ESTATE PLANNING WITH LIFE INSURANCE

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B.S. in Economics from Yale; LLB from Columbia Law; Member of Bar in NY and California (inactive status).

Former Senior Advanced Underwriting Consultant of NY Life & VP of Management Compensation Group-SF; also a principal of The Silver Group.

Frequent speaker before many organizations on Estate Planning, Planned Philanthropy, Non-Qualified Deferred Compensation, Life Insurance, & Long-Term Care Insurance:

CLU Symposium & nine CLU Institutes; AALU & MDRT; Nevada Estate Planning Conferences & Federal Tax Institute; Seminars sponsored by the Community Property Journal, Farnsworth Publishing Company, & California CPA Foundation for Education & Research; 12th Annual Federal Estate Planning Symposium sponsored by UMKC Law School; Various Estate Planning & Planned Giving Councils, SFSP & NAIFA Chapters, & other industry groups.

Past President of San Francisco Estate Planning Council & San Francisco Chapter of Society of Financial Service Professionals; member of three Estate Planning Councils: San Francisco, East Bay, & Marin County; Board member of National Association of Estate Planners & Councils.

Very active in community affairs:

Past member & Chairman of Mill Valley Planning Commission; past City Councilman & two-term Mayor of Mill Valley; past member of Marin County Transit District & past member & Chairman of Marin County Transit Commission; current member and Chairman of local Flood

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Robert E. Burton LLB CLU ChFC AEP

I. This Author's Comprehensive View of the Various Components of Estate Planning (the **A**-**B**-**C**-**D**s)

A. = Accumulate

Estate planning begins with the accumulation of asset values

B. = Benefit

When sufficient net worth has been achieved and family obligations permit, it is time to reap the benefits of your wealth accumulation efforts with careful and thorough retirement planning

C. = Conserve

The uncertainties of life and aging coupled with the high cost of dying make it necessary to take active steps to conserve your accumulated property for yourself and your family during lifetime, and ultimately for your heirs and beneficiaries

D. = Distribute

The final step in the estate planning process is to arrange for the desired and orderly distribution of your estate to the chosen objects of your bounty

The foregoing will provide the framework for the balance of this author's presentation

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II. What, Really, Is Life Insurance?

A. Life insurance is a means to an end, not an end in and of itself

B. Life insurance is a financial tool for accomplishing certain objectives, much like a mortgage is a financial tool for accomplishing certain objectives

1. Most people do not like making their mortgage payments **...** they just like owning their homes

2. And most people do not like paying for their life insurance **...** but I never heard anyone complain about the life insurance death benefit proceeds they receive

C. Examples of typical objectives that only life insurance can accomplish

- Basic family protection **...** “providing for widows and orphans”
- Protecting a business from the loss of a key person
- Inexpensive collateral for loans or credit lines
- Funding device for other arrangements
    - Buy-sell and stock redemption agreements
    - Non-qualified deferred compensation plans
    - Split-funded or fully funded 412(i) pension plans

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- Estate planning uses (discussed in detail below)
- Philanthropic planned giving
- Income tax-free liquidity (death proceeds are 100% income-tax free unless a transaction has taken place that violates the transfer-for-value rule and has not been corrected before death)
- Buying time for other arrangements to pay off

D. Life insurance is like having money in your wall safe **...** it buys peace of mind

III. Life Insurance Is Also Very Complex

A. There are many types of policies **...** all constructed out of the same basic elements

- Assumed and/or carrier-guaranteed mortality charges
- Assumed and/or carrier-guaranteed interest or other rates of return
- Assumed and/or carrier-guaranteed charges for the expenses of doing business
- Persistency and lapse rate assumptions

B. Types of policies

1. Term insurance, which is exactly what it says it is: insurance for a term of years

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It is like renting your home rather than purchasing it **...** when the term is up, you had what you paid for, but you have nothing left

a. Annually increasing term policies

b. Extended period term policies, ranging from 5-year-level-premium term to 30-year-level-premium term (and perhaps even longer with some carriers)

    i. With all of these, you pay more than the true cost of the coverage in the early years and less in the later years

    ii. Therefore, if you do not keep the policy for the entire level-premium-period, you end up having paid more than the true term cost of your coverage

c. Most term policies are convertible to permanent policies without any medical or other evidence of insurability, but only for a specified period of time that varies significantly from carrier to carrier and policy to policy

    - Every term policy should be carefully reviewed with this in mind

2. Permanent insurance, which is again what it says it is: insurance that is intended to be in force permanently until death do us part, whenever that may occur

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It is like purchasing your home rather than renting it **...** you have it permanently (provided, however, that you make the required payments)

Permanent insurance policies also almost always develop cash values

a. Traditional whole life policies, both single life and 2nd-to-die

   i. Generally the highest premium type of coverage **...** but also the safest

      (a) In its pure form, a whole life policy is an endowment at age 100, which means that the policy's cash value equals the face amount at age 100

      (b) Again in its pure form, if the premium for a whole life policy is paid in all years, the basic cash value and the death benefit are both fully carrier-guaranteed

   ii. When the policy is properly designed and managed, additional built-up policy values, generally in the form of paid-up additions purchased with policy dividends, can typically be the source of future premium payments after a period of years (erroneously referred to as "vanishing premiums")

   NOTE: In almost all cases, this does NOT mean that the policy is paid up

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iii. The cash values can also be accessed via policy loans and via withdrawals from additional built-up policy values, generally on a tax-free basis if the policy is properly managed and monitored

iv. Typically not very flexible, but can be made more flexible by including term riders and other policy features

b. Universal life insurance (really "flexible premium adjustable life"), both single life and 2nd-to-die

i. Developed in response to high interest rates in the late 1970s - early 1980s, and is now probably the most common type of permanent coverage

ii Can be viewed as a transparent whole life policy with much more flexibility

(a) Interest rates or earnings, mortality charges, and expense charges are all clearly set forth and included in each annual statement

(b) There are two basic death benefit options: level and "increasing"

(1) With a level death benefit always equal to the face amount and internally increasing cash values, the net amount at risk decreases,

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thereby lowering mortality costs (like whole life)

- However, if the cash value ever starts to go down, mortality costs will start to increase again, and the policy may well then be on a crash course heading to an early demise

(2) With an "increasing" death benefit equal to the cash value plus the face amount, the net amount at risk always equals the face amount, so that mortality costs keep increasing with age, just like pure annually increasing term insurance

- This can become a very expensive policy to maintain; who wants to pay for pure term insurance at older ages?

(c) There is no fixed premium, which gives great flexibility, but can also lead to serious problems if premiums were based on high interest rates and interest rates later decline, causing the policy to become underfunded

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iii. The key to maintaining universal life policies on a sound footing is periodic monitoring and analysis by a true life insurance professional

SEE Trusts & Estates Article **...** and see the discussion below for recent developments regarding universal life policies

c. Variable policies

i. Generally constructed on the universal life platform

ii. The primary difference is that the cash values are invested in separate account investment funds within the policy, similar to mutual funds, that often "mirror" external mutual funds

(a) Most policies have 20-30 funds to choose from, ranging from money market funds to bond funds to aggressive equity funds, generally including the carrier's own proprietary funds as well as funds from outside fund groups

(b) All policies also have a fixed account similar to traditional universal life policies

iii. Variable policies were flying high when the stock market was flying high, but many of them ran into serious problems when the stock

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market boom ended, particularly leanly-funded level death benefit policies on older insureds, because the cash values dropped precipitously, thereby causing a sudden and dramatic increase in mortality costs

iv. The key to designing and maintaining variable universal life policies on a sound footing is, first, not to overestimate the rate of return, and second, to fund them generously

(a) It would be dangerous to assume that future stock market rates of return will equal the "historic" rates of 10% or more

- Rates of return from 6% to 8% seem more prudent

(b) Since variable policy separate account investment funds "stand on their own", these policies typically have higher internal policy charges than non-variable policies, so that leanly funded policies usually perform poorly

(c) Although policies cannot be illustrated with a lower assumed rate of return in the later years, it is usually prudent to shift to more conservative policy investment funds as one grows older

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C. Recent developments in universal life policies

1. Riders that extend the coverage beyond age 100 with no further policy charges, if the policy is still in force at age 100

   - If not automatic, these riders must usually be elected when the policy is put in force, but payment can often be deferred to the later policy years and then only if needed

2. In response to adverse experience with under-performing policies resulting from declining interest rates over the years, many carriers now offer policies that have fully carrier-guaranteed premiums and death benefits; these policies are almost like guaranteed level-premium-term to age 100 - and beyond

   a. These policies generally develop some cash value along the way (similar to the behind-the-scenes reserve in a pure term policy), but not a large amount, and the cash value almost always disappears in the later years leaving a pure death benefit

   b. These policies generally require timely premium payments in order to maintain the carrier's guarantees

   c. These policies generally automatically extend the coverage beyond age 100 with no further policy charges, but in rare instances the continuation rider is separately charged for and needs to be elected

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d. While the concept of these policies is certainly attractive, one might ask if they are really preferable at a time, such as today, when insurance policy interest crediting rates are still quite low - i.e., does the problem these policies were designed to solve still exist? This author's experience is that most clients still choose these policies because they remove the adverse risks of fluctuating interest rates and mortality charges

e. Since the guarantees in these policies are carrier guarantees, and not government or similar guarantees, it is important that this type of policy be purchased from a strong, well-recognized, highly-rated carrier

3. With the advent of institutionally-financed premiums (discussed below), additional policy death benefit options have been developed

ii. Return of premium - i.e., the death benefit equals the face amount plus premiums paid; this option was often also used with split-dollar plans in their heyday

iii. Occasionally the return of premium option can be elected to include the cumulative interest on the financed premiums

Note that these options significantly increase the premium outlay required to maintain the policy

4. Policies with long-term care options

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5. Policies constructed with new mortality tables under which the internal mortality charges, and perhaps the premium payments as well, may continue beyond age 100, often to age 121

D. With the increasing complexity of today's policies, riders, and options, a thorough analysis should be made at the time of purchase of any new policy, and all inforce policies should be regularly monitored so as to be sure that they are not under-performing and are still meeting their original intended objectives

- A periodic policy audit by an independent third party may well be the prudent course of action

IV. Other Important Developments Related to Life Insurance

A. Life settlements of inforce policies

1. This is an interesting and complex subject that really requires its own separate presentation

2. But all estate planning practitioners should at least be aware of the potential benefits of life settlements in certain situations, such as:

    a. Where more attractive replacement policies are available

    b. Where the policy is no longer needed for its intended purpose

        i. Key-person insurance when a key person retires and does not need or want the policy for personal purposes

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ii. Buy-sell policies when there is no longer an underlying buy-sell agreement, perhaps because the business has been sold or goes public, or because next-generation family members have become active

iii. Policies purchased to pay estate taxes when the estate is no longer subject to tax due to decreases in value or increased exemptions

- Consider the huge potential market here in the unlikely event that estate taxes are repealed

3. Life settlements are generally viable only under the right combination of circumstances

a. The insured has a shortened life expectancy, ideally 15 years or less, but in some cases as much as 20 years

- No exam is required for a life settlement; rather, the life expectancy determination is based solely on the insured's medical records

b. The policy has a relatively low cash value; this means that whole life policies are generally not the best candidates

c. The policy has no outstanding policy loans

d. If the policy is a term policy, it must still be convertible to permanent coverage

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e. If a replacement policy is desired, the insured must still be insurable at acceptable rates. Favorable arbitrage can be achieved when a new carrier looks more favorably on an insured's life expectancy based on medical records plus an exam than the life settlement company does based on medical records alone

4. Most purchasers of policies in life settlement transactions are large, financially sound, and often well-known institutions

- This should remove any fear that a policy will end up in the hands of a stranger

5. Expected tax consequences of a life settlement

   a. If the proceeds received do not exceed cost basis, there should be no tax on the sale

   b. But any gain over cost basis should be taxed as follows:

      (1) Gain up to the policy's cash value should be taxed as ordinary income, the same as it would be if the policy were surrendered

      (2) And the best current wisdom is that any gain over the policy's cash value should be taxed as a long-term capital gain, but there have been no rulings

      SEE the California Broker Article on Life Settlements

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B. Premium Financing.

(*This will be covered as a separate subject below)*

V. Reprise: The **A**-**B**-**C**-**D**s of Estate Planning --
Examples of the Effective Uses of Life Insurance in Each of the Components of Estate Planning

A. **Accumulating** an Estate

1. For young couples, life insurance provides essential family protection in the event of premature death; it also builds an instant estate

2. The policy's beneficiary designation governs the distribution of that estate at death and, particularly when minor children are involved, requires the same care and careful planning as would apply to any other estate assets

    - The Role of Other Members of the Estate Planning Team -- preparation of wills with testamentary trusts or revocable living trusts and pour-over wills

B **Benefiting** from Your Accumulated Assets

1. Permanent life insurance policies (often variable policies) are frequently used by individuals to supplement their personal retirement benefits

2. These same types of policies are one of the most popular means of informally funding employer-provided non-qualified deferred compensation and salary continuation plans

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for corporate officers and other highly compensated employees

- <u>The Role of Other Members of the Estate Planning Team</u> -- preparation of deferred compensation and/or salary continuation agreements, and possibly rabbi trusts, along with other necessary ERISA documents; these arrangements also require appropriate GAAP accounting procedures for the employer

C. **Conserving** Your Property for Yourself and Your Family

1. During Lifetime

   Life insurance policies with long-term care riders **...** or stand-alone long-term care policies **...** are essential tools in protecting against the infirmities of aging, both physical and mental

2. At Death

   Life insurance policies, properly arranged to be free of estate taxes, gift taxes, and often even generation-skipping transfer taxes, have long been recognized as the premier tool for providing the liquidity necessary to pay estate taxes as well as income taxes on IRD with 100% dollars, i.e., dollars that are themselves not subject to any type of tax

   a. This avoids the necessity of forced liquidations of non-liquid property

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b. It also keeps the estate intact for heirs and beneficiaries

c. It can also be highly effective in situations where Section 6166 extensions may be available for closely-held business interests, either as an alternative to Section 6166, to protect against the possibility that the estate will not qualify for Section 6166, or hand-in-hand with an elected Section 6166 extension

- The Role of Other Members of the Estate Planning Team -- total estate planning, including preparation of irrevocable trust agreements and other estate planning documents, and necessary accounting and trust services

D. Distributing Your Estate to Your Heirs and Beneficiaries

1. With second marriages, particularly with a younger second spouse, it can be used to provide separately for the children of the first marriage, generally with an ILIT

2. When not all children are involved in a family business, it can be used to "equalize" estate benefits for the children not in the business, again often with an ILIT

3. It can be used to provide for special needs beneficiaries without shortchanging other family members, generally with a separate special needs trust

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4. It can be used to buy the time necessary for other arrangements to pay off, whether they be business ventures, stock market, real estate, or other investments, or other estate planning tools such as GRATs, even a series of GRATs with different maturities, or qualified personal residence trusts

5. It can be used to complete an installment sale that is incomplete at death, such as a sale to an intentionally defective irrevocable trust

6. For estate owners who wish to leave a substantial part, or perhaps all, of their estate for philanthropic purposes, it can be used to provide the family's inheritance, or replace the value of the donated property, generally with an ILIT known as a wealth replacement trust

   SEE Mortal Thoughts Article

   - The Role of Other Members of the Estate Planning Team -- all of these ideas and techniques are part of the total estate planning process and all require various estate planning documents as well as accounting and trust services

VI. Crummey Trust Issues and Opportunities --

Reflections and Suggestions from a Life Insurance Professional Who Has Worked with Many Fine Estate Planning Attorneys Over the Years

A. Crummey Beneficiaries

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1. In most situations, make the list of potential Crummey power holders as large as feasible under the Cristofani case guidelines

    a. For example, do not limit the list to only known living beneficiaries such as children, but include spouses and descendants, whether now known or not, and perhaps even parents

        - This practitioner has seen many cases where a new policy is purchased with a premium commitment that exceeds the available annual exclusions for the specified Crummey beneficiaries

    b. But, for both protection and flexibility, it is suggested that a provision be included that gives any trust donor(s) the right, in connection with any transfer to the trust, to limit or eliminate the withdrawal rights of any beneficiary

        - This should not be considered the reservation of a prohibited power over the trust, but rather nothing more than the right to determine to whom future gifts will be made

2. Some future trust benefit, even a relatively small benefit, should be included for every person to whom Crummey gifts are actually made over the years so as to be sure the gifts are deemed "legitimate" in the eyes of the IRS

B. Amount of Each Beneficiary's Withdrawal Right

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1. Make each beneficiary's withdrawal right as large as possible (subject to being limited as suggested above for actual gifts) so as not unnecessarily to restrict potential gifts to amounts less than available gift tax annual exclusions

    a. For example, do not limit the withdrawal right to the limits of the 5 x 5 rule, but rather to the lesser of the amount of the gift to that individual or the available gift tax annual exclusions

    b. And make the reference to the amount of the gift tax annual exclusion generic to what is permitted at any time under the Internal Revenue Code rather than only to the specific amount currently allowed

    c. And so as to avoid potential gift or estate tax problems with withdrawal rights that exceed the 5 x 5 amount, include either a non-general power of appointment or a (carefully drafted) so-called "hanging power" over the excess amount; either of these techniques should avoid a potential completed gift being made by the power holder to the other trust beneficiaries on non-exercised withdrawal rights

        - If the trust is divided into distinct sub-trusts for each power holder from the outset, this is probably not necessary, but this practitioner prefers the "pot" trust approach in most cases during the lifetime of the insureds

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d. In the typical case, the cumulative amount of excess will grow over the early years of the trust while the value of trust assets is less than $100,000 and the $5,000 amount is greater than 5% of the trust principal, but as soon as the value of the trust assets exceeds $100,000, the 5% amount will exceed $5,000 and will continue to grow until it eventually exceeds the amount of the annual withdrawal right

- When this occurs, the cumulative amount subject to the power of appointment or hanging power can be "worked off" annually until it disappears, and if it has not entirely disappeared by the time the life insurance death proceeds are received by the trust, it will almost certainly do so at that time

C. Notice to Beneficiaries of Their Withdrawal Rights

1. The cases and rulings all require that the Crummey power holders be given notice when a contribution is made to the trust with respect to which they have a withdrawal right

a. This means that, if multiple gifts are made to the trust each year, perhaps because the premium mode is other than annual (i.e., semi-annual, quarterly, or monthly, perhaps with automatic withdrawals), multiple Crummey notices are probably required each year, thereby causing excessive trust administration issues

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b. It appears desirable, then, to have premiums paid annually; this is also less costly than other premium modes

- But query: if it is known that a series of equal gifts will be made during the year at known intervals, is it sufficient to provide a single notice with the first gift so notifying the beneficiary?

2. Some practitioners include a statement at the bottom of the Crummey notice for the beneficiary to sign and return stating that the beneficiary chooses not to exercise the withdrawal right

a. That would appear to be the release of a general power of appointment rather than the lapse of the power, thereby causing unwanted tax consequences

b. Instead, simply have the beneficiary acknowledge receipt of the notice

D. Making the Trust a Defective Grantor Trust for Income Tax Purposes

1. There are several reasons why this can be advantageous

a. It allows an existing policy to be sold to the trust rather than gifted to the trust, thereby avoiding both the potential three-year estate inclusion rule and also a potentially large gift based on the then value of the policy

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i. There should be no income tax consequences or adverse transfer-for-value rule results since, for income tax purposes, the grantor and the trust will be considered to be one and the same

ii. And where the value of the policy is significant enough to have caused gift tax problems if the policy itself were gifted, the annual gift can be kept within desired limits by using private financing (discussed below) with a note payable over several years

b. Income-producing property can be transferred to the trust by sale or by gift with the income from the property then used to pay life insurance premiums

i. If by sale, whether for a lump sum or in installments, there should be no income tax or capital gains tax consequences since the grantor and the trust will be considered to be one and the same

ii. And in either case, since the income from the property will be taxed to the grantor rather than to the trust, which has been ruled not to be a taxable gift to the trust, the effective result is additional tax-free gifts to the trust

c. In general, it allows more flexibility in trust administration over the years

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2. Different practitioners choose different provisions to make the trust "defective"

   a. Some practitioners believe that all trusts that hold life insurance policies that still have premiums payable are automatically grantor trusts because of the ability to use trust assets to pay premiums

      - But query: if the trust prohibits the use of trust income for this purpose, will it still be considered defective?

   b. Perhaps the most "benign" provision to use is the ability of the grantor to substitute property of equal value

3. For greatest flexibility down the line, consider including a provision that gives the grantor the right to release the power that makes the trust defective

   - For example, this would enable the grantor to shift the income tax on trust income to the trust in future years, perhaps when no further premium payments are due

E. Trustee Powers Over Life Insurance

1. Many trusts contain only meager and/or outdated specified trustee powers over life insurance policies held in the trust

   a. In view of the complexity of modern life insurance policies and the myriad potential transactions that can take place regarding policies held in the trust, it

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seems desirable to this author to include very broad powers

b. Certain outdated powers -- or, more accurately, restrictions on powers -- can well be counter-productive

- For example, a provision requiring the trustee to apply dividends on whole life policies to the payment of premiums effectively prevents the trustee from having those dividends used more productively to purchase paid-up additions, which paid-up additions could either

  - Result in an ever-increasing death benefit under the policy or

  - Accelerate the time when dividend values can be the source of future premium payments

2. While not a practicing attorney, this author will provide, upon request, some suggested broad language dealing with trustee powers over life insurance to consider including in trusts that hold or may hold life insurance policies

F. Other Important Matters

1. Generation-Skipping Provisions

a. Since many trusts have at least the potential of a generation-skipping transfer somewhere down the line, it appears

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highly desirable to include appropriate generation-skipping provisions in the trust

- This can assure that, for generation-skipping tax purposes, there will only be sub-trusts with inclusion ratios of zero (“exempt”) or one (“non-exempt”), and nothing in-between

b. And depending on the nature of the trust, it may be appropriate to elect to apply part or all of generation-skipping tax exemptions to transfers to the trust

2. Powers of the Trustee to Deal with the Estates of the Grantors

a. Almost all clients who create irrevocable trusts will have a revocable living trust with a pour-over will as their basic estate planning instruments

- Yet the trustee’s powers that enable the trustee of the irrevocable trust to provide tax-free liquidity to the grantor’s estate by lending money or purchasing assets are too often limited to dealing with the personal representative of the grantor’s estate, namely, the executor

b. It is highly recommended that these powers be as broad as possible

i. They should authorize the trustee to deal not only with the personal representative of the grantor’s estate

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but also with the trustee of any other trust created by the grantor

ii. And they should make it clear that this power can be exercised even if the trustee is one and the same as the personal representative of the estate or the trustee of the other trusts

VII. Premium Financing Issues and Opportunities, Including Split Dollar

A. Institutional and Private Premium Financing

1. With low interest rates and the changes in split dollar rules, both institutional and private premium financing arrangements have become quite popular

2. Both are typically used because they facilitate policies that have large premium payments that would otherwise exceed gifting limitations

3. Institutional financing is often also used because people do not like to use their own money to pay premiums and prefer to use OPM (Other People's Money) whenever possible, primarily because they believe they can make better use of their own funds elsewhere

4. Institutional financing is highly complex, requires extensive analysis and legal and accounting services, and involves significant risks, such as:

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- Increasing interest rates, which increase the cost of loans incurred to finance the premiums -- but if policyowners can still do better with their own funds elsewhere, this can offset any additional loan costs

- Inability to renew the loan commitment at the expiration of the specified term -- but note that there are "evergreen" loans with no specified term, although the lenders do have "outs" if the interest is not paid or the borrower does not meet certain criteria

- The need for additional collateral or the failure of existing collateral

- Lesser-than-expected policy performance or longer-than-expected life expectancy

5. With institutional financing, an exit strategy is critically important

   a. For older insureds, the typical exit strategy is, quite simply, the death of the insured

   b. For younger insureds, however, the challenge is to design the program so that there will be sufficient funds to pay off the loan at a future point and still be able to maintain the policy going forward

6. IOLI / SOLI / SILI

   a. Investor Owned Life Insurance, a/k/a Stranger Owned Life Insurance, a/k/a Stranger Invested Life Insurance, are highly controversial institutional financing

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arrangements that essentially entail the "bartering" of life insurance policies, a practice generally frowned upon and considered to be against the public interest

b. However, one can probably still find a few offerings available in the marketplace, typically resulting in a contemplated life settlement of the policy two or three years down the line

c. As with other ideas that have surfaced over the years that excessively "push the envelope" and frequently lead to the loss of some of the tax advantages of life insurance, it seems prudent to steer clear of these arrangements

7. Private financing seems more attractive than institutional financing, at least to this author

   a. For example, liquid assets can be loaned to a defective (grantor trust) ILIT for nine years, thereby qualifying for the federal mid-term rate, with the excess earnings in the ILIT used to pay the premiums

   b. Alternatively, an installment sale of an income producing non-liquid asset can be made to a defective (grantor trust) ILIT under a similar arrangement

      - In both of these scenarios, there should be no income or capital gains tax consequences since, for income tax purposes, the donor and the trust are considered to be one and the same

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B. Split Dollar Arrangements

1. Split dollar is essentially a method of premium financing, typically implemented between an employer and an employee

2. Split dollar can be structured in one of two principal ways

   a. The endorsement method, under which the party that advances the premium (or most of the premium) is the policy owner, and the specifics of the desired arrangement are contained in an "endorsement" added to the policy itself

   b. The collateral assignment method, under which the policy is owned by the insured (or by a third party chosen by the insured such as an ILIT), and the policy is collaterally assigned to the party that advances the premium; a separate split dollar agreement containing the specifics of the desired arrangement is typically used and is highly desirable

   c. Although the IRS rulings until recently stated that the two methods were treated similarly for tax purposes, there was one significant underlying difference, particularly applicable to whole life policies: policy dividends belong to the policyowner

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i. In light of this, endorsement split dollar was quite common in arrangements for key employees and worked well in conjunction with non-qualified deferred compensation plans

ii. With stockholder-employees, on the other hand, the collateral assignment method was typically used because the built-up dividend values automatically showed up on the insured's side of the ledger

- This became known as "equity" split dollar and led the IRS to promulgate new rules designed to prevent this apparent tax-free shift of values from the business to the stockholder-employees

3. In its heyday between 1964 and the effective date of the new more restrictive rules in 2003, split dollar was an extremely popular fringe benefit for the key employees in any type of business and an important estate planning tool for the stockholder-employees of privately-held corporations

a. Under the new rules, "equity" split dollar of any type is unfavorably taxed under the same rules that are applicable to below-market-interest-rate loans

b. However, if a new carrier-guaranteed universal life policy is used, the chances are slim to none that the policy will ever develop "equity", since these policies

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almost never develop sufficient cash value to exceed the employer's share of the premium, even under an economic benefit contributory split dollar arrangement

i. This means that one can still have a split dollar arrangement under which the amount reportable as taxable income to the insured employee, or contributed toward the premium under economic benefit contributory split dollar, is based on the carrier's own lowest term rates (and even lower rates for 2nd-to-die coverage)

   - But note that the arrangement must be set up as endorsement split dollar rather than collateral assignment split dollar

ii. This also means that if there is an existing collateral assignment split dollar arrangement with an under-performing universal life policy that is still under the old rules because it is "grandfathered", one can replace the under-performing policy with a new carrier-guaranteed policy via a Section 1035 tax-free exchange, even though this may constitute a material change that causes the loss of the grandfathered status, provided the new arrangement is structured as endorsement split dollar and not as collateral assignment split dollar

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Conclusions

As stated at the outset of this presentation, life insurance is a means to an end, not an end in and of itself, and is often the only financial tool available for accomplishing important estate planning and other objectives

Most people do not like life insurance **...** they only like the many things that life insurance can accomplish

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