note sale to a dynasty trust that's a grantor trust in exchange for a promissory note (note sale) overcomes a GRAT's key shortcomings because a sale can be made to a dynasty trust, lock in current favorable AFRs for the note term and will succeed even if the grantor dies prematurely. But, like GRATs, the note sale also requires time to transfer wealth and, unlike the GRAT, isn't statutory.
- Life insurance also takes time to transfer wealth in the sense that, unless fully guaranteed, it depends on the favorable performance of policy investments. If not purchased currently, a prospective insured's health may decline over time, increasing the cost of that insurance or making it unavailable.
- Inflation erodes the success of every wealth transfer plan.

Considering the state of flux of estate taxes and planning due to political partisanship, one of the greatest time-related threats is a client's failure to plan based on the belief that the estate tax will be repealed, exemptions won't sunset or there will be other changes that take the bite out of transfer taxes. Over time, this failure to act could be catastrophic because no repeal or changes are likely to be permanent.[7] It's important to note that a solid estate plan isn't just about taxes but rather protects against the many threats to wealth. Bottom line: The sooner a client engages in planning, the more effective it will be.

Although AFRs have increased substantially over the last year, note sales and intra-family loans remain attractive.

Additional Planning Opportunities

Gifting unused exemptions (as well as annual exclusion gifts) is the low hanging fruit of additional estate planning, especially considering sunset and that gifts take time to move wealth. In addition, although AFRs have increased substantially over the last year, note sales and intra-family loans remain attractive.

Life insurance is best implemented when prospective insureds are in good health. One possibility is to use the cash flow of already transferred assets to fund it or, if there's been a liquidity event, directing a portion of the proceeds into life insurance. If the latter, private placement life insurance can be a particularly attractive product because it: (1) offers a wide range of non-traditional investments; (2) has the ability to tailor the product design to a wide range of needs; and (3) has the ability to have very high early cash values and favorable tax-free access to those cash values.[8] Successfully transferred assets ripe for enhancement include those held by GRAT remainder trusts, adult children and any successfully transferred assets that will be taxed in the children's estates.

GRAT Enhancement Strategy

A GRAT is successful when the grantor survives the GRAT term and there are assets remaining. Frequently, those assets remain in the GRAT or transfer into a GRAT remainder trust for the benefit of children (either trust hereinafter referred to collectively as a "GRAT remainder trust"). With the GRAT enhancement strategy, the GRAT remainder makes a split-dollar loan to a dynasty trust to purchase life insurance, moving appreciation of GRAT assets via the policy death benefit to the dynasty trust. Based on a reasonable pre-tax rate of return, the loan is sufficient to both pay policy premiums and repay the loan at the end of the term.[9] On the death of the insured(s), the policy proceeds are paid to the trust income, gift, estate and GST tax free. If the strategy funds a $20 million policy, $20 million of appreciation is moved outside the children's taxable estate into a multi-generation dynasty trust.

> Although the GRAT enhancement strategy could be used with a note sale or an intra-family loan, a split-dollar loan offers a number of important advantages.

The GRAT enhancement strategy helps address the three impediments to planning: (1) client reluctance to plan; (2) the risks introduced by the passage of time; and (3) failure to take advantage of the current favorable planning environment. First, using GRAT assets that have already been successfully transferred out of the clients' estates rather than their personal assets, shifting the planning expenses from the clients to the GRAT remainder trust and the dynasty trust and minimizing client involvement in the planning process can help overcome clients' reluctance to plan. Second, the fact that life insurance is self-completing on death, regardless of when it occurs, neutralizes an important time-related risk of wealth transfer planning. Life insurance also provides an immediate source of cash exactly when needed to pay estate taxes and avoid the forced sale of assets and competitive non-correlated rates of return. Third, moving appreciation of assets that will be taxed in children's estates into a dynasty trust is a significant planning accomplishment.

Case Study

Assume that your clients are a married couple, ages 65 and 62, both in good health. They funded a 10-year zeroed-out GRAT in 2010 that matured in December 2020, successfully transferring $6 million (now in cash) to a GRAT remainder trust for the benefit of their son (age 33). The GRAT remainder trust will hold assets for their son, distributing one-third of their son's share on attaining age 35. An independent trustee has broad discretion to select assets for distribution, invest trust assets and make loans to other trusts, provided loan interest is paid or accrued at the appropriate AFR. In 2020, the clients funded a dynasty trust for their son and future generations with their combined $23.16 million exemptions ($11.58 million/spouse). The clients were co-grantors for both the GRAT remainder trust and the dynasty trust, and each trust was a joint grantor trust with respect to the clients.

Fast-forward to today. The clients understand that: (1) since funding the dynasty trust in 2020, the $11.58 million exemptions have increased by $1.34 million ($2.68 million combined); (2) they need $10 million to $15 million of survivorship life coverage to pay estate taxes and ensure that the family business passes to their son; and (3) now's a good time to procure insurance while they're in excellent health. However, at this point, the business is doing extremely well and is demanding all of their attention. Consequently, they have a very low tolerance for any additional complexity in their lives, including any additional planning. The clients also feel that they've done enough planning for the time being and don't want to incur substantial legal fees. On the other hand, they want to protect the business from estate taxes, are concerned that their son will begin receiving one-third of the trust assets in a few years and understand the need to keep an eye on the fast approaching sunset when they'll forfeit any unused exemptions.

The clients are intrigued with the idea of using the $6 million GRAT remainder trust assets to fund insurance in the existing dynasty trust due to a number of favorable aspects of the GRAT enhancement strategy:

- The appreciation of the GRAT remainder trust assets can be moved into the 2020 dynasty trust and will help protect the family business.
- If the entire cash loan proceeds are paid into the policy, the strategy won't create any additional taxable income and, in fact, will reduce their taxable income from the GRAT remainder trust.
- Because both the GRAT remainder and the dynasty trusts are grantor trusts with respect to the clients, loan interest won't be taxable until the first death, after which, one-half the loan interest will be taxable.
- They don't have to use personal assets to fund the plan.
- The plan can use existing trusts, that is, it doesn't require that they execute a new trust.
- Their involvement in the planning process will be minimal because the trustees and the legal team will handle the lion's share of the planning.
- The trustees will pay the legal fees.
- In a few years, when their son will receive one-third of his share of the GRAT remainder trust assets, the trustee can distribute a portion of the promissory note securing the split-dollar loan in satisfaction of that obligation, and that note, a split-dollar lifetime term loan, isn't callable and is inalienable.

The clients authorize the trustees to move ahead with the planning. The planning team guides the trustees of the two trusts in implementing the plan:

- The dynasty trust purchases $12.85 million of survivorship variable universal life (SVUL) insurance based on full medical and financial underwriting.
- The trustee of the GRAT remainder trust lends the $6 million cash to the dynasty trust in a split-dollar lifetime term loan accruing interest at the current 3.74% March 2023 long-term AFR.
- The dynasty trust invests the $6 million in the SVUL policy in year one. To mitigate the effect of inflation, the policy death benefit has been designed to increase. Policy investments earn a 7% net rate of return.

The blue bars in "Benefit to Family," p. 32, illustrate the GRAT remainder trust assets available to the son during his lifetime at any point in time starting with $6 million and growing at 7% pre-tax (parents paying income taxes).[10] The red bars represent the amount available to the son's children should the son die in any given year based on a 40% estate tax (federal only). The dark blue dotted line represents the net to the family based on implementing the GRAT enhancement strategy with life insurance on parents.[11]

It's important to note that whereas none of the assets represented by the blue and red bars are GST tax exempt, approximately 70% of GRAT enhancement funds are transferred into the dynasty trust, and approximately 30% passes to the son from the clients' estates (the value of the note including accrued interest net of a 40% estate tax).

> Selecting life insurance or non-insurance assets to fund the GRAT enhancement strategy isn't necessarily an either/or choice; the two strategies complement each other.

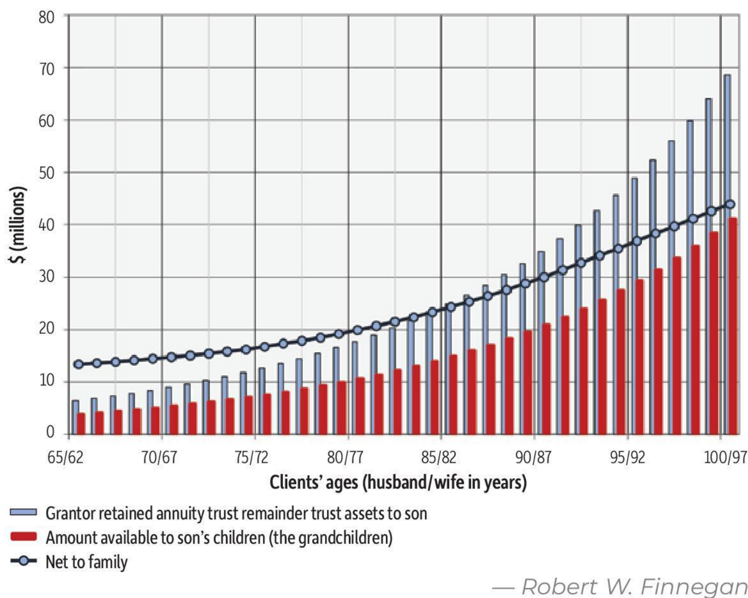
Split-Dollar Loan

Although the GRAT enhancement strategy could be used with a note sale or an intra-family loan, a split-dollar loan offers a number of important advantages:

- As a rule of thumb, in a note sale, the trust should have separate assets equal to 10% of the sale transaction.[12] This seed money isn't needed with a split-dollar loan.

Benefit to Family

Effect of GRAT enhancement planning



— *Robert W. Finnegan*

- If the parties represent that a reasonable person would expect the split-dollar loan to be repaid, the loan is automatically bona fide for federal tax purposes and, therefore, isn't subject to a number of requirements developed by case law and Internal Revenue Service rulings applicable to note sales or intra-family loans.[13]
- Note sales, intra-family loans and split-dollar loans all take advantage of the difference between the rate of return of the transferred assets and the loan rate charged. The longer the loan can run, the greater the wealth transferred. The term of a note sale or intra-family loan must be less than the grantor's life expectancy. In contrast, the split-dollar loan regulations authorize lifetime term loans locking in favorable AFRs for a longer duration. Even if the insured dies prematurely, the life insurance death benefit net of the loan completes the wealth transfer.
- A split-dollar loan is based on Treasury Regulations Section 1.7872-15 whereas, again, a note sale isn't statutory.
- The split-dollar loan test for sufficient interest (to avoid a below-market loan and original issue discount (OID)), is calculated on an annual rate, whereas an intra-family loan is calculated on a semi-annual rate.

Nevertheless, it's important to note that selecting life insurance or non-insurance assets to fund the GRAT enhancement strategy isn't necessarily an either/or choice. Rather, the two strategies complement each other. For example, the GRAT remainder trust could enter into a $3 million sale of commercial real estate to a dynasty trust that's a grantor trust and a $3 million split-dollar loan to fund life insurance. The clients have hedged the risk of living too long with the note sale and the risk of dying too soon with the life insurance, creating a more resilient estate plan. In many cases, a client may have already transferred substantial wealth, without life insurance, through exemption gifts, note sales and intra-family loans so that implementing an insurance-only strategy makes sense.

Grantor Trust Considerations

There are three important considerations regarding grantor trust status. First, in funding the insurance with a loan, is the loan interest taxable, and if so, when? Second, who pays the tax on the GRAT remainder trust and dynasty trust earnings? Is it the grantor or the trust? And, third, what are the income tax consequences on termination of grantor trust status?

Regarding the first and second questions, there are a number of different possible combinations:

- If the GRAT remainder trust (lender) and the dynasty trust (borrower) are grantor trusts with respect to the same grantor, then: (1) the loan interest isn't taxable; and (2) the taxable income of both trusts will be reported on the grantors' income tax return.
- If the GRAT remainder trust (lender) is taxed as a

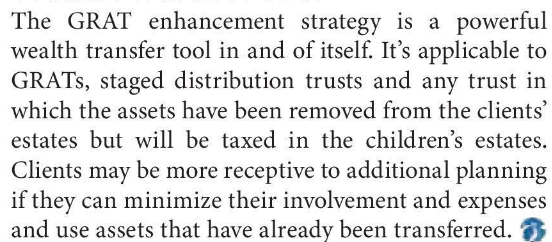
complex trust and the dynasty trust (borrower) is a grantor trust with respect to the grantors, then: (1) the loan interest and GRAT remainder trust earnings are taxable to the GRAT remainder trust; and (2) the taxable income of the dynasty trust will be reported on grantors' income tax return.

- To the extent that the GRAT remainder trust (lender) and the dynasty trust (borrower) are each taxed as a complex trust, then: (1) the loan interest is taxable to the GRAT remainder trust; and (2) each trust is taxed on its respective earnings.
- Following full termination of either trust's grantor trust status, then: (1) assuming the note remains in effect, the ongoing loan interest will be taxable to the note holder; and (2) the income earned by the trust will be taxable to the trust.

Third, regarding the income tax consequences on termination of grantor trust status, although there's little authority directly on point, the most reasonable and supportable positions appear to be:

- Termination during the grantor's lifetime with no outstanding debt is a non-recognition event, and the trust takes the grantor's cost basis in the transferred assets.[14]
- Termination during the grantor's lifetime with outstanding debt such as a promissory note or split-dollar loan triggers a deemed sale of the trust assets by the grantor to the trust.[15] The grantor's gain or loss equals the value of the debt assumed by the trust (the consideration paid by the trust) less the grantor's adjusted basis in trust assets.[16] The trust's basis in trust assets equals the purchase price of the assets, that is, the value of the debt assumed by the trust.
- The deemed sale triggered by a termination during the grantor's lifetime with outstanding debt presents three additional considerations:
    - If the grantor gifted the note prior to termination, on termination, there wouldn't be a deemed sale. It should be possible to discount the value of the note in accordance with the methodology of the recent *Morrissette* and *Levine* generational split-dollar cases, thus reducing the gift or, in the case of the deemed sale, reducing or eliminating the grantor's gain due to a deemed sale.[17]
    - To avoid OID and a below-market loan, the deemed sale likely requires creating a new note at the appropriate AFR in the month of termination.
    - If the trust owns life insurance, it would likely be treated as a sale of the policy and a violation of the transfer-for-value rule unless the deemed transfer falls within one of the exceptions to the rule.[18]
- Termination on death, whether subject to outstanding debt or not, is a bequest and not a deemed sale. The trust would take the grantor's carryover basis, and the client's estate should receive a stepped-up cost basis in the note (or stepped-down if the note is discounted).[19]

Wealth Transfer Tool



The GRAT enhancement strategy is a powerful wealth transfer tool in and of itself. It's applicable to GRATs, staged distribution trusts and any trust in which the assets have been removed from the clients' estates but will be taxed in the children's estates. Clients may be more receptive to additional planning if they can minimize their involvement and expenses and use assets that have already been transferred.

Endnotes

1. The long-term benefit of a dynasty trust can't be overstated. In addition to avoiding repeat estate taxation at each generation, a dynasty trust protects against a range of threats to wealth, which include protecting beneficiaries and family wealth from creditors, ex-spouses and predators; protecting beneficiaries from themselves with a spendthrift clause; avoiding spoiling a beneficiary with too much too soon; protecting against anti-social behavior such as substance abuse; and protecting wealth from destructive family dynamics.
2. For example, a grantor retained annuity trust (GRAT) asset may have been transferred directly to children. Staged distribution trusts, in which a child receives one-third of their share of trust assets at age 35, one-half at age 40 and the balance at age 45, are also prime candidates.
3. Each year, gift, estate and generation-skipping transfer (GST) tax exemptions are increased based on the U.S. chained consumer price index. On Jan. 1, 2026, the exemptions will be cut in half, commonly referred to as "sunset."

4. In 2021, the gift, estate and GST tax exemptions increased by $120,000, in 2022, the gift, estate and GST tax exemptions increased by $360,000, and in 2023, reflecting high inflation, by $860,000 for a combined increase of $1.34 million for an individual and $2.68 million for a married couple. The March 2023 long-term applicable federal rate is 3.74%.
5. Generally, full use of today's high exemptions prior to sunset is an "advance" on exemptions. In that case, if they do in fact sunset, due to inflation, sooner or later the lower exemptions will catch up to today's amount.
6. First, time is needed for the growth of GRAT assets in excess of payments back to the grantor to move wealth. Second, the grantor must live for the term of the GRAT for it to succeed. Third, 2-year rolling GRATs mitigate but don't eliminate the risk of premature death. If the grantor dies prematurely, the current GRAT assets are included in the grantor's estate and the future 2-year GRATs are never implemented. Fourth, 2-year GRATs introduce interest rate risk because Internal Revenue Code Section 7520 rates applicable to subsequent GRATs could, and in fact, have increased substantially—and in short order.
7. Consider that in 2021, proposed legislation threatened to tank high gift, estate and GST tax exemptions, discounts, GRATs, dynasty trust durations and grantor trusts. In addition, independent of politics, the Internal Revenue Service is constantly chipping away at planning strategies. Moreover, there have been and are continuing efforts to repeal the estate tax.
8. Based on the planned premiums, the policy is designed with the minimum non-modified endowment contract death benefit.
9. For a more detailed discussion of split-dollar-based wealth transfer strategies, *see* Lawrence Brody, David Byers and Alexander Jones, "Side Fund Split Dollar Under the Loan Regime," *Trusts & Estates* (September 2022) and Lawrence Brody, David Byers, and Hudson Williams, "Switch Dollar and the Power of Deferral," *Trusts & Estates* (April 2018).
10. Regarding the son's assets in the GRAT remainder trust, the model assumes the parents are alive all years so that trust assets grow by 7% pre-tax. In reality, on each parent's death, the trust would pay the taxes on half, then 100%, of trust income. For estate tax purposes, the model assumes the second death in any given year.
11. The model assumes that policy investments earn 7% net and taxable investments earn 7% pre-tax, which equates to a 5.25% after-tax return based on a 25% tax on earnings. The model also assumes that grantor trust status is terminated by reason of the grantor's death.
12. The 10% seed money is a convention adopted by the majority of planners and isn't required by law. As a loan endorsed by Treasury regulations, no seed money is required for a split-dollar loan. *See infra* note 11.
13. Treasury Regulations Section 1.7872-15(a)(1)(i) provides that:

    > A payment made pursuant to a split-dollar life insurance arrangement is treated as a loan for Federal tax purposes, and the owner and non-owner are treated, respectively, as the borrower and the lender, if – … (C) The repayment is to be made from, or is secured by, the policy's death benefit proceeds, the policy's cash surrender value, or both.

    For example, for an "intra-family loan" to qualify as a "bona fide loan," the lender must have an intention to enforce the debt, and the borrower must have an intention to repay the debt. The loan terms must be commercially reasonable, including adequate security. That is, if the terms are such that the loan wouldn't be made between unrelated persons, the IRS can attack the transaction as a gift. *Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd,* 113 F.3d 1241 (9th Cir. 1997).
14. IRC Section 1015(b).
15. Treas. Regs. Section 1.1001(a), (c) Example 5; Technical Advice Memorandum 200011005; Revenue Ruling 77-402, 1977-2 C.B. 222; *Madorin v. Comm'r*, 84 T.C. 667 (1985). In *Diedrich v. Comm'r*, 457 U.S. 191 (1982), the U.S. Supreme Court treated the payment of gift taxes, an obligation of the donor, by the donee as consideration paid to the donor in a sale by the donor of the gifted assets.
16. For a lifetime termination, gain would equal the accrued interest on the note because the grantor's cost basis in the case study equals the premiums paid (the initial loan proceeds).
17. *Estate of Levine v. Comm'r*, 158 T.C. 2 (Feb. 28, 2022) and *Estate of Morrissette v. Comm'r*, T.C. Memo. 2021-60 (May 13, 2021).
18. The safest exception is a transfer to a partner of the insured. IRC Section 101(a)(2)(B). This exception should be met provided that, as of the time of termination, each insured and the dynasty trust owns an interest in the same partnership.
19. In *Crane v. Comm'r*, 331 U.S. 1 (1947), the Supreme Court characterized the transfer by the decedent of an asset subject to a full value liability as a bequest rather than a sale. This is a well-established position. *See* Rev. Rul. 73-183. Some commentators have posited that trust assets receive a stepped-up cost basis on the death of the grantor pursuant to IRC Section 1014(b)(1). However, the IRS and most commentators disagree with this position, and legislation has been proposed to clarify this issue. During the grantor's lifetime, income in respect of a decedent isn't created due to grantor trust status. Therefore, based on the assumption that death isn't a recognition event, the estate receives a stepped-up basis to fair market value on the note. *See* Section 1014.

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