John Hancock
LIFE INSURANCE

Sales Strategy
Exit Strategies

Financing techniques such as Premium and Private Financing are popular ways to leverage assets to fund a large life insurance need. Financing arrangements provide a client the opportunity to minimize gift taxes or the liquidity needed to fund large premiums. However, over time, loan interest charges may fluctuate and can become costly, as well as the cumulative premium loan, especially if the loan interest is accrued. Therefore, it is necessary to consider cost-effective strategies to exit these financing arrangements.

OVERVIEW OF COMMERCIAL AND PRIVATE FINANCING

Commercial and Private Financing are planning techniques in which a loan is taken to pay the premium on a life insurance policy. With Commercial Premium Financing, the loan interest is based on the London Interbank Offered Rate (LIBOR) plus a spread. In most cases, the insured pays the interest on the loan each year, although in some instances the interest may accrue and be added to loan principal. And, the loan interest may be adjusted annually, or may be fixed for a period of time, but is usually not fixed for life. Furthermore, the life insurance policy's cash value and other collateral are used to secure the loan. Depending on the age of the client, the loan will either be paid off at death with a Return of Premium rider (ROP), or during lifetime.

With Private Financing (also referred to as self-financing), the insured (or a trust or partnership) typically provides a loan to an Irrevocable Life Insurance Trust (ILIT) to fund a large life insurance policy, and interest is set at the Applicable Federal Rate (AFR).

FINANCING CHALLENGES

The challenges that clients face with a Commercial Premium or Private Financing arrangement often depend on variables such as the age of the insured, increases in interest rates, or a change in the tax law. The typical prospects for these types of arrangements are older wealthy individuals. However, when the plan is designed with an exit strategy in place, the insured has a neat and tax-effective way to leverage his or her assets and to terminate the arrangement. Exit strategies should also be considered for Split Dollar arrangements, since the annual term cost increases with the age of the insured.

WHAT ARE EXIT STRATEGIES?

Exit Strategies are estate-planning techniques that help you terminate a Premium or Private Financing arrangement when the financing is no longer needed or when the cost of carrying the loans becomes too high. Popular vehicles used to exit these types of arrangements include Grantor Retained Annuity Trusts (GRATs) and Charitable Lead Trusts (CLTs).[2] Although not discussed at length here, in certain circumstances, a Sale to a Grantor Trust (SAGT, sometimes referred to as a Defective Irrevocable Grantor Income Trust, or DIGIT) can also provide the means to terminate a Private Financing arrangement.

GRANTOR RETAINED ANNUITY TRUSTS (GRATS)

What is a GRAT? A Grantor Retained Annuity Trust is an irrevocable trust to which a person can transfer property while retaining the right to receive an income stream for a fixed period of time. At the end of the GRAT term, the property transfers automatically to the remainder beneficiaries named in the trust. The GRAT beneficiaries may be individual family members or the beneficiary may be another trust, such as an ILIT.

How does it work? The grantor will make a gift to the GRAT of appreciating assets such as stock or real estate. The value of the gift to the GRAT is "discounted," i.e., for gift tax purposes the value of the remainder interest is based upon a formula that factors in the Section 7520 rate, the length of the trust term and the amount of the annuity payout. The GRAT technique can be used to "freeze" the value of an asset after the initial valuation. The GRAT must last for a specified term of years and not for life. If the grantor dies before the end of the trust term, all or part of the trust assets will be included in the grantor's taxable estate.[6]

The Exit Strategy. A GRAT can be used in conjunction with a financing arrangement. The grantor or a bank will enter into a financing arrangement with the ILIT. The GRAT remainder interest will transfer to the ILIT (as the beneficiary of the GRAT balance) and will be used to repay the outstanding loan. Further, if the GRAT is structured as a zeroed out "Walton" GRAT,[7] the value of the gift for tax purposes is zero since the grantor's retained annuity payment is designed to be high enough so that the gift of the remainder interest is calculated to be zero.

CHARITABLE LEAD TRUSTS (CLTS)

What is a CLT? A CLT is a split-interest trust that is the inverse of a Charitable Remainder Trust (CRT). With a CLT, the charitable beneficiary receives an income stream for a period of time and the non-charitable beneficiaries receive the remaining trust assets at the end of the trust term.

How does it work? The grantor gifts an asset to the CLT. The interest on the asset is projected to grow at the applicable federal rate. The charity will receive a percentage payout for a period of time. At the end of the trust term, the CLT assets will either revert back to the grantor or will pass to family beneficiaries or into a trust.

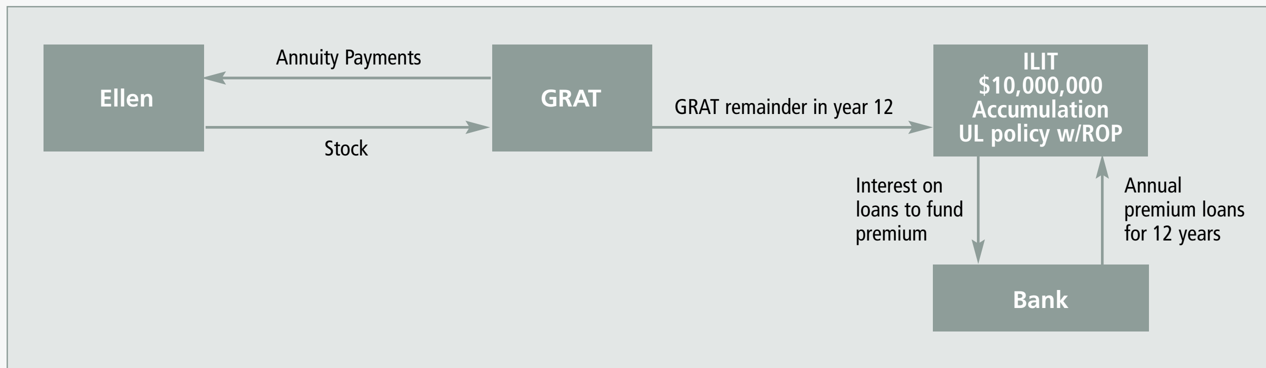
The Exit Strategy. The CLT works similarly to the GRAT as part of an exit strategy in a financing arrangement. At the end of the trust term, all of the CLT assets will transfer to the ILIT (as the beneficiary of the CLT) and the ILIT will use the available assets and income to pay off the loan.

CASE STUDY: ELLEN RIPLEY

The Facts. Ellen Ripley is a widow, age 50, Preferred Non Smoker. She has an estate valued at $20,000,000, which is growing at 5% annually. As part of her estate, she has $4,000,000 in stock. She is looking for a way to fund a $10,000,000 life insurance policy.

The Solution. Premium Financing with a GRAT as the exit strategy.

Here is how it will work. Ellen will transfer $2,512,143 in stock to a GRAT, at the same time that she establishes an ILIT. The ILIT will enter into a Premium Financing arrangement with a bank and will purchase a $10,000,000 John Hancock Accumulation UL life insurance policy on Ellen's life with a 100% Return of Premium (ROP) rider. At the end of the GRAT term (12 years), the remaining GRAT assets ($2,388,264) will transfer to the ILIT, since the ILIT is the remainder beneficiary of the GRAT. The ILIT will use the GRAT assets to repay the loan to the bank in year 13.[8]



Why does this work? In this arrangement, Ellen is able to leverage her stock, without liquidating it all at once. The GRAT will make an annuity payment back to Ellen each year, during the term of the trust.[9] Once the GRAT term expires in year 12, the stock will transfer to the ILIT (as the beneficiary of the GRAT) and can be liquidated to pay back the premium loan. This approach allows Ellen to leverage her stock without having to pay capital gains taxes, reduce the size of her taxable estate, and purchase the additional life insurance that she needed. The table below shows the benefit of financing the premiums for 12 years, and then the ILIT uses the GRAT remainder to exit from the financing arrangement in year 13.

Year	Annual Loan Amount	Loan Interest at 6% (gifts)	GRAT Annuity Payment to Ellen	Death Benefit w/100% ROP	Net to Heirs From ILIT
1	$199,022	$11,941	$96,503	$10,199,022	$10,000,000
5	$199,022	$59,707	$200,108	$10,995,110	$10,000,000
10	$199,022	$119,413	$497,933	$11,990,220	$10,000,000
13	($2,388,264)	$0	$0	$10,000,000	$10,000,000

The data shown is taken from an illustration. It assumes a hypothetical interest crediting rate and may not be used to project or predict investment results.

SUMMARY

It is always best to plan ahead, and it is even more important to plan carefully when it comes to sophisticated estate planning arrangements. Commercial and private financing are popular because they allow people to leverage low interest rates to reduce or avoid gift tax costs. However, as interest rates creep upward it is important to have an exit strategy in place.

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1. The IRS publishes the AFR on a monthly basis.
2. 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 transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.
3. Such a trust is possible because of certain differences between the estate tax rules of IRC Sections 2036-2042 and the grantor trust income tax rules of IRC Sections 671-678.
4. IRC Section 672(e). The grantor will be treated as the owner of the trust if the grantor's spouse holds certain interests or powers over the trust assets.
5. In Revenue Ruling 2004-64, the IRS ruled that a grantor can pay income tax on trust income and it will not be considered a gift to the trust. The trust may also reimburse the grantor for the tax payment in some situations, as long as the reimbursement is discretionary and not mandatory.
6. Treasury Regulations to IRC §§ 2036 and 2039, effective July 14, 2008, govern the portion of trust assets includible in the grantor's estate in the event he/she does not survive the term of the GRAT. See REG-119097-05; T.D. 9414; 73 F.R. 40173-40179.
7. The Walton GRAT is a result of a 2000 Tax Court case, Walton v. Commissioner, 115 T.C. 589 (2000).
8. Based on Female, Preferred Non Smoker, age 50, California resident, 12-pay Accumulation UL policy with an annual premium of $199,022. Products and features may not be available in all states. Guaranteed product features are dependent upon minimum premium requirements and the claims-paying ability of the issuer.
9. The GRAT is calculated based on a Section 7520 rate of 5.20%, with 5% annual growth of principal and 5% annual income. This example assumes that Ellen outlives the term of the GRAT.

Insurance products are issued by John Hancock Life Insurance Company (U.S.A.), 197 Clarendon Street, Boston, MA 02116 (not licensed in New York), and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

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