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Planning for the
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Life Insurance Strategies in Conjunction With Wealth Transfer Planning for the Business-Owner Client

Timothy C. McFarland

Basically what we're going to do is go over an approach to succession planning or business planning for the owner of a closely held business, and then we're going to look at how life insurance can play into that.

What we're going to do is we're going to go through a series of case studies and then we're going to end with a comparison of two very effective planning tools: when you would use a GRAT and when you would use a sale to a defective trust.

What I want to start with, however, is asking basically what we should do when we're planning for the business owner. As an estate planning attorney by trade, I can't plan for a client who owns a business without thinking about what's going to happen to the business. So what we're going to do today is sort of briefly go over what I think about when I think about planning, and what I look at when I plan. And then we'll look at some case studies.

We're going to look at what tools we have available to us. Then, at the end, if you have any questions, I'd be happy to answer them or I can be out in the hallway afterwards as well if you have any specific questions you want to take offline.

So, let's look at what is the planning process before we even get started. We want to uncover the client's needs and wants. That is the most fundamental thing we all know that we have to do. We have to figure out what is driving the client. And particularly, what's driving the client about his or her business. We need to review the client's estate plan, what I call the asset picture and, most importantly for business owners who are going to do any planning, where is the cash flow. What I like to call, as we'll see, where is the free cash flow, where is the cash flow I can use to pay for premiums or to pay for whatever else we're trying to accomplish in terms of the estate plan.

Then we need to design the plan. We need to be able to illustrate the plan. We need to be able to implement the plan. And, perhaps most importantly if you're dealing with planning, if we call ourselves planners, it's not enough just to put a plan together or sell a product. There are far too many people out there who are doing that. What we need to do is to put a plan in place and then we need to maintain that plan. The nice thing about needing to maintain a plan is that it puts you in front of your client every year or, if not, every other year. So it's a marketing opportunity, as well, to make sure that the plan we put in place is going forward the way it's supposed to and, then, to make sure that we don't need to do any mid-course changes or if any other issues in phases of planning have now come up and we need to address them.

You all know about the hard issues. What are the financial issues? But no one is going to move unless we address the soft issues. And with business planning, the soft issues are: who is the client, what motivates the client, what type of personality is the client and what is really driving the client.

We're going to talk today mainly about the patriarch of the family, although we know this can be the matriarch and that has whole other sets of issues that we have to think about. But if we're thinking about dad or granddad, we need to ask what's really driving him about planning for the business. What is it that he feels about the business that's going to make him move and make some decision? And when we're thinking about that with business planning and what's happening in the business, what's being said or not being said is most important as to what he's actually articulating. We have to lead them very carefully because we have to maybe help the business client articulate some of the questions that are lying under the surface. These are the hard problems that the family has been dealing with that maybe that individual doesn't really want to let come to the surface. But, if we don't open that wound if you will, we won't be able to help the client deal with it properly. We'll see where those come out as we look at the case studies.

Fundamentally it comes down to if you're going to plan for a business and you want that business to make it down the next generation, we have to get all the information. We cannot plan unless we have the information.

If you think about that, 90 percent of all companies, we know these statistics, they range over percentages, 90 percent of all companies in the U.S. are family owned or what we call closely held. That doesn't mean they're small. Some of the largest companies in the United States are family owned. Multibillion-dollar companies around the country are family owned, as well as smaller companies. What we have to think about is that most of those companies will not even make it down to the next generation, only about 15 to 20 percent make it to the next generation and even less than that make it to the third generation.

Companies that have made it to the third or fourth generation have either done so with exceptionally good planning or by sheer luck. What we want to do is help to maintain that family business down the generations so that it remains a viable operating company. It is almost an entity in and of itself that is separate from the family.

If you're going to plan, it's not enough just to talk to the owner of the company, or the owners if there are partners. We need to figure out who the other stakeholders are, because they are just as important. Perhaps the most important other stakeholder in the business is the spouse. And again, if we're talking about dad or granddad, men think one way and women think another. And often mom is not thinking the same way that dad is thinking. And dad may have very clear goals as to what he wants to accomplish, but if mom isn't buying in, you're going to have chaos when dad dies.

We also need to think about the children. Many families have multiple children, some are in the business, maybe one is in the business, two are in the business. What are we going to do with those children? Have mom and dad even talked, particularly dad, to the children? You probably all know a lot of families where dad is the business owner, dad is the patriarch and dad says junior's coming in the business. Does junior want to be in the business? And if dad has a partner, does dad's partner want junior in the business? And if junior is in fact going to be in the business, what are we going to do with the other siblings? Are some of them going to work in the business, but have no management control? Are some of them not even going to be in the

business but are going to have an equity stake in the business? All of those issues have to be addressed. We need buy-in from the children if the plan is actually going to work.

Again, partners. If there are multiple owners of the company, it is important that they all are on the same page. What I think I want to have happen to the company may not be what my partner thinks and vice versa. Do I know what my partner wants? We have cases where partners that worked together for a long time and one day the partner comes in and says I'm retiring in six months. And we all say that's information I could have used yesterday. We need to get buy-in from everybody.

These are not just the end of the story though. A lot of people will start to say well these other stakeholders here, that's great, but it's not that important. They're vitally important. Are you going to tell the employees what the succession plan looks like? And how are you going to tell the employees? If you put a succession plan in place, are the employees going to immediately think there's something wrong and want to jump ship? So, particularly if you have key employees who have been with you for a long time, they may or may not be management, what we call top hat people, but they may be vital to the company. How are you going to break the news to them? And also if you're thinking about estate planning, how do you assure them this is a good part of planning or are they going to fear something is happening, that maybe your client is sick or something is going on. Again, you start to upset the business flow.

Clients. If you want junior to take over the business, the clients are going to have to buy into that or you're going to see a flight of clients. So, who is going to introduce junior to the clients and how is that going to happen? Again, we need to think about that. Suppliers and creditors, it may be one thing for dad who's very well respected in the local community, therefore his suppliers will supply to him based on his good word alone. Bankers may have banking relationships, forgetting about what happened in the last year, but in the more traditional sense of bankers, dad can get a loan on his word. Obviously there's the financial underwriting. What happens if junior can't do that?

There's another individual here that I didn't put in here and that is someone else who might have a stake in the business. Franchisors are very important for family businesses. It's very important to know what the franchise agreement says. There are very valuable franchises around the country and there is nothing more than what some franchisers like to do than to buy back those franchises. So they may come up with a technical default under the franchise agreement. We need to know what those agreements are and what they allow us to do so that we don't force a sale of the business when we didn't anticipate doing it.

We need to know what types of assets the family has. In a lot of family businesses, 90 percent of the family's wealth may be the business. Maybe it's only 50 percent. We need to know that. And then we need to know what other assets are out there. We also need to know what type of entity the business is held in. Most companies are going to be C corporations, S corporations, limited liability companies or partnerships. That's the operating company. The operating company is going to sit on land. Who owns the land? Do mom and dad own the land? Is the land inside the company? The worst possible scenario is if the land is wrapped up into a C corporation, but that we can deal with. What if you're going to give the business to junior and, in order to equalize,

dad's thinking about giving the real estate to junior's siblings and the business can be held hostage to his own siblings when they start upping the rent. Right now if the operation is sitting on land that's owned by mom and dad, they're charging rent basically what the CPA tells them to charge. What are we going to do with that?

Where are assets physically located? We need to know that for probate planning. If there are plants around the country, we need to know what the local rules are for real estate, so we can plan for them. Anybody from California, you may know if you're trying to move property you have to worry about Proposition 13. Prop 13 is a revaluation of real estate. Right now you keep your real estate value down, but if you make a change of it then the real estate board can revalue it. Can we do estate planning without triggering those types of provisions? That's particularly important for ranching, farming, and oil and gas interests. We need to think about those so we need to know where they're located.

Ownership structure, who owns the business? Do we have one class of stock? Do we have multiple classes of stock? Do we have voting members? Do we have non-voting members in LLCs and FLPs? We need to take that into consideration because, if we're going to start moving assets around, we need to make sure that when we change ownership structures we're not impacting negatively future planning that we might want to do.

If you're working with people who have contracts with the government, you may be working with women or minorities. They often have to maintain 51 percent control of a business. Do we have to recap the company into voting and non-voting to meet the regulatory requirements so that we don't lose valuable contracts in the business? These are things we need to think about.

Are there constraints on the assets? Do we need to maintain certain asset to debt ratios for bonding? This is particularly important for those of you who deal with road developers and construction companies who have to have bonding requirements. If we start moving assets around, could we change that.

Mortgages, if we change title on mortgaged property do we have technical defaults? The last thing you want to do, in this environment or in any environment where the banks might be looking to call in a mortgage, is you want to make sure you don't create a technical default in any of your estate planning. So we have to look at the mortgage documents. Somebody has to look at them and make sure whatever we decide to do is not going to upset the apple cart.

I mentioned constraints on assets as well. Franchises and franchisors are very important. There is one particular company, that I won't mention just because of the proprietary nature of a case I was working on, but there's no choice. When the franchisee dies, the franchisor comes in and buys out at a set price. That's information we need to know because now we know that the business isn't going to make it to the next generation. So now we need to plan for the family's wealth when death occurs.

Let's look at the hard numbers. Once I've taken care of the soft issues, now I'm looking for the hard issues. How am I going to pay for what I'm trying to do? Where am I going to move pockets of money?

A lot of salaries, bonuses, distributions and dividends, think of them as pockets of wealth. It's where money is going, where dollars are going. For a lot of our planning, people will say, "Well, I don't have any cash flow because I'm paying salaries, bonuses or making distributions." Those are fungible. We can rearrange them. For instance, if dad is taking a very high salary and a bonus and we want to move asset values down to the next generation and we do a sale to a trust, those bonuses can go away and be simply turned into capital gain payments or tax-free payments in terms of sale to a defective trust. So we need to know how much is in each of these slots so that we can rearrange them.

We need to know what the working capital needs are of the business. What is the future plan for the growth of the business? We don't want to impact working capital needs. Debt service. Are we at a point where we've just begun a new debt service stream or is debt service going to trail off over time? We might have a cash crunch now, but we know, seven or 10 years out, we're going to free up some cash because we will have satisfied some debt. What it boils down to is free cash flow. What cash flow can I create so that I can plan with it? And, quite frankly, what we're looking for is life insurance dollars because we all know that in any type of planning for a business, the cheapest way to actually accomplish it is usually going to be a permanent life insurance policy. So that's where we're heading.

Unfortunately some of our clients may not have planned when we would have liked them to plan, and so now their health or their age is going to make those premiums very expensive. We need to figure out how we're going to pay for them.

When we think about that free cash flow, we can also think about whether there is going to be any growth in that free cash flow, growth in any underlying asset and any valuation discounts that we can apply. Those are your lack of marketability, minority discounts, key man discounts, ways to destroy value in the business. We've just come through, and we're still in, one of the worst economic cycles we've had since the Great Depression. If you have not been forced to sell your assets, this is a perfect opportunity to plan. What do I mean by that? If you take valuation discounts into consideration, if I have a \$10 million company and I wanted to move it to the next generation and I can get a 30 percent discount, that asset is worth \$7 million for gift tax purposes.

What if I had what I know is a temporary hit to the value of my company? Let's take an extreme case. My company is now worth \$7 million today but I know it's going to be back up to \$10 million or maybe more. With the same 30 percent discount, I'm now looking at \$4.9 million of value to move that asset. This is an opportunity to plan. This is a perfect time to do planning because we're in a low interest rate environment and we have depressed asset value. If the business is only hurting because of the rest of the economy is hurting and it's not in dire straits, this is a perfect time for our people to plan. And it's not going to get any better.

What do you need to do before you even get to the plan? We've talked a lot about the issues, now we have to look at some of the tools.

How many have clients who don't even have wills? You would not be surprised to know that there are very wealthy individuals who have very successful businesses and they don't even have a will. If they don't have a will, chances are they don't have durable powers of attorney. They don't have health care proxies. They don't have HIPAA authorizations. They may or may not have done their credit shelter and marital trusts (or if you're in a community property state your ABC trust so that you can take care of the spouse's one half of the community), let alone a life insurance trust or other irrevocable trusts. Why is it important to get at least these three in place? Because at least we've got wills and we can at least begin basic planning.

Durable powers of attorney are very important because they allow somebody else to make financial decisions for you. If my will says my company goes to junior, that's all fine and dandy, but my durable power of attorney can allow me to plan and change that as long as I have access to title. If I locked up title somewhere, where I don't have somebody in place, if I become incompetent and my will says junior gets the stock and I don't want junior to get the stock anymore, I can't change it. My will is irrevocable. The only thing I can do is lifetime transfers now. Whereas if I moved it into a revocable trust and I become incompetent, in most states my agent under my durable power of attorney can do estate planning for me and amend the revocable trust and therefore change the plan. So it's very important to have these basic documents in place anyway.

If I'm going to do this kind of planning, I need to have HIPAA authorizations. You're familiar with HIPAA authorizations, these are privacy forms. There's an issue under the federal law, a conflict with states, as to whether you need a separate HIPAA authorization for health care proxies and durable powers of attorney. So why not just put an authorization in place and name your agents upfront and avoid the issue altogether.

When we get a little bit further on, we get more into buy sell agreements, key man insurance and the more esoteric or the more complex planning ideas we have. All of these can be used with businesses. Charitable lead trusts are a little bit more difficult to make work, but they still can all be used. And I put the note at the bottom: this is not an exhaustive list. This is probably, to this certain point, a mandatory list for somebody who has a family business. This list over here is not exhaustive, there are many ways to do your planning and it all depends on what the client wants.

The other question we need to do is ask what planning has already been done. If a good plan is in place, it just may be that it's been put in place but it hasn't been funded. Or a good plan was in place but it hasn't been dealt with for years and now it no longer meets their needs. We want to get a plan that's in place that everyone has bought into. That's the goal we're trying to reach.

Now let's look at our case studies. We're going to look at the no-plan plan. As you all probably know, failure to plan is a plan. So we'll look at the no-plan plan and see what that really accomplishes. Then we're going to look at how we can use just a very simple life insurance trust to pass the family business to a child successor. We're going to look at the young and the restless. We're here in Hawaii so we might even be able to catch the last half hour of it before we're done. And then we're going to take a look at GRATs and sales to defective trusts, and just do a quick comparison and when you might use one or the other.

Let's look at our no-plan plan. We have Mr. Imperious. I use that because this is dad and he doesn't have any control issues. He's age 70. He's a standard risk. He is divorced, I won't even comment as to why he might be divorced. He has one child and the child will inherit the business on his death. His will is over 20 years old and leaves everything to his child. So actually while the will is old, it's at least going to do what he wants it to do. But it's way too old to be effective for all the tax law changes that have occurred over those 20 years.

He has a gross estate today of \$20 million. The value of his business is \$12 million so it's about 60 percent of his gross estate. And his CPA has told him, don't worry about it. We'll pay the estate taxes with Section 6166 of the Code. Is everyone familiar with 6166? Section 6166 of the Code allows you to pay your taxes in installments basically over what amounts to a 15-year period. You pay interest for about four or five years and then you annuitize your taxes over a 10-year period. The CPA is basically saying don't worry about the estate taxes, we will finance them out of cash flow of the business. So we're going to focus on this and say, "Is that what's really going to happen?"

Because the CPA has told him, "Don't worry about it. Don't buy insurance. You don't need it. We'll just rely on 6166," the client thinks he has no reason to do any planning. But we know he needs to do planning. So let's figure out how we can talk to him. The first thing we have to do is meet the CPA head on and say, "Is 6166 the best way to go?"

Let's take a look at it and see if it is. What we're going to do is make a few assumptions. We're going to assume his assets are growing at 4 percent a year across the board. We're going to assume an after-tax profit of this business is 10 percent and that is necessary to meet working capital needs and to take care of dad's income needs. The IRS, in blessing you with the ability to pay your taxes over time, requires you to pay interest. What you do is you pay at 45 percent of the underpayment rate, which historically has been 8 percent. This is why the CPA likes it because 45 percent of 8 is less than 5 percent. We're going to use a present value rate because we're going to do some present value calculations. We're going to assume the feds lock in 2009, so \$3.5 million exemption with a 45 percent maximum bracket. And we're going to assume he has a 14-year life expectancy. That's about right. Then we're going to assume he's going to buy a \$10 million secondary guarantee life insurance policy. We're going to compare that against 6166.

Because dad would do no planning and he's now 70 years old, that's not a cheap premium. The premium is \$350,000 to buy that policy but, as we'll see, it's going to be a lot better than doing nothing.

What we have are some concerns. We have qualification requirements at death. Basically with 6166 it is a matter of right to make the election to pay your taxes over 15 years roughly if you qualify. The way you qualify is that the value of your business has to be 35 percent of your, it's not really the adjusted gross estate but I'll use that for these purposes. What if you mess up with the 35 percent? His assets are 60 percent of his estate. What if they start fluctuating and he doesn't make it at death? That's a risk. You may only defer assets with the business, only the business's assets. You still have to come up with the estate taxes on the non-business assets

within nine months of the date of death. So we're only ever going to be able to defer the assets associated with the business.

This is a trap for the unwary. It won't apply in this case. If you have a 100 percent marital plan or you have a charitable estate plan where you're going to leave everything to charity and just give the business to the child, you would think that under 6166 there's no acceleration of taxes because all that's left after the marital and charitable deduction is the family business and we're allowed to defer taxes on the entire amount of the family business. That's wrong.

Q. ...

A. It depends if it's active. It has to be actively managed. If it's not actively managed, it's a passive asset and investment asset only. It all depends on how much active participation. For instance, if you own a shopping mall and all you do is collect rent, that's not going to be it. If you own a shopping mall and you actually help market the clients who come in and rent from you, that would be considered active. So it's a continuum as to how much activity is actually going on. The more active you are, the better off you are.

Q. ...

A. Passive means you're not going to be able to defer. Active is you're going to be able to defer. And to be active you've got to be actually actively managing the company. So again, just collecting rent, changing light bulbs, is not going to be enough of an active management of the company. A lot of the private letter rulings with the IRS deal with how active are you being as to whether you can do this or not.

What I want to do is stress that you do not get to defer all of the business assets when you have a 100 percent marital or a 100 percent charitable plan.

We need to make sure that cash flows are sufficient. Remember there's 10 percent cash flow in this business right now. That is being used for working capital and the family to live off of. How much net profit is going to be necessary to meet those two and pay the estate taxes? And then we have to assume the interest rate. We may have an interest rate spike like we had in the 80s. If inflation really heats up like some people are anticipating may be the case in 2012 or 2013, is this rate going to go up so much or right now you only pay 45 percent of the underpayment rate. What if congress changes the tax law and makes it 100 percent so that it's 8 percent across the board? It's not as good now.

The other thing is, for the next 15 years, you're going to be in bed with the IRS. Does your business really want to be held hostage by an IRS lien or an expensive bond requirement? Because the IRS is going to be looking over your shoulder. Again, Congress in giving you this, charges you interest, and makes you a partner with the IRS until you've paid your tax in full. And you can lose the deferral if you start selling away interest in the company or you do other things that cause you to lose your deferral.

This is a very busy chart, but basically what this chart is doing is showing you essentially what your tax payments would be under 6166 over 14 years. Fourteen years and nine months is the total amount that you can pay. Nine months from the date of death and then another 14 years out. The idea behind this chart is, at the end of the day, you will have paid a tax liability of \$11.9 million dollars, that's principle plus interest, on a present value back to the date of death which is 2022. What we did is I die and now I have a series of payments out for the next 14 years and nine months. What's the present value of that to the day I die? The present value of that is \$7.9 million or call it \$8 million. The tax on the other assets I wasn't able to defer is \$6 million. On the date of my death I have a present value tax liability of almost \$14 million. Am I going to be able to afford that? I didn't buy any insurance, so immediately I'm going to be selling assets to pay this \$6 million liability, and then the question is how am I going to pay this? Do I have enough cash flow?

This number here, that 17.11 percent, tells you that you need a pre-tax income equivalent of 17 percent in order to maintain any kind of growth in the company, to now cover son's living expenses because he's inherited the business, and to make these payments. These are total interest and principle payments. So we start to say to the CPA, "Yes, 6166 is a great tool. But are we actually going to be able to afford it? And is it going to be able to work in our case?"

So what we do is we take all of this information and we cull it into a simple plan doing present value analysis. We come up with this chart. Here's the idea, just so you know, across the bottom this is what it's going to cost, each of the plans. We can compare the costs. If I do nothing my total estate tax liability is \$14.8 million due on death. The heirs are going to net \$18.4 million. The MPV cost of that is essentially going to cost you, in today's dollars, \$13.6 million. If you do 6166 you can see, yes, 6166 will work. Today's cost is \$12.8 million.

What if I bought the life insurance? The cost of the insurance, because now I have premium dollars leaving the business. So I don't have those assets to reinvest but those dollars have to come from somewhere so they're going to decrease my estate as well. My cost has dropped down to \$4.5 million in today's dollars. And if we say to the CPA, "Mr. CPA it's a great idea to have 6166 and lead with it. Why not have an insurance policy in your hip pocket just in case? You can drop that cost in today's dollars an extra \$400,000 by doing both. Why not plan on using 6166 but buy the insurance policy. If 6166 will work, use it." You now have \$10 million that just came into the family that you can side fund and pay the installments over time if you think you can earn more on those tax-free dollars that just came in versus what you're going to pay the government. If you don't think you can, pay it all off. The worst case scenario is it costs you \$4.5 million.

"So Mr. CPA and Mr. Imperious, you want your son to take over the business. Do you want to have a business that's going to be there? In order for your son to take over the business and continue your legacy, your best planning is going to cost you \$12.8 million, your no-plan plan, as opposed to \$4.5 million. Would you rather save \$8.5 million in total cost, the vast majority of which is going to go to the IRS? Why not buy an insurance policy and have it in your hip pocket?"

So the no-plan plan is really not going to be working here. You always want to have the insurance in your hip pocket. We don't have time to talk about how we pay for that \$350,000 policy, but suffice to say we have ways of doing that in a very gift tax efficient way. That's a conversation for another day.

Anyone have any questions on 6166? The idea is not to say the CPA is wrong, the idea is to challenge the CPA away from the client obviously. We don't want to create an adversarial relationship, but challenge him with hard numbers. Is this really going to work? This is what it's going to look like on our assumptions. If you agree with the assumptions, this is what it's going to cost. Then you can lead with, "Let's buy an insurance policy for what it is, insurance. Let's have it in our hip pocket as insurance in case the world changes in 14 years and 6166 isn't available or won't work."

Q. ...

A. An interesting point is there are two things that could. One is I would probably put the \$10 million in an irrevocable insurance trust so it would be out of the estate. Even if I put it in the business, it's going to increase the value of the business, arguably, which would increase the 35 percent. If you're in the Ninth Circuit or the Eleventh Circuit, that's the west coast or down in Florida, the south, both of those jurisdictions have held that if there's a mandatory redemption, which there would be, we would put a redemption agreement in to pay the estate taxes, that the value of the business offsets the liability so the insurance has a net zero affect on the value of the business. But we can play off of that too if we wanted to boost it. We don't have to take the position that it's negative. We can let it increase the value.

Here we have Mr. and Mrs. Smith. They're 65, 62, they're young. They have a family business. They have one daughter who's in the business and they have two sons, one is a lawyer and one is a doctor. They want the daughter to continue the business when they die. The sons don't even want anything to do with it. So at least on the soft issues we've taken care of one issue. The sons are independently wealthy, they don't care. But the parents want to treat their sons fairly and this is usually where mom and dad, and you've probably heard this but I'll repeat it anyway, this is usually where mom and dad start having some differences.

Dad's going to think fairly because daughter's putting sweat equity into the business so she's getting rewarded for the sweat equity over time. Mom on the other hand may think equally. She doesn't care that sons are independently wealthy. It's our assets. We're going to treat the kids equally. We've always treated the kids equally. You've got a conflict. You've got to deal with that conflict. You want to treat these kids equally, it's going to increase the cost. You want to treat them fairly, that's probably a manageable cost.

Let's make some assumptions. We have a \$10 million estate. Five million is the business, so about 50 percent value. The value assets we expect to double in value by joint life expectancy. Again, just to repeat, if you are a 65-year-old male and a 62-year-old female on a joint life expectancy, you are young. There's a long time before a survivorship policy is going to pay off. So what we need to do is we need to find a way to get the business to the daughter on dad's death, so that mom is completely liquid. The daughter can run the business. Mom's got plenty of

assets to take care of herself for the rest of her lifetime. And, at the same time, we can treat the boys fairly. So we're going to buy two policies in one very well drafted life insurance trust. We're going to buy a \$5 million single life policy. What that's going to do is pay the taxes on the value of the business. Remember the business is going to grow from \$5 to \$10 million. We'll pay the taxes and let the business go right to the daughter.

We'll buy a \$10 million survivorship policy because we'll defer the taxes on all the other assets until mom's death. So the boys have to wait until mom dies to get their inheritance. The daughter gets her inheritance up-front and then it's up to her to grow the business.

What we're going to do is put a life insurance trust in place. A lot of people get very upset by the word irrevocable when it comes to life insurance or any document that's irrevocable. The thing that you need to make sure that your clients understand is that irrevocable.

Q. ...

A. Yes. So this will have grown to \$10 million. I just cut the tax at 50 percent. So we need \$5 million to cover the taxes so that she can inherit the business. They'll inherit it when mom dies. We're going to put a marital trust in place for mom for all the other assets.

Forgetting the credit shelter for a moment, mom's marital trust is going to have the other assets, the other \$5 million, which will be \$10 million. Plus she will have the \$10 million of other assets and we want to be able to pay the taxes. Remember that's going to grow over her remaining life expectancy. So we buy a \$10 million policy to pay the taxes when she dies.

This is the single life UL. This is the survivorship UL. The total cost of this plan is \$225,000 a year. And we're going to fund that probably out of the cash flow of the business.

Q. ...

A. What we're probably going to do is use all of our gifting. We'll use private financing or private split dollar with an exit strategy, with a GRAT or a sale to a defective trust as an exit strategy. More advanced estate planning. First, we'll use all our Crummey's, like we normally would. We'll decide whether or not we should use lifetime exemption to pay premiums or maybe recap the company and start giving some non-voting shares to daughter today, via the trust so she doesn't really get them.

What I was starting to say was that a life insurance trust has to be irrevocable. All irrevocable means is you can't change the terms. So I can't just slide a page out and slide a new page in five years from now. That's called fraud. A well drafted trust is very flexible. So my trust here would actually probably have mom as a potential beneficiary of the trust in case I needed to blow the whole thing up. I always pick the one who I think is going to die first, typically that's dad unless we knew that mom had a health problem and then we'd have mom do it and let dad be the survivor.

I'm going to have provisions in this trust that are going to allow me to do some more complex premium funding in a gift tax-efficient way. I didn't get into that today because we want to focus on how we move the business down. But that might include annual exclusions, lifetime exemption, other planning assets, premium finance, private finance, private split dollar, or any of those types of options.

Q. ...

A. Well we can do that. You can do that, those are more advanced plans. I was just keeping this very simple. If I was going to do more complex, I would probably move it along a little bit faster and start moving those assets out of the estate as fast as I could. Of course, if this were an S corporation, which 75 percent of all businesses are in the U.S., you're not going to be able to use an FLP because an FLP can't own that share.

Q. ...

A. Well it's difficult to roll an S back into a C or a partnership. There are immediate tax considerations that take into place.

Q. ...

A. The statement was I could freeze this corporation today and start a new corporation and shift all my business into the new corporation and start moving it that way. You can do that. That would assume those soft issues we were talking about, that mom and dad are ready to do that.

Q. ...

A. Corporation. Exactly. Yes. He's talking about freezing those assets, have all new contracts come out. Depending what type of business it is. The CPA would have to work that out.

Moving along. That all of this relies on is a well-drafted, flexible trust document. So your mantra for today is: "Irrevocable does not mean inflexible." Well, I would actually go with absolute discretion. All my trusts are drafted with absolute discretion and an independent trustee, a trusted advisor, friend or a cousin. Someone who knows what the plan is and is going to stick with it.

Now, what benefits do you get from doing this? Think about what we've done. Instead of a full-blown, complicated plan that we could get into, this is sort of the bare bones without getting too advanced. We have bought two life insurance policies and created a well-drafted life insurance trust. And, of course, had our marital and credit shelter trust in place. And what we've got for that is we maintain control of the business. This goes to your point, Mr. Smith wanted to maintain control of his business until his death. We've created a ready market for the business assets, because what is basically going to happen is the ILIT is going to get \$5 million of insurance, it's going to buy stock from the estate and then the rest of the stock can go to the daughter. The trust is going to distribute its shares out to the daughter and she gets the company. It ensures that Mrs. Smith will be very liquid so that she doesn't have to worry about what's going to happen to her after her husband has passed away. And it ensures that the daughter gets

control of the company solely by herself. She sinks or swims on her own. She's not in business with her mom and she's not in business with her brothers.

The benefits continued. The trustee can determine when the daughter is ready. Let's say that dad, right now, doesn't think that daughter's is quite ready to inherit it. So what if something happened today? You can put provisions in a trust where the trustee will manage the company in a way that continues to groom daughter for the CEO role and eventually gives her the economic and voting control of the stock when mom or the trustee determines she's ready. That allows you also to protect daughter against divorce or some life problems that she might have. Creditor issues, divorce, drug addiction, whatever problems you have. Trusts are very good for that, because they can be very flexible and they can protect. You can run the business, protect the business' economic value to the daughter, but not put the whole business at risk to the vagaries of daughter's life. It removes sons and then the sons get treated fairly at the second death.

This is what it looks like, rather complicated. But basically all you have here is irrevocable trust plan. To go to your question, we'd have to figure out how we're going to fund the life insurance, but we can do that. That's probably the easiest thing that we can do on this plan. But it's a very simple plan that moves the business intact to the successor using life insurance.

Let's look at the young and the restless. Mr. and Mrs. Young are 48. Mr. and Mrs. Restless are 45. They've started a biotech company that they think they're going to take public in 10 years. What you would normally do here is have a buy-sell agreement funded with term insurance. And you'd stop. Hopefully they would sign the buy-sell, and then hopefully they would buy the term insurance.

Here's the problem. They're both young and they've got young kids. When they go public in 10 years, they're going to go public because they've been successful. They have a temporary buy-sell planning need but a permanent insurance need for estate planning. You don't buy term for a permanent need. You have a temporary type of need, but a permanent overall need for insurance. How can we do it in such a way that we buy permanent insurance today? We're buying survivorship insurance for estate planning purposes (and I'll tell you why it's survivorship in a second) when they're 48 and young. That's pennies on the dollar.

This chart is nothing more than a quick summary of what if we bought term. What's the present value of the term versus buying a permanent survivorship policy? And basically what this says is you're not gaining anything by buying term. What I did was bought term for 10 years and then I bought a permanent policy and aged them up, and then I present-valued the premium streams. When you do that, these are your costs. If you present value that, it's insignificant to buy term and then buy permanent later. The point of this slide is buy the permanent today. You're not saving anything by buying term for 10 years. When you increase the costs of the permanent insurance because you've aged up 10 years, you're not saving that much. What I did was I looked at they're preferred today. What if they're preferred and what if they're standard and these are the premiums. If you present value that stream over their life expectancy, it's negligible. You are better off buying the permanent insurance and locking in their underwriting today so you don't have the risks of a health change in 10 years. That's basically what I did there just to show you that it makes sense to do so.

My point was that even if we go public, you still have estate tax issues. By definition, if they go public, they've made it. And they've got another 40 years of their wealth to continue to increase. They've got a big problem. They are going to be a wealthy couple. The point was should we buy permanent today? And the answer is yes.

Here's what would happen. The MPV of buying the term and then buying the permanent later is basically if they're 48 today and in 10 years they'll be 58, the difference of using this is basically \$5,000. That is insignificant to assume the risk that something won't happen to them and that they're permanent insuring. It's only a \$5,000 difference in today's dollars.

Q. ...

A. The permanent is actually less in this case if they're preferred because you would have preferred-preferred here. If you go to preferred-standard, the MPV of using the term is \$107 and it's still cheaper to do this. It is right, it was always cheaper. Actually it turned out it was always cheaper on my assumptions. I ran different scenarios and it was always cheaper to buy the permanent up-front, because of the underwriting costs.

Q. ...

A. No, this is \$83,000 of total cost to buy the term and then invest.

Q. ...

A. Yes, because you're buying it at 48. On a permanent basis, they're 48 and they are preferred for the rest of their lives on permanent. Here you're buying term insurance on a preferred basis and then you're buying permanent insurance on a preferred basis. The difference in the COI on a 48-year-old in this particular product was so much that, at 58, you overcame the cost of the cheaper term.

Q. ...

A. No, preferred to future preferred. Preferred to future standard. Preferred to preferred. And then preferred to future standard, and the COIs were so much less on a present value that it actually overcame the price of the term.

Q. ...

A. Yes, correct. That's why the COIs were so low, that's why.

Q. ...

A. Yes, you could do that as well.

In the interest of time, I just want to keep going. Let me show you what we're going to do with this graphic. What we're going to do is we're going to have the Youngs set up a trust and we're going to have the Restlesses set up a trust and those two trusts are going to buy survivorship insurance. The Youngs are going to buy survivorship insurance on their lives and the Restlesses are going to buy a policy on their lives. Normally, in a cross you would have each owning a policy on the other. The problem is, when you go to uncross them, you can have tax problems. So what we're going to do is have them buy their own policies and they're going to rent a portion of the death benefit each year to the other couple, because the way that this plan works is you don't have a buy-sell until one whole marital unit is out.

So for instance, let's say Mr. Young died, the buy-sell doesn't kick in because Mrs. Young is still alive. So you only have a buy-out if both of them are killed in a car accident. So we're going to rent the death benefit to each other. Now, that's a rental so it's rental income. How do you value that? Well, the IRS told us basically with private split dollar with a survivorship piece, we basically do what's reasonable. The entire industry ran Table 2001 through the Greenberg formula and came up with new rates. That's what we use here.

That is how much it costs: \$12 in the first year, \$161 in the second year. These are the annual rental costs, not on a per-million basis. This is the rental cost on the \$25 million policy bought for a total of \$1,127. That is the cost for the younger group.

What did the entire amount cost? What you have to do is if you're setting rental costs then the IRS's theory is that's rental income. So as we're renting to each other, we are paying rent to each other so each of us, as we rent to each other, have rental income. We all know the company is going to earn \$1, it's going to pay it out so, on an after-tax basis, they're buying their insurance premiums and now they're renting it. So you have what's called twice tax dollars. But what is that twice tax cost over the 10-year period? Five hundred dollars. Five hundred dollars is an option price for the flexibility of being able to buy my permanent insurance today where I want it, at the cost that I want it, which is in my ILIT at my underwriting today and at the prices we have today. Because if one thing we probably know is that prices are going up, particularly on guaranteed UL, if it's even going to be available much longer because some companies are pulling out. Some have just entered with a new product, some are coming out. It depends on how the economy does.

The idea here is that you put the permanent need where it needs to be today, and you do it through a simple rental agreement. This looks a lot like endorsement split dollar. Basically you're putting one couple in the place of the corporation and the other couple in place of the employee and you're just renting the death benefits back to each other.

If death occurs during the 10-year period, both get killed in a car accident, the life insurance premium will come into the ILIT and immediately be transferred up to the surviving couple who will then take that death benefit and buy out the couple's share. The money ends up where it needs to be anyway, and the surviving couple gets it. If it doesn't, we tear up the rental agreement, we tear up the buy-sell because we've gone public, now they own public shares, but we have the life insurance where we want it.

Any questions on renting death benefit back and forth?

Q. ...

A. The question is isn't there something in the rules that says it has to be an arm's length transaction? The answer is, normally, yes, because they're always worried about whether it should be a gift or a compensation event somewhere. Uncle Sam always wants his tax.

My answer to you is twofold. One is this is arm's length. This is the government telling us what the cost to run this rental is every year. We're paying the rental cost.

Q. ...

A. Well actually they're two separate families who have independent interests and they are paying market rate for the rental value. The government gave us this table. If they think it's wrong, it's not our fault.

So, yes. Normally, you would want to make it but this is a fair rental and we're going to report it and tax it accordingly.

Q. ...

A. Yes. That was the whole assumption here. That's why we bought survivorship insurance because it's four young people building a business. You don't normally see it that way. But I will say that the very first one of these that I did, which at the time was \$50,000 of target premium on a variable UL that we sold about eight years ago, was just this case, only the couple was younger. I actually aged them up a little bit.

The question was how often do you really see a survivorship-survivorship case. We do this most often with single life cases. I wanted to show you how a young couple with a growing estate can do this.

The last slide I have here basically tells you when I might do a GRAT to move to freeze value with stock in a company or when might I use a sale to a defective trust. From an income tax point of view, the GRAT is superior. Arrow up means superior. Arrow down means less superior. Neutral is a neutral arrow. The reason a GRAT is because a GRAT is ignored for income tax purposes. Therefore, the annuity payment is not taxed but the assets earned in the GRAT are taxed to the grantor, so it's as if you did nothing.

With a sale to a defective trust, the only reason I made it neutral, the sale to the trust is ignored for income tax purposes but the donor has to pay the income taxes on the income earned by the business and the note payment back may not be enough to fully offset that. So there could be a negative cash flow event. What I usually do when I do those is look at it one way and then I manipulate the note terms so that I make the cash flow neutral out to life expectancy. Then I give both options to the client.

Gift taxes, both positive. The GRAT is positive because you can zero out a GRAT. Sale to a defective trust, if you believe you need to seed the gift, the most your gift is going to be is 10 percent of the note. That is why I mentioned in the beginning if I'm trying to move \$10 million out, I would have had to move it for \$7 million last year. That same \$10 million today might be \$4.9 million. So instead of a \$700,000 gift, my gift only has to be \$490,000. I personally do not believe you need to seed the trust, but I also believe that you don't want to fight the government. So if you can seed it, just seed it.

As an estate freeze technique, the GRAT is a neutral. That is because you've got to beat the 75/20 rate, the government's rate. You have to beat it to make it work. On the sale to the defective trust, it's a positive. This is the 75/20 rate. This is 125 percent of the midterm AFR. That is the AFR, so there's a slight positive nod to doing a sale to a defective trust. Basis step up, you will get a basis step up for what is still in the estate. Sale to a defective trust, you give up the basis step up at death. Age and life expectancy, a GRAT you've got to survive the term. You have different ways that you can set up a GRAT. You can do two-year, rolling GRAT that Mrs. Walton did. You can do ladder GRATs. You can do a three-, a five-, a seven-, a ten-year GRAT. You can do one GRAT that is just 10 or 15 years. So it's neutral, you've got to survive the term.

Sales to defective trusts, the day you put that thing in place the note is gone and that's all you have to do. You don't have to survive a term. You always want to buy insurance to hedge the bet.

Interest rates, again, it's a neutral for a GRAT because you have a moving target in terms of your 75/20 rate. If you're going to do rolls or ladders, you may end up having to use a higher interest rate. Once you do the sale, you lock the rate forever. Today's long-term AFR is about 4 percent. So you can sell a company at a depressed price with valuation discounts and only have to charge 4 percent interest to avoid gift taxes. So that's a big positive.

Administration. GRATs are very easy to administer relatively speaking, but you have to value the assets every year. So, if you're dealing with a business interest, you're going to do valuation up front for gift tax purposes and then you have to update that value every year. If you're going to do rolling GRATs or ladder GRATs, you're going to have new GRAT instruments coming into play every year, so you increase the legal and accounting costs. Once you do the sale it's a note. Somebody just has to make sure you pay interest and principle when you're supposed to.

Control. You maintain control through the GRAT because you're always getting the asset back. All you're doing is shifting the value out of the estate. Sales to a defective trust control is neutral because if you give away the assets, you've given away the voting stock, you're going to give away voting control as well as economic control. So you might need to recap your company into voting and non-voting, so you can maintain voting control and only push out the economic control.

GST tax planning. Because of a quirk which is actually a smart move on Congress's part, for those of you who do dynasty trust planning or generation-skipping transfer tax planning, you cannot apply your GST exemption until the GRAT ends. So if the GRAT does what it's supposed to do, you will have moved this huge amount of assets out of your estate, probably

more than your GST exemption, now you're into a GST tax situation. So if you want to do dynasty planning, generally speaking GRATs are not the vehicle. You want to use a sale to a defective trust.

Tax certainty. GRATs are in the Code. You follow what the Code tells you to do and you're done. Sales to a defective trust, we have one private letter ruling from 1995 that tells us how to do it, although it's perfectly legitimate tax play. We don't have the kind of regulatory authority we have with GRAT.

That was a lot to digest. The only thing I want you to think about and take away from all of this is that there are ways to plan for succession that take into consideration the soft issues and the hard issues and don't just get bottled into one size fits all. There is a lot of planning flexibility out there and the idea is to team yourself up with the experts who know how to do it and then do what's right for the client. It's not a one size fits all model. Thanks for your time.

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