Intergenerational Split-Dollar Arrangements: What's the "Big Deal"?

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The "Big Deal" is the IRS may have finally closed a huge estate tax loophole — the use of abusive "Death Bed" split-dollar arrangements to generate discounts of 90 percent or more for wealthy individuals with reduced life expectancies. The bigger deal, often overlooked, is that traditional split-dollar life insurance plans are a tremendous planning tool to fund estate tax-free trusts without paying gift taxes. But first, let's look at what most planners consider an overly aggressive split-dollar arrangement.


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In *Estate of Cahill v. Commissioner,* a 2018 case, Mr. Cahill was 90 years old and in poor health when he advanced $10 million in premiums for policies on his son and his wife under a split-dollar insurance arrangement with his Irrevocable Trust. His Trust paid nothing for these trust-owned life insurance policies.

Why was the $10 million interest-free? Because Mr. Cahill's advisors selected the interest-free Economic Benefit (i.e., term insurance cost) option instead of the Loan (i.e., with interest) option. With the Economic Benefit method, the IRS says there's no imputed interest charge if you properly account for the Trust's Economic Benefit. Because Mr. Cahill paid everything, the Trust was deemed to have received an Economic Benefit gift of $7,578 for the year. Mr. Cahill reported that amount on his gift tax return.

What happened when Mr. Cahill died? When he died a year later, the estate valued the $10 million receivable at only $183,700! However, the cash surrender value was $9.6 million at the time. The IRS alleged a $9.6 million estate value and sought to impose an additional $2.2 million in penalty taxes. Mr. Cahill's estate asked the Tax Court to rule in its favor with a partial summary judgement. Summary judgement was denied. Instead, the Tax Court Memorandum provided a detailed analysis of the reasons for valuing the receivable at $9.6 million and referred the case back for trial.

Did the IRS win? Big time. Two months later, rather than go to trial, the estate accepted the IRS value of $9.6 million and agreed to pay a 20 percent accuracy-related penalty.

Observations

In our opinion, Cahill is a welcome outcome because abusive "Death Bed" Economic Benefit arrangements are simply wrong. You should expect an audit both with this type of transaction and with any scheme where the Exit Strategy is to cancel the policies after obtaining a valuation discount.

Two Safe and effective Split-Dollar Arrangements with Grantor Trusts

The good news is that there are safe split-dollar plans available to fund irrevocable trusts without paying any gift tax. Safety results by following the 2003 Final Treasury Regulations regarding split-dollar arrangements. Effectiveness results from using high quality life insurance contracts owned by flexible trusts that will be treated as grantor trusts for income tax purposes during life and will be estate tax-free when the grantor dies. Here are two examples:

■ **Example #1**: Guaranteed Level Premium 2nd to Die insurance policies with low or no cash value using the Economic Benefit Regime. The grantor advances premiums interest-free as long as both insureds are alive. The Trust pays the low Economic Benefit portion of the premium so that it will not have to pay loan interest. This al-

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lows up to 99 percent of the Trust's other assets to be invested for estate tax-free growth. At the first insured's death, the Trust will repay the receivable either in cash or with an interest-bearing note.

■ **Example #2:** Increasing Cash Value insurance policies to insure family members individually or jointly using the Loan Regime. Each grantor loan can lock-in the long-term AFR (Applicable Federal Rate) for the life of the insured.. The loan can be non-recourse and interest can accrue income tax free for the life of the grantor.

High-net-worth clients purchase permanent life insurance for the values they provide as an investment (i.e., Tax-Free Death Benefit IRRs or Lifetime Distributions of Cash Value). Estate planners use split-dollar arrangements to avoid paying gift taxes and loan interest when funding trust-owned life insurance. Great policies and great planning are always a "Big Deal."

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