Business Valuation
& Advisory

Case Study

Split-Dollar Receivable

MPI is periodically asked to determine the fair market value of receivables resulting from split-dollar agreements (each, a "Receivable," and collectively, the "Receivables") associated with life insurance policies. Estate planning techniques using split-dollar agreements seem to be used once more basic wealth transfer techniques have been exhausted or when the taxpayer has a significant amount of liquid assets that are harder to shield from estate taxes. In the paragraphs that follow, we summarize a recent case in which MPI was engaged to provide an appraisal of a receivable under a split-dollar agreement.

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Situation

MPI's client (hereinafter referred to as the "Donor") and four different trusts for the benefit of Donor's children (hereinafter collectively referred to as the "Donees") entered into split-dollar life insurance arrangements (the "Split-Dollar Agreements") in January 2007. Pursuant to the Split-Dollar Agreements, the Donees owned the life insurance policies (each a "Policy" and collectively, the "Policies") issued by three major insurance companies insuring the lives of each of the Donor's children (hereinafter referred to individually an "Insured" and collectively the "Insureds"). The Donor funded each Policy with various premiums in exchange for having each Policy collaterally assigned to him by the Donee. There were four Policies in existence on the Valuation Date (and, therefore, four Receivables to be valued).

According to the Split-Dollar Agreements, neither the Donees nor the Insureds have any access to, or future interest in, the cash surrender values of the Policies. Instead, the Donor (via the collateral assignment of the Policies) will receive an amount equal to the greater of the total amount of premiums paid or the then cash surrender value of each Policy at the date the Policy is surrendered. The purpose of the valuation was for estate tax reporting purposes, as the Split-Dollar receivables were held in the estate of the Donor.

Restrictions

There are certain restrictions with regard to the parties who entered into the Split-Dollar Agreements. If the Split-Dollar Agreements are terminated during the lifetime of the Insureds, for sixty days after the date of termination, the Donee has the option of obtaining the release of the collateral assignments of the Policies to the Donor. To obtain such release, the Donee must repay the Donor the greater of (i) the total amount of the premiums paid by the Donor, or (ii) the then cash value of the Policies (excluding surrender charges or other similar charges or reductions). This provision means that the Donor will receive no less than full reimbursement of the premium paid per Policy if the Donee terminates the Split-Dollar Agreements during the Insureds' lifetimes.

All proceeds from the surrender would be used to repay the Donor, in accordance with the Split-Dollar Agreements. If the Split-Dollar Agreements remain in place until the death of each Insured, the Donor will be paid an amount equal to the greater of the per-Policy premium paid by the Donor or each Policy's cash surrender value, but no greater than the total death benefit payable under each Policy upon the death of each Insured. Additionally, we note that the Split-Dollar Agreements may not be terminated, altered or amended by the Donee except by a written instrument signed by both the Donor and the Donee. This provision restricts the Donee from taking any action with respect to each Policy that would in any way compromise or jeopardize the Donor's right to be paid the amount it is entitled to per the terms of the Split-Dollar Agreements.

Valuation

In valuing the Receivables, we primarily employed the income approach, but also incorporated market data in our analysis. We first determined the appropriate discount rate to be used in calculating the present value of the future cash flow stream for each Receivable by referring to market data. Then, under the income approach, we determined the value of each Receivable by discounting the future cash flows at the appropriate market-based discount rate.

The first step in valuing each Receivable was to analyze the ability of the Donees to repay it. The sole sources of repayment for the Receivables are the Policies held by the Donees. Thus, our analysis of the Donees' ability to repay each Receivable was primarily based on the financial strength of the insurance companies that issued the Policies. The Policies are issued by three different insurance companies, all with ratings of between "A-" and "AA-" issued by credit rating agencies based on the financial strength of each insurance company. A financial strength rating is used to determine an insurer's ability to meet its ongoing insurance obligations. "A-" and "AA-" ratings fall below the highest possible rating that most rating agencies assign ("AAA").

Since each Receivable does not become payable until the Insured passes away, the eventual payment date must be estimated by analyzing the projected life expectancies of the Insureds. Sources for life expectancy information were the Internal Revenue Service Single Life Expectancy Table; the Period Life Table issued by the U.S. Social Security Administration; and, the "Commissioners Standard Ordinary ("CSO") Mortality Tables," prepared by the CSO Task Force of the Society of Actuaries and adopted by the National Association of Insurance Commissioners in December 2002. We were provided with the dates of birth of the Insureds and according to the three sources used above, estimates of assumed life expectancies of 19.0 years, 23.0 years, 21.0 years and 21.0 years, respectively, were determined from the Insureds' most recent birthdays.

Having reviewed the terms of each Receivable and assessed the financial condition of the life insurance company that issued each Policy held by the Donee, we turned to the valuation of each Receivable. To that end, we first considered the rate of return a willing investor would require when purchasing each Receivable; or in other words, what would be the current yield on each Receivable if it were freely traded in a public market. In doing so, we

considered an appropriate rate of return at which to discount the projected payments to present value.
We concluded that the Receivables, like the insurance companies, would be classified in the range of "A" to "AA" rated debt as of the Valuation Date. It appeared unlikely that the insurance firms responsible for paying the death benefits on each Policy held by the Donee will be unable to make such payments. According to each of the Policy documents, the following total death benefits were due to the Donee as of the Valuation Date:

Insured #1 – Death benefit of $10,000,000
Insured #2 – Death benefit of $10,000,000
Insured #3 – Death benefit of $25,000,000
Insured #4 – Death benefit of $20,000,000

Rating Risk

Each death benefit payable was more than sufficient to cover the per-Policy premium due to the Donor upon the passing of each Insured. However, the selection of an A- to AA- rating recognizes that each Receivable was not, in fact, risk free. For example, despite the solid financial condition (at the Valuation Date) of the life insurers responsible for the Policies held by the Donee, it is possible that insurance companies could experience downturns in the future. Such events may jeopardize the insurance companies' ability to satisfy death benefits. In addition, there was some uncertainty over the eventual payment date of the Receivables. If the Insureds live longer than their estimated life expectancy, a buyer of the Receivables would not receive a return of capital until a later date than originally anticipated.

We researched general yields on A- and AA- rated corporate debt as of the Valuation Date in the Bloomberg Professional database. A maturity-length of 30 years was chosen (the longest duration available) to match, as closely as possible, the time remaining to maturity of the Receivables, which were assumed to be either 23.0 years or 21.0 years from the Valuation Date. We also observed other proxies of required rates of return that a hypothetical investor would require in consideration of purchasing the Receivables, such as Moody's seasoned "Aaa" and "Baa" rated debt and public debt issued by each insurance company with long-term maturities.

Based on these observations, we determined that the appropriate discount rate to apply to each Receivable was 4.50%. However, this rate was based on yields of investments that enjoy active, public markets. Since there is no active market whatsoever for the Receivables, an allowance for lack of liquidity and marketability must be developed.

The existence of a ready market for a security is of definite value to its owner, or to a potential buyer, and a security that possesses such a ready market is worth more than an otherwise similar security that does not have such a market. The buyer of publicly traded securities, for example, is aware that he could likely resell those securities. This is in decided contrast to the position of the willing buyer and willing seller of the Receivables. There is no ready market for each Receivable and it is uncertain if a buyer could be found for the Receivables given that there may be no cash flow event for up to 23 years.

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Participants in the capital markets, appraisal practitioners, the IRS and the Courts all acknowledge that lack of liquidity and marketability reduce the value of a security relative to one that is freely tradable. This was recognized by the IRS in its Revenue Ruling 77-287 where, in discussing the value of unregistered shares in public companies, it stated: "The discount from the market price provides the main incentive for a potential buyer to acquire restricted securities… The two elements of time and expense bear upon the discount; the longer the buyer of the shares must wait to liquidate the shares, the greater the discount." Thus, an adjustment to reflect the negative impact upon value for such lack of liquidity and marketability is required.

In our opinion, an additional risk premium of 100 basis points was warranted to account for lack of liquidity and lack of marketability. Accordingly, we determined that the appropriate discount rate to apply to the expected payments in the instant case was 5.50%.

Conclusion

We then computed the present value of the future payment on each Receivable. The timing of the payments was estimated based on the life expectancies of the Insureds, determined as describe above. We next determined whether the premium paid or the net cash surrender value was projected to be greater at the time of the death of each Insured, as the Donor is entitled to receive the greater of these two forms of payment, as outlined in the Split-Dollar Agreement. We computed present value factors using a 5.50% discount rate and applied such factor to compute the present value of each payment. The resulting present value indicates the fair market value of each Receivable. Based on this calculation, the fair market value of the split dollar receivables ranged from approximately 29% to 32% of the expected future payment to be made to the Donor. These dollar amounts were then includable in the estate tax return for the Donor.

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About MPI

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