Split-dollar arrangements

Tax efficient leverage techniques to fund grantor trusts.

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For more than a dozen years, attorneys for high net worth clients have used IRS-approved split-dollar ("Split-$") arrangements to transfer billions of dollars to their clients' Grantor Trusts. This article describes the two types of Private Split-$ arrangements permitted by the 2003 IRS regulations and provides three Case Study examples to illustrate the benefit of using a Split-$ plan to fund a Grantor Trust.

Background. In 1985, the IRS published Revenue Ruling 85-15. It allows the Grantor of an irrevocable Grantor Trust (the "Trust") to treat the Trust's estate tax-free assets as if they are owned by the Grantor for income tax purposes. This ruling eliminates any income tax on the Grantor's private loans and sales to the Trust because the Grantor is deemed to have loaned or sold the asset to himself/herself. Some Split-$ plans are treated as non-taxable Grantor Loans.

Split-$ Plans. In a Private Split-$ Plan, the Grantor and the Trust enter into an agreement to split the costs and benefits of a permanent life insurance policy. This allows the Grantor to provide funds to pay the premium while the Trust receives most of the tax-free death benefit. In 2003, the IRS issued final regulations for the use of two types of Split-$ arrangements: Loan plans and Economic Benefit plans.

Private Split-$ Loan Plans. When the insurance policy will have increasing cash values, the Grantor loans money to the Trust. The Trust uses the loan to purchase a Trust-Owned Life Insurance ("TOLI") policy. The loan interest rate will be the IRS long-term Applicable Federal Rate ("AFR") at the time of the loan. Loan interest may be paid each year or accrued until the loan matures. The loan can be nonrecourse and the repayment of the loan can be deferred until the death of the insured.

Private Economic Benefit Spit-$ Plans. When the insurance policy will insure two people (e.g., spouses) and the cash values will be nominal, the Grantor advances premiums interest-free by using an Economic Benefit ("EB") arrangement. The Trust pays the EB portion of the premium. The EB amount is determined by using the IRS Table 2001 one-year term insurance rates. Because these are Survivorship ("2nd to die") policies, the EB amount will be dramatically less than the loan interest alternative as long as both insureds are alive.

CASE STUDIES.

Example #1. The Grantor made a $3,000,000 Split-$ Loan to fund $56,000,000 of TOLI policies by insuring the Grantor's children in an estate tax-free multi-generational Grantor Trust. There are no gift taxes, no loan interest payments and no income tax. Loan interest accrues at 2.64%. Cash values grow income tax-free for the benefit of the children. The death benefit will be paid income tax-free for the benefit of the grandchildren.

Example #2. The Grantor used an EB Split-$ plan to help their Trust purchase $50,000,000 of Survivorship Life Insurance diversified with three carriers. In Year 1, the Trust paid the EB amount of $1,508 dollars. Over 15 years, the Grantor will advance $6,062,269 without interest and the trust will pay total EB amounts of $133,991.

Example #3. The Grantor acquired $50,000,000 of permanent TOLI coverage by combining a 9-Year AFR Grantor Loan with an EB Split-$ plan. The Trust's income tax-free 1.43% loan interest payments to the Grantor are

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SPLIT-$

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funding her interest-free EB advances. The Trust will repay both the Grantor Loan and the EB advances in plan years 9 and 20, respectively.

Exit Strategies.

Beware of any Split-$ plan that does not include an effective exit strategy as part of the overall plan. With Split-$ Loans, there are many ways to terminate the plan either during the Grantor's life or when the death benefit is paid. With Split-$ Economic Benefit advances, most plans will terminate upon the death of the first insured in one of three ways: The Trust will repay the interest-free advances with funds from other trust investments; the advances will be repaid with a note that bears interest at the required AFR; or the interest-free note will be transferred to the Trust to terminate the repayment obligation.

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Bottom Line: Properly structured Split-$ plans continue to be a viable and important planning strategy for wealthy families.