The Premier Association of Financial Professionals®

2009 Top of the Table Annual Meeting

October 7–10, Kauai, Hawaii, USA

Title: Private Split-Dollar: An Alternative to Third-Party Premium Financing

Speaker(s): Thomas C. Bates, J.D., MBA

Day: Thursday, October 8, 2009

The Million Dollar Round Table® does not guarantee the accuracy of tax and legal matters and is not liable for errors and omissions. You are urged to check with professionals in your state, province or country. MDRT also suggests that you consult local insurance regulations pertaining to the use of visual material with clients.

© 2009 Million Dollar Round Table

Private Split-Dollar: An Alternative to Third-Party Premium Financing

Thomas C. Bates, J.D., MBA

Thank you, all of you, for choosing to spend a few minutes this afternoon to talk about private split-dollar. I'm very excited about this presentation for two reasons. One is the fact that this is a technique that I've spent a lot of time working with over the past 10 years or so, and I enjoy having the opportunity to present on it. The second is having the opportunity to do it with this audience, because I know that the interchange will be as good as or better than any presentation I could possibly come up with. With that in mind, I want to start this presentation with a threat instead of a joke, which is: The longer I speak uninterrupted, the more boring and monotone I promise to be, so please jump in with any questions as we go. It will make it a more interesting, involved discussion for everyone.

The first thing is I just want to run through our agenda real quickly. I'll give a brief introduction to the topic, then talk about private split-dollar and give you some background and examples. I'm going to spend a few minutes distinguishing private premium financing as a planning technique because there is often some semantics confusion with that concept. Then we'll talk for a few minutes about third-party premium financing, hybrid premium financing and some of the challenges that we're seeing in this marketplace. I know there are a number of folks involved who are very knowledgeable in that area who are in this room. If anyone wants to jump in with any comments, that would be great. I'll give a little bit of comparison results that we can see with private split-dollar, versus different premium financing techniques. And then wrap up spending a few minutes talking about different exit strategies, because one of the things I will repeat a number of times in this presentation is: Do not get into any of these planning techniques without knowing how you're going to get out of these planning techniques. We'll definitely spend some time focusing on that.

Why is private split-dollar starting to be revisited by a lot of planners? Well, first of all we've seen the regulatory environment see a lot of stabilization over the past couple of years. Since the final regulations came out in 2003, and then over the past couple of years, we've seen a lot of actually private letter rulings from the IRS in this area. So, we've seen everything pretty much settle down. We're seeing carriers start to debut alternative term rates. Now this is a topic that we'll come back to, but basically if a carrier will offer a one-year term rate that needs to be re-underwritten every year, it's probably not the most popular product you'd like to sell. That can give you tremendous amount of leverage in putting together private split-dollar arrangements. Where we used to see virtually no carriers offering that rate, now we're really seeing a lot of them coming out with those rates. So it's becoming more mainstreamed.

It's also a very flexible technique in a constantly changing environment. I think we're all very comfortable with the idea that the estate tax system is going to change going forward, but at the same time none of us really knows what ultimate form it's going to take. So I think what you'll see with private split-dollar is it's a very flexible planning technique that we can adapt to different concepts.

And finally, premium finance has become a little bit more of a complex solution. It doesn't mean it can't still be a very powerful solution. It absolutely is. But given the realities of the economic environment, it can be a little bit more complicated now.

One of the things I've heard about split-dollar, one of the challenges we face that I was talking with a couple friends about at the ALU meeting are some of the challenges that you see with private split-dollar presentations right now and the fact that sometimes it doesn't lead to the most meaningful introductions. Things that I've seen and commented on before: "Let's start off this one-hour presentation with a 55-minute review of the way things were before 2003." "That's not something I personally care about anymore." "Let's focus on regulatory minutia that discusses something you can't do." We're going to take a slightly different tact there. "Let's go through some extraordinarily complex technique that if it actually works, the IRS will shut it down by the time your client actually understands it." Are there some techniques you can pull out of the split-dollar regulations that will result in some consequences the IRS never thought about? Absolutely. Is now a good time with the mindset of the IRS to be pursuing these kinds of more aggressive techniques? I would submit probably not. There are some incredibly powerful planning things, that are set out in the Code, that we are perfectly able to do. There is no reason to waste any time focusing on something that might be considered an abuse of the regulations. And finally: "Let's ignore exit strategies." All these techniques that we'll talk about should be considered ultimately a temporary planning technique and it's again important not to get into them without knowing how you're going to get out of them.

It's our focus today, we'll spend all of our time on current solutions that I would submit are practical and actionable and for which you'll never have to apologize in the planning that you do.

Private split-dollar. It is governed by final regulations that apply to any arrangement entered into or materially modified after September 17, 2003. In other words, we've had more than six years of these rules under our belt. It memorializes the use of split-dollar and provides direction for how to implement a plan. And that's important. In 1999, I did a presentation to a bar association tax section meeting on private split-dollar. I was the only presentation that did not reference a Code or a regulation section, which is an interesting way to present to a group of attorneys. There was not a lot of authority out there in the books.

Now we have codes, sections, we have regulations that memorialize split-dollar. It's something you can point to when you're dealing with attorneys and dealing with accountants, just say you can do this. It's in the Code, it's statutory. There are not a lot of questions about this.

It addresses the sharing of rights and benefits under a permanent life insurance policy and really provides for both, what I would call a compensatory setting. We won't get into that today, but it can be a very powerful executive benefit planning technique in the private setting, more for estate planning, which is what we'll be focused on today. It does provide for two forms of split-dollar, for our purposes a loan regime and an economic benefit regime, and we'll compare the results you can get under both of those.

Instead of walking through just the bullets, I think it's easier to walk through a diagram for everybody. So I'll do that real briefly just to go through the structure. This happens to be the

economic benefit structure, but the loan regime only differs in two places, so we'll talk about them both. The transaction begins when the client makes a premium payment into a grantor trust which actually owns the policies, but the client retains an assignment equal to the premiums paid or the contract value. Now if it's a loan regime split-dollar, it's simply the premiums paid. That becomes the principle of your loan. If it's an economic benefit regime split-dollar arrangement, the measuring assignment is the greater of the premiums paid or the contract value.

Now this is one area where the rules can get a little bit fuzzy. If you read the regulations, it would appear when they're talking about contract value. It means the interpolated terminal reserve of the policy, which can be a higher number. If you read all the latest private letter rulings that have come out, they very specifically reference cash surrender value. Know that that distinction is out there, but be aware of it in your planning. Also know that if you're planning on using an exit strategy, any of these techniques or you're going to get out of them, hopefully you can exit this arrangement before that difference actually would begin to matter.

In order to validate the transaction, the client has to make an additional gift into the grantor trust. If you want to view it as a rent payment, I've heard some people term it that allows the transaction to operate. If you're using loan regime split-dollar that will be equal to the applicable federal rate, the midterm AFR which right now is .084 percent, less than 1 percent, so it could be a very powerful planning technique. And if you're using economic benefit split-dollar it would use either Table 2001, which is a statutory rate that the IRS gives us, or it would use a carrier's alternative term rate.

I said earlier I wanted to come back to this in more depth, specifically why would you be interested in a one-year term life insurance policy that you have to re-underwrite each year, which pays absolutely no commission? It's not the most appealing product in the world, but it is one which the IRS allows us to use as a measuring stick technique for the amount of the gift tax in a private split-dollar transaction. In order to use it, it has to be provided by the carrier used in the split-dollar plan. So, if you're using multiple carriers, each one might have their own rate and you can't borrow one for the other. It must be regularly sold. Now what does regularly sold mean, as an actuary at our company put it, for a product that no one in their right mind would actually buy?

Q. ...

A. I was told not to mention carriers in this, but I'll tell you afterwards. There are eight or 10 right now in the market that offer them in the U.S.

They have to be regularly sold. Most folks have gotten comfortable with: There have to be some sales during the course there to validate and, as long as you're seeing that, then you should feel reasonably comfortable with it. The carrier can fill you in on more depth on where those might be happening. But you do see them. Especially in group term rollout situations is one place where they are used.

Now comparison for what they look like. If you looked at $10 million of face amount on a policy, on a 65-year-old, Table 2001, the IRS rate would be about $119,000. The "alternate term

rate," I'm calling this in example, most of the carriers fall within a fairly narrow range on these rates. So this would be indicative of a number of different carriers. It would be about $20,300 or about one-sixth of the IRS rate. So that gives you a tremendous amount of leverage.

You get out to age 65, $330,000 under Table 2001, about $57,000 for an alternate term rate. Out to 85, $887,000 versus $194,000. You can see significant differences in the gift taxes that would be paid. And that is something when you're looking at the right carrier for a given situation that needs to be weighed in. It's not just who's going to have the cheapest premium in a given situation or the most, I shouldn't say cheap, the most cost-beneficial premium that this alternative term rate can weigh significantly on the total cost of the transaction. So that needs to be worked into the equation.

And to go through a quick example, with these term rates, one way they can be leveraged even further is in the survivorship context because, in that context, if you're using two lives, the term rates get multiplied by each other and they result in a much lower number, which I'll get to in a second.

I want to start this off by going through a quick survivorship example. We've got two insureds, age 65, policy owner is an ILIT. I'm going to use a joint life hypothetical policy and we're going to assume a 15-pay premium assumption with a level face amount of $10 million. I'm going to assume a short-term AFR for this example of 4 percent, even though the current one is .082 percent. Since we're looking at something that will hopefully happen a number of years out in the future, I'm going to choose to be a pessimist and think interest rates are going to go up at least somewhat. I think it's probably more fair for planning purposes to show something that uses a little bit higher rate, and this would be roughly the average over the past eight- to 10-year period.

So, in our example, we're going to assume a premium of $215,000. That gets paid in the first year and results in a loan balance, if you will, of $215,000 and a trust death benefit of the remainder of the $10 million or $9.784 million. The survivorship economic benefit which, remember, is going to be measuring the chance that both insureds die in the same year, is going to be roughly $1,400 for that first year. So it's a tremendous amount of leverage as you move forward.

One of the questions we had earlier is what are some of the objections you get? A lot of attorneys see that number, how low it can be, and their eyebrows raise over it. They think that can't possibly be. But that is actually the number you get, or so actuaries will tell me.

The price that you pay for that number is what happens at the first death. If one of the insureds dies, you can't use the survivorship rate anymore. You've got to move to one of your other choices. So you could move to Table 2001, the IRS table, in that case your $1,420 gift is going to jump to $116,000, significantly greater. If you go down here to your 10, what would have been a $7,300 gift is going to jump to $236,000. That's more than the premium on the IRS table, so a significantly worse outcome.

Under the loan scenario, you can choose to pay off this balance, if you will, and switch it to loan regime split-dollar in the first year, in which case instead of going from $1,420 to $116,000, you go to $8,600. That's a lot more manageable. Or to a sample alternate term rate, which would be about $19,000. Now what's the right option? In my opinion there is no one answer to this, although I've heard it presented as such. I think it's a process of looking at it when the first insured dies, projecting it forward based on current interest rates, what the environment is, how your rollout strategy is coming along, and seeing what the best option looks like. But there are lots of different ways you can go. It may make more sense, in this case, to stick with the alternate term rate, because that looks like it would, overall, be a lower rate going out versus taking the risk that interest rates rise as you go forward.

Q. ...

A. Give you an idea of the differential in this case.

Q. ...

A. Absolutely. We don't know when that's going to be. It might be year 10, it might be year 12. And also to your point, some carriers don't have an alternate term rate, so in that case you have to use Table 2001. So you need to, at least, be aware of what the numbers are.

Q. ...

A. Yes, if I understand your question. You certainly could be making additional gifts to the trust along the way, which could help offset future premium payments that might be due. I'd roll that into exit strategies, but that would be sort of an ongoing exit strategy that you would be pursuing.

Q. ...

A. Absolutely. And I'll mention one place I've seen that used pretty effectively: several times recently, with executive bonus plans in a compensatory arrangement, that once the insured receives the policy any restrictions are lifted. They might then split-dollar it (to turn that into a verb), so the death benefit's outside the estate. But they're keeping access to the cash value. That's another way you can put it together.

Q. ...

A. The accounting does change at the first death. You have to switch from a survivorship measurement to a single life measurement for gift tax purposes.

And then in our arrangement, we'll assume in year 15 that funds roll in from an outside source and are able to pay off this $3.2 million obligation and leave a $10 million policy sitting free and clear in that trust, the planning going forward. And we'll come back to the exit strategy and how that money got in there in a minute.

Q. ...

A. Absolutely. That could be an exit strategy. Let me come back to that point as I think I'll address it in the course of this in a little more depth.

Observations on this: The survivorship term rates can be a very attractive option. At first death, Table 2001 is punitive. That indicates looking for carriers that have attractive alternative term rates. The choice of the term rates versus a loan depends on the prevailing interest rates at the time of death. And all the professional advisors who are involved in this planning process need to understand this, and the options going forward, to enable this plan to be a success.

Now to distinguish this quickly from private premium financing and sometimes see again there could be some semantics questions about this. Some people prefer calling split-dollar "premium financing," to get away from using the term split-dollar. I'd rather stick to the language what it is.

It is similar to loan regime in operation. The difference is that's typically one large loan upfront from the irrevocable life insurance trust to the grantor. Or, to your point, it could be a large loan later if that made for a better rollout technique.

Q. ...

A. Exactly, and you'd use that as well.

The amount in excess of premium, just typically used to establish a side fund. The advantage particularly today is that you can lock in a low interest rate for a long term permanently. The disadvantage is that you might have higher interest cost gift tax charges initially, because of your larger principle amount.

I would say this, there are some planning techniques floating around with private premium financing that I'm not entirely in favor of. One is they structure it as a balloon note then discount that balloon rate at a credit card interest rate, 22 or 23 percent. I'm not particularly enamored about technique or think it would hold up under IRS scrutiny, although it does give you a very nice discount. We do see that.

Some other things that sometimes get overlooked with this. This is a loan transaction, so the formalities of a loan need to be respected for this to operate efficiently. One of those formalities I believe is that there is some need to pre-fund the trust, so that the loan will be respected. You'll hear different attorneys come down different places on this, but typically you'd want to pre-gift we'll say 10 percent as a fallback, a lot of people do, of the principle, the note, in advance, the structure, to make it work properly.

Q. ...

A. In the 16th year we're going to use an exit strategy, so additional assets will come in from another source. My personal favorite one to use is grantor-retained annuity trust, because they're so powerful in the current interest rate environment. Or, from additional gifts or from other

sources and we'll cover that right at the end as to where the different places those might come from would be.

Q. ...

A. Absolutely. They could settle it or you could again do some type of other third-party premium financing transaction that could happen.

Third-party premium financing or what happens if you're getting the money not from yourself but from some other place: There really are two different flavors here. I mentioned earlier I'm trying to generalize, in this presentation, something that absolutely defies generalization. So I'm going to speak about it in those terms. If any of the folks who are more heavily involved in premium financing want to jump in with any comments, that would be great.

Traditional premium financing, to generalize it, is a very simple design, similar to any other loan. There are a number of different approaches. They might use a cash value product to minimize the collateral need. They might use a death-benefit-focused product to minimize the interest cost. I would contrast that with hybrid premium financing where there are a number of different programs that are out there or have been out there, some of which are dormant now. Some of these can be very difficult to understand.

Typically in these transactions, the policy settlement value is going to be the primary collateral and you're typically going to have a personal guarantee required to affect these transactions.

Now challenges that we're seeing in the marketplace. You might have deterioration of any of the following: certainly the policy's life settlement value might have deteriorated especially given some of the things that have gone on in the life expectancy market over the past couple of years. There might have been deterioration in external collateral required for the loan. There might be deterioration in carrier ratings. We've heard a couple of folks comment on that in the meeting this morning. There may have been a lack of an exit strategy. There might have been not as much planning maybe as should have been done, as to the endgame, with the premium financing transaction. There might be an inability to obtain financing or renew a loan. Or they may just be, depending on timing, a lack of available capital in the market. There could be a number of different challenges going on in that market.

Q. ...

A. I would defer to someone in the premium finance market if they wanted to address that.

Q. ...

A. Could you speak into the mike for planning purposes? The question is what happens if the carrier gets downgraded? What would happen in a premium-financed transaction?

Q. Usually, if the transaction is already placed that, means that the lender is already committed the loan facility, so their intention is to fund that. Unless it drops below investment grade, then

they could call the loan or give you some time to roll into another carrier that has sufficient ratings. But outside of that, there shouldn't be the problem. What they'll probably do is haircut the adjustment on the cash value of that product, probably bump the collateral requirement up. So maybe there's a 5 percent discount on the cash value of the product to start with. that maybe is lowered to 10 or 15 percent.

A. Thank you.

I like to summarize some of these differences with a chart because, in spite of what's going on with David Letterman right now, I've always like top 10 lists for comparison purposes. So I thought this could be helpful as far as comparing the ins and outs of the different transactions.

So first of all, key questions that might be asked. Do I need liquidity? With private split-dollar the answer is absolutely yes, because you're going to be the one funding the premium payments. With third-party and hybrid premium financing, no, you don't need liquidity necessarily to do that. That's where those transactions really see their greatest use.

What growth rate assumptions do you use on your assets? Typically with a private split-dollar transaction, you might be dealing with an older person who is going to be using less aggressive growth assumptions on their assets. With third-party premium finance or hybrid premium finance to make the transactions attractive, that might be someone who would be looking at a more aggressive growth rate assumption on their other assets.

Planning focus? Typically with private split-dollar, it's going to be long-term liquidity. For estate planning with third-party and hybrid premium finance, it might be shorter-term planning focus.

Do you need a secondary market for the products with private split-dollar? No. Although, as you point out, it can be useful in the right circumstances. With third-party and hybrid premium finance, sometimes a third-party premium financing, definitely with the hybrid arrangements.

Personal guarantees required? Yes on the premium financing, not with the private split-dollar.

Type of policy? Private split-dollar can use any type of policy. Typically with premium financing arrangements I think it's fair to generalize. They would generally be with single life policies.

Splits of commissions? Generally, no, unless you're dealing with some of the hybrid providers.

Origination fees? Not necessarily.

How long does it take? Private split-dollar, it's as long as it takes to draft the documents. With premium financing transactions, it can vary with the availability of money in the market and how long it can take to put structures together.

Who administers the plan? Either the carrier or the agent would. With private split-dollar, the lender or the agent. With third-party premium finance, typically the hybrid provider with those arrangements.

How do the interest rates compare? You typically would be using a blended AFR for the split-dollar arrangement, so for 2008 and 2009 that rate was 2.8 percent. For 2009 and 2010, it's 0.82 percent. So a very favorable interest rate right now. The only problem is they do adjust each year. The past couple of years we've been in a very low interest rate environment, so this has been a very powerful planning technique, but if rates go up that discussion could change as far as loan regime split-dollar. It would not affect economic benefit regime. With third-party and hybrid premium financing, the rates would vary. When I put these slides together, the best guess I was hearing was about 6.5 percent for a third-party premium finance and about 9 percent for a hybrid, where there's money available for those transactions.

Now I want to put together a quick comparison on a single life case. As Lou Pierce put it when I was putting this presentation together, tell me who gets the money. So we'll work through that. I want to do a single life comparison here.

Policy owner again an ILIT, single life hypothetical policy. We're going to use in this case, loan regime split-dollar. We're going to start it with loan regime instead of economic benefit regime, because of the older age and the single life. Again, face amount of $10 million. We're going to assume a premium of about $531,000 and a life expectancy, in this case, at age 85, and a rate of return on other assets of about 4 percent net. And we're going to assume here that all annual exclusion gifts and unified credit have already been fully utilized for purposes of this comparison.

Now for purposes of this comparison, I'm going to compare it on three levels: the annual gift impact, or how much you're going to be spending out of pocket each year on this arrangement; the death benefit impact; and the impact on estate assets. I don't want to do this so much to tell you there is an answer, because I think the answer is going to different for every client and depending heavily on the assumptions you use, but more think about the process: What are the different variables that you need to take into account when comparing what might be the best option for a client as to whether they should look at a premium financing transaction or whether private split-dollar might present a better alternative in any given situation.

So, first of all, with annual gifts. If you have a client who is averse to paying gift taxes, hybrid premium financing can be a wonderful solution, because they don't pay any gift taxes. Assuming the policy is owned by a trust, there are not necessarily going to be any gifts that are going to be paid in there. So there are no payments needed to cover the interest. No gift taxes are paid. For some types of clients, that may be very interesting.

For third-party premium finance, there is going to be interest paid each year on the premium payments as they go in, to cover the loan and keep the principle from building up, which would total over the life of this transaction about $1.115 million.

With private split-dollar, we're also making gifts. I've used 2.8 percent in this example. In this case, our taxable gifts will be required to cover the interest payments, because we're using an interest rate that's about a little less than half of that. Would be about $480,000.

So hybrids give you the best result. You spend some money with private split-dollar. Third-party premium financing, the traditional financing, would result in you paying the most interest cost.

Q. ...

A. Well, you pay gift taxes to cover the interest on the loan. To validate the transaction.

Q. ...

A. Now the price that you pay for not paying gift taxes transaction switches the math around a little bit. With the hybrid transaction, where we paid no gift taxes, the problem is that the interest has accumulated over that period of time, so you've got less death benefit now going to the estate. So we were starting with a working arrangement with a $10 million death benefit. In this case, the principle amount of the loan has built up to a point where $8.8 million would be going to the lender and $1.2 million would be going to the ILIT at life expectancy. So, $1.2 million is in the ILIT, but at the same time you haven't really spent any money out of pocket, so it's a fairly favorable transaction from that respect.

With third-party premium financing, since you paid the interest for 10 years, our principle is simply 10 times the premium payment, or $531,000 times 10, roughly $5.3 million. The remaining $4.7 million gets paid into the irrevocable life insurance trust.

Q. ...

A. Sure, and again I'm trying to generalize something that defies generalization, so it's not going to be true for all cases. But every one would require its own analysis.

Q. ...

A. Right. With the private split-dollar you would have advanced the same $5.3 million, but in this case it would be owed back to you. So it would be owed back to you as the lender. but it would be includable in your estate. So instead of the $5.3 million going to a bank, your $5.3 million would go to your estate and be included in the estate. It would be subject to tax at that point in time, so you'd have $2.65 million in your estate and $4.7 million in the trust.

Q. ...

A. There are a lot of different ways to structure it. I'm just trying to provide a basis for comparison here.

Q. ...

A. Absolutely. You can do that, I like to view that more again as the exit strategy so you put this in place to cover. I'll come back to the point when we go through the exit strategies, but this is just to compare what the results would look like at this point.

Q. ...

A. Lot of good ways to structure it. Let me keep going here.

Q. ...

A. In this case, yes.

Q. ...

A. Life to 85. You could do that. Be another way to put it together.

The last point would be impact on the estate assets, or what benefit did you get from financing the transaction? This is where the growth rate that you're using on your other assets really comes into play. If you've got a conservative growth rate assumption, then you didn't get that much benefit from having the assets to reinvest and grow. If you had a very aggressive growth rate, then these numbers could turn around completely.

In this case, if you use the hybrid arrangement, you would have had all of your assets to reinvest and work with. Assuming you had a pool to start with, it would have grown to $3.3 million by the end of the arrangement. Third-party premium financing, because it was depleted slightly by making interest payments, you would have had $2.3 million. And private split-dollar would be about $615,000, but those assets would have grown too because you were paying premium along the way. So that would be a much smaller number.

When you pulled them all together, the results you would get, and again this is on this example for this type of structure, with private split-dollar you would have paid $480,000 in gift taxes so that would be a negative. You would have $4.7 million going to your ILIT. You would have $2.65 million retained in your estate after taxes, and $615,000 that would be growth on the assets retained in the estate by financing the premium. And you'd come up with about $7.5 million.

With third-party premium financing where you're paying the interest along the way, you would have paid gift taxes, reduced your estate by $1.115 million. Net to ILIT, $4.7 million. Growth on assets retained in the estate, about $2.3 million. You'd have about $5.85 million in that case.

And then, with hybrid arrangement, you'd have the benefit of the assets growing outside the estate, $3.3 million. You'd have $1.2 million going into the ILIT, no reduction in the estate from gift taxes. It would be about $4.5 million.

Those numbers obviously, particularly with the hybrid, can turn around substantially if you used the higher growth rate assumption on the assets. And it depends on the particular hybrid you're working with, number of different variables that could come into play, but I hope that kind of

analysis is helpful in looking at which one might be the best choice for a client in a given situation.

Often I hear questions about split-dollar as an alternative to premium finance. Can it be used as a rescue technique where premium finance transactions, if you will, have gone bad? Sometimes possibly I like to think of it more as what are the key questions that you can really ask. One is how much life insurance does the insured actually need and what does that indicate for structure going forward? Two, what are the terms of the financing transaction? How can you get out of it? What does it cost to get out of it? Is the insured still insurable? Is the carrier used still appropriate? Or have the various ratings decreases caused a problem? Is more life insurance obtainable? The answers to those types of questions can help drive what direction you go with and give you one of several alternatives: either buying out the policy and possibly entering into a private split-dollar structure going forward, or purchasing new insurance in an appropriate amount and evaluate whether to continue the premium financing transaction or to cancel it going forward.

Exit strategies are the concept of introducing assets into a trust which then either the principle or the income those assets generate can then be used to rollout any of the techniques that we've talked about, be it split-dollar, private premium financing or third-party premium financing.

I like to use one of my favorite quotes (from General George S. Patton) with these when talking about doing them: "A good plan, violently executed now, is better than a perfect plan next week." It's important if you're going to put in one of these transactions to actually get these strategies implemented so they have a chance to work. And the alternatives that you usually see looked at, including a number of things: Simply making ongoing gifts to an irrevocable life insurance trust which can accumulate and allow you to roll out of the transaction. Using a grantor retained annuity trust. Using a charitable lead annuity trust, which I candidly think is one of the most overlooked ways of doing this if you have a client who is charitably inclined. Using gifts of stock options where you have a lot of companies right now that have assets, stock values that are fairly depressed. Options can be a wonderful gifting strategy.

Some of these I'll not go into but a grantor retained income trust, that's another one that a lot of attorneys, who maybe aren't full-time in estate planning, might look at a GRIT and say you can't do those anymore. And that's true, if you're dealing only with blood relatives of someone. But if you're dealing with a client who's looking to benefit nieces and nephews or if you're dealing with a non-traditional family, a grantor retained income trust can be a very powerful planning technique and it's certainly worth looking at.

A close cousin of the GRIT, qualified personal residence trust is another option for the installment sale to an intentionally defective grantor trust which is a variation on the technique you were referencing earlier.

My thoughts on exit strategies, because I think these sometimes get put into a box: We're going to put in this private split-dollar program. It's going to build up a $3.2 million obligation. We're going to have this GRAT dump into it and it's going to produce exactly $3,283,000.87 into the

policy in the 15th year and allow it to roll out. That never happens, so these are some of the thoughts I like to think about with exit strategies.

First and foremost, in my experience, none of these work particularly well if they're never actually implemented, getting back to the Patton quote earlier. And number two, you are not limited to one. A lot of folks present this as here is the exit strategy. I like to think of it as a package of exit strategies, particularly if you're doing it in the context of where the insured wants their assets to go. If that trust that's the subject of the split-dollar agreement can become more of the centerpiece of an estate plan, it makes it much easier to aggregate a lot of these planning opportunities.

Next, to my earlier comment, these don't have to be perfect. If there is excess, is it going to a place where the grantor would like it to be anyway? They need to be continually monitored and if it's not sufficient, there's always the option of lending the money at the end for any remaining balance.

And then, a final point is you don't actually have to exit, you just need to create the option to do so. An example I used earlier, there was $3.2 million that was owed back to the trust in the 15th year. The economic benefit cost there, both insureds were still alive, was about $17,000. Even very conservatively invested, if they've got $3.2 million in their trust, they can probably make a heck of a lot more money leaving it in there. So, the choice may be, at that point, do you pay off the split-dollar obligation or do you let it ride? The point is to create the option to do so by putting this into place.

The first one we'll go to is a grantor retained annuity trust. I've structured this using a 15-year GRAT with a 75/20 rate of 2.8 percent. What term you would actually use for any of these would vary with the assets that you're putting in there and the planning horizon of the trust. I'm going to assume $2.9 million gifted and a 25 percent discount resulted from using a family limited partnership, which results in a current gift that's going to be about $1. So it is a very leveraged technique.

Now the way GRATs work, a brief review: Client is going to take their assets, $2.9 million discounted to $2.1 million. They're going to contribute to the GRAT, which is a taxable gift at that point, the $2.1 million taxable gift, but they're going to retain in annuity stream from this GRAT for 15 years equal to $180,000 a year which, using that discount rate, would roughly equal $2.1 million or just under it, enough to reduce the amount of this gift to just about $1. And we can thank our dear friend, Sam Walton for affecting the transaction that originally allowed this to happen. He sued the IRS on this technique and won because he had more money than the IRS to fight it. So that enabled the transaction to go through.

Once this money, net of the annuity distributions, is in the GRAT, it can be distributed to the irrevocable life insurance trust and then the choice can be made whether to use the proceeds to pay off the split-dollar life insurance agreement.

How much do you need to transfer to make this work? This assumption I'm simply using a 7 percent return, which indicates transfer of about $2.9 million to the ILIT. If you thought you

could get 9 percent on your money, you'd only need to transfer $1.9 million. If you thought you'd get 5 percent, you might want to be more conservative and transfer about $4.7 million in order for this amount of appreciation to transfer. What we're accomplishing here, you'll sometimes hear these called estate freeze techniques, is simply transferring the appreciation over and above that annuity stream to the ILIT. It can be a very powerful planning technique.

One of the ways, actually four of the ways, that you can use this technique (and you can stack the deck if you will to get the best possible results out of the transaction) are to incorporate four different planning techniques which can give you additional leverage.

The first of these is to segregate your assets. Why use one GRAT when 50 will do? The reason you do this: The downside to a GRAT is that your money comes back to you if it doesn't work. So if the growth rate you've chosen is less than what you were planning on, your money simply comes back to you and you do it over again. In other words, there's not that much penalty for being wrong on the investment rate, but one of the ways you can make the results better, GRATs are very simple plan documents. Typically they'll be four to six pages, there's not that much to them.

If you had two assets in a GRAT and one of them went up 10 percent and one of them went down 10 percent, you got a net zero, the GRAT didn't work. It failed. If you use two different GRATs, one asset went up 10 percent, that appreciation transfers into the trust and can be used for your split-dollar plan. The one that went down 10 percent comes back to you. So you're better off using multiple GRATs with multiple assets so one non-performer doesn't drag down the others. It's also fun to talk about because it's the only chance I get to tell about your financial professionals that asset diversification is a bad thing. Because, in this context, it absolutely is.

Discount we referenced using the family limited partnership early. Early you would absolutely want to do that with this technique. It helps you leverage the results because your returns are going to be based on the underlying assets, not the discounted amount. You can use an increasing annuity payment, particularly if you have clients with hard assets, like apartment buildings, that might be used. I used one recently, an apartment building in rehab where they thought the income would grow exponentially over time. You can structure it so the annuity payment starts very low and then increases as much as 20 percent a year, so you've got a much higher payment later. And you can cascade GRATs by having one rolling into another after another. I would say moving to the next point of recent developments, typically that type of cascading structure would be viewed as the most powerful way to do it. The current legal environment, GRATs, the structure around them is probably going to change a little bit because they're perceived as being maybe too good a deal.

Some of the proposals that are out there would make a minimum term of 10 years so they'd be longer. Given the facts that interest rates are so low right now, that, in general, asset values are fairly depreciated right now, and that family limited partnership discounts might be limited going forward under the same legislation, you may want to think about whether you do want to use a short-term GRAT or whether now is a good time to lock into something with a longer term. There is definitely something to weigh and discuss all the economic factors with the attorneys involved.

Q. ...

A. It is outside the estate.

Q. ...

A. You put it back in to pay off the split-dollar obligation. The reason you do that is so the policy sits out there free and clear of any encumbrances and goes forward.

Q. ...

A. I misunderstood your question. You would do this, the highest and best use of the structure is going to be with a survivorship private split-dollar plan where you've limited the gift tax cost over 15 years with that alternate term rate, then had a GRAT come in and pay off the obligation going forward. If you financed it, if you've done loan regime split-dollar or third-party premium financing transaction, then this introduces money which lets you manage the amount of the loan or gift going forward. So it can be done different ways.

Q. ...

A. Well no, you're using them all. You haven't actually paid any gift tax.

Q. ...

A. There's a gift but it's a net gift.

Q. ...

A. Right. You typically will net it out to a $1 gift and the only reason you have a dollar gift is so you've got something to file a gift tax return with, and that makes the clock start ticking for IRS purposes.

Q. ...

A. Absolutely.

Q. ...

A. Well, that's one reason and it might depend on the particular asset that you're using in there. A two-year GRAT, you may not want to do that if you've got an apartment building or something that is going to be a more gradually increasing asset. I would let the type of asset and the present legislative environment drive the decision. Absent the legislative proposals, I would say two-year rolling GRATs are absolutely the way to go. Given that they're out there and I

think the best thinking I've heard is that there is at least a pretty good chance something along those lines is going to pass. You might want to at least consider a longer term.

Q. ...

A. Every two years you're carving off a chunk of appreciation and you're doing it again. You can set up a number of these. I've heard of estates that have as many as 50 running concurrently.

Q. ...

A. No, your annuity rate, which in this case is relatively small, $180,000 if you were doing a two-year GRAT that would be a little over $1 million coming back each year, so you've have to bet that you're going to have some growth in that two years that would be greater than those principle payments coming back. But it can be a very, very powerful planning technique particularly, I would submit, right now.

A close cousin of grantor retained annuity trusts are charitable lead annuity trusts and they work virtually the same way. One of the challenges that you see with charitable lead annuity trusts is the number of different forms that are out there. You have testamentary charitable lead annuity trusts, you have reversionary trusts, at last count on the planned giving design center Web site there were seven different adjectives you could theoretically throw in front of the word charitable lead annuity trust to define exactly what type you're using. That can lead to some planning challenges because people might have experience with one but not the other.

For split-dollar rollout use, though, I think there's really one form of charitable lead annuity trust that we focus on which really is simply the mirror image of the GRAT. The key difference is that the income stream instead of coming back to the grantor is going to go to a charity. The benefit that gives you, the grantor may receive an upfront both gift and income tax deduction. So this is a great technique. Let's say you have a retiring executive who might be in a very high income year the year they retire. This is a chance to get a deduction in that year, possibly by doing this technique. The difference is they have to include income in the later years. So, depending how you're investing those assets, that can generate some additional taxable income. Or, you can structure it without that income tax implication so you've simply got just a gift tax deduction.

You'll see here our client simply puts the assets into the lead trust, they get their income and a gift tax deduction but that annuity stream is going to select charities. Other than that, the math works out exactly the same as the grantor retained annuity trust and you do have all the same planning options with it.

I'll mention briefly on gifts of stock options, and I think this is a technique that frequently gets underutilized, with gifts of stock options, if a company has depressed stock values, and there are a lot of companies right now that do, making gifts of the options can be extremely valuable. The client can transfer options so long as the option plan allows it, to a grantor trust. The trust can then choose to exercise the options, at some point in the future, in which case the client gets the opportunity to pay the tax on the option exercise. The key to this technique being successful is that paying the tax on the option exercise is not an additional gift to the trust. That's a free gift.

The stock is then transferred to the client's heirs or to the irrevocable life insurance trust where it can be used for a split-dollar rollout. The stock is transferred with a fair market value basis and at that point it can then be sold. Again, you have to go through a couple more steps with this because the company has to actually allow you to do this through changing the option plan. But, if you've got a closely held company, that can certainly be done and this can be a very valuable planning technique.

Q. ...

A. You do. You have to use a Black-Scholes model when the option is initially gifted to determine what the value of the gift would be. My friends who do that say a rule of thumb would be between 10 percent and to 20 percent of the amount of the stock. It's probably not a bad rule of thumb, but if you've ever seen a Black-Scholes model and not thrown up, there are a number of different variables that go into it.

Q. ...

A. It could work with a public company, but the stock option plan would have to allow you to make transfers. So if it doesn't already, typically boards of directors are going to be not too excited about messing with option plans right now. So I think it would be a tough road to hoe at this point. But again can be a very, very leveraged planning technique.

With that, I will wrap up. Again, I think there's probably no premium finance or split-dollar strategy that should be entered into without some thought as to how you're going to exit out of it. In a survivorship policy situation, I would submit that survivorship private split-dollar is probably one of the most leveraged and advantageous planning techniques out there. If you've got single life situations where adequate liquidity exists, and that is the key variable, private split-dollar plans may provide enhanced benefits relative to premium financing. These are well-established, straightforward techniques. There is not anything going on here with the Internal Revenue Code or regulations that would create a scenario where you would have apologize for any of these techniques.

And, in my opinion, the current environment makes this a very, very good time to act. There is a need for flexible planning techniques. You're in a very low interest rate environment, which makes all of these techniques work particularly well. You've got depressed asset values and you've got a number of these exit strategies that may be subject to changing regulations. So now would be a good time to go ahead and get them implemented before those things change.

So with that, any final questions?

Q. ...

A. Absolutely.

Q. ...

A. Would love to do that. Any other questions? Well, thank you very much.

Q. ...

A. You can absolutely do that.

Q. ...

A. Absolutely. That can be a very powerful way to structure. The only caution I would raise with that is something called assignment of income doctrine, to make sure the ownership and everything is set up correctly to where it doesn't get looked at and the income doesn't get assigned out away from the trust to the owner. But that's more something I'd file away just to be sure it gets covered off. But you can absolutely structure it that way. That can be a very leveraged way to do it.

Thank you.

Thomas C. Bates, J.D., MBA is a principal with COLI Consulting Group LLC. Bates consults with financial services professionals, distribution organizations and life insurance carriers with respect to a wide variety of advanced markets issues, including high-net-worth estate planning, nonqualified benefit plan design, corporate-owned life insurance, and bank-owned life insurance. He is nationally known for being a leader and technical expert in these areas and for his orientation to the promotion of real-world solutions for this complex marketplace. Bates has been a frequent speaker at life insurance industry meetings, including speaking multiple times at both MDRT Annual Meetings and meetings of the Association for Advanced Life Underwriting.

3115 Willow Oak Drive
Greensboro, NC 27408
Phone: 336.404.0823
E-mail: tbateshome@gmail.com