Estate Planning With Life Insurance

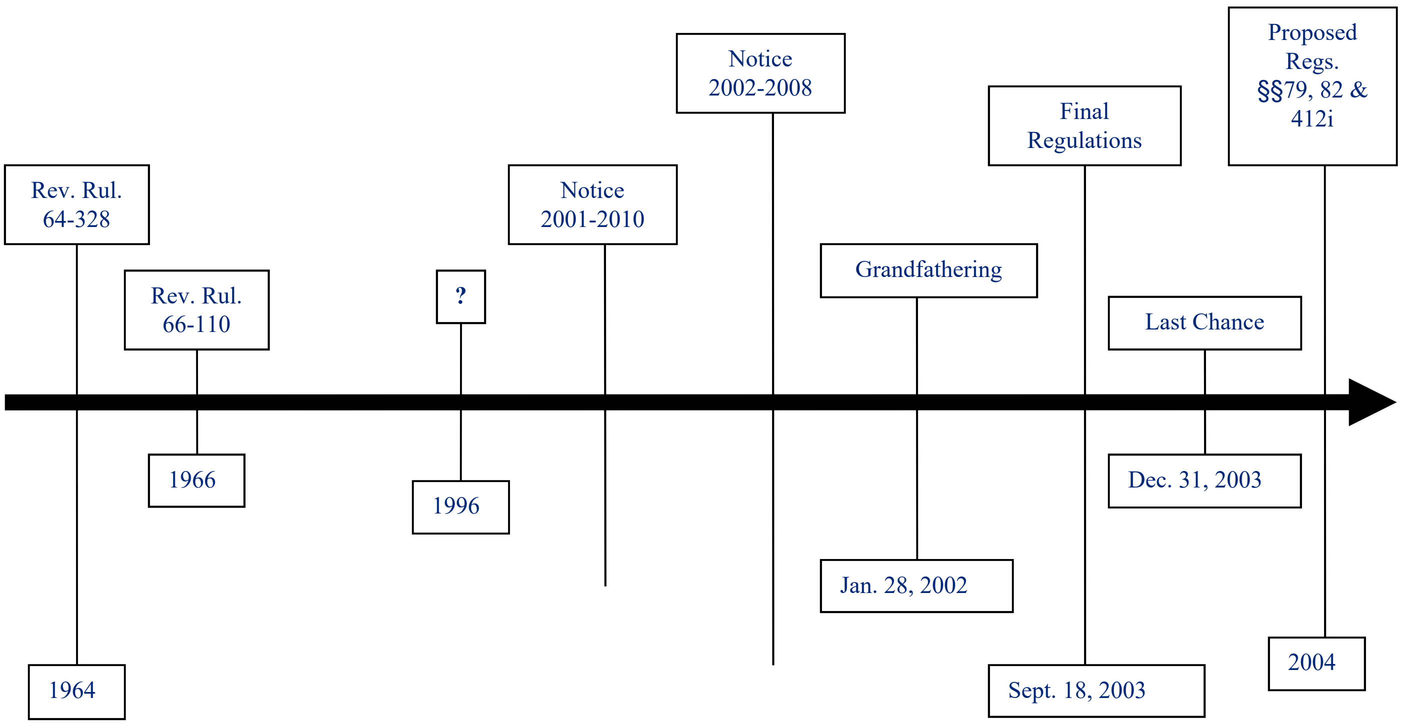
Holland & Knight

SPLIT DOLLAR FUNDING

- Split Dollar premium financing has been recognized by the IRS since 1964 with the issuance of Rev. Rul. 64-328
- Historically, there were two regimes:
  - Endorsement
  - Collateral Assignment (Equity and Non-Equity)
- Notice 2001-10, Notice 2002-8 and the 2003 Final Regulations changed the rules governing split dollar
- Many people assumed split dollar was no longer relevant – IT STILL IS!

SPLIT DOLLAR TIMELINE

The history of the taxation of split dollar



SPLIT DOLLAR TODAY

- Endorsement split dollar still exists, primarily in the employment context, and the rules have not changed
- “Collateral Assignment” split dollar is now governed by one of two regimes:
  - Economic Benefit
  - Loan Method

WHICH REGIME COVERS?

- Ownership of the policy determines which regime applies, but it's a bit more complicated than it appears
- If the only benefit provided to the true owner of the policy (i.e. the owner listed on the policy) is annual life insurance protection, the funding party is deemed the owner for split dollar purposes
- If other benefits exist, particularly access to the policy cash value, the policy owner is considered the owner for split dollar purposes.

ECONOMIC BENEFIT REGIME

- If the funding party is deemed the owner, the Economic Benefit Regime applies – this is modeled after the endorsement method of split dollar
- The measure of value transferred each year to the policy holder/non-owner is the cost of a single year's life insurance coverage.
- The amount of economic benefit is determined by reference to the insurer's regularly issued, publicly available one year term rules, or Table 2001
- On termination of the arrangement, by death or agreement, the funding party must receive back at least the cash value of the policy on the date of termination

LOAN REGIME

- Advances to the policy owner are loans (this means “equity” can be built inside the policy)
- The loans must bear interest at least equal to the Applicable Federal Rate (AFR) for the loan’s duration
- If the notes do not bear adequate interest then the arrangement is taxed under IRC § 7872 and Treas. Reg. § 1.7872-15
- Foregone interest is deemed to be gifted to the policy owner and paid back to the lender as interest
- Below market term loans for a term certain are taxed at inception on the present value of all foregone interest
- Below market term loans that are payable on the death or termination of employment of the insured are taxed on the foregone interest (determined by the AFR) on an annual basis.

GRANDFATHERING

- Agreements that pre-date September 18, 2003, are “grandfathered” and may continue as Collateral Equity arrangement
- This has two distinct benefits:
  - No annual taxation of the cash value increase, or “equity”
  - For agreements before January 28, 2002, the parties may continue to use the old insurer’s published rates (i.e. artificially low)
- Agreements entered into after September 18, 2003, or grandfathered agreements that are “materially modified” after that date, are subject to the new rules

MATERIAL MODIFICATION

- Treas. Reg. § 1.61-22(j)(2)(ii) provides a non-exhaustive list of changes that are not a "material modification," which includes mostly administrative, non-substantive changes to the policy or arrangement
- Most conspicuously not included on the list are IRC § 1035 tax-free policy exchanges
- Grandfathered collateral equity arrangements that are materially modified but not terminated will be taxed on the annual cash value equity growth each year

TERMINATION

- » Termination of a grandfathered collateral split dollar arrangement with equity in the cash value has uncertain consequences
- » If the death of the insured causes the termination there will be no income taxation of the equity
- » The IRS has said verbally that it would attempt to tax the equity component of the policy that stays with the policy owner after repayment of the funding party if the agreement is terminated while the insured is alive
- » That said, the IRS has had since 2003 to come forward with a theory of taxation and has not done so – is that because there is not reliable authority for taxing the equity?

ROLLOUT / ALTERNATIVES

» What strategies are available for terminating or continuing an existing split dollar agreement:

- Terminate and take the position equity is not taxable
- Terminate an economic benefit arrangement before there is equity in the policy and enter into a loan agreement to provide payment of the outstanding obligation under the economic benefit agreement(“conversion” of the agreement)
- Assumption of some of the rights and obligations under the arrangement by another party without fully terminating the existing arrangement

CASE STUDY

- Old Trust and donor are parties to a grandfathered collateral equity private split dollar agreement
- New Trust has been created to take advantage of extended rule against perpetuities under state law
- New Trust and Old Trust enter into an agreement for New Trust to assume the premium payment obligations under the split dollar agreement and to “freeze” Old Trust’s repayment rights under the agreement in return for its release of premium payment obligations

WHEN TO USE ECONOMIC BENEFIT VS. THE LOAN REGIME

- The annual insurance cost component for a second-to-die life insurance policy under the economic benefit regime is very low
- The insurance cost measure for single life policies on older individuals becomes very high
- For second-to-die policies, economic benefit is almost always less expensive than the loan regime – in a higher interest rate environment, the same may be true for younger insureds
- For single life policies on older individuals, the loan regime will often be less expensive

INTERGENERATIONAL SPLIT DOLLAR

- » What is all the buzz about?
- » How does it work?
- » Does it work?
- » How is a bank lender involved?
- » Questions?

WHAT IS ALL THE BUZZ ABOUT?

- A more and more prevalent technique to provide the life insurance coverage and potential tax savings.

- It has been both very successful and somewhat controversial – why?

- In the right scenario it is a powerful estate and gift tax as well as succession planning tool.

HOW DOES IT WORK?

- Senior generation (G1) advances funds to ILIT pursuant to split dollar agreement.
- Insured is younger generation (G2).
- Economic Benefit (?) or Loan Regime.
- Receivable is payable only on the earlier death of the insured or mutual agreement of the holder of the receivable and the ILIT trustee.
- What is that receivable worth?

DOES IT WORK?

- The Morrissette and Levine cases generally say yes – but its not a panacea. Cahill threw cold water on economic benefit planning in this context.

- Morrissette and Levine validated the arrangements as legitimate split dollar arrangements BUT did not determine the valuation of the receivable. Cahill ruled that the split dollar regulations do not control for estate tax purposes.

- Are there other risks?

- How do you mitigate them?