Estate Planning for Affluent Clients After the New Tax Law

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Preface

Northwestern Mutual is uniquely positioned to help clients with all aspects of financial planning, including estate planning, in light of the New Tax Law that was enacted in late 2017. With our premier planning process, knowledgeable financial advisors backed by experts in our home office, and world-class insurance and investment products, we can help you achieve a sense of financial security that will allow you to spend your life living. Whether you are concerned about mitigating estate tax, leaving a legacy to loved ones, benefitting your favorite charities, or selling your business, our unique planning process is designed to help individuals like you achieve all your planning goals. Throughout our process, we will work with you and your other advisors to best position you to achieve all of these outcomes.

As we work together on your plan, the recommended next steps are likely to involve some or all of the following, depending on your current situation and expected outcomes:

1. Undergo comprehensive review of (and any necessary updates to) your existing financial plan.
2. Visit with your estate planning attorney to begin the process of updating your estate planning documents to account for changes under the New Tax Law and any recent changes to your personal situation.
3. Ensure that your legacy goals for loved ones are in line with your wishes.
4. Reevaluate any charitable planning aspirations, including uses of private foundations, Donor Advised Funds, and/or other charitable planning techniques.
5. If you own any businesses, visit with your tax and/or business attorney and CPA immediately to reevaluate how the businesses are owned and operated, including the choice of entity. This will enable you to ensure that you are accomplishing your goals of limiting income tax exposure under the New Tax Law, while continuing to minimize liability and achieve other non-tax goals. If you are planning to retire, sell, or give away your business, work with us and your business planning team to put a plan in place to allow you to do so.
6. Reconsider any ownership of life insurance and investments in your planning.

We encourage you to have a conversation with Northwestern Mutual today to evaluate your plan in light of today's tax and economic environment. We look forward to working with you to achieve your goals and dreams!

Chapter 1 – Introduction

What is meant by the phrase, "estate planning?" There are probably several workable definitions, but for many people it refers to the process of ensuring that, after they pass away, they transfer the right assets to the right people, in the right way.

As such, estate planning might entail transferring a family business to the one child involved in the business and cash to the other children, or placing an investment account in a trust for heirs rather than willing it to them outright. No matter the specific goals, there are often obstacles to successfully transferring wealth to younger generations.

One obstacle is that a senior generation could have its wealth heavily depleted even before death, either because they live longer than expected, or get hit with higher long-term care expenses than expected or both.

Other obstacles include taxes upon or after the death of the senior generation. These could be income taxes imposed on beneficiaries of assets that don't enjoy a basis step-up at death, like qualified retirement plans. And for those wealthy enough, a major hurdle to passing assets to loved ones comes in the form of federal transfer taxes.

There are three kinds of "transfer taxes" you might owe to the federal government when you transfer assets to your children or other heirs.

- If make the transfer during life, you may be subject to "gift tax."
- If the transfer is made when you die, your estate may be subject to "estate tax."
- If you make the transfer (either while alive or at death) to a person more than one generation below your own, like to a grandchild or great-grandchild, an additional tax called "generation-skipping transfer tax" may apply.

The taxes are imposed on the right to transfer property; and you, as the donor, generally pay the tax, not the person who receives the property.

In this white paper, we will first provide an overview of these three transfer taxes, and then we'll explain some planning strategies that you can use to greatly reduce or even eliminate your transfer tax liability.

Estate Tax

If you are a citizen or resident of the United States, and the value of your taxable estate when you die exceeds $11.18 million, it will be subject to estate tax.

The $11.18 million is a 2018 dollar figure that is indexed annually for inflation. It is scheduled to sunset at the end of 2025, after which time it generally will be half as large.

Brief History and Rationale

The current estate tax was created by the Revenue Act of 1916 to help provide revenue for World War I. Although it produced far less revenue than the income tax, Congress maintained the tax after the war because it was seen as a way to prevent large amounts of wealth from being passed from generation to generation, creating an economic aristocracy by "dynasty" families like the Rockefellers. Over time, however, the tax began to reach a larger and larger percentage of estates. This trend was reversed in recent years, and now only about 0.2% of all estates owe a federal estate tax.

Operation of the Estate Tax

In determining the amount of your taxable estate, the Tax Code starts with the value of your "gross estate." This is generally the value of all the property interests you own when you die, plus the value of all the taxable gifts you made during life. Then certain deductions are subtracted, and a tentative tax is calculated on this amount. Finally, certain tax credits are subtracted from this tentative tax to arrive at a tax payable.

Gross Estate

The gross estate includes the value of all property owned by a decedent at death, real or personal, tangible or intangible, wherever situated. It includes not only money, stocks, bonds, and real estate, but also the value of certain property you transferred during life. For example, if you transferred property but retained a right to revoke the transfer, or you retained a right to income from the transferred property, it will be included in your estate. A common example is property in a revocable trust. There are also rules for taxing special types of property. These include annuities, joint tenancy property, and life insurance on your life if the proceeds are payable to your estate or you had too much control over the policy when you died (or, often, if you had such control at any time within three years before death).

Deductions

Estate tax deductions are allowed for certain expenses and claims against the estate. These include funeral expenses, administration expenses, debts of the estate and unpaid mortgages. A deduction is also allowed for casualty and theft losses not compensated by insurance or otherwise.

The most important deductions, however, are for charitable and marital bequests. A charitable deduction is available for transfers to organizations operated exclusively for a recognized religious, scientific, literary, educational or other charitable purpose. These transfers are often made to split interest charitable trusts, either a Charitable Remainder Trust (CRT) or a Charitable Lead Trust (CLT). These trusts and their planning implications are explained in later chapters.

You can also get an unlimited marital deduction for the value of any property interest that passes to your surviving spouse who is a U.S. citizen (the surviving spouse being a U.S. resident is not sufficient), provided that the property is included in your gross estate, you were married at the time of death, and the transfer is made in an approved form. Approved forms include an outright transfer, a transfer to a power of appointment trust, or a transfer to a qualified terminable interest property (QTIP) trust. A power of appointment trust generally gives your spouse a right to receive all the trust income for life with a power to appoint the trust corpus to him- or herself or to the estate. As such, under a power of appointment trust, the surviving spouse controls where the trust assets go after a later death. To qualify as a QTIP trust, the trust must provide the surviving spouse the right to all income from the trust property (or a specific portion of the property) for life, and no person can have a power to appoint any part of the property to anyone other than the surviving spouse. A QTIP can be drafted, however, so that the surviving spouse has no control over where trust assets go after a later death. Both of these trust alternatives have the effect of including the trust property in a spouse's estate when one dies so it doesn't avoid estate tax twice.

Credits

The most important credit allowed for estate tax purposes is the unified credit. For 2018, this credit exempts $11.18 million from estate tax. In other words, you pay no estate tax unless your taxable estate exceeds $11.18 million.

Tax Rate

Although estate tax rates nominally run from 18% to 40%, the rates below 40% are never used because they apply to amounts below the $11.18 exemption amount (also called the applicable exclusion amount). Thus, as a practical matter, the value of the taxable estate in excess of $11.18 million is subject to a flat 40% rate.

Gift Tax

The second wealth transfer tax is the federal gift tax. The gift tax applies to certain transfers made during your lifetime.

Brief History and Rationale

The present gift tax dates back to the Revenue Act of 1932. The tax has two important purposes. One is to prevent taxpayers from avoiding the estate tax by transferring property during life. The other is to prevent avoidance of the income tax by transferring income-producing assets to relatives in lower tax brackets.

Transfers to Which the Tax Applies

The gift tax applies whether you make a transfer in trust or otherwise, whether it is direct or indirect, and whether the property is real or personal or tangible or intangible. For example, a gift can be made by giving assets to a trust, forgiving a debt, transferring a right to receive income, making an interest-free loan, or selling property to a relative for less than its fair market value. On the other hand, if you perform free services for someone else, there is no taxable gift.

Completed Transfer Requirement

Only completed transfers are subject to the gift tax. A transfer isn't subject to gift tax if you retain a power to revoke it or a power to alter it. The transfer becomes a completed gift if you later relinquish the power that made it incomplete. The amount of the taxable gift is also reduced to the extent you retain an interest in the property transferred.

Consideration

There can be no gift if you receive adequate consideration for the transfer. If you receive only partial consideration, however, you make a gift equal to the value of the property transferred minus the value of the property you receive in return. These rules don't apply to business transactions, however. Transfers that result from arm's length negotiations that are free from donative intent aren't treated as taxable gifts even if the consideration received is inadequate.

Gift Tax Exclusions

Certain gifts are excluded altogether from the gift tax system. These include gifts you make to pay educational or medical expenses for someone else, as long as you make the payments directly to the provider of that service (e.g., paying tuition directly to a college or paying a medical bill directly to the hospital). Additionally, the "annual gift tax exclusion" permits you to make gifts up to $15,000 per year per donee and still have the gift ignored by the gift tax system, as long as the donee has a "present interest" in the gift (generally meaning the recipient must have immediate use, possession, or enjoyment of the given property or of that property's income). Gifts to spouses who are not U.S. citizens enjoy a super annual exclusion of $152,000 per year. This amount and the general $15,000 dollar figure are indexed annually for inflation.

Gift Tax Deductions

The deductions allowed under the gift tax system are the charitable deduction and the marital deduction (for gifts to U.S. citizen spouses). Lifetime gifts to QTIP trusts and power of appointment trusts can qualify for the marital gift tax deduction, just as at-death transfers to these trusts qualify for the estate tax deduction.

Calculation of the Gift Tax

Gifts that don't qualify for exclusions or deductions are called "taxable gifts." Under current law, the gift tax has the same $11.18 million exemption amount and the same 40% effective rate as the estate tax. The gift tax is payable on a cumulative basis. This means that each year your taxable gifts are added to your gifts from previous years. No tax is payable until the sum of taxable gifts exceeds $11.18 million.

The gift tax is also integrated into a unified system with the estate tax. When a taxpayer dies, the amount of lifetime gifts is added to the amount of the taxable estate. A tentative tax is calculated on this estate tax base, reduced by the gift tax payable on all taxable gifts made by the decedent after 1976. This effectively means that, if you make taxable gifts during life, you not only use and reduce your gift tax exemption, but also use and reduce the estate tax exemption remaining for your estate when you die.

Generation-Skipping Transfer Tax (GST tax)

The last federal wealth transfer tax is applied to transfers that skip a generation. When the GST tax is incurred, it generally applies in addition to a gift tax or estate tax.

Brief History and Rationale

Prior to 1976, generation-skipping transfers were a popular estate planning strategy. Taxpayers could pass assets to multiple generations of their families while paying estate or gift tax only once. For example, a transfer to a great-grandchild was subject to the same tax as a transfer to a child. More importantly, transfers in trust could be used to skip numerous generations. To partially block this strategy, Congress enacted the GST tax in 1976 and substantially revised it in 1986. The GST tax doesn't impose a tax each time property passes to the next generation, however, but merely adds one level of tax to a transfer regardless of how many extra generations the property passes down.

Taxable Transfers

The GST tax is imposed on transfers that skip a generation. There are three kinds of generation-skipping transfers – Direct Skips, Taxable Terminations, and Taxable Distributions. Below are some examples.

Example 1 (Direct Skip). Grandparent gifts $50,000 to Grandchild. This is a direct skip because Grandchild is at least two generations below Grandparent. Making a gift to a trust in which all beneficiaries are skip persons is also a direct skip. In either case, the transferor, Grandparent, is responsible for paying any GST tax.

Example 2 (Taxable Termination). Mother (M) transfers property to a trust for the benefit of Child (C). The trust states that C receives the trust income for life, and when C dies, the trust terminates and distributes its assets to M's grandchildren. When C dies, there is a taxable termination. The trustee is responsible for paying any GST tax.

Example 3 (Taxable Distribution). Grandfather transfers property to a trust under which the trustee has discretion to make distributions to either Child or Grandchild. The trustee makes a distribution to Grandchild. This transfer is a taxable distribution, and the Grandchild is responsible for paying any GST tax.

GST Annual Exclusion

Gifts that qualify for the annual exclusion ($15,000 per year per donee) that are made directly to an individual skip person are excluded from the GST tax.

GST Tax Rate and Exemption

The GST tax has the same 40% tax rate and the same $11.18 million exemption amount as the gift tax and the estate tax.

The $11.18 million is a 2018 dollar figure that is indexed annually for inflation. It is scheduled to sunset at the end of 2025, after which time it generally will be half as large.

Chapter 2 – Overview (The Six Pillars of Estate Tax Planning)

The stage is now set to discuss estate planning strategies that can help minimize or eliminate transfer taxes. There are six pillars of estate tax planning:

1. The advantage of lifetime gifts,
2. Interest rate arbitrage,
3. Valuation discounts,
4. The tax burn,
5. Generational planning, and
6. Bet-to-live and bet-to-die strategies.

Taking Advantage of Lifetime Gifts

Lifetime gifts have important advantages over transfers made at death.

- First, you can transfer $15,000 each year to each of your beneficiaries without any transfer tax consequences by using your annual exclusion amounts. Over time, this can produce dramatic tax savings.
- Second, you can use lifetime gifts to freeze the value of your assets for transfer tax purposes. Suppose, for example, that you own an asset with a current value of $1 million that is expected to be worth $3 million when you die. By gifting the asset now, you can remove the $2 million of growth from wealth transfer tax.
- Third, lifetime transfers are taxed at a lower effective rate than transfers at death. This is because the gift tax is imposed only on the amount given to the transferee. By contrast, the estate tax is imposed on the amount transferred plus the amount used to pay the tax. For this reason, the gift tax is often referred to as "tax exclusive," in that this tax is imposed on an amount that excludes the money used to pay the tax. The estate tax is "tax inclusive," in that the tax is imposed on an amount that includes the money used to pay the tax. The result is that the gift tax would equate to a mere 28.57% rate if it were a tax-inclusive rate like the estate tax. These tax-inclusive vs. tax-exclusive features are discussed more in Chapter 3 – Lifetime Transfers.

Interest Rate Arbitrage

Some of the most powerful estate planning strategies take advantage of IRS interest rate assumptions. These strategies include:

- Grantor retained annuity trusts (GRATs),
- Charitable lead annuity trusts (CLATs),
- Intra-family sales,
- Sales to intentionally defective grantor trusts (IDGTs), and
- Intra-family loans.

In valuing the taxable gift for transfers to GRATs and CLATs – which essentially is the predicted value of the trust's remainder interest – the IRS assumes the assets will grow at the Internal Revenue Code Section 7520 rate. As of July 2018, this rate is set at a historically low 3.4%. If the assets you transfer to the GRAT or CLAT grow faster than 7520 rate, the value that is gift taxed will be lower than the value of the assets that actually reach the trust remainder beneficiaries (e.g., the grantor's children or other loved ones). The lower the 7520 rate, the more likely this is to occur.

The 7520 rate is 120% of the mid-term applicable federal rate, briefly described immediately below.

To avoid imputed gifts for intra-family sales, sales to IDGTs, and intra-family loans, the IRS requires that you charge an interest rate at least equal to the applicable federal rate (AFR) for the term of the promissory note.

- Short-term AFR applies to notes of up to 3 years (2.38% in July 2018).
- Mid-term AFR applies to notes more than 3 years but no more than 9 years (2.72% in July 2018).
- Long-term AFR applies to notes over 9 years (3.06% in July 2018).

The lower the prevailing AFR, the more likely that the value of assets you sell to your family or a trust for their benefit will grow faster than the government predicts, resulting in a tax-free transfer of value. Finally, if you loan money to heirs, they often will be able to invest the funds at a rate much higher than the low AFR they owe back to you, shifting value from you to them without making a taxable gift.

Valuation Discounts

Many families create and put assets into family limited partnerships (FLPs), limited liability companies (LLCs) or closely-held corporations. In addition to important business reasons for creating these entities, doing so also makes it possible to give or sell partial ownership of these business to younger generations at so-called discounted values. For example, if a parent transfers 30% of the business, that transferred interest might be entitled to 30% of the distributed profits each year and be entitled to receive 30% of the business when it's liquidated, but that ownership interest still could be legitimately valued for gift and estate tax purposes at an amount much lower than 30% of the entire business. This is due to the fact that the transferred interest is often restricted in some way that makes it difficult for the owner (transferee) of that interest to make it generate cash. This could be because it represents a minority interest and thus lacks voting control (minority discount) or because it's an interest that would be difficult to sell on the open market (marketability discount).

Tax Burn Advantage

Suppose that you create an irrevocable trust for the benefit of your children, and the trust is outside of your estate for estate tax purposes. It is nonetheless possible for this trust to also be a "grantor trust," which means you are treated as owning the trust for income tax purposes. The result is that the trust's income – even though it is paid to the trust and not to you – is reported on your Form 1040 instead of on the trust's income tax return. The grantor's liability for the income tax bill on trust-generated income means that the grantor is effectively paying taxes for the trust beneficiaries without being deemed to be making an extra gift to them. This enables you to make large tax-free transfers. This type of trust is often called an intentionally defective grantor trust (IDGT), and the technique is commonly referred to as a tax burn.

Generational Planning

By using a dynasty trust you can pass property down through the generations of your family for the maximum trust duration allowed under state law, and your family is only exposed to transfer tax once. If the gift tax exemption and the GST tax exemption are used when gifts are made to the dynasty trust, it is possible for no transfer tax ever to be owed no matter how long the trust lasts and no matter how many generations it spans. Some states have a maximum term for a trust (called a rule against perpetuities), but many states do not. So if you create your dynasty trust in a state that permits perpetual trusts, a one-time use of your gift and GST tax exemptions allows your family to avoid transfer tax forever. The dynasty trust strategy can be enhanced by having the trust own life insurance (perhaps on the grantor(s) and on subsequent generations).

Bet-To-Live AND Bet-To-Die Strategies

For some common estate planning strategies, the longer the taxpayer lives, the better the strategy works. These strategies are sometimes referred to as "bet-to-live" strategies and include:

1. The advantage of lifetime gifts,
2. Interest rate arbitrage,
3. Valuation discounts,
4. GRATs, and
5. The tax burn when paying the income taxes generated by IDGTs.

Other strategies work extremely well if the taxpayer dies early. These strategies are sometimes referred to as bet-to-die strategies and include:

1. Private annuity sales,
2. CLATs, and
3. Self-canceling installment notes (SCINs).

Taxpayers who don't fall clearly into either category might wish to hedge their bets by using a combination of bet-to-live and bet-to-die strategies, which include:

1. GRAT + SCIN,
2. GRAT + life insurance,
3. IDGT + SCIN, and
4. IDGT + life insurance.

The following chapters discuss many of these wealth transfer techniques.

Chapter 3 – Lifetime Transfers

As noted previously, lifetime transfers have three important advantages over waiting until you die to transfer property to heirs. You can use annual exclusions, you can freeze the value of assets to remove future appreciation from your tax base, and you can use the tax-exclusive gift tax rate instead of the higher tax-inclusive estate tax rate.

Annual Exclusion Gifts

For individuals with taxable estates, annual exclusion gifts are the first strategy to consider. They are simple, effective and expressly authorized by the Internal Revenue Code. The exclusion is indexed for inflation and is set at $15,000 for 2018. If you and your spouse both make gifts, you can remove $30,000 per year from your estates for each beneficiary. Over time, these annual exclusion gifts can remove substantial amounts from your estate. Consider the following example.

Example 4. H and his wife W are wealthy taxpayers who expect to have a taxable estate when they die. They have three children and seven grandchildren. Every year, H and W both make annual exclusion gifts to each child and to each grandchild. This makes a total of 20 annual exclusion gifts with a total value of $300,000 (2 x 10 x $15,000). The following chart shows the amounts removed from the gross estate and the resulting tax savings given the current 40% estate tax rate if they make the annual exclusion gifts for various time periods. Assume that the annual gift tax exclusion amount remains at $15,000 per year/per donee and that the assets transferred produce a total return of 8%.

Years	Total Transfer	Tax Savings
5	$1,759,980	$703,992
10	$4,345,969	$1,738,387
15	$8,145,634	$3,258,254
20	$13,728,589	$5,491,436
25	$21,931,782	$8,772,713
30	$33,984,963	$13,593,985

Taxable Gifts

The next strategy to consider is taxable gifts (those exceeding the annual exclusion). This strategy is also simple and produces two important benefits.

Freezing Value

Property tends to increase in value over time. By making lifetime gifts you can lock in the property's current value for transfer tax purposes instead of the much higher value it might have when you die.

Example 5. M owns Blackacre with a current fair market value of $1,000,000. The property is expected to increase in value to $4,000,000 by the time she dies. If M gifts Blackacre now, it will be included in her estate (as a previous taxable gift) at its current $1,000,000 value. By contrast, if M holds onto Blackacre until she dies, it will be included in her estate at its $4,000,000 date of death value. Thus, M removes $3,000,000 from her estate by transferring the property now.

Tax-Exclusive Rate

As mentioned earlier, the gift tax has a lower effective rate than the estate tax because the gift tax is applied against a smaller base. While the estate tax applies to the full value of the property included in your estate (tax-inclusive rate), the gift tax applies only to the amount transferred to the donee (tax-exclusive rate). In other words, the amount used to pay the gift tax isn't subject to tax.

Example 6. Grandmother has $10 million that she wants to transfer to her children but also knows that any transfer tax must be paid from this amount too. Assume that Grandmother has already used up her gift and estate tax exemption amount.

If the property is transferred at death, the full $10 million is subject to tax. The tax payable is $4 million under the current 40% estate tax rate (0.40 x $10 million), leaving the heirs with $6 million. Note that tax is payable on both the $6 million the heirs receive and on the $4 million that is used to pay the tax.

If the property is given during life, however, only the amount transferred to the donee is subject to tax, but the amount used to pay the tax is not. As such, if the value of the gift and the gift tax added up to $10,000,000, the gift tax would be $2,857,143, leaving $7,142,857 as a gift for the children. Note that the $2,857,143 of gift tax paid is 40% times the amount received by the heirs (0.40 x $7,142,857 = $2,857,143). In effect, the $2,857,143 of gift tax paid is removed from the tax base.

The result of the tax-exclusive nature of the gift tax is that, if it were tax inclusive like the estate tax, the gift tax rate would be just 28.57% (0.40 / 1.4).

The benefit of the tax-exclusive rate is lost if the taxpayer does not live for at least three years after making a gift, however. A special gross-up rule in the Internal Revenue Code provides that if a donor dies within three years after making a gift, the amount of gift tax paid is brought back into the gross estate and added to the amount subject to estate tax.

Chapter 4 – Interest Rate Arbitrage

Interest rate arbitrage can be used to create large tax savings for lead annuity trusts and for sales or loans to your heirs.

Lead Annuity Trusts (GRATs and CLATs)

There are two kinds of lead annuity trusts that can be used to create interest rate arbitrage: GRATs and CLATs.

GRATs – Grantor Retained Annuity Trusts

Let's look at GRATs first. A GRAT is an irrevocable trust that pays an annuity interest back to the grantor for a term of years. Any property remaining in the trust at the end of its term passes to the remainder beneficiaries, typically the grantor's children. The value of the annuity interest isn't subject to tax because the grantor keeps it, but the value of the remainder interest is a taxable gift.

The value of the remainder interest – the value the grantor reports on a gift tax return when funding the trust – depends on how fast the trust assets are expected to grow. It would be impractical to try to determine an expected growth rate for every asset that might be transferred to a GRAT, so the IRS assumes a growth rate to value the remainder interest. This rate represents what the IRS assumes is a reasonable rate of return and is based on the interest rate paid on certain Treasury obligations. This IRS assumed rate relevant to GRATs is referred to as the Code Section 7520 rate. If you transfer assets to a GRAT that end up actually growing faster than the 7520 rate, the value that reaches the remainder beneficiaries will be larger than what it was predicted to be. Naturally, this is more likely to happen when the 7520 rate is low, and as of July 2018, the 7520 rate is set at a historically low 3.4%. When this happens, the grantor has effectively made a gift in excess of what was gift taxed.

Zeroed-Out GRATs – Calculating the Tax Benefit

Another way to describe the amount of the taxable gift when you create a GRAT is that it equals the value of the property you transfer to the trust, minus the value of the annuity payments you receive. You can set the value of your annuity interest equal to the full value of the property you transfer to the trust, creating a "zeroed-out GRAT" with no taxable gift. This means that the remainder interest that is expected to remain in the trust at the end of the term (per the 7520 rate) is zero.

If the assets placed in a zeroed-out GRAT in fact produce a total return equal to (or less than) the assumed interest rate (7520 rate), there will be nothing left in the GRAT at the end of its stated term. The remainder interest will have been valued at zero, and it will turn out that zero was what it was worth.

If the GRAT assets actually produce a return in excess of the 7520 rate, however, property will remain in the GRAT at the end of its term to pass gift tax-free to the remainder beneficiary. This is shown in the following examples.

Year	Beg. Balance	Return (2.6%)	Payout	Ending Balance
1	$1,000,000.00	$26,000.00	$266,459	$759,541.49
2	$759,541.49	$19,748.08	$266,459	$512,831.06
3	$512,831.06	$13,333.61	$266,459	$259,706.16
4	$259,706.16	$6,752.36	$266,459	$0

Example 7. Assume that T transfers $1,000,000 to a zeroed-out, 4-year GRAT when the 7520 rate is 2.6%. The annual payout needed to zero out the GRAT is $266,459. Assume that the actual return produced by the trust is 2.6%. Operation of the GRAT is to the left.

Under these assumptions, the remainder beneficiaries receive $0.

If the GRAT assets produce a return in excess of 2.6%, however, property will remain in the GRAT at the end of its term to pass tax-free to the remainder beneficiaries.

Example 8. Assume the same facts as the previous example except that the GRAT assets produce an actual return of 10%. The operation of the GRAT now looks like this.

This $227,466.05 represents a gift tax-free transfer to your children or other remainder beneficiaries.

Year	Beg. Balance	Return (10%)	Payout	Ending Balance
1	$1,000,000.00	$100,000.00	$266,458.51	$833,541.49
2	$833,541.49	$83,354.15	$266,458.51	$650,437.13
3	$650,437.13	$65,043.71	$266,458.51	$449,022.33
4	$449,022.33	$44,902.23	$266,458.51	$227,466.05

The greater the excess of trust returns over the Section 7520 rate (sometimes referred to as the hurdle rate), the larger the gift tax-free transfer. The following chart shows the tax-free transfers for a $1,000,000 zeroed-out GRAT for various rates of growth actually produced by assets in the GRAT, when the relevant 7520 rate is 2.6% and we assume the same general fact pattern as in Examples 7 and 8, immediately above.

$1 million transferred to GRAT when 7520 rate is 2.6%	
actual growth rate of assets in GRAT	actual growth rate of assets in GRAT
2.6% or less	$0
5.0%	$67,028
7.5%	$143,612
10.0%	$227,456
12.5%	$318,944
15.0%	$418,469

CLATs – Charitable Lead Annuity Trusts

A CLAT has the same structure as a GRAT except that the lead annuity interest is paid to charity instead of to the grantor. If the trust produces a total return above the Section 7520 rate, it does not increase the amount the charity receives via the front-end annuity payments, but the remainder beneficiaries receive a bonus amount that isn't subject to gift tax.

If the trust in Example 8 above had been a zeroed-out CLAT instead of a zeroed-out GRAT, the donor would have received a charitable deduction for the full $1,000,000 transferred to the trust, and the remainder beneficiaries would have received $227,466.05 even though no gift tax was paid. Thus, the taxpayer gets the same $1,000,000 deduction she would get for an outright gift to charity, and the $227,466.05 that passes to the remainder beneficiaries is a bonus resulting from rate arbitrage. This makes CLATs a very favorable way to make charitable contributions.

Sales and Loans

Interest rate arbitrage can also be applied to sales and loans to family members. If you sell property to your children and you take back a note that pays a relatively low interest rate, and the property then appreciates faster than that interest rate, the value leaving your estate will be greater than the value coming back. Even so, there will be no gift tax as long as the interest rate you charged on the note isn't below the minimum rate required by the IRS. This minimum interest rate is referred to as the applicable federal rate (AFR). The AFR is based on the interest rate at which the federal government borrows money and is generally much lower than market interest rates or the returns on most assets. The current AFRs are historically low, creating important arbitrage opportunities.

As stated above, the AFR depends on the term of your installment note or loan:

- Short-term AFR applies to notes of up to 3 years (2.38% in July 2018).
- Mid-term AFR applies to notes more than 3 years but no more than 9 years (2.87% in July 2018).
- Long-term AFR applies to notes over 9 years (3.06% in July 2018).

Installment Sales to Family Members

An installment sale can be used to remove assets from your estate without any payment of gift, estate, or GST tax. There is no transfer tax because the assets are replaced with an asset of equal value (the promissory note). If the transferred assets grow in value at a rate in excess of the interest rate on the note, then there will be a net transfer of value to your beneficiaries.

> Example 9. Mother owns interests in the ABC Family Limited Partnership. The interests are currently worth $480,000 and are expected to appreciate in value at 12% per year. Mother sells her ABC interests to Son on a six-year installment note with an interest rate of 2.10%. Thus, the annual payments are $81,680 ($80,000 x 1.021). Assume that Mother can reinvest the installment payments at 8%. After six years, the value of the ABC interests has increased to $789,530, but the value of the reinvested installment payments is only $599,199. Thus, Mother has removed $190,331 ($789,530 - $599,199) from her estate on a gift tax-free basis.

Again, the mechanism by which the tax-free gift is created is simple rate arbitrage. In many cases, you can further increase the tax-free gift by claiming valuation discounts on the assets sold (discounts are discussed in more detail later). In addition to the transfer tax benefits, the installment sale also gives you an income stream. The disadvantages of the strategy are that you must recognize gain on the appreciation in the assets sold, and the interest payments received are taxable income – that is, unless the sale is to an intentionally defective grantor trust; see immediately below.

Installment Sales to an Intentionally Defective Grantor Trust

If you make the sale to an intentionally defective grantor trust (IDGT), you can add important income tax benefits to the transfer tax benefits of a family installment sale. An irrevocable trust achieves the status of being an IDGT (also called a "grantor trust") if it contains certain provisions. One provision found in many trusts is to provide the grantor the power to take assets out of the trust by substituting assets of equivalent value. The effect of a trust being a "grantor trust" is that the individual grantor and the trust are treated as the same taxpayer for income tax purposes (this is true even though the assets in the irrevocable grantor trust are outside of the grantor's estate). This means that transactions like the sales of assets between a grantor and a grantor trust produce no income tax consequences. The transactions are simply ignored.

Mechanics of the Strategy

Here's how you do an installment sale to an IDGT.

1. Create an irrevocable trust for the benefit of your children or grandchildren.
2. Seed the trust with assets worth at least 10% of the value of the assets to be sold to the trust, or have the beneficiaries guarantee a portion of the sale payments to avoid the argument that the sale isn't commercially reasonable.
3. Sell assets to the trust that are expected to grow rapidly in value. The assets sold to the IDGT are typically assets that also qualify for valuation discounts, like FLP interests.
4. Set the interest rate on the note at the lowest rate allowable under tax law (AFR) to avoid the imputation of a gift.
5. Set the sale price equal to the FMV of the assets sold so there is no taxable gift.
6. If the total return on the trust assets after they are sold to the trust exceeds the AFR, assets are transferred tax-free to the trust beneficiaries.

Tax Benefits

Installment sales to IDGTs, being grantor trusts, produce the following income tax benefits:

- The grantor recognizes no gain on the sale;
- The grantor has no income tax on the interest payments received from the trust; and
- The trust recognizes no gain if it makes payments with appreciated assets.

Installment sales to IDGTs also produce the following transfer tax benefits.

- If the total return on the assets sold exceeds the interest rate on the note, assets are transferred tax-free to the trust beneficiaries. This is basic interest rate arbitrage.
- The tax-free transfer to the IDGT can be enhanced by transferring discounted assets. Valuation discounts are discussed in Chapter 5.
- Payment by the grantor of the income tax generated by trust-owned assets provides a further enhancement. This payment of the trust's income tax is called a tax burn and is discussed in Chapter 6.
- Finally, the property could be sold to the IDGT for a private annuity that ceases payments at the grantor/seller's death. The trust could also pay in the form of a self-canceling installment note (SCIN), which has a death terminating feature that cancels payments if the seller dies before the note is paid off. Both the private annuity and SCIN provide transfer tax savings if the grantor passes away before the IDGT has made enough payments to fully pay for the asset. These strategies are discussed in Chapter 8.

Intra-family Loans

Another strategy that takes advantage of interest rate arbitrage is the intra-family loan. When applicable federal rates (AFRs) are very low, as they are now, intra-family loans from parents to children can produce substantial tax-free transfers. If the children can invest the borrowed funds at a rate that exceeds the AFR, the difference represents a tax-free increase in the children's wealth. The current AFRs are lower than current returns on most stocks or bonds. The following example shows the potential power of the intra-family loan strategy.

Example 10. Father loans $1 million to Child and takes back an eight-year, interest-only balloon note. The interest rate on the note matches the federal mid-term rate, which at the time is 2.10%. This makes the annual interest payments $21,000. Child invests the money in an S&P 500 index fund that produces a 10% return.

At the end of eight years, Child's investment has grown to $2,143,589. Assume that Father could invest the payments received from Child at the same 10% rate as Child. The future value of a payment stream of $22,100 appreciated at 10% for eight years is $252,733. Thus, the amount Father ends up owning after eight years using the loan payments is $1,252,733. Father has transferred $2,143,589 from his estate and taken back $1,252,733, a net transfer to Child of $890,856. Because there was no taxable gift, this amount is a tax-free gift to Child. Assuming a 40% transfer tax rate, the tax savings is $356,342.

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Chapter 5 – Valuation Discounts

Discounts can be used to substantially reduce the value of property transferred by gift or the property included in a taxpayer's estate. Three important discounts in gift and estate planning are minority interest discounts, marketability discounts, and fractional interest discounts.

Minority Interest and Marketability Discounts

Minority interest and marketability discounts apply to ownership interests in closely held businesses like family limited partnerships (FLPs), limited liability companies (LLCs), and privately held corporations.

A minority interest discount reflects the fact that a minority owner lacks control over the operation of the business. These operations include the power to:

1. set company policy,
2. appoint management,
3. determine management compensation,
4. make distributions,
5. acquire and dispose of business assets,
6. select vendors and suppliers,
7. make distributions,
8. set dividend policy,
9. make business acquisitions,
10. acquire businesses, and
11. block any of the above actions.

A marketability discount reflects the lack of an existing market for interests in a family business and the difficulty of liquidating the investment. Discounts ranging from 20% to 30% are frequently used.

Interests in closely held businesses generally qualify for both kinds of discounts. When this is the case, the two discounts are applied serially.

Example 11. Father transfers a minority interest in ABC Limited Partnership to his daughter. The undiscounted value of the interest is $1,000,000. Suppose that the limited partnership interests qualify for a 25% minority interest discount and a 30% lack of marketability discount. The discounted value is $1,000,000 x .75 x .70 = $525,000, making the total discount 47.5%.

Discounted assets can also be used to greatly increase the amount of annual exclusion gifts. The following chart shows the increase in the $15,000 annual exclusion amount (year 2018) for various discount percentages.

Discount %	Effective Exclusion Amount
10%	$15,000/.90 = $16,667
15%	$15,000/.85 = $17,647
20%	$15,000/.80 = $18,750
25%	$15,000/.75 = $20,000
30%	$15,000/.70 = $21,429
40%	$15,000/.60 = $25,000
50%	$15,000/.50 = $30,000

Discounts are easier to obtain for assets transferred during life than for assets transferred at death. For lifetime transfers, discounts are available for simultaneous transfers of minority interests in a business to multiple recipients even though the sum of the interests adds up to a controlling interest. This isn't the case when these kinds of interests are transferred at death.

Example 12: T owns 80% of the partnership interests in XYZ partnership. T transfers a 20% interest to each of his three children during his life. The transfers aren't aggregated for purposes of determining their gift tax value. Instead, each gift is valued separately, and minority interest discounts are available. By contrast, if T had held the interests until death, T's estate wouldn't have been entitled to a minority discount because collectively the interests represented more than 50% ownership.

Fractional Interest Discounts

Taxpayers often own property as "tenants in common." This is a form of concurrent ownership in which each owner has an undivided interest in the whole property. Each party's ownership is a fraction of the value of the property. It is similar to a joint tenancy except that there is no right of survivorship. Fractional interests are generally difficult to sell because the consent of all owners may be necessary to make decisions. Under state law, however, tenants in common can ordinarily sue for a partition of the property or a judicial sale, with the sale proceeds divided according to the tenants' ownership percentages.

The IRS has generally taken the position that fractional interest discounts should be limited to the cost of partitioning the property.

Example 13. B owns a 50% undivided interest in real estate that is worth $400,000 as a whole. It would cost $10,000 to partition the property. According to the IRS traditional position, B's interest is worth $195,000 (50% of $400,000 minus 50% of $10,000).

Despite the wishes of the IRS, courts have allowed deeper discount, because partition costs alone don't reflect the seller's lack of control and the difficulty in selling an undivided fractional interest. Discounts have typically been less deep than discounts for FLP interests, however, generally ranging from 10% to 20% percent. Taxpayers must prove that a discount is appropriate with satisfactory evidence. The best evidence is the opinion of a real estate dealer or appraiser backed by numbers from actual sales of fractional interests in the same or similar property.

Chapter 6 – The Tax Burn Strategy

Historically, taxpayers could achieve large tax savings by creating an irrevocable trust. Many years ago, trusts were taxed at income rates much lower than those applicable to individuals. Taxpayers would also create multiple trusts rather than just one trust, as this would provide the opportunity to use the low trust tax brackets numerous times. To block this strategy, Congress enacted the "grantor trust" rules.

An irrevocable "grantor trust" is the same as an intentionally defective grantor trust (IDGT).

The grantor trust rules can be triggered by many different trust provisions, some of which relate to the grantor retaining too much control over or benefit from the trust assets. (A popular provision is to provide the grantor the power to swap assets in and out of the trust, as long as they are of equivalent value.)

No matter how "grantor trust" status is triggered, the effect is that trust-generated income is taxed to the grantor at his or her individual rates (even though the income stays in the trust or is distributed to trust beneficiaries). This eliminates the multiple bracket ride.

Also, when a trust is a taxpaying entity (i.e., is a "non-grantor trust"), trust income tax brackets are now compressed so that trust income rapidly moves into the higher brackets. For 2018, the highest trust tax rate of 37% is reached with only $12,500 of income. Individual taxpayers don't hit that high 37% rate until exceeding $500,000 of income if single or $600,000 if married filing jointly.

It might seem that taxing the individual grantor on trust income would be an obstacle to tax savings. The reality, however, is that the grantor trust rules – combined with the fact that irrevocable trusts that are not subject to estate tax – are in fact the foundation of some powerful estate planning strategies.

If the trust itself (or its beneficiaries) were liable for the tax imposed on trust-generated income, the individual grantor's act of paying this income tax would be treated as a gift. The payment by the grantor of the tax bill imposed on a grantor trust's income is not a gift, however, because the grantor is the one who is legally obligated to make this payment. Over a long period of time, these payments by the grantor can produce very large gift tax-free transfers to children or other beneficiaries.

Example 14: Mother transfers $2,000,000 worth of assets to an irrevocable grantor trust for the benefit of Daughter. Presume the assets produce income of 10% before tax and 8% after tax. If the trust pays the income tax, the trust assets will grow at 8% to $6,344,338 after 15 years. If Mother pays the income tax, the assets will grow at their pretax rate of 10 percent, and the value of the trust will be $8,354,963 after 15 years. Thus, payment of the trust's income tax by Mother results in a gift tax-free transfer of $2,010,160 ($8,354,963 - $6,344,338).

The longer the tax burn continues, the greater the gift tax-free transfer. The following chart shows the amount of the tax-free transfer for various time periods based on the facts of the example just described above.

Years	Tax-Free Transfer
5	$282,364
10	$869,635
15	$2,010,160
20	$4,133,086
25	$7,972,462

Over time, paying the tax bill for trust-generated income may create a cash flow problem for the grantor, or the grantor may decide that he no longer wants to pay tax on income he isn't receiving. If so, a provision could be included in the trust allowing the settlor to relinquish grantor trust status so the trust pays its own income tax.

One of the most important applications of the tax burn is the installment sale to IDGTs (i.e., installment sales to grantor trusts). See Chapter 4.

Chapter 7 – Generational Planning (Dynasty Trust)

The key strategy for GST tax planning is the Dynasty Trust. By allocating your gift tax and GST tax exemptions on the initial transfer to this type of irrevocable trust, you can pass assets down through successive generations of your family at no transfer tax cost for as long as the trust is permitted to last under applicable state law. Some states have a maximum term for a trust (called a rule against perpetuities), but many states do not. So if you create your Dynasty Trust in a state that permits perpetual trusts, a one-time use of your gift and GST tax exemptions allows your family to avoid transfer tax forever.

Example 15. Grandpa transfers $5 million to a Dynasty Trust. Grandpa uses his gift and GST tax exemption amounts so there is no current transfer tax. The trust provides that the trustee has discretion to make distributions to Child for life, then upon Child's death has discretion to make distributions to Child's children for life, then to Child's grandchildren for life, and so on down through the generations of Child's family.

No estate tax is due when Grandpa dies, because the assets are in an irrevocable trust. No estate tax is paid when Child dies because he has only a life estate in the trust assets and does not control their disposition (through, say, a general power of appointment). There is no estate inclusion at the death of each succeeding beneficiary for the entire duration of the trust. No GST tax will be owed when the trust terminates and the trust property is distributed to the last beneficiaries, even though they will be many generations below Grandpa (this is because allocating the GST exemption to the initial gifts to the trust "inoculates" its assets from the GST tax forever, no matter how large they grow).

The following examples show the power of the strategy over a long period of time.

Example 16. Grandma transfers $5 million to a Dynasty Trust for the benefit of her heirs. Assume that all trust income is transferred to descendants at each generation so there is no appreciation in value. The chart below compares (i) the family's wealth at the end of each generation if a Dynasty Trust is used (no estate tax) with (ii) the family's wealth if they distributed all income and had not put assets in trust (40% estate tax at death of each generation).

Generation	Dynasty Trust	No Dynasty Trust
1	$5,000,000	$10,000,000
2	$5,000,000	$6,000,000
3	$5,000,000	$3,600,000
4	$5,000,000	$2,160,000
5	$5,000,000	$1,296,000
6	$5,000,000	$777,600
7	$5,000,000	$466,560

Example 17. Assume the same facts as in Example 16 except that the Dynasty Trust makes no distributions, instead accumulating value for future generations. Assume further that the trust assets grow at 7% after income tax and that the generations of the family are 30 years apart. The following chart shows the wealth accumulation of the Dynasty Trust at the end of each generation.

Generation	Dynasty Trust Value
1	$5,000,000
2	$38,061,295
3	$289,732,134
4	$2,205,514,898
5	$16,788,938,780
6	$127,801,681,050

Sales to Dynasty Trusts

The future value of a Dynasty Trust can also be enhanced by selling assets to the trust that are expected to appreciate rapidly in value. Provided that the sale is for adequate and full consideration, there will be no taxable gift. This enables you to increase the funding to the trust, in effect amplifying the gift, estate, and GST exemptions.

Life Insurance Inside the Dynasty Trust

The value of the GST tax exemption amount can also be maximized by funding the Dynasty Trust with life insurance.

- Life insurance in a Dynasty Trust – on the lives of the grantors and on the lives of successive generations of trust beneficiaries – is one of the best assets for this purpose because it has a relatively low value when purchased that can increase to a very substantial value when the insured dies.
- While the insured or insureds are alive, the cash value appreciation of the policy is not subject to income tax as it grows. The trustee could nonetheless access the policy's cash (tax-free up to basis) if those funds were needed to make distributions to trust beneficiaries.
- Life insurance proceeds aren't subject to income tax when received by the trust. This means that death benefit from a life insurance contract, even when in an irrevocable Dynasty Trust that escapes estate tax, provides the equivalent of a step-up in basis at death. Other assets offer a basis step-up only if they are in a decedent's estate (and subject to estate tax) at death.

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Chapter 8 – Hedging Bet-to-Live and Bet-to-Die Strategies

For some lifetime estate planning strategies, the longer the taxpayer lives the better the strategy works. For other strategies, the strategy works better the shorter the taxpayer lives (within limits, and purely from a wealth transfer perspective).

The former are called bet-to-live strategies and the latter bet-to-die strategies. Taxpayers with actual life expectancies longer than their actuarial life expectancies might benefit from using bet-to-live strategies. Taxpayers with unusually short life expectancies might benefit from using bet-to die strategies. Taxpayers who don't clearly fall into either category might wish to hedge their bets by using a combination of the two.

Bet-to-Live Strategies

A good example of a bet-to-live strategy is a Charitable Remainder Trust (CRT) for a taxpayer's life. This involves an irrevocable trust in which a donor transfers property to the trust and retains an annuity or unitrust interest for life. The remainder interest passes to charity when the donor dies. (Not all CRTs have to endure for the donor's life, but that is what is involved in this strategy). The donor receives an income tax charitable deduction for the present value of the remainder interest. The longer the donor lives, the more payments the donor receives and the better the strategy works from an economic perspective. The amount of the income tax charitable deduction is based on the average life expectancy for a person of the donor's age using IRS actuarial tables. Thus, if the donor lives longer, the retained annuity or unitrust interest is undervalued and the remainder interest is overvalued, giving the donor a higher income tax charitable deduction. As for the trust being included in the taxpayer/donor's estate at death, this is generally rendered irrelevant by the unlimited estate tax charitable deduction.

GRATs, installment sales to IDGTs, and the tax burn with IDGTs could also be thought of as bet-to-live strategies, as they work better the longer the grantor lives. If the grantor dies before the end of the GRAT term, the date of death value of the trust assets is generally included in the grantor's estate, eliminating any transfer tax benefit. If a taxpayer sells property to an IDGT and dies prematurely, the tax savings isn't completely eliminated, but it doesn't have time to reach its full potential.

Bet-to-Die Strategies

Bet-to-die strategies can produce much more dramatic tax savings. These tax savings are made possible by the difficulty of determining a person's actual life expectancy. Because lifespans vary considerably, it is never possible to value these interests precisely for transfer tax purposes. This creates a dilemma for the IRS and the courts in deciding how these interests should be valued. One alternative would be to conduct a thorough examination of all the facts and circumstances every time a taxpayer made a transfer. This might involve looking at the taxpayer's medical history, investigating the longevity of ancestors, and obtaining an opinion from the taxpayer's current physician. While this would produce the most accurate valuation possible, it would place an unreasonable burden on the IRS and the courts.

At the same time, the courts realized that taxpayers could go too far, and that the use of standard government mortality tables for valuing annuities and lifetime interests is improper when the measuring life is of someone who is terminally ill. Eventually, the IRS created regulations that state that taxpayers and the IRS must use standard mortality tables to value a life interest unless the measuring life is of someone who is diagnosed as having a 50% or more probability of dying within one year. The regulations go on to state that if the person lives for at least 18 months after the transfer, it creates a presumption that the person was not terminally ill – meaning the standard mortality tables can be used – and this presumption can be overcome only by clear and convincing evidence.

This means that a person who is so unhealthy that his actual life expectancy is far less than his actuarial life expectancy, but not so unhealthy that he's expected to die within the next year, can engage in transactions that effectively overvalue a retained life interest and greatly understate the value of gifts of remainder interests (thereby saving on gift tax).

There are two vehicles in particular that might be used to create these tax benefits: (i) private annuities and (ii) charitable lead annuity trusts.

Private Annuity Sales

In the context of estate planning, a private annuity sale is generally a sale of property from Parent to Child, or to a trust for Child's benefit, in exchange for a promise by Child or the trust to make annuity payments to Parent for the rest of Parent's life. The annuity is (present) valued to equal the value of the property sold by the Parent, so no gift occurs.

A simple example can be used to show how a private annuity sale can produce dramatic transfer tax savings for the right taxpayer.

Example 18. Dad, age 60, has an actuarial life expectancy of about 24 years but has a medical condition that reduces his actual life expectancy to only four years. At a time when the Section 7520 rate is 2.6%, Dad transfers assets worth $1 million to his children in exchange for a private annuity for his life.

Using the standard IRS mortality tables, an annuity payment of $64,048 is necessary to set the value of the payment stream equal to $1 million and avoid any gift tax consequences on the transfer.

If Dad in fact lives to his actuarial life expectancy, the present value of the annuity stream that's actually paid until Dad's death will be about equal to the value of the property that Dad transferred (so there is no real transfer tax play).

If Dad actually lives for only four years after making the transfer, however, he will transfer $1 million and take back only $256,092, removing $743,908 from the estate on a transfer tax-free basis.

Disadvantages of Private Annuities

There are two important disadvantages of private annuities.

- First, under proposed regulations issued in 2005, if appreciated property was transferred by Parent in exchange for the private annuity, Parent would be income taxed on all built-in gain at the time of the exchange. This unfavorable income tax rule would substantially decrease the transfer tax benefit if the property transferred had a relatively low basis. On the other hand, if high basis assets were transferred for the private annuity, the gain recognition requirement might make little difference, and if cash was exchanged for the private annuity it wouldn't matter at all.
- Second, if you sell the property to a trust or other closed fund, the IRS will generally take the position that you can only value the annuity payments until such time as the trust assets would be expected to exhaust the assets in the trust, given IRS interest rate assumptions (growth at the 7520 rate). The calculation of this test can be complicated, but the following example provides a feel for its effect:

Example 19. At a time when the section 7520 rate is 2.6%, Mom (age 50) sells $1,000,000 of assets to a trust for her children. Mom sets the amount of the annuity payments to a level that would ordinarily avoid any taxable gift ($50,550/year). When the exhausting corpus test is applied, however, there will be a taxable gift of $116,442. The amount of the taxable gift from the exhausting corpus calculation increases with the seller's age. For a 60-year-old, the taxable gift is $153,370, for a 70-year-old $196,882, and for an 80-year-old $249,134.

Thus, private annuity sales work best if you sell high basis assets directly to your beneficiaries instead of to a trust.

Charitable Lead Annuity Trusts (CLATs)

As explained previously, a CLAT is a split interest trust that pays a lead annuity interest to charity and the remainder interest to non-charitable beneficiaries like the donor's children. Lifetime CLATs can be used as a bet-to-die strategy in much the same way as a private annuity sale. If the person who is the measuring life for the lead annuity interest has a life expectancy that is more than one year but far less than the person's actuarial life expectancy, only a few payments will be made and there will be a large tax-free transfer to children. The same exhausting corpus rule applies to CLATs, but no gain is recognized on appreciated assets when the assets are transferred to the trust.

Self-Canceling Installment Notes (SCINs)

A SCIN involves the sale of an asset for an installment note, but the buyer's obligation to make payments terminates if the seller dies before the end of the note's stated term. To compensate the seller for the possibility that the payments will be cut short due to death – and to make sure that the note's value is equal to the property sold, so that no gift is made – the buyer pays extra money that is added either to the principal amount of the note or to the interest rate. Even if the seller dies during the note term, the buyer owns the asset purchased with no further payments. Neither the asset nor the note is included in the seller's estate for tax purposes.

Example 20: Auntie, age 65, owns Blackacre, vacant land with a fair market value of $1,000,000. Auntie sells Blackacre to Nephew and takes back an interest-only 10-year installment note that has a balloon payment of $1,000,000 at the end of the 10-year term. To compensate Auntie for the possibility that she will die – and payments to her will stop – before all payments on the note have been made, the interest rate is increased to 4.964%. This makes the annual interest payments $49,640. Auntie dies after receiving the Year 4 payment, and because she died, future payments on the SCIN are canceled. Nephew now owns Blackacre. Auntie's estate owes no estate tax on the note or on Blackacre. Auntie has transferred $1,000,000 worth of property out of her estate for a total of $198,560 ($49,640 x 4). Thus, $801,440 ($1,000,000 - $198,560) is removed from Auntie's estate without the imposition of any transfer taxes.

A word of caution is in order for SCINs, however. The IRS takes the position that the 50% rule explained above doesn't apply to SCINs so that actual life expectancy must be used. Thus, SCINs are introduced here for their value as a component of a hedge rather than as a stand-alone bet-to-die strategy.

Hedging Bet-to-Live and Bet-to-Die Strategies

Research indicates that people tend to be risk averse. For example, most people would prefer a 100% chance of winning $50,000 to a 50% chance of winning $100,000. They would only choose the riskier option if its expected return was significantly higher than the expected return for the safer option. Thus, they might need a 50% chance of winning perhaps $120,000, providing an expected return of $60,000 (.5 x $120,000) to make the riskier option desirable.

A common strategy for reducing risk on investments is hedging. This involves reducing the risk of an investment by taking an offsetting position. For example, an investor might take a long position in a stock (where he wins if the stock's value rises) and sell the same stock short (where he wins if the stock's value decreases). By doing so, he hopes to achieve a gain, or at least avoid a loss, no matter what direction the market takes. Hedging generally limits the range of possible returns, eliminating the possibility of unfavorable returns but also limiting the investor's upside potential.

Hedging may also be a favorable strategy for risk-averse estate planners. It may be possible to combine bet-to-live and bet-to die strategies to avoid unfavorable outcomes or to reduce estate tax regardless of how long the taxpayer lives.

Combine traditional installment note with SCIN

One example is to sell an asset to an IDGT partly for a traditional installment note and partly for a self-canceling installment note (SCIN).

- If the seller survives until the end of the installment note received from the IDGT, and the transferred assets grow faster than the interest rate on the note, the combination of interest rate arbitrage, valuation discounts, and the tax burn will produce substantial estate planning benefits. If the seller dies early in the note term, however, these benefits will be greatly reduced.
- To provide protection against the possibility of dying early, the seller may wish to also use a SCIN. If the seller dies during the note term, the interest rate arbitrage and tax burn benefits will be reduced, but the payments to the seller will be cut short, often greatly reducing the amounts coming back into the seller's estate. The earlier in the term the seller dies, the greater the tax-free transfer will be. The downside is that if the grantor survives the SCIN's term, however, more value will come back into the seller's estate than if she had used a straight installment sale because of the risk premium.

Hedge with life insurance

Another way to hedge the risk of dying early before a bet-to-live estate planning strategy (e.g., CRT, GRAT) has had time to produce substantial benefits is with life insurance. The policy's death benefit is not subject to income tax, and if the insured dies early, the proceeds will likely far exceed the amount of premiums paid. This can add substantial wealth to the insured's estate and transfer substantial wealth to the insured's beneficiaries. Moreover, if the policy is owned by someone other than the insured, for example by an irrevocable trust, the income tax-free proceeds also won't be subject to estate tax.

Chapter 9 – Payment of Estate Taxes

Depending on your net worth, you may still be projected to owe state and/or federal estate tax, even after implementing the various estate planning strategies mentioned previously. Depending on what you own at death, there are a variety of methods for paying estate tax.

Use Existing Assets to Pay Estate Taxes

1. Liquid assets.

   Assets such as cash, money-market accounts, equities, and other liquid investments can be used to pay estate taxes.

2. Closely held business interests.

   If you own any closely held business interests, your estate can sell the business. Possible buyers include children, a third party, or the business itself. Your estate's basis in the business is generally the fair market value on the date of death. If the business interest is then sold for fair market value (i.e., the estate's basis), there generally is no income taxable gain to the estate upon the sale.

   • Sell to children.

   One of your goals may involve transferring your business to your children. Although a sale will accomplish your goal of getting the business to your children, in the absence of any planning, your children may not have the funds to buy the business. What's more, if your goal was to transfer the business to your children gratuitously so as to increase their wealth, having them buy the business for fair market value doesn't particularly enhance their wealth after you die (particularly if the sale proceeds received by your estate are willed elsewhere, like to a charity).

   • Sell to third party.

   With a sale to a third party, there are some considerations and potential drawbacks:

   o There is no guarantee that your estate will be able to sell the business in a timely manner (estate taxes are generally due nine months after death).

   o Even if your estate can sell the business, a buyer might not be willing to pay what your estate thinks the business is worth (this is especially true if the buyer knows the estate is under pressure to sell quickly).

   o Even if your estate can sell the business for the right amount, consider that your heirs might end up with less than you wish after estate taxes are paid out of the sale proceeds.

   o This does not accomplish your goal of passing the business to your children (or perhaps to employees, if they are not the buyers either).

   • Sell back to corporation (redemption).

   If a C corporation has family members as shareholders, the corporation's purchase of stock from a family member may result in dividend treatment for the selling shareholder, rather than the typical and more favorable "sale or exchange" treatment. This is a bad result, as it converts the sale price to ordinary income rather than capital gain, with no offset for basis. A partial solution to this dividend problem is found with a so-called § 303 redemption. Under this rule, a closely held C corporation can redeem stock for the purpose of helping the estate of the deceased shareholder pay estate taxes and expenses, and the redemption won't be treated as a dividend. Among the requirements that must be met are:

   o The stock comprises more than 35% of the value of the adjusted gross estate.

   o The amount paid for the stock does not exceed the amount of all federal and state estate and inheritance taxes (including interest) and funeral and administration expenses allowable as an estate tax deduction.

Another issue when selling to the corporation is that there must be other shareholders; otherwise the redemption of your 100% ownership interest would simply be a liquidation of the business. For example, if you wanted to pass the business to your children, you would generally want each of them to own at least one share each before your shares are redeemed. To achieve this, you could pass one share to each child before death or perhaps even at death. The corporation can subsequently redeem your stock. After that, the children will own all outstanding stock – 100% of the business – thus accomplishing your primary goal. However, unless the corporation has enough cash, finding the purchase money without further planning remains a major hurdle.

Borrow to Pay Estate Taxes

1. Bank loan.

Your estate can borrow money from a bank to help pay estate taxes and expenses. The interest will be at the then market rate; the bank will also likely require collateral. If your estate borrows and now has the cash to pay taxes, it will not be forced to sell the business to a third party, allowing your business to pass to your children. Also, interest on funds borrowed to pay federal estate taxes is generally deductible against the estate tax as a cost of administering the estate.

Possible downsides of borrowing from a bank include the following:

- Your estate may not qualify for a large enough loan.
- The loan principal and interest must be paid back to the bank.
- If loan payments cannot be made, it may become necessary to sell the business to repay the bank.

2. Government loan - § 6166.

Your estate can elect to pay the estate tax on the business in installments – essentially borrowing from the government – if the value of the business exceeds 35% of your adjusted gross estate. With a $7 million business, your estate must pay about $1.4 million of estate tax (on the $3 million of non-business assets) within nine months of your death. As for the $3.4 million of estate tax on the business, the estate pays interest only for the first five years, followed by up to 10 annual installments of principal and interest. A special 2% interest rate applies to the estate tax on the first $1,520,000 of the business value (2018 figure). The interest on the balance is 45% of the regular underpayment rate, which is the federal short term rate plus three percentage points.

At first glance, this option might look attractive your estate, particularly the rather low interest rates. However, there can be some negatives

- The estate must remain open for the duration of the payments.
- The estate is saddled with an obligation to the U.S. government.
- The availability of credit for the business might be limited since banks are not willing to be second in line behind the government.
- Transferring the business is restricted since the deferred estate tax is accelerated if more than 50% of the value of the business interest is disposed of, if money or property withdrawn from the business interest exceeds 50% of its value, or if a payment of principal or interest is missed.
- The interest cannot be deducted by your estate.
- Finally, given the low interest rates the past few years, the government's "special" 2% rate is no longer special, making this less financially attractive.

If no planning has been done, this option may prove to be a good fall-back option.

Use Life Insurance to Pay Estate Taxes

Life insurance is very often a critical component of a plan to help pay estate taxes, in addition to serving other needs, such as providing a legacy for your family, assisting a loved one who has special needs, or charitable planning.

Life insurance is great for paying estate taxes for several reasons:

- The death benefit is received income tax-free.
- It provides cash at the exact time it is needed, i.e., when your estate will need to pay estate taxes or otherwise carry out the wishes laid out in your estate planning documents.
- If it not owned by the insured, the life insurance proceeds are generally not subject to estate taxes.
- Life insurance is also very cost efficient when comparing the cost of premiums with the death benefit.

Depending on your circumstances, there are a number of ways to use life insurance in your plan.

One example for business owners is for the purchaser of the business (perhaps your children or a key employee) to purchase and own a life insurance policy on your life. At your death, the beneficiaries will use the death benefit to buy the business (or a portion of it) from your estate.

1. Children own life insurance.

Your children can own life insurance on your life and also be the beneficiaries. If your children work in the business, the business can pay the premiums and treat it as taxable income to the children and deductible compensation for the business (assuming it is reasonable compensation). Upon your death, the death benefit is not included in your estate, and the children receive cash income tax-free from the insurance company. Your children then use the death benefit to buy the business from your estate. Of course things can happen to your children before you die, which may jeopardize this use of life insurance. For example, a child can become divorced or have creditor problems, both of which could divert the life insurance away from its intended use.

2. Business owns life insurance.

Your business can own life insurance on your life and will be the beneficiary. In fact, this option may be more attractive than ever given the new 21% corporate tax rate for C corporations, and the fact that cash value and/or death benefit is no longer subject to corporate AMT under the new tax law.

The payment of premiums is not deductible to the business. Upon your death, the death benefit paid to the business is not included in your estate directly, and to the extent it might increase the value of the business, this is normally offset by your business' obligation to redeem your stock. The business then uses the death benefit to buy the business from your estate. However, in order to avoid dividend treatment, this solution is effectively limited to the § 303 redemption amount. Any stock not purchased in a § 303 redemption can pass to your children under your estate plan. If the estate's cash needs are limited to estate taxes and funeral and administration expenses, the § 303 limitation should not create a problem.

3. Irrevocable life insurance trust (ILIT) owns life insurance.

An ILIT can be the owner and beneficiary of the life insurance. Upon your death, the death proceeds are not in your estate and are not income taxable.

The ILIT could then use the death benefit to buy the business from your estate and subsequently hold the business interests for your children, or simply distribute those interests from the trust to your children.

The ILIT could instead lend money to the estate, so that the executor has sufficient cash to pay estate taxes. The loan could be paid back with some of the business interests or with other assets that the trustee would have an easier time handling (e.g., marketable securities). The bulk of the business interests would not be transferred to or through the trust, but instead would be distributed from the estate directly to the children.

There are several ways to get the funds into the ILIT to pay life insurance premiums.

- Gifts from grantor / insured.

You could give funds to the ILIT to pay the premiums. The size of the gifts might fall within the annual exclusion ($15,000 per trust beneficiary in 2018, or double that if you are married). If the gifts exceed that amount, they would be taxable gifts, but wouldn't trigger an out-of-pocket gift tax until they exceed your gift tax exemption ($11.18 million in 2018; double that if you are married).

- Loans from grantor / insured or from the business.

If you want to dial down the gift tax implications, you could lend funds to the ILIT. This is frequently referred to as a "private loan" or "split dollar treated as a loan."

You would have to charge the trust a market rate of interest (again, based on the applicable federal rate (AFR)), otherwise the foregone interest would be imputed and be deemed a gift from you to the trust. It is usually best to charge interest, as the interest-imputation rules can be complicated and can have more costly results than you might expect.

If you don't have the cash, the loan could come from the business instead. If this is done, it is essentially treated as compensation or a loan from the business to you and a loan or a gift (among other options) from you to the ILIT.

In either case, paying the premiums through loans presents the downside of not knowing, today, what the relevant interest rate will be for future loans (i.e., when premium payments are due in future years).

An upside of the private loan is that the annual gift to the trust needs to be only about the size of the AFR interest amount on the loan (rather than the entire premium), and if the cash value ultimately grows to be substantially larger than the cumulative premiums (i.e., the loan principal), the ILIT could withdraw cash from the policy to pay back much or all of the loan and still have excess cash value to keep the policy afloat.

- Loans from bank (premium financing).

If you and your business are short on cash or would prefer to use your cash elsewhere, the ILIT could borrow from a bank. If you understand the mechanics and reasoning of why someone borrows from a bank to buy a house or car, you understand the same when a trust borrows to buy life insurance.

These situations are often referred to as "premium financing." As with any loans, the terms could vary widely, but they differ from private loans in that the interest rate charged by the bank will be higher than the applicable federal rate, and the bank is more likely to require regular (perhaps monthly) payments of at least the interest amount. Also, if the ILIT finds that it does not have sufficient assets to repay the loan when it is due, a third-party bank lender likely will be less forgiving than you or your business would be as a lender.

Nonetheless, there are banks that have special programs that are designed to facilitate the making of loans to irrevocable trusts (and others) to buy life insurance, and are particularly fond of doing so when the borrower will buy from an insurance company that issues permanent policies with healthy cash values.

- Non-Equity Split Dollar.

Structurally, this is similar to you or your business lending money to the trust to buy life insurance, as you or your business pay the premiums for the policy, and the trust owes money to you or the business.

With non-equity split dollar, however, the amount the trust owes to you or the business is not the premiums paid (loan principal) plus interest, but instead is the fair market value of the policy (roughly, its cash value) at any given time.

Tax-wise, this arrangement is nearly identical to you owning the policy and endorsing some portion of death benefit – and only death benefit – to the irrevocable trust. It is just that non-equity split dollar makes it more certain than an endorsement arrangement that the death benefit paid to the ILIT will not be subject to estate taxes if you die while the plan is in place.

Akin to any endorsement of death benefit, the annual gift from you to the ILIT is the cost of insurance controlled by the trust. This is often called the Value of Economic Benefit (VEB), and it is based on the age of the insured(s), the amount of death benefit controlled by the trust, and the term rate table used by the parties. The resulting VEB amount that's given to the ILIT can be an incredibly small number, much smaller than an annual interest rate on a loan.

Whether you use a loan or a non-equity split dollar plan, you should have a good idea of how you and the trust are going to exit the plan before you get into it. It might be painful to try to exit a premium financing arrangement with a bank if, in the future, loan interest rates rise faster than expected and policy cash values grow more slowly than illustrated.

No matter who you choose to own the life insurance or how to pay for it, most any plan works better with a permanent life insurance contract from a quality company that has a history of providing high-performing cash value and death benefit.

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Chapter 10 – Choosing the Right Life Insurance Product

Financial Planning and Its Importance to Estate Tax Planning

The first step in considering any life insurance policy involves the design of the product, as well as the proper amount of death benefit. To determine the proper amount of death benefit, that process starts with your financial plan. Now is the time to update your financial plan, to take into account the new tax law and any changes in your personal circumstances or financial goals. From an estate planning perspective, it is critical to get an understanding of what your estate is projected to be worth at your death as opposed to what you are worth today. This will account for growth in the estate over time, as well as any spending and other outflows, including charitable contributions, legacy goals, the cost of any long-term care expenses over time, and retirement income, among others.

The next step of the financial planning process is to calculate the amount of federal and state estate taxes your estate will owe using either current or projected estate tax exemption amounts. It is important to remember that it is not the estate tax exemption and rates that are in place today that will determine how much estate tax will be owed, but rather the law in place at your death. Throughout history, we have seen numerous changes to estate tax laws, ranging from full repeal to both increasing and decreasing tax rates. This uncertainty—as well any likely changes to the laws in the future—is but one situation where we believe that you benefit from having some flexibility built into the insurance product that you select as part of your overall financial plan.

The Various Types of Life Insurance Products and Estate Planning Considerations

Product Type	Advantages	Disadvantages
Term Insurance	• Death benefit is paid tax-free • Low cost • May be convertible to a UL or WL product (generally not UL-G)	• High probability of outliving the coverage period • Death benefit remains level and may not cover future growth in estate tax liability
Universal Life (UL)	• Death benefit is income tax-free • Can be designed to provide an increasing death benefit • May provide premium flexibility • Policy cash value is accessible tax-free either through policy loan or via withdrawal* • Lower ultimate cost considering the potential growth of, and accessibility of, policy cash value • Policy growth has upside potential resulting from positive company experience with respect to expenses, claims (mortality), and investment performance	• Lack of policy guarantees • Larger out-of-pocket premium to help ensure adequate policy funding

* It is important to note that taking policy loans or withdrawals will reduce the death benefit and impact policy cash values.

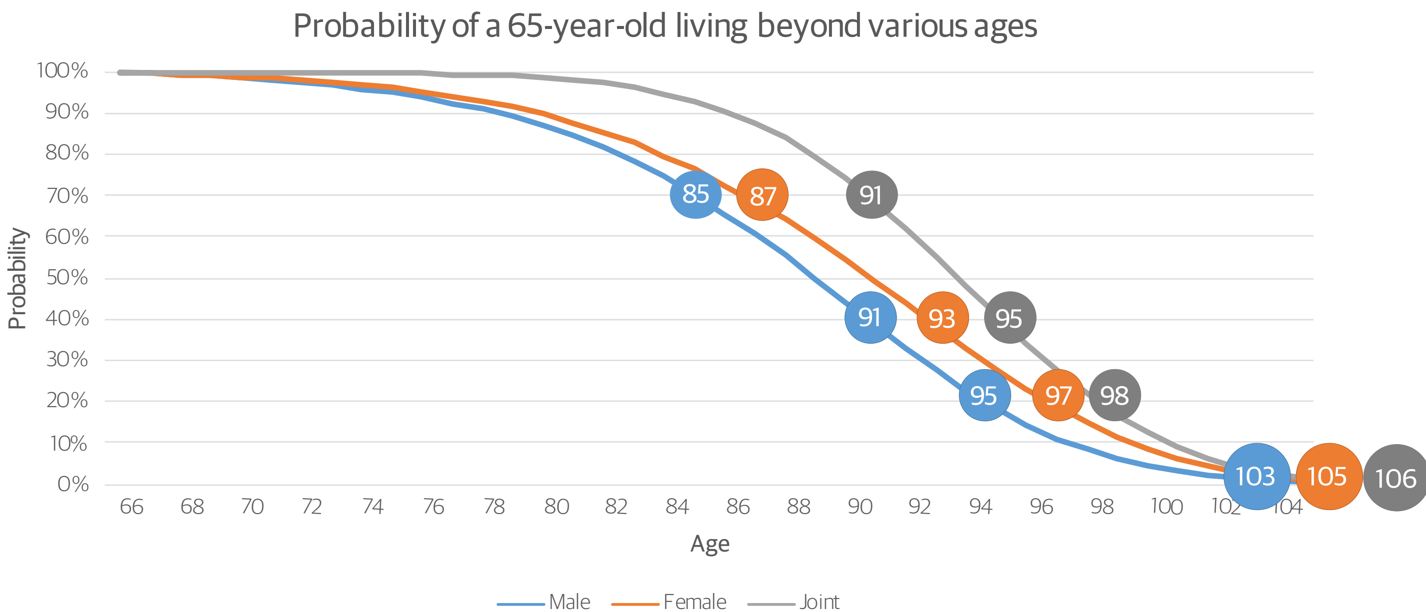
Product Type	Advantages	Disadvantages
Universal Life – Guaranteed (UL-G)	• Death benefit is income tax-free • Lower out-of-pocket premium • Coverage provides a contingent guarantee for a period of time (age 85, 90, or even 120) • Length of the guarantee will affect the cost	• Death benefit remains level and may not cover future growth in estate tax liability • Guarantee may lapse based on a number of possible events o Insured lived past the guarantee period o Missed premium payment o Mistimed premium payments. Premiums paid early or late may not be credited at the intended time and thus would constitute a missed premium payment. o If this type of policy does provide some level of cash accumulation, it may further be subjected to reserve adequacy testing. This means that the guarantee may be contingent upon the cash accumulation meeting a specific threshold determined formulaically. While the formulaic test is disclosed to the policyowner, often the specific threshold amount is not. • Lack of policy cash value accumulation means the policy cannot be supported if the contingent guarantee is lost. The result would be having to pay all internal policy expenses and mortality charges out of pocket to keep the policy inforce. At older ages these costs can be significant and prohibitive. • The policy will not benefit from positive company experience.
Whole Life (WL)	• Death benefit is income tax-free • Increasing death benefit that can keep pace with your growing estate • Guaranteed reliable policy growth that can never go backwards • Policy is an asset where growth is not correlated to any market • Premium payment flexibility depending on policy design • Policy cash value is accessible tax-free either through policy loan or partial surrender • Policy may be reduced to paid-up • Low ultimate cost considering the growth of, and accessibility of, policy cash value • Policy growth has upside potential beyond base guarantees resulting from positive company experience with respect to expenses, claims (mortality), and investment performance	• Larger out-of-pocket premium

Growth of Death Benefit, Flexibility in Paying Premiums

What do we mean when we say "flexibility"? While many regard universal life – guaranteed as the simplest and cheapest life insurance policy available to address estate tax planning needs, other products, such as whole life insurance, can provide both death benefit and cash value accumulation and can serve a variety of planning needs over the course of your lifetime.

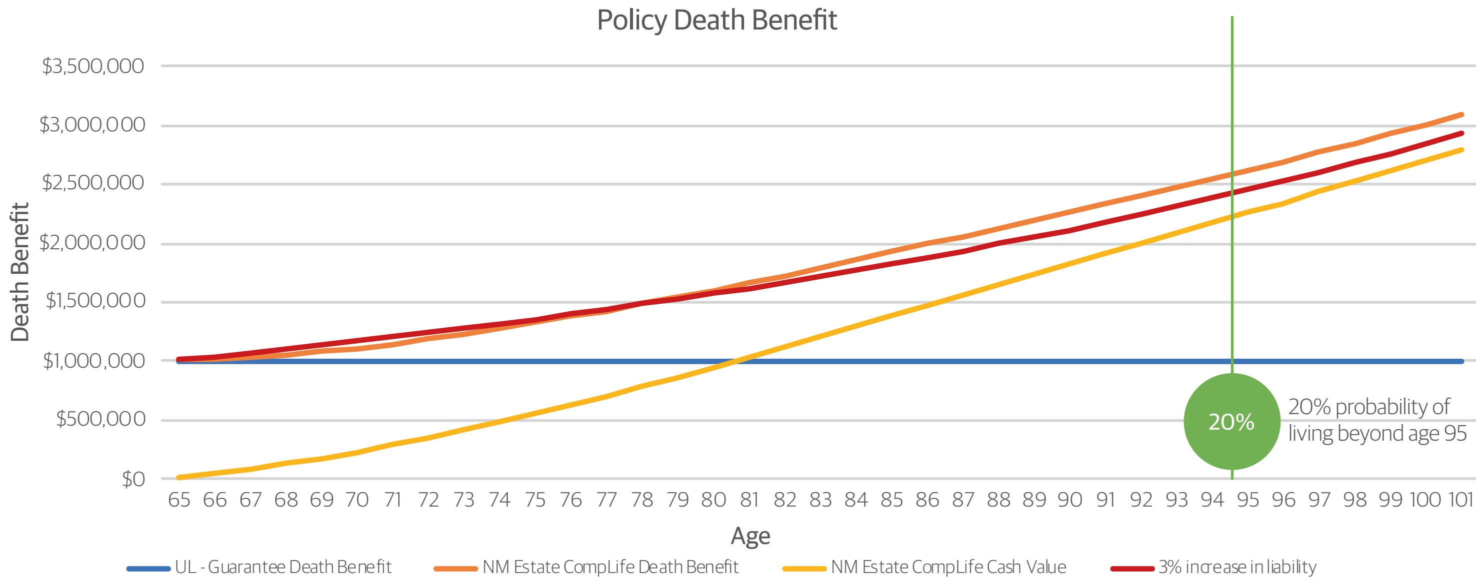
The potential growth of a whole life insurance policy allows it to keep pace with the appreciation in your estate and your planning needs. This also makes it much less likely that you will need to purchase additional insurance in the future, which may or may not be an option for you as you get older and your insurability changes.

Today, people are enjoying heathier, more active life styles and living longer than prior generations. As the chart below illustrates, there is a 40% chance that a healthy 65-year-old male today will live beyond the age of 91. A healthy 65-year-old couple has a 40% chance that one of them will live beyond the age of 95.



Source: Probability of survival data is based on Society of Actuaries 2017 Commissioner Standard Ordinary mortality tables with adjustments made to reflect healthy underwritten individuals.

The following example reflects the growth of the death benefit of a $1,000,000 whole life insurance policy over that of a UL-G non-cash-accumulating policy with a flat death benefit:



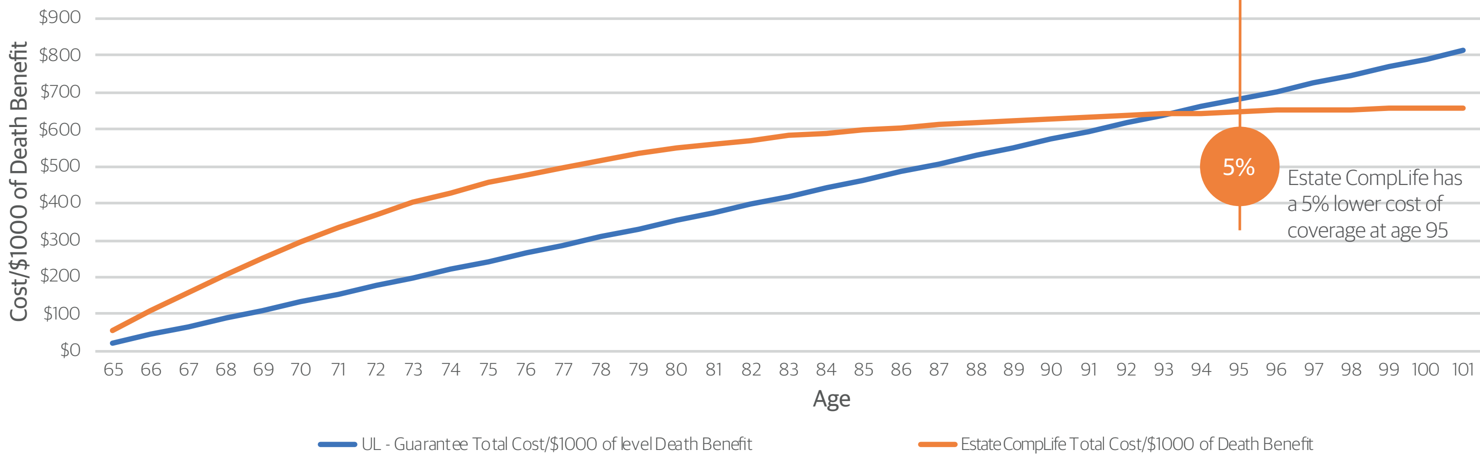
Northwestern Mutual Estate CompLife, All Base, $1mil Death Benefit, Male Age 65, Best Class.
UL - Guaranteed level $1mil Death Benefit policy, Male Age 65, Best Class. Premium amount represents the 2018 average level premium of ten major carriers.

As you can see from this example, the death benefit of the cash value accumulation whole life insurance policy has the ability to grow and keep pace with your growing estate tax liability and to achieve the planning objective for which it was intended. Given that a healthy 65-year-old male has a 20% chance of living beyond age 95, it would be wise planning, if using a level non-cash accumulating policy, to purchase an amount of coverage that may be more likely to meet a future need. In this example, if we assume a 3% increase in the anticipated liability, you need to purchase at least two and half times the amount of non-cash-accumulating coverage today, at two and a half times the annual cost, to meet the future liability amount at age 95.

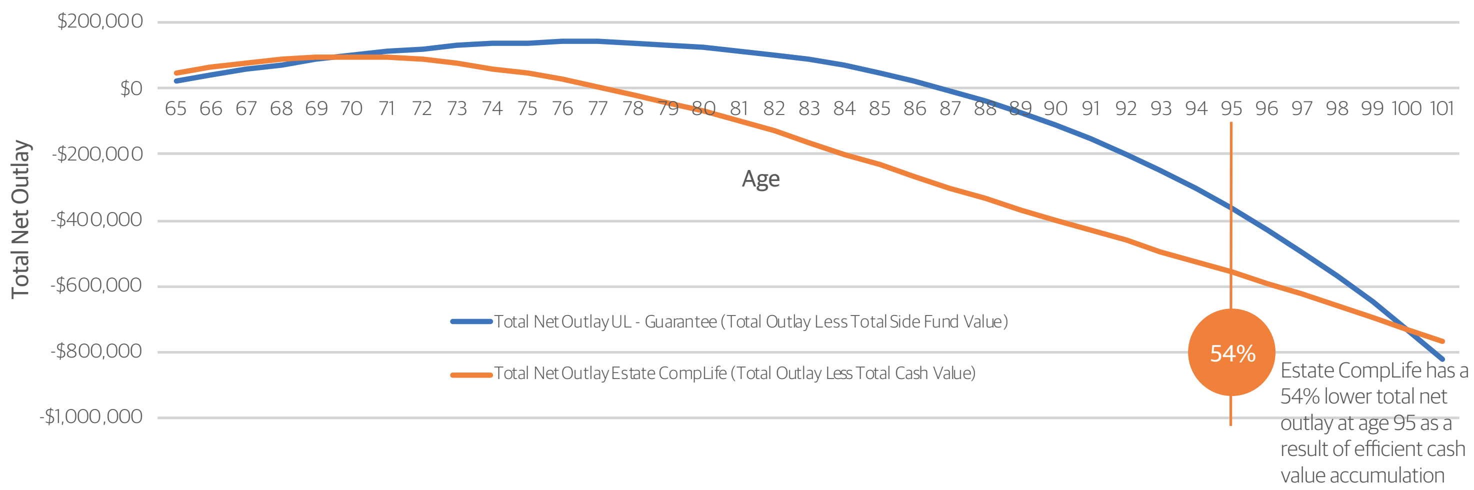
Cost Comparison

The chart below shows the difference in the total cost per $1,000 of death benefit coverage through age 100 between the whole life insurance policy that grows and accumulates policy cash value and the one that doesn't. The cash-accumulating whole life insurance policy has a cost per thousand through age 95 that is 5% less than that of the level non-cash-accumulating policy. When the accessibility of the policy cash value is taken into consideration, the policyowner breaks even in year 13 and has the full advantage of all aspects of the WL policy as outlined in the preceding table comparing the various product types. Taking into account the difference in out-of-pocket outlay between the two policies and investing the difference, you would need to earn a consistent before-tax return of nearly 6% to achieve a similar total net out-of-pocket outlay at age 100. Furthermore, at age 95 the Northwestern Mutual policy would have a total net out-of-pocket outlay of 54% less given the efficiency of its cash value accumulation. It should also be noted that the "investing the difference" approach has additional significant drawbacks, including having the accumulated amounts outside the policy included in the taxable estate, paying ongoing tax on any gains, and the necessity to incur investment risk just to match the growth of the cash-accumulating policy.

Cost/$1,000 of Death Benefit Coverage



Total Net Outlay



Northwestern Mutual Estate CompLife, All Base, $1mil Death Benefit, Male Age 65, Best Class.
UL - Guaranteed level $1mil Death Benefit policy, Male Age 65, Best Class. Premium amount represents the 2018 average level premium of ten major carriers.

As you consider the different forms of life insurance available, it is also important to highlight the differences in the flexibility of premiums. Depending on your financial circumstances, flexibility in how and when to pay the premiums on a policy may be attractive to you. Perhaps you would prefer to reinvest in your business in given years, you may have a lack of liquidity at certain times, or you have other needs for your cash flow. With cash accumulation whole life insurance, you may have premium flexibility to help ensure that your coverage remains in place. Contrast that to other products you may be considering, which typically require you to pay the premium year-in and year-out until you die with no prospects for growth in the policy's death benefit. Permanent insurance can be designed in ways that allow you to stop payments at certain ages, allowing you to accomplish other goals and objectives with the dollars earmarked for the premiums.

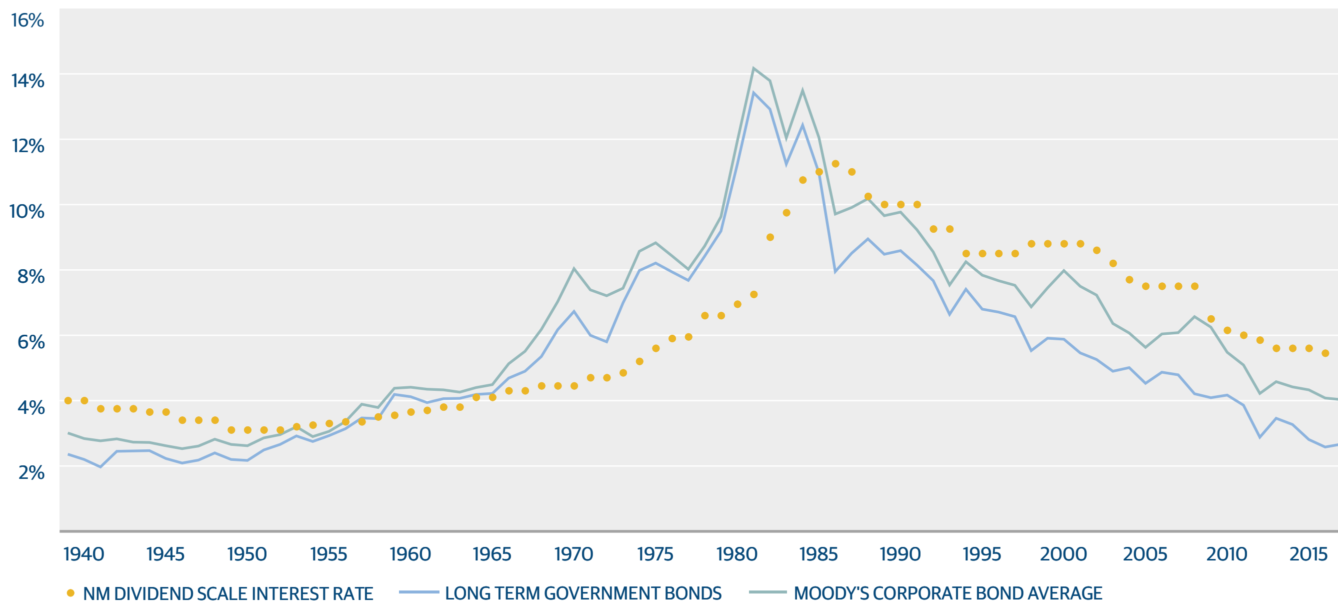
Benefits of Cash Value Accumulation

Whole life insurance cash value, which accumulates on a tax-deferred basis, can offer significant benefits.

The growth of your policy, both cash value and death benefit, is ultimately a reflection of how well the company performs. Better claims experience derived from high-quality underwriting, low expenses through efficient operations, and excellent investment performance reflected through the dividend interest rate all translate to industry-leading policy growth for your premium dollar. Stated another way, excellent policy growth means a lower ultimate cost of coverage. The graph below offers historical perspective on Northwestern Mutual's dividend interest rate:

The Investment Component of Northwestern Mutual's Dividend

A reflection of what the company has earned on its investment portfolio in recent years in relation to bond averages that approximate general market interest rates



*Dividends are not guaranteed on any policy in any given year. The dividend scale is reviewed annually by the Company's Board of Trustees and is subject to change. The interest component of the dividend is not the rate of return on a policy and is only one factor for determining the whole life insurance dividend. The majority of our life insurance dividend payout is a result of persistency, favorable mortality costs and diligent expense management. It is not possible to invest directly in the company's general investment portfolio and its yield is not the same as the interest component of the dividend associated with participating insurance policies or annuity contracts.
Bloomberg: 30 year Treasury Bonds (1929 – Present), Moody's Corporate Bond Average (1984 – Present); The Economic Report of the President 2017: Moody's Aaa Corporate Bonds (1939 – 1983)

Many affluent clients like yourself, whether you are a business owner, real estate investor, or someone who has other uses for your current cash flow, often rely on the cash value in their whole life insurance policies for a variety of reasons. One common use is borrowing. Your whole life insurance policy is a great way to secure a loan, whether from a third-party lender or from the insurance company. Because you're using your life insurance as collateral (i.e., assigning the life insurance policy as a guarantee of loan repayment), you have the option to obtain a loan from either a bank (bank loan) or from the insurance company (policy loan). Given Northwestern Mutual's financial strength and the strength of its products, most banks will readily accept your whole life insurance policies as collateral for loans with the potential of a lower cost given the lower risk.

Asset "Repositioning"

As previously discussed, the cash value—and growth of a whole life insurance policy—benefits from success in keeping expenses low; managing claims experience through careful, consistent underwriting; and sound investing within the insurance company's general account portfolio. The performance of the company's general account portfolio is reflected in the interest rate credited on its permanent life insurance policies. The growth of the policy is not subject to the volatility of the markets, grows tax-deferred, and is guaranteed to grow. For these reasons, many affluent clients like you choose to "reposition" a portion of their net worth into whole life insurance, to diversify your assets and as a hedge against market volatility, which has returned in 2018 after a long absence. Regardless of market performance and your other investments, you can rest assured knowing that your policy is guaranteed to grow. This, in addition to the tax-free death benefit for estate tax purposes, is a significant benefit of whole life insurance for clients like you.

> "...the cash value—and growth of a whole life insurance policy—benefits from success in keeping expenses low...

> "Regardless of market performance and your other investments, you can rest assured knowing that your policy is guaranteed to grow.

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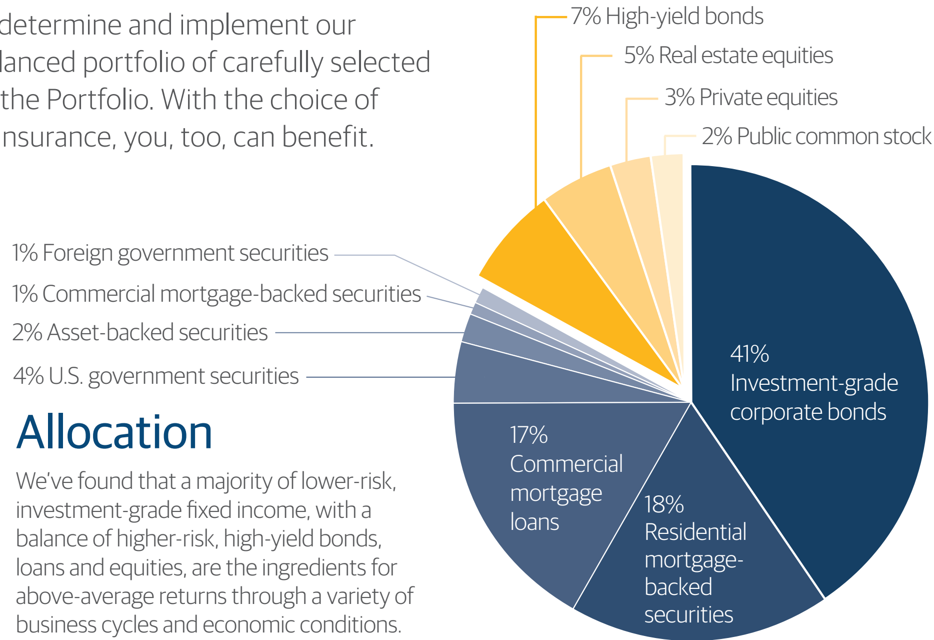
A pillar of our financial strength, Northwestern Mutual's over $200 billion General Account investment portfolio backs our insurance policies and contributes to the dividends paid to policyowners like you.

We're engaged in a $200 billion balancing act: on the one hand, providing the product value that is essential to keeping our clients on the path to financial security; and on the other, maintaining the financial strength that ensures that we'll be here to meet our obligations to you for the life of your policy. Together, these require seeking the highest possible returns while also managing risk.

This takes a large team of experts who determine and implement our strategy to achieve a diversified and balanced portfolio of carefully selected investments. We call this The Power of the Portfolio. With the choice of Northwestern Mutual's permanent life insurance, you, too, can benefit.

83% LOWER-RISK ASSETS
For a stable foundation and current income

17% HIGHER-RISK ASSETS
For greater return potential and incremental diversification



Allocation

We've found that a majority of lower-risk, investment-grade fixed income, with a balance of higher-risk, high-yield bonds, loans and equities, are the ingredients for above-average returns through a variety of business cycles and economic conditions.

Northwestern Mutual General Account asset class performance rank

One-year total returns

	2012	2013	2014	2015	2016
Highest-performing class	Private Mezzanine	Public Equities	Private Equities	Real Estate Equities	Private Mezzanine
	Private Equities	Private Equities	Public Equities	Private Equities	Private Equities
	Public High Yield	Private Mezzanine	Private Mezzanine	Private Mezzanine	Public High Yield
	Public Equities	Real Estate Equities	Real Estate Equities	Real Estate Mortgages	Public Equities
	Real Estate Equities	Public High Yield	Real Estate Mortgages	Private Fixed Income	Real Estate Equities
	Private Fixed Income	Real Estate Mortgages	Public Fixed Income	Public Fixed Income	Private Fixed Income
	Real Estate Mortgages	Private Fixed Income	Private Fixed Income	Public High Yield	Public Fixed Income
Lowest-performing class	Public Fixed Income	Public Fixed Income	Public High Yield	Public Equities	Real Estate Mortgages

Because financial markets are always in flux, no asset class is consistently the best performer (or worst). Diversification across asset classes helps mitigate market unpredictability and capture opportunities as they arise.

"Lower Risk" and "Higher Risk" are general indications of the relative risk of loss of a particular type of investment compared to other investments. Generally, in investing, higher-risk investments offer greater potential return. All investments carry some risk of loss. The vast majority of the company's managed assets back most of its life, disability income and Portfolio Income Annuity liabilities. The investment strategies described apply to the investment of those assets. A portion of managed assets backs the remaining liabilities (primarily fixed deferred annuities, income plans and long-term care insurance), which have different investment exposures. When purchasing the company's life insurance and annuity products, clients are not investing in the company's General Account portfolio but purchasing products backed by the financial strength of Northwestern Mutual.

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Financial Strength: Why NM?

When you buy life insurance to solve estate planning needs, you are purchasing a promise to deliver benefits in the future from the company selling the policy. Because that promise may be outstanding for years, even decades, you want a company backing it that will last at least that long and have the financial standing to pay your claim without hesitation, no matter what. That's why financial strength ratings are important when evaluating insurance companies and their insurance products.

At Northwestern Mutual, we believe financial strength is important. The chart below reflects financial strength ratings from the four major financial ratings agencies:

A++	AAA	Aaa	AA+
A.M. Best	Fitch Ratings	Moody's Investors Service	S&P Global Ratings
The rating takes account of our "leading participating ordinary life insurance franchise, consistently profitable operating performance and supportive risk-adjusted capitalization, along with a well-developed enterprise risk management program."	"Fitch views Northwestern's successful distribution system, large and stable block of traditional life insurance, and expense advantage relative to peers as key competitive advantages."	The ratings reflect "the company's leading positions and strong franchise in its core markets, with a focus on participating whole life insurance, excellent career agency-based distribution, strong underwriting skills, and its robust and resilient balance sheet."	"Extremely strong" competitive position stemming from national presence, top market position, complementary products (including whole life and term insurance, disability income insurance, annuities, mutual funds and long-term care insurance), and dedicated financial representatives.

Third-party ratings are subject to change. *Ratings are for The Northwestern Mutual Life Insurance Company and Northwestern Long Term Care Insurance Company.* Third-party ratings are a measure of the company's relative financial strength and security but are not a reflection of the performance or stability of funds invested in a company's separate accounts. Ratings as of: 01/18 (Moody's Investors Service), 04/18 (A.M. Best Company), 06/18 (Fitch Ratings), 06/18 (S&P Global Ratings).

Ownership: ILIT vs. Flexible ILIT vs. Individually Owned Insurance

Traditionally, clients who purchase life insurance for estate planning needs created an irrevocable trust to own the insurance, ensuring that the death benefit was not included in the value of their estate for estate tax purposes. In many cases, these trusts were designed for the sole purpose of owning the insurance, paying the premium on the policy, collecting the death benefit from the insurance company, and using that cash to lend money to the client's estate or to otherwise purchase assets from the estate, enabling the executor to pay the estate taxes.

With flexible trust planning, permanent life insurance cash values may be utilized during your lifetime.

Over time, with changes to tax laws, the added complexities of life, and changing personal circumstances, more clients like you have benefitted from building more flexibility into their estate plans, including irrevocable trusts. In the estate planning community, these trusts have a number of different names (e.g., Spousal Lifetime Access Trusts, Flexible Trusts, etc.) but share the following characteristics:

1. Spouse, children, grandchildren, and other loved ones are the beneficiaries of the trust.
2. The trustee has the ability to access the cash value in the insurance policy via loans, surrenders, and other methods.
3. The trustee has the discretion to make distributions of that cash value (or other cash or assets) to the beneficiaries while you are still alive.
4. The trust is designed for unexpected circumstances, such as divorce, drug and alcohol dependency, or loved ones with special needs.

You and Northwestern Mutual: Stronger Together

Permanent life insurance from Northwestern Mutual inside an ILIT can provide many benefits, including a legacy for your family, liquidity to pay estate taxes, and protection from creditors. If the ILIT includes certain flexible provisions, cash value in the policy can be available to your family when needed during your lifetime.

You may also consider whether to own at least some insurance individually, which means that the death benefit will be included in your estate at your death, unless you later choose to transfer ownership of the policy to an irrevocable trust. While this may seem novel, individual ownership of whole life insurance provides you with the easiest access to the policy's cash value. It also allows you to benefit from many of the other features of whole life insurance, including the ability to annuitize the contract to provide a guaranteed, steady source of income in retirement to complement your other income, or to purchase long-term care insurance if you opt not to self-insure the cost of care down the road. These are but some of the advantages of owning whole life insurance individually.

Should you later decide that you do not need to own the policy individually, you have a number of options to remove the policy from your estate. You may opt to give the policy to an irrevocable trust, using a portion of your gift tax exemption to cover the amount of the gift (the policy's gift tax transfer value, which is roughly equal, in most cases, to the policy's cash value). Another option is for the trust to purchase the policy from you for the transfer value. A third consideration would be to exercise your "power of substitution" and transfer ownership of the policy to the trust in exchange for another asset owned by the irrevocable trust. You should discuss these options in combination with your financial advisor and your estate planning attorney if you choose to own some whole life insurance individually.

Your estate plan, like all of your planning, is an ongoing process that needs to evolve with you over time, as your circumstances change. Some things will likely be under your control, such as the growth of your estate, choosing to start a business or get married, or choosing to relocate to another state. Other circumstances that are beyond your control may change, such as tax law, creditor protection matters, or loved ones divorcing or requiring assistance with special needs or substance abuse. By creating a flexible estate plan that evolves with you and is designed to protect you in the event of these kinds of possible changes, and by incorporating the flexibility provided by permanent life insurance, you can provide the greatest amount of certainty that your goals of getting the right property to the right people in the right time and in the right ways will be accomplished, regardless of what happens around you.

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