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LIFE INSURANCE

Building-Up A Tax Strategy

The increased utility of life insurance in estate, retirement and asset protection planning

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Three recent developments present new and important roles for life insurance in estate, retirement and asset protection planning:

First, the so-called "SECURE Act," passed just before Christmas, 2019, generally requires that all IRA and similar tax-deferred qualified retirement plan benefits be paid out within 10 years of the owner-participant's death.

Second, the recent national elections (including the Senate runoff elections in Georgia) will not only likely mean lower federal estate tax exemptions in the near future, but may also result in the loss of income tax basis step-up at death and, potentially even worse, deemed capital gains at death as well as when lifetime gifts are made. These same elections will likely mean higher income tax rates generally, including on capital gains and on distributions from tax-deferred IRAs and qualified retirement plans.

Finally, recent demographic trends involving the movement of retiring baby boomers from traditionally Democrat majority states (such as New York, Illinois and California) into warm weather and traditionally Republican majority states (such as Arizona, Texas and Florida), will likely serve to support this trend towards higher federal taxes in the future.

The Utility Of Cash Value Life

One approach which may serve to help minimize the new taxes on both tax-deferred investments and taxable investments utilizes cash value life insurance. The build-up in the cash surrender value of a life insurance policy can be accessed income tax-free during the insured's lifetime, through tax-free withdrawals and/or loans, and the death benefit of a life insurance policy is, of course, income tax-free. How can these traditional income tax attributes of life insurance help counteract the recent developments described above?

For tax-deferred investments such as IRAs and other qualified plan interests, investing in cash value life insurance, either annually as part of the individual's retirement planning, or by taking taxable withdrawals from the owner-participant's tax-deferred investments over time and reinvesting them in cash value life insurance, will have the effect of pushing these funds into a tax-free, as opposed to tax-deferred, environment. This step may not only serve to minimize income taxes to the owner-participant over time, but it will also significantly reduce the adverse tax effects of the SECURE Act on the owner-participant's beneficiaries after his or her death, since the life insurance proceeds are income tax-free.

As an option to investing all in taxable investments such as brokerage accounts, investing part of the individual's savings in cash value life insurance can help counteract the effects of the proposed loss of income tax basis step-up at the investor's death and/or deemed sales at the investor's death. As described above, because the life insurance proceeds will be income tax-free to the insured's beneficiaries, the otherwise adverse effects of the proposed loss in income tax basis step-up and/or deemed sales at death will become moot. This option will also minimize the investor's current income taxes on what would have been taxable investments, including on capital gains.

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Obviously the income tax-tax free life insurance proceeds can also be utilized by the insured's family after his or her death to help pay any additional income taxes caused by the SECURE Act and/or loss of income tax basis step-up, as well as any additional estate taxes caused by a lowering of the federal estate tax exemption.

Enter the WRAP Trust™

If estate taxes are a concern as a result of the likely significant lowering of the current $11.7 million federal estate tax exemption, the life insurance policy can be placed inside an irrevocable life insurance trust and the death benefit will thereby be removed from the insured's taxable estate. Through an irrevocable trust device developed in the mid-1990s, called the WRAP Trust™, the insured may still access the cash value of the insurance policy during his or her lifetime, either via a so-called "spousal access trust," if the insured is married, or via a traditional irrevocable life insurance trust, if the insured is not. In the case of the single individual, cash value of the life insurance policy would be accessed through tax-free loans from the insurance trust. Because Roth IRAs cannot be invested inside an irrevocable trust, this feature of life insurance presents a unique advantage over investing in Roths.

The purpose of this article is to revisit the 1997 Journal of the American Society of CLU and ChFC article – "The WRAP Trust™." The letters WRAP are short for Wealth, Retirement and Asset Protection.

The Original WRAP Trust™

As excellently summarized by the law firm Cox, Hodgman & Giarmarco in their Spring 1998 Newsletter, this is how the WRAP Trust was structured in its infancy:

"The WRAP Trust theoretically provides the best of both worlds to the grantor/insured. By contributing a life insurance policy to this trust, the grantor can retain access to increasing cash values in the policy (especially variable products with strong growth potential), yet avoid inclusion of the proceeds in the grantor's estate. Many clients are motivated to use life insurance products for more than traditional insurance needs.

For example, frequently clients will capitalize upon the tax advantaged growth and withdrawal options available with a life insurance product to save for long term accumulation goals such as education or retirement. The WRAP trust introduces an innovative technique for allowing the grantor/insured to retain access to these financial benefits without triggering estate tax inclusion.

The WRAP Trust is a specialized form of irrevocable life insurance trust. The grantor/insured is given the power to borrow funds from the WRAP Trust at any time; provided that he/she evidences the loan with a promissory note. The note should bear interest at the prevailing market rate, and should be secured by a pledge of the grantor's assets.

The trustee is able to provide cash for the loan by taking tax-free withdrawals from the cash value of the policy owned by the WRAP Trust. The loan is usually repaid to the WRAP Trust upon the grantor/insured's death. The death benefit of the policy, together with the repaid loan amounts, are positioned to be estate tax-free since they are owned by the WRAP Trust.

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Loans that are repaid to the WRAP Trust upon the death of the grantor/insured are essentially exempt from Federal estate taxes. For example, assume a single individual with $2 million of assets dies while still owing $500,000 to his WRAP Trust. The $500,000 owed to the WRAP Trust reduces his taxable estate from $2 million to $1.5 million. Another tactical advantage provided by the WRAP Trust is the income tax-free nature on the annual interest payments from the grantor/ insured to the WRAP Trust. This tax advantage is achieved due to the special design of the WRAP Trust as a "grantor trust" for income tax purposes.

The asset protection inherent in a WRAP Trust is derived from the grantor/insured's lack of any identifiable interest in the assets held within the WRAP Trust. The funds transferred to the WRAP Trust are secure from the grantor's creditors absent proof of a "fraudulent conveyance" (i.e., transfers made to hinder, delay or defraud a creditor). Absent proof of any fraudulent conveyance, the WRAP Trust will also protect against the loss of trust assets to creditors of the grantor/insured's beneficiaries (typically the grantor's spouse and children) through spendthrift provisions and discretionary trustee powers."

A couple of additional clarifying points about the WRAP Trust need to be made. The original WRAP Trust actually included two alternative versions which were intended to address the situation where the insured/grantor was fearful that a retained right to borrow from the trust might create an estate tax issue.

- First, rather than retain a right to borrow, the trust can be drafted granting the trustee the sole power to determine whether to make a loan to the grantor/insured, thus eliminating any potential estate taxable retained interest in the grantor/insured, absent a showing of a preconceived plan.
- Second, assuming the grantor/insured is married and the policy is not a survivorship life insurance policy, the trust can be drafted as a traditional "spousal access trust," allowing indirect use of funds for the grantor/insured through distributions to the spouse.

The next clarifying point about the original WRAP Trust is that its asset protection features stem not only from the asset-protected status of the trust assets themselves, but also from the first secured creditor status the trust achieves in the assets of the grantor/insured which are pledged as security for any loans from the trust. The interest of any subsequent creditor would therefore be subordinated to the first secured creditor status of the trust, which in essence is the grantor/insured's family.

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The WRAP Trust™ Revisited

As a result of a single favorable development occurring soon after the original WRAP Trust article was developed, any estate tax risk associated with the original version of the WRAP Trust technique has been virtually eliminated. This development was the Internal Revenue Service's release of Revenue Ruling 95-58. There the Internal Revenue Service ruled that "even if the decedent had possessed the power to remove the trustee [of an irrevocable trust] and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income." While Revenue Ruling 95-58 does not directly address Section 2042, most commentators believe, and later IRS private letter rulings in this area suggest, that this retained power in the grantor/insured is permissible for life insurance estate tax exclusion purposes, also.

In most instances it will therefore now be preferable to eliminate any estate tax risk associated with the WRAP Trust by opting for the "right to change trustee" approach over the "right to borrow" approach. Most grantors/insureds will be satisfied that the right to change the trustee of the WRAP Trust will effectively provide them with the power to borrow from the trust during their retirement years (or earlier, if necessary).

If the grantor/insured is concerned that he or she may lack sufficient resources down the road to be able to borrow from the trust with adequate security, the trust can be drafted to grant one or more beneficiaries the power to direct the trustee to make these loans, regardless of security. Unless the Internal Revenue Service were somehow able to establish a preconceived plan that the trust beneficiaries would act at the grantor/insured's direction, the only issue this drafting technique creates is the potential of a taxable gift by the beneficiary, if the grantor/insured lacks the ability to repay the loans. Of course, this is always the situation whenever a child opts to help out his or her parents, financially.

Wrapping Up

As introduced above, the increased utility of the WRAP Trust in present day estate planning stems not only from its already-existing ability to

- save the grantor/insured's family estate taxes,
- provide for the grantor/insured's retirement on a tax-favored basis, and
- help insulate the grantor/insured against lawsuits,

but from its impressive ability to counteract recent and proposed efforts in Washington to increase income and estate taxes on a decedent's heirs. When purchased and owned inside of an irrevocable WRAP Trust, income tax-free permanent life insurance will serve to

- minimize the significant adverse income tax consequences associated with the SECURE Act,
- offset the effects of a likely significant reduction in the federal estate tax exemption, and
- help render moot the harsh impact of proposed carryover income tax basis at the grantor/insured's death, all while allowing the grantor/insured income tax-free and asset-protected access to the policy's cash surrender value during his or her retirement years.

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