WRMarketplace
An AALU Washington Report
Case Study Series

Thursday, 16 June 2016 #WRM 16-24

TOPIC: Case Study Series: Private Split Dollar in Action – Ensuring a Legacy.

MARKET TREND: Split dollar life insurance arrangements remain an important tool for funding large life insurance purchases, especially in light of many validating private rulings and recent case law.

SYNOPSIS: Private split dollar is a flexible, relatively conservative, and cost-effective tool for incorporating life insurance into a multi-purpose estate plan, which can provide family security, generate estate liquidity, and create a multi-generational legacy. It is particularly important for clients whose net worth is concentrated in illiquid assets, such as family or closely-held businesses, real estate, farms, etc. These clients often need significant life insurance to generate liquidity to preserve their family legacy, but coverage may be limited if they just rely on annual exclusion gifts or gift tax exemptions to fund premiums. Private split dollar offers a solution in these cases.

TAKE AWAYS: Private split dollar allows highly-illiquid clients to obtain needed life insurance coverage on a sustainable, long-term basis, without sole reliance on annual exclusion gifts and federal gift and GST tax exemptions to pay premiums. Post-implementation monitoring and pre-planning for an "exit" or termination of the arrangement, however, will be crucial to overall success of the approach.

PRIOR REPORTS: 14-15; 14-27; 09-32; 08-55.

Private split dollar provides a powerful, flexible, yet relatively conservative tool for funding the acquisition of significant life insurance coverage, particularly for highly-illiquid clients who need liquidity to preserve their family legacy (family business, real estate, etc.). Advisors who may have avoided split dollar planning due to concerns over complexity and potential adverse tax consequences may want to revisit private split dollar, especially in light of various validating IRS rulings and recent case law.[1]

PRIVATE SPLIT DOLLAR BASICS

"Private" split dollar arrangements ("SDAs") can facilitate the purchase of personal life insurance for gift tax purposes. With a private SDA, the costs of buying a life insurance policy typically are shared between a grantor (often the insured) and his or her irrevocable life insurance trust ("ILIT"). The grantor pays the premiums, retaining a right to repayment upon termination of the SDA, as secured by the policy proceeds (in effect, the grantor extends a loan to the ILIT). After repayment, the ILIT retains any remaining policy benefits. Private SDAs generally are taxed under two mutually exclusive tax regimes for income and gift tax purposes:[2] (1) the economic benefit regime[3] or (2) the loan regime.[4]

- Economic Benefit. The grantor agrees to fund all policy premiums in exchange for an interest in the policy equal to the greater of its cash value or the total premiums paid. As a result, for gift and GST tax purposes, the grantor's annual gift to the ILIT equals the "economic benefit", which generally is deemed to be the value of the term cost of the current insurance protection provided. This term cost is determined by using premium rates published by the IRS in Table 2001 ("Table 2001 rates") or, if lower, the qualifying one-year term rates published by the issuing insurer ("alternative term rates").[5] For an insurance company's term rates to qualify, however: (a) the rates must be published and available to all standard risks who apply for term insurance with that company, and (b) the insurance company must regularly sell term insurance at such rates through normal distribution channels to individuals who apply for term insurance.[6] Note that most insurance companies generally will not certify that their term rates are "qualifying" rates for purposes of determining the economic benefit under a SDA. The parties to the SDA must decide and evidence, if necessary, that the company's rates satisfy these requirements.

The annual economic benefit is taxable as a gift from the grantor to the ILIT, unless the ILIT reimburses the grantor for this amount. The economic benefit will increase each year with the insured's age and at the passing of the first spouse, if a survivorship policy is covered by the SDA.

- Split Dollar Loan. The grantor makes interest-bearing loans to the ILIT to pay the policy premiums (i.e., each premium payment made is deemed a separate loan to the ILIT; the grantor also can make a lump-sum loan, which the ILIT then uses to pay premiums). The grantor has no specific interest in the policy's cash value; rather, the ILIT retains all rights to the policy's cash value and death benefit, subject to its obligation to repay the loan(s) at the specified maturity date(s). If a loan provides for sufficient interest (generally at the applicable federal rate ("AFR")),[7] it is governed by the general tax rules for debt instruments. If the interest rate charged is insufficient, or if any interest payments are forgiven, the foregone or forgiven interest is a taxable gift to the ILIT.

PRIVATE SPLIT DOLLAR IN ACTION: CASE STUDY

Client Background – Meet Adam. Adam is age 45, divorced, and the father of four minor children. He is a successful entrepreneur with significant holdings in real estate and various closely-held businesses. He has implemented some lifetime planning, including gifts of business interest to irrevocable trusts for his descendants using part of his federal gift and generation-skipping transfer ("GST") tax exemptions. However, to preserve his family legacy, Adam must generate liquidity for his largely illiquid estate. Accordingly, he created an ILIT to acquire $25 million in universal and guaranteed universal life insurance coverage for the benefit of Adam's descendants and his three nieces. Each of Adam's children and nieces hold withdrawal rights over contributions to the ILIT sufficient to qualify them as annual exclusions gifts. The annual premiums for his coverage total $278,000.

Adam's Concerns. Adam is concerned about long-term succession of his business and real estate ventures. Thus, he would like predictability regarding the amount of future gifts he must make to the ILIT so that he can quantify the exemption that will remain for future planning. With his concentration in illiquid investments, Adam does not have the liquidity to make a substantial lump-sum gift or loan to the ILIT to pay premiums. An annual contribution to the ILIT of the full premium amount, however, will only be partially covered by Adam's annual exclusion gifts[8] and will require a commensurate annual allocation of Adam's federal GST tax exemption, a significant annual drain on Adam's already reduced transfer tax exemptions.

Solution – Private Split Dollar. After discussion, Adam chose to use an economic benefit arrangement, given his relatively young age, his desire to have predictability regarding the amount of future annual gifts to the ILIT, and his concern about limiting exposure to potential interest rate hikes, which can arise when annual split dollar loans (rather than a single, lump-sum loan) are used to fund premiums.

Adam entered into a non-equity collateral assignment arrangement with the ILIT, in which Adam agreed to pay the insurance premiums on the policy in exchange for payment of the greater of the policies' cash value or total premiums paid upon termination of the arrangement. Each year, Adam will make a gift to the ILIT equal to the term cost of the current insurance protection. Upon request, the issuing insurance companies provided a schedule of alternative term rates, which are lower than the Table 2001 rates and may be available to measure this term cost if they are qualifying rates. In looking at the first 10 policy years, use of either the alternative term rates or the Table 2001 rates will result in substantially lower annual gift and GST transfers as compared to Adam's contribution of the total premiums to the ILIT, alleviating some of the initial premium funding pressure on Adam's gift and GST tax exemptions.

Adam's Annual Transfers to ILIT for Gift and GST Tax Purposes

Year	SDA – Alternative Rates[9]	SDA – Table 2001	No SDA – Full Premium
1	$13,597	$37,825	$278,000
2	$14,422	$40,821	$278,000
3	$15,225	$44,224	$278,000
4	$16,244	$47,298	$278,000
5	$16,999	$50,289	$278,000
6	$17,732	$53,664	$278,000
7	$18,904	$58,096	$278,000
8	$20,271	$64,001	$278,000
9	$21,373	$71,994	$278,000
10	$22,664	$81,103	$278,000
Totals	$177,431	$549,314	$2,780,000

Post-SDA Implementation. Adam's SDA will be monitored to review (1) the annual economic benefit to the ILIT, which will increase each year with Adam's age, and (2) the growth in the cash value of the ILIT's policies (since the SDA entitles Adam to the greater of the premiums he paid or the policies' cash value). When either the gift of the economic benefit becomes impractical for Adam and/or the policies' cash value is close to exceeding the total premiums paid, Adam may want to consider modifying or terminating the SDA.

For instance, Adam may consider switching to a split dollar loan (so-called "switch dollar"). Adam and the ILIT would convert all prior premium payments to a loan, based on the terms they choose (e.g., duration, interest rate, etc.). The parties should review the projected performance of the policies, the alternative term rates for determining the annual economic benefit, the AFRs that would apply to the loan, and any potential tax issues.[10] Alternatively, Adam and the ILIT could terminate the SDA, applying a planned exit strategy, as discussed below.

Exit Planning. The ILIT must eventually repay Adam for the premiums he advances. Thus, part of Adam's SDA planning included the design of a potential "exit" strategy, which involved Adam entering into an installment sale with the ILIT. Post-sale, the performance of the ILIT assets must be monitored to ensure there is a sufficient investment return to meet the ILIT's repayment obligations both under the installment note and the SDA. Otherwise, additional exit strategy planning may be required (e.g., additional gifts, the use of a grantor retained annuity trust, etc.).

TAKE AWAYS

Private split dollar allows highly-illiquid clients to obtain needed life insurance coverage on a sustainable, long-term basis, without sole reliance on annual exclusion gifts and federal gift and GST tax exemptions to pay premiums. Post-implementation monitoring and pre-planning for an "exit" or termination of the arrangement, however, will be crucial to overall success of the approach.

NOTES

TCO 362000377v2

[1] See e.g., *WR Bulletin No. 15.05.10-1, "Tax Court Rules Intergenerational Split Dollar Arrangement is Covered by Split Dollar Regulations Section 1.61-22"*, discussing the case of *Estate of Clara M. Morrissette et al v. Commissioner,* 146 T.C. 11 (April 13, 2016); *Washington Report No. 09-32*, discussing PLR 200910002; and *Washington Report No. 08-55*, discussing PLR 200825011.

[2] See Reg. §1.61-22 for the final split dollar Treasury Regulations, made effective as of September 17, 2003 for SDA entered into or materially modified after September 17, 2003.

[3] Reg. §1.61-22(d)-(g).

[4] Reg. §1.7872-15.

[5] See Notice 2002-8, Sec. III.3, referencing Rev. Rul. 66-110, as amplified by Rev. Rul. 67-154. This Notice provides that SDAs entered into before the date of "future guidance" may continue to use qualifying alternative term

rates. However, since no "future guidance" has been published in the Internal Revenue Bulletin with regard to a new table of life insurance premium factors or rates, there has been continued reliance on the interim guidance set forth in Notice 2002-8 for measuring the cost of current life insurance protection

[6] *Id.*

[7] Whether interest is sufficient for a split dollar loan depends on the type and term of the loan (*e.g.*, term, demand, or hybrid (*i.e.*, loans payable on the death of an individual or conditioned on the future performance of services)) and the month of issuance. The sufficiency of interest for term and hybrid loans will be based on the monthly AFRs issued by the IRS for the term period of the loan (*i.e.*, short-term (3 years or less), mid-term (4 to 9 years), or long-term (more than 9 years)). Demand loans are a separate category, with AFRs based on the blended average of the January and July short-term AFRs for the applicable year.

[8] With seven withdrawal power holders multiplied by a $14,000 annual exclusion gift (current annual exclusion gift for 2016), Adam's annual exclusion gifts would only cover $98,000 of the premium, leaving $180,000 annually to be covered by federal gift tax exemption.

[9] Based on sample rates and used for illustration purposes only. Alternative term rates will vary by insurance carrier and age.

[10] For example, if the policies have gain, there may be a taxable gift of the gain from the switch.

WRM #16-24 was written by Greenberg Traurig, LLP
Jonathon M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012