Non-Equity Split-Dollar

NON-EQUITY SPLIT-DOLLAR

OVERVIEW

- In addition to purchasing new second-to-die policies inside a new ILIT, you may also wish to consider entering into a split-dollar arrangement with the ILIT.
- One of the principal benefits of this technique is that the gift between yourself and the ILIT as a result of you paying the premiums pursuant to a split-dollar arrangement should be considerable less than if you were to just gift cash directly to the ILIT allowing the ILIT to pay the premiums itself.
- This memorandum describes split-dollar arrangements and the benefits of using them in conjunction with an ILIT.

BRIEF DESCRIPTION OF SPLIT-DOLLAR ARRANGEMENTS

- A split-dollar arrangement is an agreement between multiple parties to purchase a life insurance policy. These arrangements typically involve three parties: (i) the party responsible for paying the premiums (the "Contributors"); (ii) the Grantors of the ILIT as the "Insured"; and (iii) an ILIT as the owner of a survivorship life insurance policy.
- The Contributors agree to pay premiums on the policy held by the ILIT in exchange for the right to receive at the death of the Insured or termination of the agreement, the greater of the premiums paid by the Contributor or the cash surrender value (CSV) of the policy.
- To secure their interest in the policy, a collateral assignment in the policy is given to the Contributors by the ILIT.
- While the split-dollar arrangement is in place, the Grantors are deemed to have made a taxable gift to the ILIT in an amount equal to the "economic benefit " attributable to the Sponsor's payment of the premiums.
- While both Grantors are alive, this economic benefit is usually de minimis and the Grantors' available annual exclusion gifts are sufficient to cover the deemed gift to the ILIT.
- If the split-dollar arrangement is still in place when one of the Insured dies, the economic benefit will increase substantially.
- Contributors typically "rollout" or terminate the agreement when the cumulative premium payments are equal to the policy's CSV (the "Crossover Point").
- Two options exit strategies exist at the time the arrangement is to be terminated: (i) switch to a loan regime; or (ii) the Contributors release the collateral assignment without requiring repayment of premium advances.
  - Under the loan regime, the ILIT gives the Contributors a promissory note equal to its obligation under the split-dollar arrangement at the time of termination (i.e. – the note's initial principal balance is equal to the greater of the cumulative premiums paid or the policy's CSV).
  - If the Contributors wish to release the collateral assignment and treat the release as a gift, the amount of the gift would be the greater of the premiums paid, or the policy's CSV, but is limited

under the split-dollar agreement to values contained in the policy. As long as the value of the gift is less than $10,500,000, no out-of pocket gift tax will be paid by the Contributors unless they have previously used their lifetime gift tax exemptions.

- If the split-dollar arrangement is still in force upon the death of the survivor of the Insured, the survivor's taxable estate would most likely include an amount which is equal to the greater of premiums paid or the policy's CSV. Any remaining death benefit proceeds would be paid to the ILIT.

BENEFITS OF SPLIT-DOLLAR ARRANGEMENTS

- *Minimized Gift Taxes.* Since annual gifts to the ILIT are measured by cost of insurance rates instead of policy premiums, large survivorship policies may be purchased without taxable gifts and the need to file gift tax returns each year. Annual exclusions not used as part of the split-dollar arrangement are available for intra-family gifting purposes.
- *Excluded from Estate.* A survivorship life insurance policy owned by an ILIT avoids inclusion of death proceeds in both of the Grantors' estates.
- *Flexibility.* You may avoid payment of out-of-pocket gift tax if the policy rollout value is less than the available combined gift tax lifetime exemptions, generally $10,500,000 ($5,250,000 per spouse).

EXAMPLE

Entities Involved in the Transaction

- *Smith Family Irrevocable Trust*
  - » John and Jane created the new ILIT with GST provisions.
  - » The trusted advisor is the Trustee of the ILIT.
- *John and Jane*
  - » John and Jane will be responsible for premium payments and will enter into a private non-equity split-dollar agreement with the ILIT.

<u>STEP 1:</u> The ILIT Purchases a $20 Million of Survivorship Life Insurance

- The ILIT purchases a survivorship life insurance policy with a death benefit of $20 million.
  - » The estimated annual premium payment on the policies is approximately $301,418.00.
- The ILIT is the owner and beneficiary of the policy.

<u>STEP 2:</u> The ILIT Enters into a Non-Equity Split-Dollar Agreement with John and Jane

- The ILIT and John and Jane will enter into a non-equity split-dollar agreement under which John and Jane agree to pay all premiums due under the policy.
- In return for the payment of premiums, the ILIT collaterally assigns the policy to John and Jane.
- The collateral assignment guarantees that John and Jane will be repaid the greater of the cumulative premiums paid on the policy or the policy's CSV.

<u>STEP 3:</u> Economic Benefit is a Deemed Gift to the ILIT Beneficiaries

- The amount of the deemed gift each year to the ILIT beneficiaries is equal to the "economic benefit." This amount is set by IRS pronouncement.
- The economic benefit amount will be recognized as income to John and Jane each year, but this amount

is initially much lower than the amount of the policy premium paid.

- » For instance, based on your current ages (John is 66 and Jane is 63) and assuming a $20 million policy is purchased, the economic benefit in the first seven years is approximately $2,453, for the next three years it is approximately $3,164, 4,027 and $5,053, respectively. In fact, the economic benefit does not reach $13,000 per year until John reaches age 74, at which point it is approximately $13,713.
- » This allows the insurance policy to be funded without exhausting your lifetime gifting exemptions.

STEP 4: Crossover Point

- At the Crossover Point, the ILIT can repay John and Jane the greater of the cumulative premiums paid on the policy or the policy's CSV, and John and Jane will release the collateral assignment.
    - » At the Crossover Point, the amount of income recognized by John and Jane pursuant to the repayment will be minimal or eliminated entirely.
    - » The repayment may be made by borrowing against the CSV of the policy or by a loan to the ILIT from John and Jane.

STEP 5: ILIT Owns Policy Not Subject to Collateral Assignment

- After John and Jane releases the collateral assignment, the ILIT will continue to own the policy.
- Any future premium payments may be made through gifts or loans to the ILIT by John and Jane.
- Upon the death of the survivor of you, the policy death benefit will be held in the ILIT for the benefit of your children and their descendants.

TAX AND RISK CONSIDERATIONS

Estate Tax

- A collateral assignment must be used with the split-dollar arrangement. Such a collateral assignment must prevent the Insured from having any of the following rights:
    - » The right to change the beneficiary;
    - » Surrender, cancel or assign the policy;
    - » Revoke the assignment; or
    - » Borrow from policy's CSV.
- An insured that enjoys any of these rights risks having an incident of ownership in the policy and thus, could face inclusion of the death benefit in his or her estate.
- If the arrangement is not cancelled prior to the survivor's death, the survivor risks the inclusion of the greater of premiums paid or the policy's CSV will be included in his or her estate.

Gift Tax

- For a split-dollar arrangement, the annual exclusion gift to the trust is generally equal to the amount of economic benefit.
- If one spouse dies before the split-dollar arrangement terminates, the increase in the economic benefit may exceed the surviving spouse's available annual exclusion gifts and could result in a taxable gift.

Income Tax

- Since the ILIT is a grantor trust for income tax purposes, any reportable income earned by the trust is taxable to you as the Grantor.

DIAGRAM

Please see the diagram below which generally illustrates the GSD concept described above.

JOHN AND JANE SMITH NON-EQUITY SPLIT-DOLLAR