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Private Split Dollar: How Clients Can Capitalize on Exemptions

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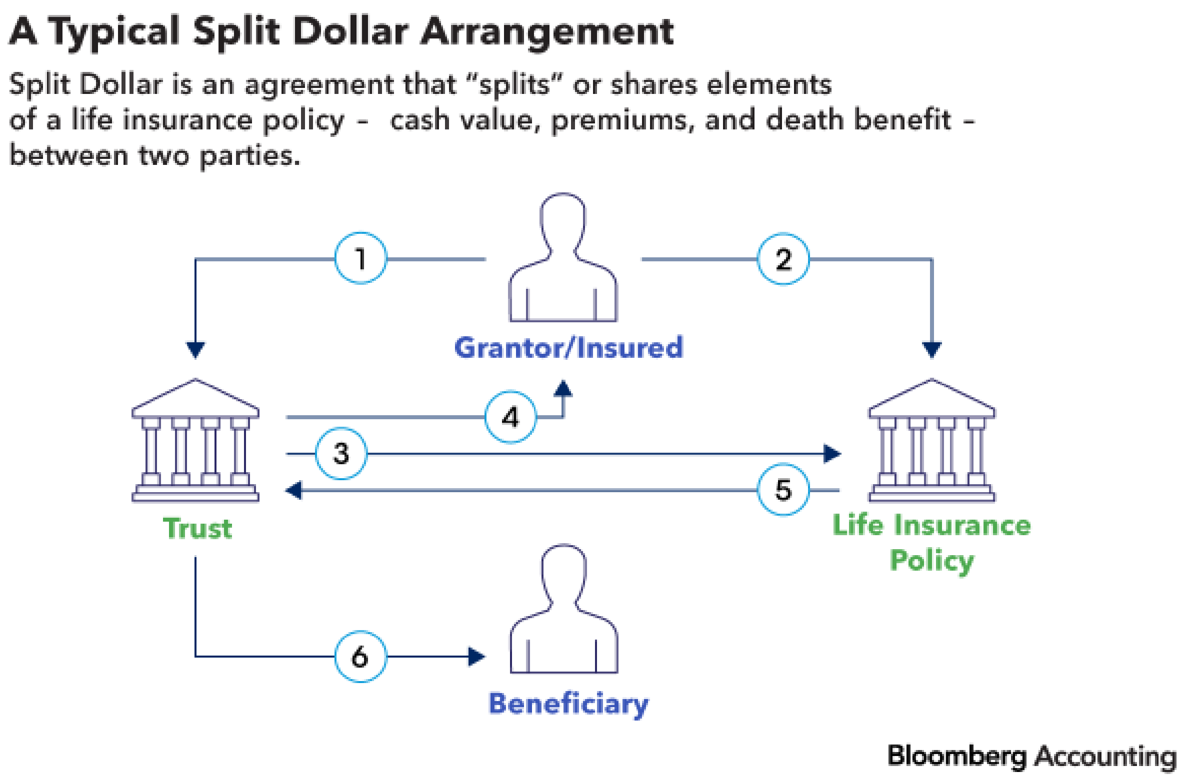
For clients who are looking for an alternative method to fund trust-owned life insurance, private split dollar can help accomplish this while minimizing its near-term cash flow commitment, says Coyle Company’s Joel Desjardins.

In anticipation of potential tax legislation in 2021, many ultra-high net worth clients took advantage of the large exemption amount to transfer assets outside of their taxable estate. Despite this planning, numerous clients will still have a significant estate tax liability that will need to be funded. Trust-owned life insurance is a helpful planning solution that creates future liquidity outside of client’s taxable estate to help fund this liability.

With exemption deployed and trusts funded, clients are turning their attention to strategies to leverage these gifts. Understandably, there is hesitation to liquidate recently gifted assets to fund insurance coverage. For clients who are looking for an alternative method to fund trust-owned life insurance, private split dollar can help accomplish this while minimizing its near-term cash flow commitment.

Split dollar is an agreement that splits or shares elements of a life insurance policy—cash value, premiums, and death benefit—between two parties. Split dollar can take several forms, but this article will focus on the economic benefit regime and assume the grantor of the trust will be the insured.

Figure 1 provides a visual representation of a typical split dollar arrangement.



A Typical Split Dollar Arrangement

1. **Grantor** funds the trust (Gift, Sale transaction, GRAT)
2. **Grantor/Insured** advances majority of annual premium
3. **Trust** pays portion of the annual premium – Economic Benefit Change
4. **Trust** repays the **grantor/insured** (at an optimal point in the future) the greater of premiums paid or cash value
5. At death of the insured, the death benefit is paid to the **trust**
6. The **beneficiaries** of the trust have access to the death benefit offering elements of flexibility and control to fund tax liabilities

Bloomberg Accounting

Split Dollar is an attractive planning solution for many reasons:

Ability to fund significant death benefit with little or no gift tax. Say a couple who are ages 55 and 54 and in good health want to secure $25 million of second-to-die coverage with an annual premium of $250,000 payable for 20 years. The trust's share of the premium is modest because rates for survivorship insurance are based on Table 2001 joint mortality. Under split dollar, the economic benefit—the trust's share of the initial premium—is only $384.

Allows existing trust assets to be managed as intended. The grantor in a split dollar arrangement funds the majority of the premium, allowing their advisers to continue to invest the trust assets as intended.

The trust's small annual liquidity requirement frees up the advisory team to make longer term investments to grow trust assets. It may also lead to a smaller income tax bill for the grantor in the form of forgone capital gains taxes.

Provides excellent leverage due to low annual economic benefit charges. With the same example, assume the trust has an investment account of $3.3 million growing at 5.00% annually. If the trust liquidates $250,000 annually to fund life insurance, by the end of the 20th year, the investment account would be approximately $600,000.

Under split dollar, this same trust is projected to have over $9 million in year 20. This is a direct result of the trust only contributing the smaller economic benefit charges. For clients with little or no exemption remaining, their trust can secure a $25 million death benefit for under $100,000 of total trust cash flow for the first 20 years.

The importance of an exit strategy. Split dollar is a temporary method of funding life insurance—this cannot be emphasized enough. As clients age and plans mature, certain variables will impact the economics of split dollar.

Economic benefit charges increase each year. If this charge exceeds the annual premium, the excess is considered an imputed gift to the trust. After the final premium is paid, the economic benefit charges in future years will generate an imputed gift.

With no exit strategy and the split dollar plan still in place, the grantor in our example could expect an imputed gift of $20,500 at ages 75 and 74. This figure continues to balloon overtime.

Generally, in an economic benefit private split dollar arrangement, the grantor's interest is the greater of premiums paid or policy cash value. Until a split dollar plan is unwound, the grantor's interest is assigned back to them. This receivable is part of their taxable estate should they die with the collateral assignment still in place.

A well-designed split dollar plan considers the eventual termination of the plan at inception by ensuring the trust has sufficient assets to eventually repay the grantor.

In the example we have been using, the total premiums paid after year 20 are $5 million (20 times $250,000). The trust's share was $95,770, and the grantor advanced $4,904,230. Therefore, the trust owes the grantor these cumulative advances of $4,904,230. No interest factor is applied; it is purely a return of premium or cash value.

Given the number of moving parts, ongoing administration of a plan is integral to ensure the desired outcome is achieved. Therefore, it is vital to partner with a life insurance firm with both the experience and infrastructure for ongoing service and administration.

Changing Economic Benefit Rates

If the split dollar arrangement is still in place at the time of the first death, a decision is required as to how to administer the plan going forward. The choices are usually the following:

1. Maintain economic benefit arrangement by utilizing carrier alternative term rates or using Table 2001 Rates for an individual.
2. Convert from economic benefit to a loan arrangement (switch dollar).
3. Trust repays the grantor for their advances and terminates the split dollar arrangement.
4. The grantor uses exemption to exit.

Switch Dollar

When an economic benefit private split dollar arrangement is converted to a loan regime, the grantor's interest becomes a loan to the trust at a current applicable federal rate, or AFR. When this conversion coincides with the end of the insurance funding period, it can fix the ongoing cost of the arrangement.

Gift Tracking and Ongoing Management

Under loan arrangement split dollar, each premium paid is considered a separate loan to the trust at the then-current AFR. It is critical that there are protocols in place to monitor and manage a program like this to ensure it remains compliant.

As clients age, economic benefit factors and corresponding premium splits change. Working with an insurance advisory firm that can clearly communicate to a trustee the premium splits, annual gifts, Crummey notices, roll-out amounts, and more allows a client's team to focus their resources elsewhere.

Finally, we cannot overlook the importance of reviewing the underlying life insurance policies to ensure that they are performing as expected.

Split dollar is an efficient way to fund trust owned life insurance. Clients can leverage existing funded trusts or, with their advisory team, thoughtfully implement other planning strategies to fund trusts to complement the split dollar planning.

Working with an insurance firm well-versed in this sophisticated type of planning, advisers can be more comfortable that the planning will achieve the desired outcome.

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