Audio file

KN11 - Morgan Scott.wpp.m4a

Transcript

Hello and welcome to the New Knowledge podcast. My name is Mark Singer, partner with Newton 1 advisors. And today I'm joined by my colleague Stephen Target, managing partner of our firm, Steve. How are we today?

Hi Mark, I'm doing great. Thanks for asking.

Great. The New Knowledge Podcast will provide meaningful content to our valued advisor community and clients who are interested in learning more about sophisticated insurance related topics. Focusing on estate planning and executive. Profits during our podcast, we focus our discussions on content that will deliver unique insights into the people, processes and products that make our industry so critical. We want is a national life insurance planning firm delivering customized insurance solutions structured to help clients and their advisors engaged in solving estate planning, wealth transfer, business succession and executive benefits. We are a member of the M Financial Group offering our clients access to the nation's most prestigious insurance carriers and innovative products available only through our network. Today, we have the privilege of speaking with Morgan Scott, head of advanced Sales and design of and Financial Group, where he assists in the marketing and positioning of life, annuity and disability insurance products for use in business planning estate planning. Charitable planning, along with other advanced applications, Morgan is a seasoned advanced market attorney, manager and dynamic public speaker with diverse experience and advanced sales, team building, departmental planning and marketing and distribution of life, annuity and disability insurance products across the independent brokerage and institutional channels. Morgan received his Juris doctorate from the University of Connecticut School of Law and his BA in history from Trinity College in Hartford, CT, so no further ado. Morgan glad to. Have you on today and welcome?

Thank you very much. Glad to.

Be here. So today's focal point is intergenerational split dollar, and over the last year or so, the hot case has been carrying more said. Now most of the discussion. Is about that. But before we dive into detail on that specific case for our listeners foundational, what is intergenerational still dollar as a? Starting point warning.

Yeah. So just to to completely level set, let me give a brief explanation, not just of that, but even even more fundamentally, what is private split dollar. So every generational split dollar is just private split dollar that has been modified slightly and you mentioned the Cahill and more such cases there was there actually two more asset cases. First morriset case. That basically that intergenerational dollar as legitimate intergenerational dollar. Excuse me as legitimate split dollar within the context of the final slip dollar regulations. So private split dollar insured is where our client the Grand Tour and the variations on the scheme but but. Basically, the client our grandeur here advances funds to their trust for the purpose of purchasing life insurance and exchange will get or. Receive more note there. Are two types of split dollar permitted under the final regulations as the economic benefit regime or will be spending? Most of our time today. And there's also the loan version, so the economic benefit, the receivable that the

grantor receives in exchange for premium advances to the trust entitles them to the greater of premiums paid or the cash surrender value of the policy or policies, any excess death benefit that basically is owned by the trust and exchange. About the trust paid, the economic benefit, which is based on the return cost per $1000, insurance publishing entitled to under the Split dollar Arrangement that committed we paid back from the trustee to the holder of the receivable. Dollar is is very similar. I might I might seem to be able to. Differentiators is based in granular, literally loans funds to the trustee for the purpose of purchasing or paying life insurance from the purchase life. Policy that loan is secured by the cash surrender value, death benefit. Both or both language can be important. I'm not sure if we'll get around to it today, but that can be an important consideration. And the trustee in this instance owes that interest on that loan every year to the Grand Tour that can be paid back in cash or property to the grantor letter to the note order. It can be accrued capitalized to principle, or it can be forgiven and treated as imputed gift by the grantor. Trust. There's there's some legal, some details you don't have to go in and go into that, but that's the thrust of it. So what differentiates them? Intergenerational split dollar and why are we so concerned about these court cases? What was the controversy so ordinarily would establish the dollar arrangement? The insurance policy purchased by the trust would ensure the life of the Grand Tour or their end or their spouse. Here it's a little. Bit different we. Our client will call them generation one or G1. Is usually older, usually with limited life expectancy, uninsurable, or has health issues. The point where insuring them is prohibitively expensive. They advance premiums to the trust. Could be a dynastic trust. The trustee loan purchases and insurance policy on their child or children. Uh Generation 2 and the purpose of this is to benefit generation through the indoor generation. Two would be beneficiaries of this trust. So that's all very straightforward, right. And the more asset one decision validates this design. Is actually like garlic. That's sort of what we would call the steak, right? That's the that's the basic design where we're utilizing. So where's the controversy? Well, when the Grand Tour passes away, let's assume you're supposed to be fake. They are the holder of the receivable or the hold. No. What's that worth? Is it worth the face amount that is in the case of the mechanic benefit regime case? Is it worth it later out premiums paid or cash the number values? Or is it worth something less? In other words, can you apply a discounting factor since the insured has not died yet? The policy has not matured. We don't know when the insurer will. I believe can approximate that through some life expectancy calculations. I'm gonna buy applying the discount factor. We can utilize the discounted cash flow method to discount. Receivable where this has been an issue and the reason why we're talking about this is it's sometimes been abused as a means of discounting cash and then This is why they would review case has been so important since the the first or one of a cohort of three cases, that view of this issue and the first in which the taxpayer has succeeded on all legal. Items all substantive items, as well as evaluation.

Well, that's great. So what fact patterns is this strategy most commonly implemented or both strategies per se?

And one has done all of their estate planning. Their estate has buttoned up, they have sufficient liquidity. There's really no more need for insurance on them. Or like I said that it's not insurable any longer and and we're not beginning to pivot the families. Planning to where we want to help generation 2 perform their estate plan so it might be you know this this would be clearly indicated. In a situation where. Again, generation one, their plan has flattened out the generation two, such as the case with Levine, might be extremely wealthy in their own right, but their wealth. Is tied up in illiquid assets, right? So we we're trying to provide liquidity for generation. Too. It's also going to be critical over typically indicative of

utilizing split all, but the client doesn't want to make gifts. You can do this right without having to go through the complexity of the split dollar. If the client still has gift and GST exemption, remain if they wish to allocate. We utilized the dollar when the client no longer. And or or or wishes to make reportable gifts for whatever reason.

So that's where we would we would typically typically see this, the the utilized. So Morgan let me just circle back for a second here because we you, you did mention some of the previous cases, but I think one of the reasons why we're we're talking about this today is because of the Levine case and the the Tax Court decision that was made, is it possible for you to summarize? For our listeners, maybe what changed or why practitioners are are looking at this strategy again? From the you. Know the the previous, maybe some concerns about following the Marset and Cahill cases to where we are now at the Levine Court decision.

Yeah, right. And this is this is really the the thrust of it. And this is this is the critical part we're dealing with. So before I sort of get into that, I want to make a quick comment about why, you know why are we so concerned with litigation on this issue with these three cases since #1 as I mentioned that there have been some alleged abuses in this area which and it is distinctly. On the IRS's radar. Right. So when we're dealing with the ultra high net worth estate tax audits are almost guaranteed, and they're going to look at this. And and I have it on good authority on those audit questioners they asked about whether or not intergenerational split dollars involved. All of the litigation. That I'm aware of anyway, and this is not saying all of the audits, but all of the Tax Court litigation has involved economic benefits, routing all three of these. None of these addressed longer we can tie this back in at the end of the year. The reason for that is economic benefit regime and and and they still dollar operator. And that give guidance how to operate that benefit regime control for the purpose of income tax law for gift tax for FIFA or, you know, railroad pension tax, all of that stuff. But it does not control. Four is the estate tax valuation of the receivable. That's where we have some litigation around this. So this is very much a fact pattern dependent decision. We can't we can't rely strictly on the regulations say because we did XY and Z when we're in the clear. So the key the key point here is Robin is a good facts. Cahill was a terrible fax case and Marissa was a mixed case, and I'll go through these briefly just to give you a very brief background extra time. So Kay Hill this this again was just about the worst fact we could possibly get. We had a 90 year old generation one. Who was a Richard Cahill? His son Patrick was attorney. In fact, under part attorney for Richard, Richard was completely incapacitated. His son Patrick, basically established in a year in the year prior to his death and intergenerational Split dollar arrangement between the Revocable Living Trust, of which Patrick his son. Was the trustee and an island where his cousin and close business she had William was the trustee of the island. They ended up financing. This was about a $10 million premium commitment. They financed this through Northern Trust on a five year note. And then when G1, when Richard passed? Way within a year, they ended up taking a approximate 9899% discount on the receivable. Again recall they advanced $10 at at Richard's death, but it was about $9.6 million cash surrender value and they valued that receivable at approximately. $183,000, so massive discount, very greedy and because of the the the a couple of key items, most notably that the split dollar agreement had mutual termination rights. So it could be it it it it. Could not be terminated. By by Patrick we, the sun unilaterally and it could not be terminated by William, the trustee of the island unilaterally, but they had to do so together, mutually, and that was sufficient from the IRS's perspective to open up a tax under 20362038. And then also 20. 7:00 and 3:00 because of the ability. To terminate or modify these arrangements. Conjunction with another person. I I don't want to get too deep into the weeds here

because it's difficult to describe these things, particularly over a podcast, but this is a critical element. And then there being that and by the way, Cahill, this is interesting. It's a published settlement, so it is not binding legal precedent. Settlement they they stipulated to 0 valuation discount so they got no valuation discount that case so it could collapse in that instance. More asset two. Much better facts. In brief, we had a multi generational family business and for those who work in the family business space and you're probably where, it's not always the case that family members can get along even though it's a profitable business and family relations of the of the various. Officers in the business were related to each other. We're dysfunctional, as in the least. So there is. This is similar in that generation, one was incapacitated and the family members entering these transactions for doing so. I I don't remember correctly. Anyway, under powers of attorney. But it was done in in concert with a buy seller. So there was a legitimate non tax purpose for establishing the life insurance coverage for the life insurance coverage in place and and that was for the kindly and organized transition of the business from one generation to another, particularly in light of that that the various family members and did not get along with each other. So in Morris that because of these non tax purposes associated with establishing by cell arrangement, they managed to to evade 20362038 and 27 or three largely on 25 several exceptions and measurement non tax purpose exceptions to those. So there's there's, there's those elements of Internal Revenue Code where they failed, however, and this was a massive failure, was on the discounting of the receivable state, claimed the discount is 75%, but there's there's two moving parts here when when you're trying to discount an asset, right, there's the discount rate. And then there's the time horizon. Maturity date your. So the discount rate, what the what the court ultimately held was that and this was a Tax Court and branding as well got just to be clear not control tax course this is not also most presidential strength but initially the taxpayer was utilizing a high discount rate 15% discount rate which is oftentimes using like 7. And the maturity date. They were utilizing was the life expectancy.

Of the insured.

Ultimately it came up during discovery that there were discussions between the family and their legal counsel that they intended to terminate the arrangements after the statute of limitations that ran. So without going into all of the details, but they ended up doing was reviewing the discount rate and suggesting somewhere between the five and 8%. Rate is used 15. Rate and instead of life expectancy, they really only had a couple of years until the maturity date. The purpose of valuing the receivable. The result was that there was that the actual the actual discount they got was not 75% but really minimal. I can't believe exact percent off the top of my head. Single digits. So in addition to having their their 75% discount disallowed, they will also subject to a 40% under payment penalty. So pretty massive stuff. I'm going to go into the Naveen case and differentiate the 1st. Just want to pause for a second for you folks. Mark Steve, if you guys have any questions at this point let me know.

And I'm happy to address that. I think that's that's a good kind of setting that that's transitioned now to Levine and and this will help you distinguish the difference and and where we are today versus. Where we were. Prior to this this court decision.

And I appreciate. Them being patient. So I do think it benefits the. So #1 Levine, this is full a full Tax Court decision, which means it's binding legal precedent. That's a very big deal. Some key differentiators here between this and the other cases. Again, this was a good facts case here. The Split dollar agreement was between a revocable living trust and. Again, this is also arguably sort of deathbed planning. This was done within one year of Nancy Livings death, but for whatever reason, according didn't really seem. To

focus through heavily on that, perhaps because overall planning for us they have begun decades earlier, but what ends up happening is the local living trust advanced six and a half million dollars of premium to the Iowa. There's a guaranteed interest rate on those policies of 3% and death benefit of around 17 and a quarter million. Hours or I think two or three or two hours. Excuse me. Two seconds of my policies. Uh, I'm. I'm sorry. So, Nancy, this generation were married and living with generation one. Her daughter Nancy was generation two. She was putting this plan together. And the policies range during Nancy and her house. The key issue here was that there's a couple of key issues that differentiate this number one I mentioned earlier, and this is the case in reviewing. This is the case in Morisset was the like the case in Cal, the slip dollar or agreement in those cases had mutual termination provisions here this. Dollar arrangement had unilateral. Termination provisions, whereby only the trustee of the island could terminate the agreement, and this is important in light of Internal Revenue codes. Section 2036 and 2038, which have to be with retained interests or reversionary interest, or the ability to to have. Hours to further amendment that that are held either individually or in conjunction with another. Here, the Grand Tour had no ability whatsoever alone or in conjunction with other person, only party who had the ability to terminate the agreement was the trustee of the island, the trustee of an island was an individual who was not a family member who was an officer of a of their of. I think was a CFO member correctly and had a fiduciary duty to all beneficiaries of the island holding the life insurance policy and this is critical. Some of the island beneficiaries were not just generation to. You know, as would have been the case in kale, where it really was for the benefit of generation too, largely. But here they also had generations. Three of the grandchildren as beneficiaries of the trust. Should the IRA trustee have unilaterally terminated this dollar range, generation three would have got nothing out of the out of this transaction and the trustee would have violated their duty. For the crucially, duty two generation three. So the court look at this and this night and with two key elements. That we have independent trustee or the Court can serve this individual to be beyond the control of of the estate of Levine or of her children who are acting as power of attorney and that that independent trustee had a fiduciary duty to Generation 3, which again. They had to act in those individuals that interests, not just in the best interest of generations. So as a result of all of this, the taxpayers succeeded on all substantive issues on 20362038 and 27. Three now. Initially they had claimed a a an estate tax value of around I'm not mistaken around $2.3 million probably $2.1 million per day on the $6.5 million premium advance, which had a cash value of about. $6.2 million of debt they had stipulated. With the tax code. That should be taxpayer should be a state succeed on all substantive issues. The value of the receivable would be $2.2 million. So this is another key thing to bear in mind that the family and the attorneys are presenting them and we're being we're not greedy. They were not claiming in 9899% discount. Even a 75% discount, they claimed a 65% discount and that was upheld again stipulated by the court and no valuation held. So just a couple of other things to throw in there that that I think differentiate this from other cases. The the court was was enthusiastic in his in his praise for the attorneys involved, how they this was a well thought out strategy, well documented, well communicated to the client. There was no prearranged. Termination language if there were any communications to that effect, which I have no reason to believe there were. But if there were between the client and their attended, they were discrete and there was a legitimate purpose for both the the life insurance, which was to provide liquidity. For generation two, who are heavily invested in real estate and wealthy in their own right, basically a system in in providing them or jumpstarting their estate plan. It was also important the court held with our just the Court perceived it as a button that the the the planning only utilized basically assets that were. Cluster requirement for generation one for Marian living. In other words, they did not want to affect Mary and standard of. So it was only her excess

holdings that were utilized to fund this. And then finally there there was a legitimate investment purpose. The receivable was held as legitimate fixed investment with the Revocable Living Trust. So all all key differentiators and important factors that that helped to provide us at least the road map going forward. Directly benefit intergenerational slope dollar.

Yeah, that that's really helpful. And Morgan, you know, because we worked together that we had Newton one, our planning firm that really focuses on solving problems that are presented to us versus you know leading with a a concept or a planning idea and trying to find a problem afterwards. That's kind of like putting the square peg in the round hole. So there are clearly potential abuses of this this strategy, but it sure sounds like if if the plan is put together in a deliberate manner, planners don't get too greedy and they do things in in the right format without too many aggressive. Discounts on receivables or other areas that you spoke of that this could be a very viable plan if it's if it's you know if it if it fits the right way. So I guess my my closing question for you is, is there anything else that you would want to present that you think would be important for our listeners? Hear about the current state of intergenerational split. Dollar practitioners out there, or even clients, potential clients that are that, are scratching their head trying to determine what what might work for G2 and G3 in terms of planning.

Yeah, #1, I just want to be responsible to something you said about about the nature of your practice and and how you operate, right, applying the solution to a problem versus shopping the solution for everything, right. And when I think particularly with the transactions like this, it has to fit with the client fact pattern. Like if we're out there. More than newer generation is still dollar off of what being gay saying. This is what this is the greatest thing. Since sliced bread every. Client we have should be entering into these. Transactions, I think we're we're we're we're we're losing the. Right. Again, this has to be linked directly to your point to a client mood. So with the review case, does is provide us with a road map that we can stick to and the closer we stick to what the what the drafting attorneys doing, the planning attorneys did in reviewing the safer we are. But bear in mind this is still fact based, right? So we should we should. They will plan on defending this. The iOS is not going to lay down on these issues. So what can we do to help shore up these transactions? #1 I'd I'd say to improve upon the. Plan well in advance. You know, a lot of these cases involve clients who are generation one who are very advanced in age and generation. Two who is acting on their behalf as attorney. In fact, under a power of attorney, I think it makes a heck of a lot of sense to start working on this while the clients are still keep the generation that it's OK for handling. That on affairs I would also suggest that we are very careful involving commercial premium finance in these transactions. It was something that the. Really went after in jail in terms of trying to say that this was a sham transaction. For instance the, the, the, the commercial loan and KO was a more than trust loan for five years and normally issues the court come up with this. Hey, look, this is a five year loan with no guarantee of renewal and you're trying to tell me that. This isn't that that the actual still dollar transaction, there's 10 is intended to be paid off 45 years in the future. Uh. Those two facts don't really line up. So, being cautious or careful around commercial premium finance here I think is going to be important, making sure that we have those unilateral termination provisions we mentioned that was a critical differentiator between the view and the cases. So giving the highlight or generation skipping trust trustees sole authority to terminate the arrangement. That's very important. I think making sure the trustee truly has independent. Trustee status. You know, I think oftentimes and maybe you see this in your practice as well. So when I see it, if you're a second of our rather the client, we're dealing with all the times that his friends or family as trustee because they wanted us to check it, typically doesn't cost them what they ask. Pattern actually hurts us, right? Having influence over the

trustee. So it might make sense to look at truly independent trustees, such as corporate fiduciaries or trust companies. And then finally, we're gonna double underline the fact that the trust. Who had a fiduciary duty to generation 3 to another generation where? If they had. Terminated the agreement. They would be in violation of their tributary duty, so having that that tight, tributary duty element and making sure they have beneficiaries but who cannot be removed from the trust by a lifetime power of appointment by generation. To other entities is important, and of course having a legitimate life insurance need from evaluation standpoint. So number one, I would never suggest going. For the purpose of discounting, right, that is something that may occur and may provide some element of added benefit, but really the reason. You would do. This is because generation two has a legitimate life insurance need generation. One has the money and the best way to do it is slip dollar, right should you elect. To claim the discount. Upon generation ones best mix your fingers. Don't be greedy. Apply a reasonable discount rate and ensure all of the planning you've done all of the communications and presentations you've given and all the documentation you have generally supports the composition. That the life insurance is intended to be held until maturity until the insured passes and the receivable has legitimate legitimate investment components and benefits to the holder. Now that's for economic benefit. Do I have 5 minutes to quickly touch on loan base or we are we have time for?

Sure. I think so. Thank you.

Alright, I I don't wanna. I don't want to try our audiences stations, but I do think this is important. So long they slip dollar in the inner general intergenerational context. As I mentioned earlier, has not been litigated. And one of the reasons it hasn't been litigated. And at least this would be my best guess on the large don't know. Certain is that the sections of the Internal Revenue Code the Treasury regs dealing with line based split dollar control not just for economics, not just for income tax purposes, gift tax purposes etcetera, but also for estate tax purposes to give us a little bit more certainty than. When we do with economic benefit, which we can also be assured that if we follow certain attestations that are provided in the treasury legs that this is this is deemed to be a legitimate loan, right, even though it is a non recourse loan secured only by the life insurance policies, cash to undervalued debt benefit. Both, you know interest rates are going up, curious to see how inflation is going to affect us, but we are still in the historically low interest rate environment. And interestingly the loans can be for the life of the insured even if the insured life expectancy is in that term is longer than generation one or lenders. Life. Except. It's like I think we can still apply everything we mentioned before from Lavine, but the fact that a loan is a loan is a loan, right? We have experienced the state party. He has experienced valuing for for, gift and estate tax purposes, properly documented and executed debt instruments. Right. It makes it a lot safer from evaluation perspective as long as as our planners don't get greedy that that we can really utilize loan based with dollar as an alternative that may be safer. And again I would still suspect them of it, but again no litigation on this front. Until now, so a viable alternative to consider as well.

Excellent organ. Thanks for spending time with us today. I think this is this is a topic that will interest a lot of our our listeners and audience. And I think you presented in in a in a very understandable manner, but also getting into a enough detail that you know helped back up some of the details. So thanks for being with us and certainly if anybody has any additional questions. Reach out to us here at noon one and we can connect you with Morgan as well. Take Care now.

The material and opinions voiced are for general information only and are not intended to provide specific advice or recommendations for any individual to determine what is appropriate for you, please contact a member of our team.

Disclosure: Securities and Investment Advisory Services Offered Through M Holdings Securities, Inc. A Registered Broker/Dealer and Investment Advisor, Member FINRA/SIPC. Newton One is independently owned and operated.

Content provided do not reflect the views of M Holdings Securities, Inc. nor its Associated Persons/Affiliates, and have not been reviewed by M Holding Securities as to accuracy or completeness.

This material and the opinions voiced are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine what is appropriate for you, please contact me directly or consult another qualified professional.

The testimonials/recommendations used may not be representative of the experiences of other clients, and they are not indicative of future performance or success.

6428068.1