

## M INTELLIGENCE

### DESIGNING PRIVATE SPLIT-DOLLAR FOR FLEXIBILITY AND ACCESS

Life insurance held in irrevocable life insurance trusts (ILITs) can be a critical part of a high-net-worth (HNW) family's estate plan. Held outside of the taxable estate, the life insurance policy can provide much-needed liquidity during the estate settlement period, and long after for the benefit of the trust beneficiaries.

While the simplest way to purchase life insurance in trust is via gifts, alternatives may be sought if:

- there is a potential tax on the gift if the taxpayer has utilized most or all of their lifetime gift tax exemption,
- the taxpayer does not wish to utilize their gift tax exemption, or
- the taxpayer does not wish to give up complete access to the policy.

In any of these cases, a private split-dollar plan could provide the solution.

#### PRIVATE SPLIT-DOLLAR AS AN ESTATE PLANNING TOOL

A private split-dollar plan is typically between an ILIT and an individual or family who wants estate tax protection while also minimizing the value of gifts to the trust.

These arrangements allow for the advancing of funds to the ILIT for the purpose of purchasing life insurance without the transferred premiums being treated as gifts. This can prove to be a powerful estate planning

tool for those who would benefit from additional life insurance coverage in trust but do not wish to make reportable gifts or have utilized the entirety of their lifetime exemption.

Additionally, spit-dollar plans can address concerns about losing control of the asset. By employing the non-insured spouse as the ILIT's grantor and premium payor, the insured is able to avoid incidents of ownership while still maintaining indirect access to the policy.

#### PRIVATE ECONOMIC BENEFIT SPLIT-DOLLAR PLANS

When structuring these plans, IRS split-dollar regulations<sup>1</sup> (the Final Regulations) provide for two mutually exclusive tax regimes for split dollar: the economic benefit regime and the loan regime. While this piece will briefly touch on the loan regime, the primary focus of this design utilizes the economic benefit regime.

In typical private economic benefit split-dollar plans, the grantor of the trust is the insured. He or she also acts as the premium payor by advancing funds to the

<sup>1</sup> Split-dollar arrangements, 68 Fed. Reg. 54,336 (Wednesday, September 17, 2003; amending 26 C.F.R. pts 1, 31, and 602)

trust to pay for the life insurance. In order to differentiate this transaction from a gift and avoid any gift tax liability, a collateral assignment is placed on the policy. This assigns back to the premium payor (in this case, the insured) the greater of premiums paid or the policy's cash value.<sup>2</sup>

The death benefit over and above this amount is payable to the trust. Each year, the trustee must pay for the portion of coverage received.<sup>3</sup> This is known as the reportable economic benefit (REB) and is generally determined by virtue of the lesser of IRS Table 2001 rates or, if applicable, the carrier's one-year annual renewable term rates. Particularly when the insured is younger, the REB will be a fraction of the overall premium paid for the life insurance policy.

The trustee may pay the REB directly to the grantor/premium payor or it may be imputed as a gift from premium payor to trust. The grantor/premium payor may gift cash to the trust which the trustee may use to pay the REB. If the trust has "Crummey provisions" that are adequately complied with and followed, the cash gifts may be subject to the grantor/premium payor's annual exclusion based upon the number of underlying trust beneficiaries. If the grantor/premium payor does not receive payment from the trustee but instead elects to impute the unpaid REB as a gift, it is not deemed to be a gift of a present interest and must be recognized on the grantor/premium payor's gift tax return.

## AVOIDING INCIDENTS OF OWNERSHIP

One of the critical elements of ILIT planning involves ensuring that the trust (and related agreements) is drafted in such a way as to avoid inclusion of trust assets in the estate of either spouse.

This means that the insured cannot have any incidents of ownership in the trust-owned policy under IRC Section 2042. These rights include, but are not limited to:

- changing the policy beneficiary,
- pledging the policy as collateral for a loan,
- surrendering the policy, or
- borrowing against the policy's cash value.<sup>4</sup>

When the grantor/premium payor is also the insured in a split-dollar plan, care must be taken to adequately restrict the collateral assignment to avoid these incidents of ownership.

## NON-INSURED SPOUSE AS GRANTOR AND PREMIUM PAYOR

Incidents of ownership can generally be avoided if the arrangement is structured so that the grantor and premium payor is the non-insured spouse and the other spouse is the insured on the policy. In this design, the private split-dollar plan provides:

- a gift tax-efficient means of purchasing life insurance outside the estate,
- grantor access to life insurance policy values via the collateral assignment, and
- policy proceeds vested in the trustee, leaving it outside of the estate of both spouses.

*The net result of this is that the non-insured spouse holds a collateral assignment that enables them to access life insurance policy funds without risking the inclusion of **all** life insurance proceeds.*<sup>5</sup> In effect, the premium payor may have ownership rights over policy cash value, with the excess death benefit protection allocated to the trust and remaining outside of his or her estate.

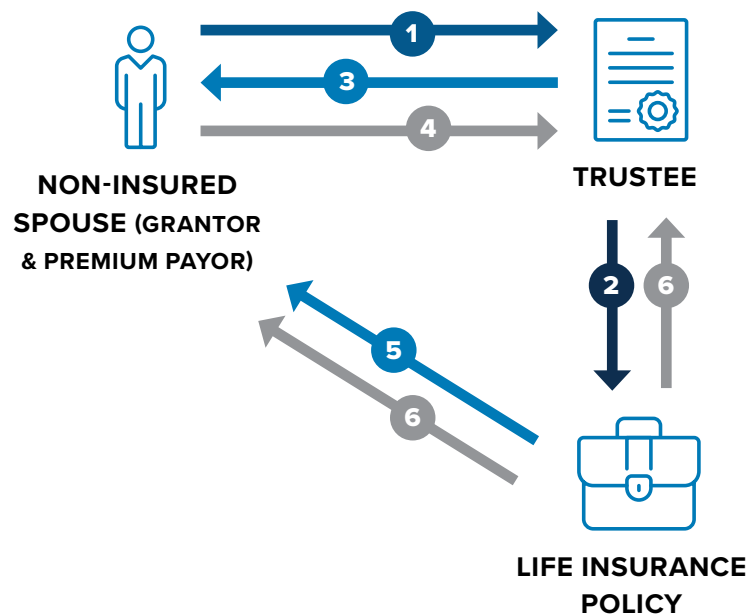
<sup>2</sup>Treas. Reg. 1.61-22(c)(1)(ii)(A)(2)

<sup>3</sup>Treas. Reg. 1.61-22(d)(3)(ii)

<sup>4</sup>IRC Sec. 2042(2)

<sup>5</sup>If the collateral assignment is outstanding, the greater of premiums paid or cash value will be included in the estate of the premium payor.

## Non-Insured Spouse as ILIT Grantor & Premium Payor



1. Grantor/premium payor advances premiums to trustee
2. Trustee purchases a life insurance policy insuring the life of the non-grantor spouse
3. Trustee and grantor/premium payor enter into a split-dollar agreement; trustee assigns the *greater* of premiums paid or cash value to grantor/premium payor per the terms of the split dollar agreement
4. Grantor/premium payor gifts funds to the trust for payment of the REB or imputes REB as a gift

5. Subject to the collateral assignment, the grantor/premium payor may request funds from the policy's cash value via partial surrenders or policy loans
6. Upon the insured's passing, policy proceeds are split between the trust (assignor) and grantor/premium payor (assignee) per the terms of the collateral assignment

### PLANNING THE COLLATERAL ASSIGNMENT

It is critical that steps are taken when drafting the trust and split-dollar agreement to avoid estate tax inclusion under IRC Code Sections 2036, 2038, and 2042. The agreement should address the possible scenario of the grantor/premium payor pre-deceasing the insured.

Were this to happen, the insured could have the right to access policy values via an unrestricted collateral assignment, causing inclusion in their estate under IRC Section 2042. Therefore, both the grantor/premium payor and their planning attorney should ensure that the collateral assignment would not pass to the insured in this situation.

Further, the insured spouse should not be executor of the estate or trustee of a trust holding the collateral assignment. Steps should be taken in advance to assign a special executor or trustee to administer the collateral assignment and associated contractual rights.

Should it come to pass that the insured possesses incidents of ownership over the policy, they should discard them as soon as possible since, per IRC Section 2035, death within three years of holding such incident of ownership under IRC Section 2042 would result in estate tax inclusion.

## The Effects of Divorce on Collateral Assignments

Divorce will not directly render this design impractical. The holder of the collateral assignment will still maintain his or her contractual rights over the assignment. However, the collateral assignment creates a valuable receivable that may be subject to division per a divorce decree. If this is a concern, the taxpayer should consult with experienced counsel.

## EXIT STRATEGIES FOR PRIVATE ECONOMIC BENEFIT SPLIT-DOLLAR PLANS

Irrespective of the purpose behind the split-dollar plan, it is critical to have a well-thought-out exit strategy in advance. That is, a plan or series of options for the future termination of the split dollar plan. This is important for two reasons: (1) the collateral assignment causes the greater of premiums paid or policy cash values to be included in the estate of the holder, and (2) if the insured lives long enough, the REB will continue to increase until the gifts/funds required become uncomfortably large.

### SOME OPTIONS FOR EXIT PLANNING INCLUDE:

- **Converting to a loan regime arrangement:** It may be possible to convert an economic benefit regime split-dollar plan into a loan regime. This is typically done at the earlier of the cash value equaling premiums paid, or when the REB becomes uncomfortably high. This can have the effect of “freezing” the value of the receivable if interest is paid every year. Note that this arrangement will be based upon interest rates in affect at the time of conversion.
- **Pre-funding the trust with present interest gifts to the degree that the trust has Crummey provisions:** Annual gifts to the trust may be made to both pay the REB and to establish a side fund. This side fund can be invested, and should there be adequate appreciation, be used to repay the collateral assignment.

- **Utilizing leveraged gifting techniques to prefund the trust:** Gifts of closely-held business interest (subject to valuation discounts permitted under law) may be gifted to trust, and/or grantor retained annuity trusts (GRATs) may be utilized to shift equity into the trust on a gift tax-efficient basis.

When the arrangement is terminated, it ought to be done in such a fashion as to preserve the life insurance policy within the trust. Failure to carefully plan for an exit could result in policy surrender or lapse, and the trust beneficiaries receiving significantly less than planned (or nothing at all).

## COMPARISON TO SPOUSAL LIFETIME ACCESS TRUSTS (SLATS)

This split dollar design may appear to be similar to a SLAT.<sup>6</sup> While neither is a better or worse solution than the other, SLATs are generally designed so that insured is the grantor, who then gifts the assets into the trust for the benefit of the spouse. Once established, it is the beneficiary spouse who is permitted to access the assets, not the insured/grantor. This setup does, however, allow the insured/grantor indirect access via the spouse.

In private split-dollar plans, it is the trust grantor who has access to trust assets (per the terms of the collateral assignment and not to exceed the policy cash values), not the beneficiary spouse. This may appeal to those taxpayers who wish to have personal control over the transaction versus delegating that access to their spouse.

Finally, SLATs are traditionally funded with gifts, which can count significantly toward the insured’s lifetime gift-tax exclusion. A private economic benefit split-dollar plan minimizes the amount of gifts needed and, therefore, the potential negative impact on the insured’s estate plan.

## POLICY SELECTION AND DESIGN

Selection of the life insurance policy is every bit as important as the design of the trust or split-dollar plan. Life insurance policies come in various designs, and as such, it is critical to work with an experienced and qualified life insurance professional to select and design the policy that is most complimentary to the broader plan. In these arrangements, permanent insurance is

<sup>6</sup> Please contact your M Financial professional for a copy of the M Intelligence piece “The Benefits of a Slat: Efficiency and Access.”

always used, and policies should generally be designed so there is sufficient cash value for future access by the grantor/premium payor.

As a broad rule, however, survivorship policies must be avoided. As mentioned above, should the grantor/premium payor also be an insured, it would raise potential estate tax inclusion concerns under IRC Section 2042 and be counterproductive to the intended purpose of this design.

## FLEXIBILITY AND EFFICIENCY

Traditionally, private split-dollar plans have been deployed as a means of privately financing life insurance

without the need for significant reportable gifts. Where additional flexibility is desired, insuring the grantor's spouse can provide the grantor with current access to policy values (subject to the collateral assignment).

For HNW individuals who may be younger and uncomfortable making irrevocable gifts, or for those who have already utilized their lifetime gift tax exemption but value flexibility, this design can help provide the right balance to their overall plan.

*This piece was created by M Financial's Advanced Markets experts and produced by the marketing team.*

### Carlson Hammond

CA 415.256.8960 | HI 808.532.2826 | [carlsonhammond.net](http://carlsonhammond.net)

Securities and Investment Advisory Services offered through M Holdings Securities, Inc., a Registered Broker/Dealer and Investment Adviser, Member FINRA/SIPC. Carlson Hammond is independently owned and operated. Insurance offered through Carlson Hammond Financial and Insurance Services.

This material and the opinions voiced are for general information only and are not intended to provide specific advice or recommendations for any individual or entity. To determine what is appropriate for you, please contact your M Financial Professional. Information obtained from third-party sources is believed to be reliable but not guaranteed.

The tax and legal references attached herein are provided with the understanding that neither M Financial Group, nor its Member Firms are engaged in rendering tax, legal, or actuarial services. If tax, legal, or actuarial advice is required, you should consult your accountant, attorney, or actuary. Neither M Financial Group, nor its Member Firms should replace those advisors.

© Copyright 2024 M Financial Group. All rights reserved. #4838283.2 Expires 7/8/2026

M Financial Group | 1125 NW Couch Street, Suite 900 | Portland, OR 97209 | 503.238.1813 | fax 503.238.1815 | [mfin.com](http://mfin.com)