KB FINANCIAL PARTNERS

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GENERATIONAL SPLIT DOLLAR

Structured properly, life insurance offers unique benefits not found in any other asset class. These include:

- Potentially guaranteed death benefits which in turn produce guaranteed liquidity
- Arbitrage for other investments
- High risk-adjusted tax equivalent returns
- Opportunity to enhance a family's charitable legacy
- Possible opportunity to substantially discount cost via split dollar
- Very effective for Generation Skipping

In addition, various sophisticated strategies can be used to leverage the benefits of life insurance and boost the internal rate of return (IRR). An example of such a strategy is Generational Split Dollar.

Generational Split Dollar

This strategy works where there are 3 generations.

- Generation A - Grandmother or Grandfather
- Generation B - Child
- Generation C - Grandchild

A trust structured for the benefit of Generation C or beyond would own life insurance on Generation B's life. Generation A would enter into a non-equity collateral assignment split dollar agreement with the trust.

- This agreement would be consistent with the "Final Split Dollar Regulations" and structured so that neither party can unilaterally terminate the arrangement.

Generation A would pay the premiums minus the economic benefit amount. The policies would be funded over a short period of time, such as 3-5 years. Generation A would own a "collateralized receivable" payable to Generation A by the trust at the death of Generation B. Once the policies are fully funded to guarantee the proceeds, the receivable may be gifted, sold or transferred at the death of Generation A.

- Valuation firms have conferred substantial discounts on collateralized receivables determined by life expectancy and applicable discount rates.

The transaction creates an opportunity for the trust for the benefit of Generation C to substantially reduce the cost of the acquisition of insurance. It may also be an efficient way to transfer assets from Generation A to Generation C without triggering the Generation Skipping Transfer Tax (GSTT).

The table below shows the possible benefits of this strategy. The results are based on the potential discounts that may be achieved on the collateralized receivable. Results are not guaranteed.

		GENERATION "A"					TRUST					
Yr	EOY Age	Net Annual Premium	Collateralized Receivable	Net Cash Flow	Cash Surrender Value	Death Benefit	Economic Benefit	Tax on Econ Benefit	Collateralized Receivable	Cash Surrender Value	Net Death Benefit	IRR
1	48	($2,810,433)	-	($2,810,433)	$803,866	$2,810,433	$178,040	($71,216)	-	-	$97,289,567	140458.4%
2	49	(2,810,433)	-	(2,810,433)	3,213,314	5,620,866	187,069	(74,827)	-	-	94,479,134	3596.9%
3	50	(2,810,433)	-	(2,810,433)	5,866,096	8,431,299	195,254	(78,102)	-	-	91,668,701	983.1%
4	51	(2,810,433)	-	(2,810,433)	8,660,820	11,241,732	204,374	(81,750)	-	-	88,858,268	482.8%
5	52	(2,810,433)	-	(2,810,433)	11,597,220	14,052,165	216,841	(86,736)	-	-	86,047,835	301.2%
6	53	-	2,177,487	2,177,487	-	-	-	-	(2,177,487)	12,070,750	100,100,000	209.0%
7	54	-	-	-	-	-	-	-	-	12,538,957	100,100,000	156.0%
8	55	-	-	-	-	-	-	-	-	13,030,635	100,100,000	121.5%
9	56	-	-	-	-	-	-	-	-	13,521,057	100,100,000	97.6%
10	57	-	-	-	-	-	-	-	-	14,013,845	100,100,000	80.5%
23	70	-	-	-	-	-	-	-	-	20,748,260	100,100,000	21.7%
28	75	-	-	-	-	-	-	-	-	22,441,410	100,100,000	16.8%
33	80	-	-	-	-	-	-	-	-	22,940,998	100,100,000	13.7%
38	85	-	-	-	-	-	-	-	-	20,555,630	100,100,000	11.5%
43	90	-	-	-	-	-	-	-	-	18,759,527	100,100,000	10.0%
48	95	-	-	-	-	-	-	-	-	13,632,948	100,100,000	8.8%
TOTALS		(14,052,165)	2,177,487	(11,874,678)				(392,631)	(2,177,487)			

As an alternative to what is shown above, the Trust could pay a portion of the premium equal to the amount of economic benefit. This would avoid the income tax on the economic benefit and would offset the amount of premium paid by Generation “A”.

If structured properly, the return on death benefit would be income tax and estate tax free. The table below calculates the pre-tax return required in a taxable portfolio to match the return earned on the life insurance death benefit from the Trust’s perspective.

Life Insurance				Equivalent Gross Pre-Tax Return		
Yr	Age	Death Benefit	IRR on Death Benefit - Trust	Low Turnover (20%)	Medium Turnover (50%)	High Turnover (100%)
23	70	100,100,000	21.7%	28.6%	31.1%	36.2%
28	75	100,100,000	16.8%	22.1%	24.0%	28.0%
33	80	100,100,000	13.7%	18.0%	19.6%	22.8%
38	85	100,100,000	11.5%	15.2%	16.5%	19.2%
43	90	100,100,000	10.0%	13.1%	14.2%	16.6%
48	95	100,100,000	8.8%	11.6%	12.5%	14.6%

It would be difficult to replicate the tax equivalent returns provided by the life insurance to a trust with any other investment vehicle. On a risk adjusted basis the returns are even more compelling. Depending on the discounts achieved on the collateralized receivable, the return could be boosted further.

Conclusions

Generational Split Dollar can be structured to achieve family generation skipping goals for the benefit of grandchildren and future generations. Death benefit proceeds could be used to free up other assets to accomplish other planning objectives, such as charitable giving.

This is a very complex strategy which requires a significant amount of legal input. You must work with a firm that has a good understanding of the implications of this approach.

Assumptions

1. The equivalent gross pre-tax return of portfolio assumes 100% equity portfolio with no dividend or ordinary income and tax rates for LT cap gains (20%) and ST cap gains (40%).
2. Life insurance figures are based on Universal Life from a consortium of carriers with a combination of guaranteed level death benefit and current assumption policies. Underwriting offers are hypothetical and vary by carrier.
3. Tax rates - Ordinary income and short term capital gains (40%), Qualified dividends and long term capital gains (20%), Estate Tax Rate (45%), Trust Income Tax Rate (40%)
4. Collateralized Receivable for Generational Split Dollar assumes total discount = 85%:
5. Discount Rate = 6% / Date of Sale = End of year 5 / Life Expectancy = Age 84