Flexible Estate Planning Strategies

Private split-dollar

Planning for the eventual transfer of a client's estate presents a number of unique challenges. Primary among them is the fact that the estate planning strategy is triggered by an event that will occur at some unknown point of time in the future.

During the time frame between implementing the estate planning strategy and when the strategy goes into effect, a lot may happen. Tax laws may be amended, family dynamics may change, and financial goals may shift. This makes estate planning strategies a bit of a moving target. As clients focus on developing a strategy that minimizes taxes, protects their assets from creditors, and keeps family wealth in the family, it may also be prudent to consider strategies that offer a level of flexibility.

By emphasizing flexibility, strategies may be implemented that address a client's wealth transfer goals, while seeking to retain the ability to adapt to changing circumstances. These may include retaining the right to:

- Continued use and enjoyment of assets/property
- Continued access to income
- The ability to control and manage assets/property
- The ability to change future recipients of income, assets, and property

ONE SUCH STRATEGY FOR BUILDING A LEVEL OF FLEXIBILITY INTO A CLIENT'S ESTATE PLANNING STRATEGY IS PRIVATE SPLIT-DOLLAR.

Final Treasury regulations issued in September 2003 define a split-dollar agreement in broad terms to include any arrangement between an owner and a non-owner of a life insurance policy in which one party pays the premium, that party is entitled to recover all or a portion of the premiums, and such recovery is to be made, or is secured by, the death benefit and cash value proceeds of the life insurance policy.

While there are many different potential ways to structure a private split-dollar agreement, the most common design for estate planning strategies is the collateral assignment **private split-dollar agreement**.

- Parties to this agreement include the client/insured and a third party – typically an irrevocable life insurance trust (ILIT)
- The ILIT owns the policy
- The client/insured pays the premiums

- The client/insured retains the right to recover either: 1) their premiums paid (equity split-dollar), or 2) the greater of their premiums paid and the policy's cash value (nonequity split-dollar).
- A collateral assignment agreement is executed in which the ILIT assigns the policy to the client/insured to secure their rights under the split-dollar agreement. The collateral assignment should limit the insured's right to take loans, take withdrawals, or surrender the policy in order to avoid incidence of ownership (and inclusion of the death benefit in their estate).
- Upon the death of the insured, if the split-dollar arrangement is still in place, the ILIT receives its share of the death proceeds. The proceeds are held, distributed, or otherwise utilized based on the terms of the ILIT.

Private split-dollar

Type	Allocation of death benefits and cash values		Value of annual gift
	ILIT	Client	
Collateral assignment (equity)	Right to death benefits and policy cash values in excess of total premiums paid by client	Right to recover total premiums paid upon death or termination of split-dollar agreement	Based on the loan regime method. IRC Sec. 7872 – Foregone Interest Measured by multiplying the total premiums paid by the "annual blended rate" Rates are variable, changing annually based on interest rates
Collateral assignment (nonequity)	Right to death benefit in excess of whichever is GREATER – policy cash surrender values or total premiums	Right to recover an amount equal to the GREATER of the policy cash surrender value or total premiums paid upon death or termination of the split-dollar agreement	Based on the economic benefit regime method Measured by multiplying the ILIT's total death benefit by the IRS Table 2001 rates Rate increases as the client's age increases

IRC 26 CFR § 1.61-22(b)

Note: Endorsement split-dollar, in which the client/insured (or their business) owns the policy and endorses a portion of the death benefit to an ILIT, is an alternative design, but rarely used for estate planning strategies.

Practice tip: The best way to remember which design is an equity split-dollar and which is a nonequity split-dollar is to think of it in terms of what the ILIT receives, not the client. In a nonequity split-dollar, the ILIT has no right to the cash values, only a right to death benefits that exceed the cash values.

ADVANTAGES

- There is minimal to no gift tax exposure when premiums are paid, as the measure of the annual gift is determined by either the economic benefit provided to the ILIT (nonequity split-dollar) or the amount of the foregone interest (equity split-dollar), not the full value of the premiums paid.
- When properly designed, the death benefit paid to the ILIT will not be included in the client's gross estate for estate tax purposes, and may provide a level of creditor protection.
- The client retains the right to "forgive" repayment of premiums paid, and therefore the flexibility to delay the decision on making gifts to the ILIT.
- The client may terminate the split-dollar agreement (typically with 30-day notice) and recover their share of premiums (equity split-dollar) or the entire cash value (nonequity split-dollar), providing the client with access to future cash flow should they need it in the future.

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DESIGN CONSIDERATIONS

- If the client chooses to forgive the amount they have a right to recover under the split-dollar agreement, it will be considered a gift to the ILIT for federal gift tax purposes.
- In general, the economic benefit regime (nonequity split-dollar) results in a lower initial value for gift tax purposes than the loan regime (equity split-dollar). In later years, there may be a crossover point where the loan regime results in a lower gift tax value.
- If a nonequity split-dollar arrangement is terminated prior to the death of the insured, the ILIT will need to pay the client/insured the entire cash value. If cash values are used to make the payment, the policy will need to be surrendered, resulting in no death benefit for the ILIT.
- It is important to develop a repayment strategy. When and how will the ILIT repay their obligation to the client/insured? If policy cash values will be used to repay the obligation, the policy should be properly funded and monitored. The obligation may also be repaid at the death of the insured. In this case, the repayment would be paid to the insured's estate. There are also a number of ways the insured may contribute their own funds to the ILIT to repay the obligation instead of using policy cash values, while minimizing their exposure to gift taxes or use of their gift/estate tax exemption. Two of the more common strategies utilize the remainder values from a Grantor Retained Annuity Trust (GRAT) or a Charitable Lead Annuity Trust (CLAT) to provide sufficient funding to pay back the loan.

Clients considering this type of strategy should consult with their tax advisor and attorney to discuss their specific situation.

The death benefit is generally income-tax-free when passed on to beneficiaries.

FIUL is subject to health and underwriting requirements.

Policy loans and withdrawals will reduce the available cash value and death benefit and may cause the policy to lapse, or affect guarantees against lapse. Withdrawals in excess of premiums paid will be subject to ordinary income tax. Additional premium payments may be required to keep the policy in force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. If a policy is a modified endowment contract (MEC), policy loans and withdrawals will be taxable as ordinary income to the extent there are earnings in the policy. If any of these features are exercised prior to age 59½ on a MEC, a 10% federal additional tax may be imposed. Tax laws are subject to change and clients should consult a tax professional.

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