Private non-equity split dollar

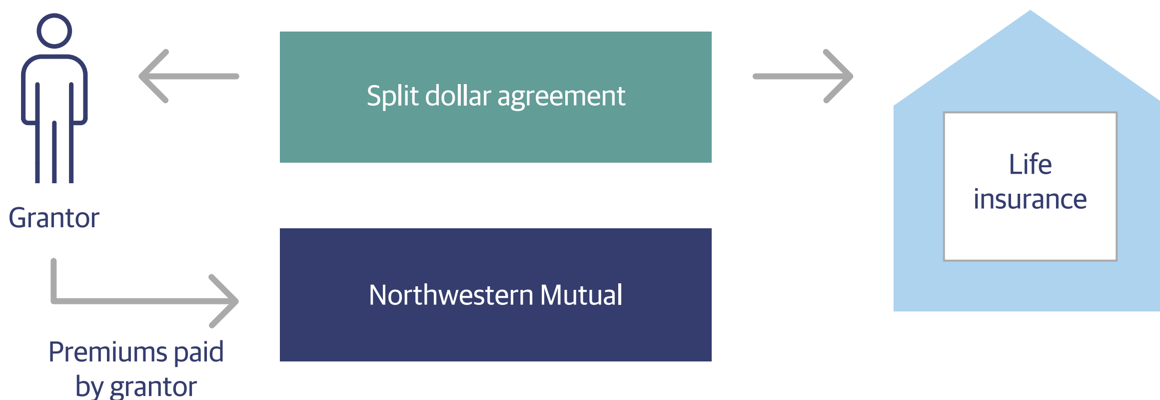
In brief

PAYING PREMIUMS ON A TRUST-OWNED POLICY

When it comes to estate plans, many people create irrevocable trusts to own permanent life insurance. The irrevocable trust typically pays premiums with cash provided to it by the trust's grantor, who is usually also the insured (or one of two insureds on a joint life policy). The insured could *give* premiums dollars to the trust but might not like the gift tax results. Or the insured could *lend* premium dollars to the trust but might not like the interest rate risk or income tax results (for example, each annual premium is often a new loan that carries a different interest rate). Another option for paying premiums in these situations is to enter into a private non-equity split dollar arrangement.

THE PRIVATE NON-EQUITY SPLIT DOLLAR OPTION

- An irrevocable trust owns a life insurance policy.
- The trust is typically a grantor trust for income tax purposes under Internal Revenue Code (I.R.C.) §§ 671-679.
- A written split dollar agreement between the trust and the grantor provides that:
  - The grantor pays policy premiums and is entitled to an amount equal to the policy's fair market value (under gift tax regulations) upon termination of the arrangement while the grantor/insured is alive. Treasury Regulation § 1.61-22(g).
  - The only benefit provided to the trust is life insurance protection. The trust has no right under the split dollar agreement to access the policy's cash value (also known as accumulated value).
  - Upon the death of the grantor, the trust receives the portion of the policy's death benefit not controlled by the grantor.
- The parties must account for the cost of insurance, attributable to the amount of death benefit that is controlled by the trust. The cost of insurance is also known as the term cost, value of insurance benefit (VIB), or value of economic benefit (VEB). The VEB can be accounted for either by having the trust pay it to the grantor, or by having it treated as an annual gift from the grantor to the trust.



(REV 0621)

NON-EQUITY SPLIT DOLLAR AND ESTATE PLANNING

Gift and estate planning advantages

- The trust has permanent life insurance, and its portion of the policy's death benefit is not included in the insured/grantor's estate and is paid to the trust free of income tax or estate tax.
- The split dollar "special ownership rule" – see explanation on next page – treats the grantor/insured as if he or she were the policy's owner while alive, meaning that:
  - The grantor's premium payment is not a gift. As such, the grantor retains the ability to make other gifts (via the trust, or via other means) that fit within the annual exclusion or lifetime exemption amount.
  - If the trust does not pay the VEB to the grantor, then the VEB is treated as given by grantor to the trust each year.

VEB causes very small annual gifts

- The VEB is based on one-year term insurance rates provided by the government (Table 2001), or the parties involved can select rates provided by the insurer, if lower.
- The VEB increases as the insured or insureds get older, and can increase substantially after the death of one of the insureds on a survivorship (second-to-die) policy.

EXAMPLE: VEB FOR $10 MILLION DEATH BENEFIT		
Age	Second-to-die (both alive) Joint life table 2001	One insured NM 2016 low table, sex neutral
55	$ 177	$ 13,431
65	$ 1,452	$ 44,563

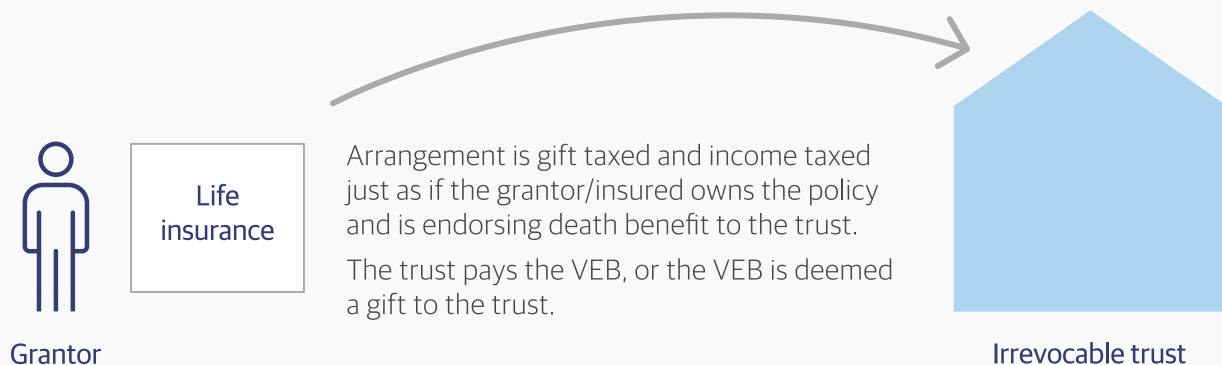
- Because the VEB and consequently the amount of the grantor's gift increases each year, it is important to know – prior to entering into the split dollar plan – how the arrangement can be terminated before the VEB becomes too high.

KEY: UNDERSTANDING THE “SPECIAL OWNERSHIP RULE”

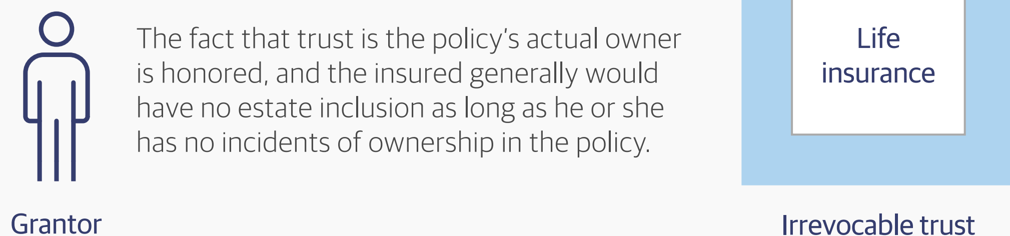
The key to understanding the taxation of private non-equity split dollar is to understand the effect of the “special ownership rule” found in Treasury Regulation § 1.61-22(c)(1)(ii). This rules states that when a split dollar agreement is entered into between a donor (the grantor/insured) and a donee (the irrevocable trust), and if the only economic benefit provided under the split dollar agreement (as opposed to the insurance contract itself) is current life insurance protection, then:

- For tax purpose other than estate taxes, including for purposes of *income tax* and *gift tax*, the grantor/insured is treated as the owner of the life insurance policy, even though the policy is actually owned by the trust on the insurance company’s records.
- For estate tax purposes, the special ownership rule does not apply, such that the irrevocable trust’s actual ownership is respected, and the insured’s estate tax is governed by normal incidents of ownership rules under I.R.C. § 2042.

Gift tax and income tax effect – while grantor/insured is alive



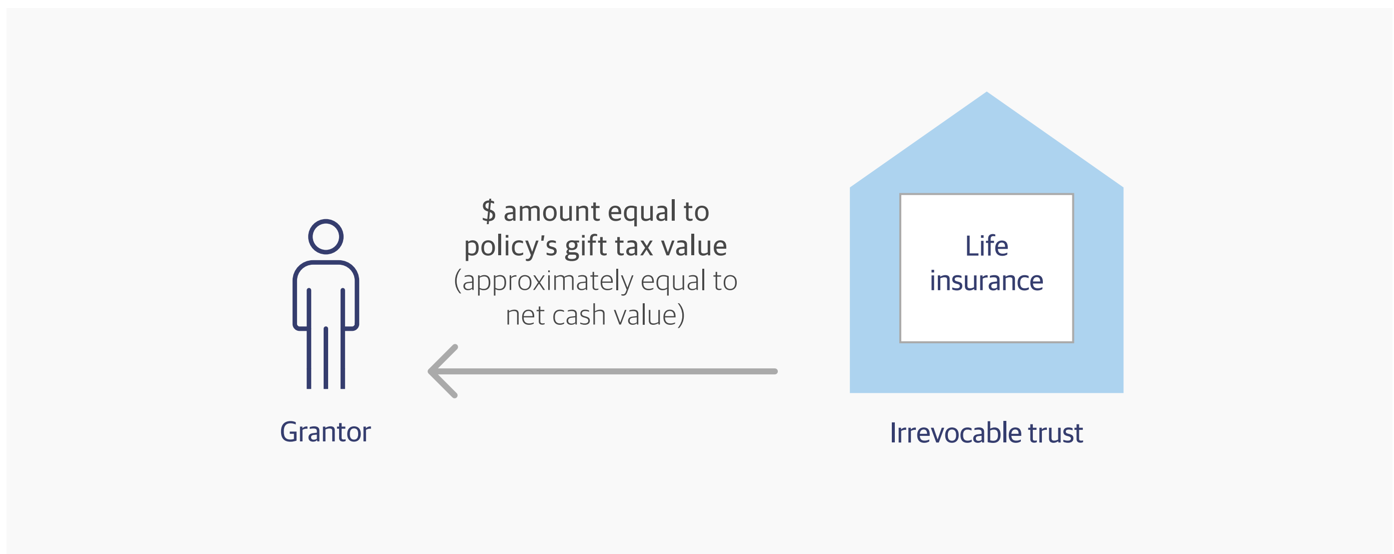
Estate tax effect – at death of grantor/insured



TERMINATING THE ARRANGEMENT DURING LIFE

- If the non-equity split dollar agreement is terminated while the insured is alive and the parties want the trust to own the policy after termination – without an additional gift to the trust – the trust must pay the grantor *an amount equal to the policy's fair market value, determined under the gift tax regulations.* See Treasury Regulation § 1.61-22(g)(2) and its reference to Treasury Regulation § 25.2512-6(a).
  - The gift tax value contains formulas including "interpolated terminal reserve, plus unearned premiums, minus loans," but it oftentimes is approximately equal to the policy's net cash value.
  - The trust does *not* have to pay the higher of (i) premiums paid by the insured, or (ii) the policy's gift tax value.
  - If the grantor forgives this payment obligation, it would be a gift to the trust equal to the value of the policy.

- The trust's possible sources for making the payment to the grantor/insured include:
  - Other assets owned by the trust, such as:
    - Investment accounts owned by the trust;
    - Closely-held business interests held by the trust; and/or
    - Assets that passed to the trust because it is the remainder beneficiary of a split interest trust elsewhere, such as a grantor retained annuity trust (GRAT) or a charitable lead trust (CLT).
  - Funds the trust borrows from the grantor, thereby converting the arrangement to a loan.
  - A portion of the policy's cash value combined with any of the above sources. However, since the trust's payment obligation is generally equal to the policy's value, using *only* the policy for payment would mean that the entire policy must be transferred to the grantor – defeating the original estate tax exclusion purpose.



TAX SUMMARY

Gift Tax

- No part of the premiums paid by the grantor is a gift to the trust if the trust pays for the VEB with the trust's own funds.
- If the trust doesn't pay for the VEB, it is a deemed gift to the trust from the grantor.

Estate Tax

- If the grantor/insured has no incidents of ownership in the policy, the death benefit controlled by and paid to the irrevocable trust should not be included in the estate of the grantor/insured.
- To avoid estate inclusion when the grantor is the insured, the trust's payment obligation to the grantor/insured should be unsecured, or secured by a limited rights collateral assignment. See Priv. Ltr. Ruls. 2009-10-002 (March 6, 2009) and 2008-48-002 (November 28, 2008).

Income Tax

- The irrevocable trust should be designed as a grantor trust for income tax purposes under I.R.C. §§ 671-679.
- If the trust is a grantor trust, the trust's payment of the VEB is not income taxable to the grantor.

Split Dollar Regulations

- Guidance on non-equity split dollar arrangements is found in Treasury Regulation § 1.61-22, and these arrangements generally fall under the "economic benefit" regime.
- To meet the regulations' definition of "split dollar" precisely, the grantor's right to recover some or all of his premium payments generally must be secured by, or be made from, the policy's proceeds.
- Granting the insured a security interest in the policy or providing that his recovery is to be made from the policy might create an incident of ownership in the policy and cause its proceeds to be included in the grantor's estate.
- To avoid possible incidents of ownership, some arrangements are wholly unsecured and the parties treat it as a non-equity split dollar plan even though it might not technically fit within the split dollar regulations. Alternatively, the parties could use a limited rights collateral assignment.
- The parties' legal counsel must determine the merits of either approach.

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