Audio file

New Bob Fin.m4a

Transcript

But we know the drop. We don't know the ocean.

Hello and welcome to the Newton Knowledge podcast. My name is Mark Singer, partner of Newton 1 advisors and I'm joined by our managing partner Steve Target. The Newton Knowledge Podcast will provide meaningful content to our valued advisor community, which is the state planners, CPA's, wealth managers, and financial planners. Our discussions will deliver unique. Insights into the people, processes and products that make our industry so. Vehicle Newton One is a national life insurance planning firm delivering customized solutions structured to help clients and their advisors engaged in solving estate planning, wealth transfer, business succession and executive benefits challenges. We are a member of the M Financial Group, which grants our clients access to the nation's elite carriers and exclusive products only available through our network.

Work.

Today we have Bob Finnegan, Vice president of M Financials Advanced planning team. He's responsible for providing advanced planning for support to M member firms, attorneys, accountants, family offices and institutions, Mr. Finning and his pen is 45 plus year career in the life insurance and wealth transfer industries, the majority as an estate planning attorney. Devoted to protecting and transferring wealth for high net worth. And Ultra affluent net worth individual and business clients. He has been published in a number of highly regarded national newsletters, journals and trade magazines, and is serving on the insurance Committee of Trust and Estates magazine to no further ado, Bob Fagan it's a pleasure to have you on the show. Thanks for joining us.

The.

Thank you, mark. I'm, I'm glad to be here.

About this, the inspiration for today's podcast is also founded in the a recent paper that you published. Is that where was the document published?

Yeah, I published an article on what I call the Grat enhancement strategy and trust in the States magazine and a kid that as a being on the insurance committee, one of my obligations is once a year they they twist my arm and and beat an article out of me. So that was that was when I did last year. But it's a, it's a topic that I'm really passionate about. I think it's a really powerful strategy.

The article was was great and as well as the.

The.

The presentation you provided with some of our our colleagues at the the marketing meeting and and just for our audience for for what grants stand for grantor retained annuity trust?

That's right. And it's a it's a wealth transfer strategy that's designed to move wealth at a discount. And if you want, I'll take a minute and walk through the basic grant strategy and how it works.

That would be great.

So basically a client will. Transfer assets. Then it could be a closely held business interest or commercial real estate or could even be cash. Or other assets and the client places those assets in a graph which is a special kind of trust. And under the terms of that trust, the grantor is going to receive income back from the asset for a term of years. Let's I'm going to use 10 and the examples that we're going to use today and at the end of the 10 years, if the grantor is still alive, whatever is left in the trust transfers out to a trust for the benefit of children. And I call that a grant remainder trust or those assets may go directly to the children. So either in trust Grant remainder trust or directly to the children. And in my experience, most of the time the assets do go into a grant remainder trust that May may remain in trust for the lifetime of the children. And then that those assets are ultimately taxed in the children's estate. Now, because the grantor has retained the right to receive income back from net asset over those 10 years, the value of the gift for wealth transfer purposes is well less than the value of the asset. So if client were contributing $10 million of assets into this brat and based on. 6% or $600,000 payment back to the grantor each year, and that payment is fixed. The value of that asset is reduced for wealth transfer purposes, so it might be valued at $6 million or $7,000,000 and they're actually our IRS tables that value that asset. So the basic value of this Brad, is that you can transfer an asset out of the estate into a trust for the children at A at a substantial discount. But actually when you set up the grant, you control how much income the grantor is going to get back and the more income that the grantor gets back the lower value of the asset that's transferred. So it can even get to the point where you can actually zero out the value of the gift. Now that means that the grant is going to take back more into his estate and the income payment each year, but it's it's reduced the value of the gift in some cases to 0.

Oh.

If you're contemplating doing this type of planning, what are some of the concerns A grantor should be aware of?

So they're basically 2 negatives to the graph, or two risks to the graph. The 1st is if the grantor dies during the term of the graph. So in our 10 year example, if the grantor dies within that 10 year period before the grant completes, those assets are brought back into the Grant Tours estate. Right. So that's a pretty significant risk and there's different strategies. The way grats are structured to minimize that risk. The other negative is that those assets only pass to the children. And as I mentioned earlier, those assets are going to ultimately be taxed in the children's estates now for high net worth and especially Ultra High net worth.

Yeah.

Clients a lot of times they'll be want to do planning with a dynasty trust and that's a multi generational trust. That can go on for hundreds or even thousands of years and not be subject to the transfer taxes, the gift to state and generation skipping transfer taxes. So the grant, although it's a very powerful wealth transfer strategy, it only moves at one generation, so you don't get that multi generation benefit of a dynasty. Crashed.

So you brought up Dynasty trust so there. Additional trust that this type of planning could be implemented with or is it solely just grats and and in turn somewhat dynasty trusts?

Yeah, well, a lot of times, a lot of the planning the clients will do. For example, even if they're just using their lifetime gift exemption, which was 12.92 and it's up to something like $13.6 million for 2024. So that's a lifetime amount. So when clients are gifting it, the ultra high net worth clients again typically gift those assets into a dynasty trust. And once they're moved outside of their taxable estate into the dynasty trust, they're outside the gift estate and GST tax tax provisions for hundreds or thousands of years. And so there's an obvious. Benefit if you looked at if assets are transferred to the children, they're taxable in the children's estate and then the children transfer them to their children, their taxable and those. Children or grandchildren's estate, there's a diminishment of assets over the years and it's it's actually more like a saw blade. If you think of if the assets grow and grow and grow in the children's estate, then they get hit by this 4050%. Estate taxes and they. Dropped significantly than they grow over the next generations lifetime and drop zip by another 4050% of state. Tax and so on. And by transferring assets into a dynasty trust you avoid that. Repeat state taxation of the assets. So over time it it just builds substantial wealth and and protect the family wealth.

Are there certain states that are that have more favorable laws or regulations with regard to dynasty trusts?

Yeah, definitely. The top two that come to mind are Nevada. And Wyoming, any dynasty trust is subject to the state laws in which the trust is formed and administered. Each state has what's called a rule against perpetuities, and traditionally a rule against perpetuities. This was almost uniform across most states, would allow a trust to last for about 100 or maybe 120. Years within the last, I'd say 15 years, states have changed their rule against perpetuities and every state has a different rule now and some states, as you mentioned are more favorable than others. So for example in Nevada, I think a trust can last 360 years somewhere around that which is which is pretty ridiculous. If you think about if you've created a trust in something like 1640, it just being maturing now and being subject to state taxes or transfer taxes, it's quite a long time and I believe in the case of why. Filming that the trust could last it's it's indefinite. There's no limit on the rule against perpetuities for Wyoming, so those states tend to also have a lot of other very favorable laws and typically to be in a a jurisdiction to have a. So, for example, a a client in New York might want to create a trust in. Wyoming and there's so they need to have a Wyoming trustee to get at that site as to establish the site just for the trust.

Yeah. So I guess where we're going with this is this, this can be a pretty powerful estate planning tool, but you've identified another opportunity that that may be overlooked by a lot of. Planners is it possible for us to maybe run through a case study or or go through some numbers where we might demonstrate what, how, how you've thought through some solutions?

Yeah. Let me let me just first and and I'll start at a very high level. Then we'll get into a case study, what I call the grant enhancement strategy. Originally, I I was calling it grant rescue, but grants that have successfully completed. In other words, the Grant tour has lived to. The end of the ten years in my example, and it's successfully transferred assets into those children's trusts, those, and that's our focus. We're going to focus on successful grats those grats don't need rescuing, they they're successful, they accomplished what they intended to. They transferred wealth with little or minimize gift tax. Sequences and so they've they've been very. Successful and and done the job they were expect. That to do, but there's more that can be done, and a lot of times clients want to do more, but they don't want to dip into their own pocket. They can actually take use these grant assets and this would be up to the trustee of the remainder trust. And that trustee can use those assets to fund life insurance. In the dynasty trust. So in other words, we're going to take the appreciation. Of those successful brand assets and move that appreciation into a dynasty trust, and we do that with either alone or another type of split dollar plan that's going to be a premium advance, but we're going to focus on the loan for now, just because it's more easily understood and and I think it's also and there's a lot of nuance. Through this and every every situation is different, so I don't want to make this sound like it's too simple because you really have to look at each situation to determine whether this approach works, whether it has the right type of assets and how we're going to structure it in the most favorable way. Very general. If you can lend assets to a dynasty trust. And use those loaned assets to buy life insurance and also use those loan assets to ultimately repay the loan. We've moved all this appreciation via the life insurance policy into a dynasty trust and again and as is well known, life insurance, death proceeds or income tax free. So it's given an extra jump start. To the transaction, whereas over the many years of a dynasty trust, most of those assets, they're going to be invested in taxable investments and those are going to tax is going to be paid. But one of the benefits of the life insurance is that we're starting out with a tax free will. Money to get that dynasty trust rolling.

As we're talking about that loan, what are some of the the the risks to that loan and and and the one that comes to mind for me is is potentially increasing Fr rates. I I guess you know you would look at where the rates are and whether the mid term rates are are competitive compared to long term and they're they're very close these days.

Yeah, actually they're they're very close these days. And in fact, they've been inversions and in the short term loan is a loan that's between 3:00 and 9:00 years and and then a loan over nine years is a long term. Loan and there's each month the IRS publishes what are called the optical federal rates and you have a short term for a loan less than three years, midterm for three to nine years and long term rates for greater than nine years. And typically the mid term rate is lower than the long term rate, although now they're very close and they've actually been. Inversions where the mid term rates been higher, which is counterintuitive, but at any rate, I always recommend using a long term rate and and I'll come back to why in a second. But so right now if you did a transaction in December of 2020. Three, the long term AFR is 5.03%, so the reason that the loan regime strategy works of lending assets to the dynasty trust as if the assets that are invested can produce a rate of return that's greater than that 5.03%. And that excess is used to fund the life insurance. So obviously. It's it's much higher to get a 7 and 8% return in order to generate sufficient cash to fund the life insurance premiums and repay the loan. So that's a bit of a a drawback right now. One thing I'll mention is a very brief aside is if the remainder trust can transfer assets that can be discounted, you can actually get a lot more leverage and you can actually create a differential between the loan rate and what the assets are earning that's very favorable. So this transaction, if you have a closely held business. Interest or commercial real estate? They and if if the remainder trust transfers A minority interest in one of those assets, you can get discounts and you can have creating a spread between what the assets are earning and what the loan rate is being charged. And that would probably be a topic for for another another one of these sessions. But there is still a lot of life. Left in loan regime. So it's not as harsh as it sounds with that 5.03% loan rate.

You know, discounting those assets just creates greater leverage I suppose, and if you're looking at a long term rate and a long term than investment yield from whatever that asset is, even at a 5% long term Fr right now, one would assume that that you're going to hopefully obtain a a greater. Rate of return in that asset than the AFR and the longer the period of time the lower the risk. So if you're if you're looking at a mid term of. 7-8 year, even six year time horizon the risk is much higher because you have to achieve the the rate of return on that asset versus a 15 or 20 or 30 year and then buying life insurance over a 1520 thirty year period of time. Paying those premiums means a lower premium per year which which then kind of mitigates some of the the risk as well.

Yeah, that's that's exactly right. And that's one of the reasons that I always use want to use a long term AFR. Is one of the benefits of what we call a loan regime or a split dollar loan is that you can do lifetime term loans. So when we design these programs, we'll we might design it with a 20 pay policy and design the loan to be repaid in 20 years and it might require a 7%. Rate of return annual rate of return over those 20 years. You know I I prefer lower rates for designing these but one of the beauties if you've designed to be repaid in 20 years and now you get to the end of those 20 years and you don't have enough to repay the loan well because we've designed this as a even though we've designed to be repaid in 20 years. We've made the agreement for a lifetime loan, so you can let that loan just continue to run. And build up and now if you've already paid all the 20 premiums required on the policy, then you don't have the drain of premiums on those investments going forward. And ultimately you'll have enough to repay the loan so that it really provides a great deal of flexibility by by implementing a lifetime term loan.

Let's think positively here. Not projecting, but hoping. Perhaps hope is not a strategy, but.

Positivity is.

Positivity. If Fr rates do go down in the future. We can also renegotiate the loan, can't we?

That's right. Yeah. Yeah. You could essentially refinance the. Loan at the at the lower AFR.

Are there other ways to implement this strategy without the use of life insurance and if? So. How do they compare?

The one of the beauties of of the loan regime, and it's true of the other form of split dollar that we use in these situations as well, is that it's it's statutory, it's the the rules for loans. Split Dollar loans are in the regulations. So we have a very clear set of guidelines now. You could also do what's called a code section 7872 or sometimes called an intra family loan and that's not under the what dollar regulations under Code Section 7872. And those rules aren't anywhere near as flexible but a client. Could lend other assets to the dynasty. Trust could just lend the assets without buying the life insurance essentially, but unfortunately the rules for 7872 are just not as favorable as the loan regime. Nations, for example, the 7872 loans most attorneys limit the loan to less than the clients life expectancy at the time of the loan. So if you've got a 65 year old client they want to make a loan, they're probably the attorneys probably going to do a 20 or maybe a little bit longer loan. With those assets, whereas with the life insurance again we can do a lifetime term loan which provides a great deal more flexibility also with a. 7872. Loan there's a number of requirements that the loan has to meet in order to qualify as a loan for federal tax purposes. And so you have to charge interest. You'd still be using the AFR rates, but the interest is going to need to be paid. You need to document the loan. There's a lot more stringent requirements around the loan, whereas when you're under the loan regime rules, in addition to being able to doing lifetime loans, you can also accrue loan interest. The regulations clearly allow this and the the power of accruing interest rather than paying interest in cash is pretty substantial over time and the way to think about that is if if you have a loan that's charging 5%, your assets are earning 7. Set. Why repay a 5% obligation with a 7% asset? It just doesn't make sense. So we can let that interest accrue for the lifetime of the loan which makes a big difference in the amount that you need to fund repayment of the loan. Ultimately one of the other additional benefits of the lifetime term loan is. You could let it run for life and end up using the death benefit to repay the loan. So if you've used discounted assets and lent those to the to the dynasty trust, and those assets do very well, it's a successful business or piece of commercial real estate and it's growing in value and you don't want to cash that out to create funds to repay the loan. You can just. Let the loan be repaid upon the death. Of the insured.

What other sorts of assets you mentioned business interest, I presume in a privately held business commercial real estate, what what other assets can be loaned?

Well, cash, cash is king. You can always lend cash. There aren't going to be any discounts on cash, although there might be if you put it in a in a limited liability company for planning purposes. Also you could lend a portfolio of marketable securities. I'm not going to get.

Yeah.

Into all the nuances. Because there's a few different combinations, but. We always want to do loan transactions with the grant or trust. If we have generation 1. So this is the generation with the wealth and they created the graph. And let's say that that grant remainder trust is what's called a grant or trust and what that means is for income tax purposes. The Grantors still own those assets, which means they pay the tax and trust earnings trust investments. Now. That sounds like a bad thing on the surface, but it's really a good thing because it it means that those trust assets grow undiminished by income taxes. If the if the trust had to pay the taxes. Instead of earning a 10% return, they might be earning a 7% return after tax, and so you can see by the grant or paying those taxes, the assets in the trust grow and more wealth is transferred. Now the other benefit of a grant or trust is that if the grantor makes a loan to that trust, a loan is under income tax rules, the loan interest that's paid or accrued back to the grantor is not taxable. So now if we take that one step further, if our rent remainder. Trust as a grant or trust with respect to the initial Grantors who created the grant. And then the. Dynasty Trust is a grantor trust with respect to those same grantors, so I'll call that generation. One so the remainder trust the grantor and the dynasty trust are all the same person for tax purposes, meaning the grantor pays the tax. Now where that comes in, it is important in this transaction is when the grant remainder trust makes a loan to the dynasty. Trust. It's just the grant or making a loan to himself. So for income tax purposes, the loan interest that's occurring on that loan to fund the life insurance is not creating taxable income back to the grant. Sure.

Well, the other advantage I suppose, is that the grantor that's paying the tax on any growth of the investment inside of the trust is also effectively reducing their taxable estate.

Absolutely. Yeah. Great. That's a really good point. So I'd like to walk through a simple example and let's say back in 2010 now these are very successful clients. They have a family business, might be a second generation business or it might have been this is first generation. But anyway in 2010, the clients created a 10 year grant. And they funded it with $25 million and their attorney advised them that you can, as we mentioned earlier, you can zero out that graph and now they're going to transfer closely held business interests. So that's going to be discountable. We're going to assume that was discounted at 30%. So it looks like the assets that are being contributed to the grade are not worth 25,000,000. But there were seventeen and a half million dollars. Now, if that Grant pays the grantor $1.67 million each year for 10 years, that would zero out the gift to the grant that would be around a 10% return on the 17 and a half million dollars. But on the underlying value of 25,000,000, that's about a 6% return or 6%. Cash flow and that was. And so at the end of the 10 years that Grant would have successfully transferred $16.8 million. So in December of 2020, let's. It was initially done in in December of 2010. In December of 2020, that was successfully transferred $16.8 million. And then over the intervening 3 years, let's say those assets grew to $20 million. So now we've the clients have successfully transferred $20 million in a grant remainder trust for the benefit of the children and that remain grant remainder trust is a grant to our trust. So the grantors are paying the income taxes on trust earnings. So now the clients. G1 they've been very successful in the and from the businesses continue to flow. They only transferred a portion of the business in the graph and over the years, over the 10 years they've done other planning, moving assets to their children. So now they're the attorneys, advised them that they need an additional $25 million of survivorship. And let's say that the clients are a couple of 60 year olds at this point in time, but they're kind of they've got planning fatigue over the last three years. There have been a lot of threatened changes to the tax laws and these state tax laws. And the clients have done a lot of planning and they're really they're really a bit tired of it, but they understand the need for more insurance and and the risk. The other thing is they've moved a lot of assets out of their own pocket and if they, the attorney explains well, we have this strategy called the great enhancement strategy where we can. Lend the assets that you've transferred to your children through the GRAT through a dynasty trust and that dynasty trust is going to. Then buy the $25 million of life insurance so the clients find this really attractive because they they don't have to be really involved in the process other than signing some forms. They're not dipping into money out of their own pocket, and the other thing that's really kind of one of those little more subtle points is when they moved the $20 million into the grant remainder trust, that's really just asset that's been put there for their children. But now we're taking those assets. And we're using it to buy $25 million of new life insurance. In the dynasty trust, and not only are we moving wealth into a dynasty trust, but now we've converted some of those successfully transferred grant assets into life insurance that can be used at the clients death to help pay their estate taxes. So where is that $20 million that just went into the grant remainder? Trust for the children. It really wasn't going to be used to pay estate taxes on the client. Now we've converted it or transformed it into life insurance that can be used to pay state taxes on the clients. State. So it's something that a lot of clients that this strategy will they'll find be very attractive.

Bob with the legislative sunset coming in a few years, I can only see discussions and considerations around this planning increasing. Would you, would you say the same?

Yes. Yeah. And and a lot of these clients that we're dealing with, they've already fully used their, their lifetime gift exemptions, which is again is something in the neighborhood of $13.6 million per individual. So a husband and wife of of. $27.2 million of gift capacity don't don't hold me to that number. I'm going from memory, but it's somewhere in that range. But a lot of these ultra high net worth clients have already used up all their lifetime exemptions, and they're looking for other strategies to move well. And this is one that can be very attractive. And one of the things I really like. About this strategies, clients have transferred billions upon billions. I mean, there's there's individual clients who have transferred $8 billion in graphs. So there's a lot of grant money out there now because graphs are statutory, they're blessed in the the tax code. Attorney is and have really liked them as a wealth transfer strategy. So now again, this strategy can be used to further enhance the grant planning and it's being done with a loan regime or economic benefit regime split dollar rules that are both creatures of the regulations of the tax regulations. Again, the tax code outlines the rules regarding these transactions.

Bob, this has been very informative. We appreciate your time before we close out. Is there anything else you would like to add or anything we missed that you want to you want to add on to this discussion?

It's a great strategy, but it may not be for everybody, but it starts a conversation, although this strategy may not be the best one, there are other ones that are. Nonetheless, I think for a lot of clients, this is really a very powerful strategy and they don't need to use their own funds. It's going to move wealth. Into a much more tax protected environment. And it's using life insurance, which has a number of favorable tax benefits as well as the rules surrounding its funding, with the economic benefit and loan regime split dollars.

Thanks. Bob, we'll have your. Your article the grad enhancement accessible within the bio of this episode, so those that want to do a an even deeper dive on this this concept they can they can go right ahead and and dive into your article which again is super detailed. Right.

Right. And and Mark, I'll also offer you know, if you have clients or advisors who would like to discuss this and and person, you know, I'd be happy to get on a call with them as well.

Thanks Bob.

Bye bye.

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