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LIFE INSURANCE

Wealth Transfer Planning in a Low Interest Rate Environment

MLINY0508088997

Did You Know…

- 1/3 of affluent households over the age of 50 do not have an estate plan in place

- 31% of households with $3 million or more do not have an estate plan

www.limra.com, Financial Plans – Real and Imagined Held by the Affluent, 2002.

Although the Estate Tax is expected to change in the next few years, Estate Plans serve purposes BEYOND avoiding Estate Taxes.

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Wealth Transfer Planning Needs

- Clients always have the same planning needs
  - Protecting family members
  - Leaving a legacy and being remembered
  - Control during life
  - Minimizing Taxes
  - Planning can also provide non-tax benefits

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Non-tax Reasons for Wealth Transfer Planning

- Income:
  - Provides resources for surviving family members
- Creditor / Divorce Protection:
  - Can protect children against creditors claims
  - Not part of children’s marital estate if divorced
- Legacy Protection:
  - Protect legacy from Grantor’s creditors
  - Provided transfers are not a fraudulent conveyance

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3 Wealth Transfer Planning Sales Ideas for use in a Low Interest Rate Environment

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Municipal Bond Maximization

Municipal Bond Maximization

- Did you know that a municipal bond may be subject to income and estate taxes at death?
- Do you have a client who does not need municipal bonds for income purposes?
- Are your clients concerned about outliving their money?
- When interest rates are low, municipal bonds may become less attractive as an asset.

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Solution: Municipal Bond Maximization

- Sell the municipal bonds
- Use the proceeds to purchase a single premium immediate annuity (SPIA)
- Gift part of the annuity income stream to an irrevocable life insurance trust (ILIT) using annual exclusion gifts*
- Keep the rest of the annuity income.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

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Advantages of Municipal Bond Max

- Municipal bonds can generally be sold with minimal income tax cost.
- Unlike municipal bonds, a SPIA is not subject to estate tax.
- Life insurance owned by an ILIT is generally free of income and estate taxes.
- The ILIT proceeds can increase the transfer of wealth to the next generation.

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Disadvantages of Municipal Bond Max

- Unlike municipal bonds, SPIA income is subject to income tax.
- Life insurance may have fees associated with it such as the cost of insurance.
- The exchange from municipal bonds to a SPIA may be taxable and/or result in additional charges or risks.

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Case Study: James and Ellen Weingart

- James (age 74) and Ellen (age 71) are both non-smoker preferred
- Total estate of $5 million
- Two children
- Have $1 million in municipal bonds that they do not need for income purposes

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How It Works

- James and Ellen will convert their municipal bonds to a Single Premium Immediate Annuity (SPIA).*
- They will receive annual income of $68,555 from the SPIA (after tax).
- They will gift $23,110 annually to an ILIT and keep the remainder as income ($45,445)
- The trustee will purchase a John Hancock Survivorship UL-G policy with an initial death benefit of $1,300,000.

*A SPIA may have more risk associated with it than a municipal bond. Please consult with an advisor for a detailed discussion on the risks and cost of this conversion.

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Here is what it looks like

Municipal Bonds
$1 million

Joint and Survivor SPIA
Annual Income: $68,555

$23,100
Annual Gifts

Trust
$1,300,000

Annual
Disposable
Income
$45,445

The data shown is taken from a hypothetical calculation. It assumes a hypothetical rate of return and may not be used to project or predict investment results.

Summary

- The Weingarts were able to increase the net to their heirs and reduce their taxable estate by using Municipal Bond Maximization.

Private Financing

Options for Funding Large Premiums

1. Premium Gifts To ILIT
2. Commercially Funding Premiums Through Bank
3. Privately Financing Premium To ILIT
4. Funding Premiums Using Private Split Dollar Plan

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What is Private Financing?

- Fair market loan between client and their Irrevocable Life Insurance Trust (ILIT)
- Loan interest is based on the Applicable Federal Rates (AFR)
  - Short (0-3 years), mid-term (3-9 years), and long-term rates (10 years or more)
- ILIT will use loan to purchase life insurance on Dad/Mom
- Gift taxes may be reduced or eliminated completely

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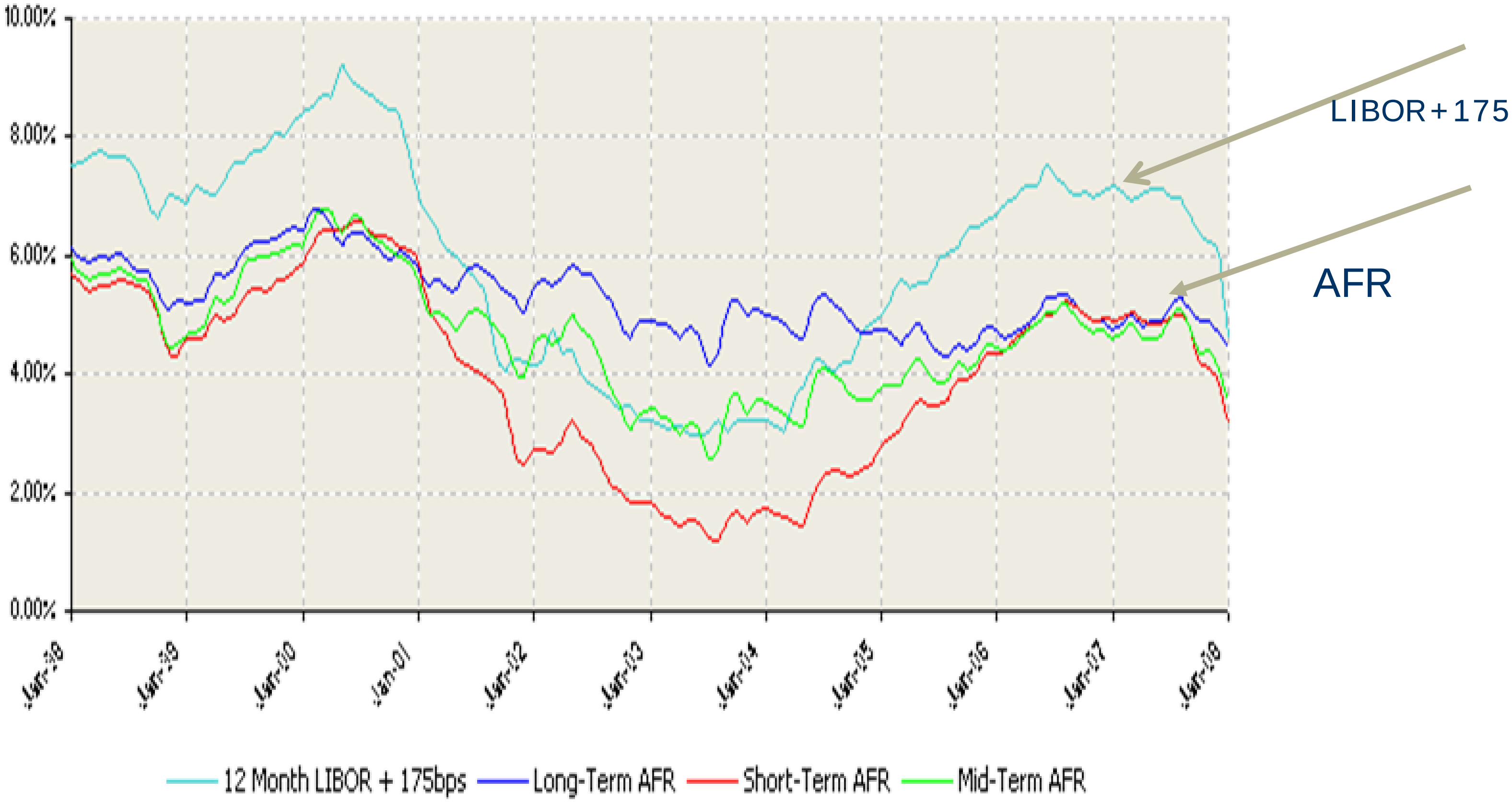
Gifting Limitations

- The annual exclusion is currently $12,000 per person
- The lifetime gift exemption is currently $1,000,000 per person.
- Beyond these limits, any additional gifts to a trust will be subject to gift tax.
- Clients often want to use their gift exemptions to fund discounted gifts or vehicles such as college savings, rather than life insurance.

Graph: 10-Year Average Rates By Type of Loan

Stand-Alone Commercial Financing May Not Make sense

The data presented represents historical values and are not to be used as an indicator of future results



*April 2008 mid-term AFR is 2.87%

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Advantages of Private Financing

- Gift tax costs may be eliminated or significantly reduced.
- In many cases, your client's heirs will receive the loan repayment net of estate taxes.
- Unlike a commercial loan, the client does not have to qualify or post collateral.
- Unlike a commercial loan, your client can make a single loan for all future premiums, locking in the current interest rate.

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Disadvantages of Private Financing

- Your client must have enough cash flow to pay the full premium or make a lump-sum loan
- If your client is also the lender, the loan repayment will be included in their estate and subject to estate taxes
- If an existing trust is the lender, it must pay income tax on the interest it receives

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Private Financing works best when?

- Low interest rate environment
- Older single-life policies
- Client wants to lock in low interest rates
- Client has the ability to make large lump-sum loans
    - Client wishes to completely eliminate gift taxes
    - ILIT wishes to own cash value in excess of premiums

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Private Financing Example

- Female, Age 62, NS Preferred
  - $24,000 available annual gift exclusions
  - Plenty of liquidity
- Cost is not an issue but she wants to completely avoid gift taxes
- Plan design
  - Gift $24,000 a year to an ILIT
  - Make a lump-sum loan of about $2.6M to ILIT, which earns 9% on assets
  - Loan interest rate is 2.74% (May 2008 mid-term AFR), deferred
  - $5,000,000 Protection UL-G Policy with a guaranteed premium of $189,284
- Loan, including capitalized interest, repaid in year 9

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The Results

Yr	Initial Loan	Cumulative Loan @ 2.74%	Loan Repayment	Annual Gifts	Trust Side Fund @9%	Death Benefit	Total Trust Assets Net of Loan EOY
1	$2,616,791	$2,688,491	$0	$24,000	$2,672,143	$5,000,000	$4,982,333
2		$2,762,156	$0	$24,000	$2,732,476	$5,000,000	$4,967,902
3		$2,837,839	$0	$24,000	$2,798,240	$5,000,000	$4,957,141
4		$2,915,595	$0	$24,000	$2,869,922	$5,000,000	$4,950,529
5		$2,995,483	$0	$24,000	$2,948,056	$5,000,000	$4,948,591
9		$3,337,529	($3,337,529)	$24,000	$3,337,529	$5,000,000	$5,000,000
15		$0	$0	$0	$0	$5,000,000	$5,000,000

The data shown is taken from a hypothetical calculation. It assumes a hypothetical rate of return and may not be used to project or predict investment results.

*8% is hypothetical gross return on trust side fund and a lower assumption may make sense based on the given financial environment

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Summary

- In this example, the insured only has to make annual exclusion gifts of $24,000 to the trust each year to fund a policy with an $189,284 annual premium.
- The initial lump sum loan is invested inside of the trust and is used for repayment of the loan balance in year 9.

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Private Split Dollar

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Private Split Dollar (PSD) Refresher

- Many forms of PSD but we will focus on the "typical" approach
  - Generally, PSD uses Non-equity Collateral Assignment
  - Donor pays premium and owns policy cash value
  - Trust receives remainder of death benefit
  - Annual economic benefit to trust (and gift) based on Table 2001-10 or carriers alternative term costs

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Similarities Between Private Financing and PSD

- Both reduce gift tax costs: instead of the full premium, the taxable gift is either:
  - Loan interest on premium up to the annual exclusion amount, or
  - Annual term cost (Economic Benefit)
- Both need an **exit strategy** as interest and term costs can increase over time.
- Both can benefit from the return of premium (ROP) rider.

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Private Split Dollar works best when?

- Relatively high premiums (rated cases, smokers)
- Younger Clients
- Survivorship Policies
  – Full-pay scenarios
  – Cash flow to make a large up-front loans is limited
  – Client has available annual exclusion gifts to cover term costs
- Option to “switch” from PSD to Private Financing (aka “Switch Dollar”)

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Comparison of Gift Value in Each Approach:

- Married couple
- Age 65 preferred non-smoker
- $1,000,000 Protection SUL-G policy with ROP
- Interest rate 5.02%
- Long-Term AFR
- Net DB is Net of Loan Repayment

Year	Age 1	Age 2	Economic Benefit Premium	Economic Benefit Private Split Dollar	Economic Benefit Private Financing 5.02%	Net Death Benefit to Heirs
1	65	65	14,467	145	726	1,000,000
5	70	70	14,467	436	3,631	1,000,000
10	75	75	14,467	1,120	7,262	1,000,000
15	80	80	14,467	3,051	10,894	1,000,000
20	85	85	14,467	8,075	14,525	1,000,000
24	**89**	**89**	**14,467**	**18,240**	**17,430**	**1,000,000**
25	90	90	14,467	21,343	18,156	1,000,000
30	95	95	14,467	53,447	21,787	1,000,000
35	100	100	14,467	80,964	25,419	1,000,000

Switch Year is when first spouse dies, or when gift tax cost of PSD exceeds that of Private Note based on interest rate environment

****Note: The long-term AFR rate at April 2008 is 4.4%**

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Comparison of Economic Benefit vs. Interest Cost

- Widower
- Age 65 Male preferred non-smoker
- $1,000,000 Protection UL-G policy with ROP
- Interest rate 5.02%
- 10-Pay Policy

			Economic Benefit		
Year	Age 1	Premium	Private Split Dollar	Private Financing 5.02%	Net Death Benefit to Heirs
1	65	67,704	2,750	3,399	1,000,000
5	70	67,704	4,030	16,994	1,000,000
10	75	67,704	6,880	33,987	1,000,000
15	80	0	11,010	33,987	1,000,000
20	85	0	17,030	33,987	1,000,000
25	90	0	32,240	33,987	1,000,000
26	**91**	**0**	**35,580**	**33,987**	**1,000,000**
30	95	0	52,620	33,987	1,000,000
35	100	0	112,070	33,987	1,000,000

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Typical Profile for Private Split Dollar

- Young Married Clients (Ages 40 - 55)
- Wealthy yet reluctant to do "irrevocable planning" (Ages 55-70)
- Commercial Financing unattractive
  - Interest rate risk over long horizon
  - Collateral issues
- Private Financing not viable
  - Insufficient cash for lump sum financing
  - Interest rate risk over long horizon

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“Sweet Spots” For Private Split Dollar

Second to Die Cases

- “IRS” survivorship term rates still are very low
- Need rollout strategy – at or before first death
  - Transfer unified credit to trust (uncertainty)
  - Convert to loan regime at first death, “Switch Dollar”
    - Interest rate sensitive (historic low rates today)
    - Cannot lock rates until “switched”
  - Use a Zeroed out GRAT to roll-out split dollar arrangement

“Sweet Spots” For Split Dollar (cont.)

- Younger Single Life Cases
  - Term rates are still lower than interest at many ages
  - Use with rollout strategy
    - GRATs
    - Sales to Defective Trusts
    - CLTs
  - Use with low cash value products where there is no equity
  - Switch Dollar

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Typical Scenarios for Private Split Dollar

- Young, Married and Wealthy – $10 million plus estates
- Older, Married and Wealthy Clients – As long as there is a 10+ year life expectancy
- Older Clients – PSD is not feasible if
  - Term rates and mortality risks are too high

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Basics of a Grantor Retained Annuity Trust (GRAT)

- Estate freeze technique – especially attractive with low interest rates
- Arbitrage Sect. 7520 rates
  - 120% of the mid-term AFR
  - 3.2% in May 2008
- Principal contributed to GRAT and annuitized using a fixed rate for a term of years.
- Goal is to "zero-out" the GRAT using actuarial assumptions
- GRAT remainder is transferred gift tax-free to an ILIT and remainder used to fund roll-out

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Use of PSD and GRAT

- Assumptions for Example
  - Husband (age 55), Wife (age 54)
  - $50,000,000 total estate
  - $25,000,000 Protection SUL-G Policy with an annual premium of $166,581
  - Establish a Private Split Dollar arrangement between them and their ILIT.

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Assumptions for PSD/GRAT, cont.

- A GRAT will be used as the exit strategy for the Private Split Dollar arrangement.
- They will fund a 15 year GRAT with $2,855,088 in assets and cash (3% growth, 7% income).
- In year 15, the GRAT remainder is projected to be $4,101,958.
- The ILIT is the beneficiary of the GRAT.

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Use of Private Split Dollar and GRAT

Gift of assets to GRAT
$2,855,088

Walton GRAT

Annuity payment
to client
$242,635

GRAT remainder
Interest $4,101,958

Split dollar Agreement:
Premium ($166,581) less
Economic benefit gifts ($386
in year 1, $7,297 in year 15)

Client

Annual Exclusion Gifts $24,000

ILIT

Termination of Split Dollar, year 16
Repayment = $2,498,710

All-pay $166,581

$25,000,000
Policy

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Summary

- In this situation, Private Split Dollar can reduce the amount to be gifted to the trust, while funding a large premium.
- A “zeroed-out” GRAT can be used to transfer assets to the ILIT without gift tax and the GRAT remainder can be used to rollout from the Private Split Dollar arrangement.

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Private Financing vs. PSD

	Private Split Dollar	Private Financing
Rated policies	X	
Survivorship Policy (all ages, especially with one uninsurable)	X	
When you may want to switch plan types	X	
Client has ability to make large lump-sum loan & lock in AFR rate		X
Client wants to completely eliminate taxable gifts		X
ILIT wants to own cash value in excess of premiums paid or rollout policy from cash values		X

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