ADVANCED SALES COMMENT

Private Split Dollar Arrangements: The Best of Both Worlds

Keeping life insurance death benefits out of your clients' estates while still giving them access to policy cash value.[1]

A question often asked is, "How can my clients keep the death proceeds of their life insurance policy out of their taxable estate, yet still permit access to policy cash value[1] to supplement retirement income?" At first blush, it may seem that the clients' request just can't be met. However, there is a strategy that can accomplish this goal by utilizing a private split dollar arrangement.

Scenario 1

Your client, Fred, is 50 years old and would like to put $100,000 per year into a 10 pay life insurance policy. When Fred retires at age 64, he would like to help supplement his retirement income by withdrawing $80,000 from the cash value of the policy. For planning purposes, he would also like to keep the death proceeds of the life insurance policy out his estate.

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Strategy

Fred will create an irrevocable trust to own the life insurance policy. Fred and the trustee will enter into a private split dollar arrangement. Under the terms of the arrangement, Fred will pay all of the life insurance policy premiums and will be entitled to all of the cash value if the trustee terminates the arrangement. Fred's estate will be entitled to the cash value at the time of death if Fred dies while the private split dollar arrangement is in effect. The life insurance policy will be collaterally assigned to Fred as security for his interest in the policy cash value. To eliminate any "incidents of ownership" in the policy that could cause estate taxation of the entire death proceeds, a "restrictive" collateral assignment form will be used. This form does not provide Fred with the ability to directly access policy cash value[1] or to otherwise interact with the life insurance policy.

Under the private split dollar rules, Fred will be deemed to have made a gift to the irrevocable trust each year equal to the term insurance value of the portion of the death proceeds (in excess of the policy cash value) that would be paid to the trust if Fred died during that calendar year. Alternatively, to facilitate qualifying these gifts for the annual gift tax exclusion, Fred could gift cash or other assets to the trust. The arrangement can require the trust to contribute, toward the annual premium, an amount equal to the term value of the trust's death benefit protection.

If Fred can't touch the policy cash value, how can he begin to take withdrawals out of the policy?

The key is the future termination of the private split dollar arrangement by converting it to a loan at or prior to retirement. Another way of looking at this transaction is that the insured is going to sell his interest in the policy's cash value to the trust in exchange for a note payable. Under the terms of the loan agreement, the trust now owes Fred a note payable equal to the cash value of the life insurance policy at the time of termination of the arrangement. The note payable can either be an installment note requiring regular fixed payments or a demand note. In either case, interest will be payable to Fred in addition to the note principal, however, the interest will not be taxable to him. Under the grantor trust rules of Internal Revenue Code (IRC) §§ 671-677, transactions between a grantor and a grantor trust are not recognized for federal tax purposes.

Once the private split dollar arrangement is converted to a loan, the trust now owns the policy cash value. Prior to this transaction, the trust did not own any of the cash value even though the trust was the legal title owner of the life insurance policy. Now that the trust owns the cash value, the trustee may begin to access that cash value[1] to make payments on the outstanding loan to the insured/grantor.

Payments to Fred

Assume that the private split dollar arrangement is terminated when the value of the life insurance policy is $1.25 million. Let's also assume that the applicable federal interest rate (AFR) is at 4%. The trust will take $80,000 out of the life insurance policy (probably by taking the current-year dividend[2] in cash and surrenders[1] of paid-up additions for the remainder if needed). The $80,000 will then be paid to Fred in the form of $50,000 of interest (non-taxable under the grantor trust rules) and a $30,000 principal reduction of the note payable.

In year two, interest in the amount of $48,800 and principal of $31,200 would equal the $80,000 payment. The principal is being reduced slowly enough that, at a 4% interest rate, the loan payments can continue from the trust for 25 years before the trust's liability is fully repaid. If Fred dies before the loan amount is fully paid, the remaining balance will be includible in his taxable estate.

Note that once the trustee has fully recovered the trust's $1 million tax basis from the policy, any further policy distributions[1] will have to be in the form of policy loans in order to prevent Fred, as the trust grantor, from being taxed on the distributions. Any policy loans will eventually be repaid from the policy death benefits. The parties should carefully monitor policy values to ensure that the policy is never at risk of lapsing.

Scenario 2

Your client, Kim, is 60 years old and would like to fund a life insurance policy to help fund her estate tax liability and for estate liquidity. She owns a substantial amount of illiquid assets. Kim is concerned that she may need access to some of the life insurance policy cash value[1] in the future. Unlike Fred in the earlier example, Kim is not counting on the cash value to supplement her retirement income, though she would like to retain some flexibility to access cash value.[1]

Strategy

Kim will create an irrevocable trust to own the life insurance policy. She and the trustee will enter into a private split dollar loan arrangement. Under the terms of this arrangement, Kim will loan one-half of all of the life insurance policy premiums to the trust each year. The plan is that Kim will make gifts to the trust of the remaining premiums. The loan arrangement is required to bear interest in accordance with below-market rate loan rules of IRC § 7872. Interest can either be accrued annually and added to the loan balance, or Kim can gift the amount needed to satisfy the loan interest to the trust each year.

The life insurance policy will be collaterally assigned to Kim as security for her interest in the policy cash value. As in the prior example with Fred, a restrictive collateral assignment form will be utilized in order to prevent Kim from having incidents of ownership that would cause the death benefit to be includible in her taxable estate.

If Kim needs a quick infusion of cash in the future, she can ask the trustee to repay all or any portion of the outstanding private split dollar loan. The trustee can access the policy cash value[1] to make the payment to Kim. If at some later point Kim no longer needs the funds that she received from the trustee, she could always loan or gift the funds back to the trust, and the trustee could repay any loans that were taken from the life insurance policy.

If Kim dies while any portion of the loan remains outstanding, that amount will be includible in her taxable estate. The remainder of the life insurance policy death benefit will be paid to the trust and will not be includible in her taxable estate.

Private split dollar arrangements provide substantial flexibility in structuring arrangements to enable the insured to continue to have indirect access to policy cash value[1] while still keeping the bulk of the death benefits out of his or her taxable estate.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

Loan interest is charged when a policy loan is taken. If you take additional policy loans to pay loan interest, your policy's cash/account value will be reduced. At some point, no policy values may be available to pay additional loan interest and out-of-pocket payments will be required to prevent the policy from lapsing. Failure to pay out-of-pocket amounts will result in the loss of life insurance coverage and a tax liability in the year of lapse.

[2] Dividends are not guaranteed.

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