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# Private Split Dollar

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# Private Split Dollar

## What is it?

Split dollar is an arrangement where two parties share the death benefits, cash values, and premium costs of one life insurance policy. The two parties in a traditional (or classical) split dollar arrangement are employer and employee, or corporation and shareholder. The two parties in a private split dollar (or family split dollar) arrangement are typically relatives, such as husband and wife, or father and son.

Traditional split dollar programs are designed to bring a party (usually an employee) who needs the life insurance proceeds together with a party (usually an employer) who has the funds to pay the premiums on the life insurance policy.

Private split dollar arrangements are designed for a different purpose. A source for premium dollars is not needed. Instead, the main objective of private split dollar arrangements is to maximize certain tax and economic benefits.

This is accomplished by separating the ownership of a cash value life insurance policy (thus a pure term policy cannot be used) into the policy's two parts: (1) "pure" insurance (the net death benefit portion, or "risk" portion), and (2) cash value (the "investment" portion). The "pure" insurance portion is owned by one family member (e.g., a spouse, son or daughter, son-in-law or daughter-in-law, grandchild, or an irrevocable life insurance trust (ILIT)), and is designed to avoid estate taxation in the insured's estate. The cash value portion is owned by another family member (e.g., a spouse, parent, grandparent, or a revocable trust), and is designed to ensure access to the policy values for funding personal income or retirement needs.

Because ownership rights are split, the premium payments must likewise be split. Therefore, the portion of the premium that relates to the "pure" insurance portion of the policy (the term cost, economic benefit cost, or Table 2001 cost) is paid by the owner of that portion, and the balance of the premium is paid by the owner of the cash value portion of the policy. In effect, however, the entire cost is born, directly and indirectly, by the insured and the party(ies) who "split" with the insured, usually the insured's family members.

Final IRS guidance effective September 17, 2003, provides rules that apply for federal income, employment, and transfer tax purposes. The IRS states that the regulations will apply for gift tax purposes in situations involving private split dollar life insurance arrangements. Depending upon how it is structured, the private split dollar arrangement may be taxed under the economic benefit regime or the loan regime as outlined in the final regulations.

For more information, you may want to consult your tax advisor.

## Is a private split dollar plan right for you?

### *You want to both minimize estate taxes and have access to policy values*

A private split dollar arrangement may be appropriate if you (1) want to minimize estate taxes, and (2) would like access to the policy values for funding personal income or retirement needs. The difficulty in establishing a split dollar arrangement is justified only if you want both of these advantages. If your sole aim is to escape estate taxation, and you do not need access to the policy values, a simple ILIT will serve your purpose. On the other hand, if you need life insurance for the cash values only, and the death proceeds do not cause you to incur an estate tax liability, it may be easier for you to own a life insurance policy outright.

### *You don't have enough "Crummey" beneficiaries to avoid gift taxes on premiums paid to an irrevocable life insurance trust*

A private split dollar arrangement may be an attractive alternative if you want to establish an ILIT, but do not

have enough "Crummey" beneficiaries to shelter your annual premiums.

### *You want to provide insurance for someone who cannot afford it*

You may be in a situation where your objective is to bring together a need with the means (as in a traditional split dollar arrangement). For example, a private split dollar arrangement would enable you to purchase insurance on your son-in-law's life that he himself cannot afford. That way, you can provide additional financial security for your daughter.

## How does the private split dollar plan work?

There are a number of ways in which a private split dollar plan can be established. The best arrangement for you depends upon your specific situation and objectives.

### *Basic or standard plan*

Under the standard plan, which should meet the objectives of most taxpayers, there are three parties involved: (1) the insured, (2) an ILIT established by the insured, and (3) the spouse of the insured. The net death benefit (the pure or risk portion) is owned by the ILIT. That way, the net death benefit is not includible in either the insured's gross estate or the gross estate of the insured's spouse for estate tax purposes. The policy cash value is owned by the spouse of the insured. This allows the spouse access to the policy values through withdrawals and loans.

The insured makes annual gifts to the ILIT equal to the Table 2001 cost portion of the premium gift tax free under the annual gift tax exclusion. The trustee of the ILIT then pays that amount to the insurance company. The spouse of the insured pays the balance of the premium directly to the insurance company. If the spouse of the insured does not have the funds, the insured can make a gift to the spouse of the insured gift tax free under the unlimited marital deduction. After the insured retires, the spouse of the insured can make income-tax-free withdrawals or loans to supplement their income. When the insured dies, the policy pays the net death benefit to the ILIT, both income tax and estate tax free. The net death benefit is paid income tax free to the beneficiaries according to the terms of the ILIT. The remaining cash values are paid to the surviving spouse income tax free.

> **Caution:** The cash value will not be available to help fund the insured's retirement if the insured's spouse dies prematurely or divorces the insured.

### *Variations of the standard plan*

Variations of the standard plan described above entail substitute ownership arrangements. For example, instead of an ILIT, the insured might establish a qualified terminable interest property (QTIP) trust or an S corporation. Or, the role of the spouse of the insured might be filled by a revocable trust, or an ILIT, established by the spouse of the insured.

Each of these variations, however, poses different potential problems. The extent of these potential problems, and the possible solutions, are beyond the scope of this discussion. If you are considering the use of a private split dollar plan, be sure you understand the ramifications of each element of the plan to ensure that your objectives are successfully attained, and consult an experienced estate planning attorney.

## What are the advantages of a private split dollar plan?

### *Accumulation of cash value is tax deferred*

There is no current taxation of the "inside buildup" of cash surrender values within policies that meet the definition of life insurance under the Internal Revenue Code.

### Retirement income can be accessed income tax free

Withdrawals from policies to the extent of the policy owner's basis (return of capital) are income tax free. Likewise, loans from policies are income tax free.

### Death benefits are income tax free

Death benefits received by the insured's spouse and other beneficiaries are income tax free.

### Policy proceeds escape estate taxation in estates of both spouses

As long as the insured does not possess any "incidents of ownership" in the insurance policy, proceeds are not includable in the gross estate of the insured or the estate of the insured's spouse.

### Offers multiple investment options

Any type of cash value life insurance can be used in a private split dollar plan. This provides you with the opportunity to choose from many types of investment vehicles--from conservative to risky, or from inflexible to flexible.

### Avoids probate

Proceeds from a life insurance policy pass directly to the beneficiaries named in the policy. They do not go through probate first. This avoids delay, expense, and inconvenience.

### May offer protection from creditors

In some states, owners and beneficiaries are protected from creditors.

## How do you implement a private split dollar plan?

### Choose a life insurance policy

Almost any type of cash value life insurance policy can be used to fund a private split dollar plan, from a traditional whole life to a flexible premium variable universal life policy. Meet with your life insurance agent to determine which type of policy is best for you and your family.

### Establish any trusts or an investment company

If an ILIT, QTIP trust, S corporation, partnership, etc., is to hold the net death benefit portion of the policy, it must be established before an application can be completed for the policy itself. You may also want to establish a revocable trust or ILIT to hold the cash value portion of the policy. You must have an attorney draft these documents.

### Include a provision in spouse's will to ensure the desired results

Where the insured's spouse is the owner of the cash value portion of the policy, and if the insured's spouse dies first, it is essential that the insured's spouse's will disposes of this interest in a way that ensures that the policy values will be available to the insured and that the desired estate tax results are achieved. See an experienced estate planning attorney to make sure that the proper provisions are included in the insured's spouse's will.

### Execute a private split dollar agreement

A private split dollar agreement between the two parties who are sharing ownership of the policy (e.g., an ILIT and the insured's spouse) must be executed before an application can be completed for the life insurance policy. The agreement creates the necessary split interests. This agreement should be drafted by an experienced attorney.



See disclaimer on final page

### *Complete the application*

When applying for life insurance, there may be several forms to complete. Because there are multiple owners, the private split dollar application forms must be carefully completed by the correct owners. Subsequent transfers because of errors may incur severe penalties.

### *Make the premium payments*

After the private split dollar program is established, the two parties involved must pay their respective share of the premiums. To avoid gift and estate tax consequences, it is essential that each party provide the appropriate share of each premium. When premium payments cease being made to the insurance company, adjustments in the parties' respective interests must still be maintained. How this can be accomplished depends upon the other elements of the private split dollar plan involved and is beyond the scope of this discussion. Be sure to take whatever steps are necessary to accomplish this element.

## What are the tax consequences of a private split dollar plan?

### *Income taxes*

The premium payments under a private split dollar plan will not be treated as salary and/or dividend income.

Additionally, there is nothing in the private split dollar context that should interfere with the other income tax benefits enjoyed in the traditional split dollar context:

- Income-tax-deferred growth of policy values
- Income-tax-free death benefits
- Income-tax-free withdrawals (to the extent of return of capital) and loans

### *Gift taxes*

Private Letter Ruling 9636033 addresses the gift tax issues surrounding facts that mirror the standard plan. That is, the insured made a cash gift to an ILIT in the amount of the Table 2001 portion of the premium. The trustee subsequently paid the insurance company. The insured's spouse paid the balance of the premium directly to the insurance company. Regarding these circumstances, the IRS ruled that:

- The insured's cash gift to the trust was a taxable gift to the extent of the excess of the applicable annual gift tax exclusions
- The subsequent payment by the trustee to the insurance company was not a taxable transfer
- The spouse's payment to the insurance company was not subject to gift tax because the spouse was entitled to reimbursement

However, if there is a transfer of an existing policy, there will be a taxable gift. The methodology for computing the amount of the gift is set forth in Rev. Rul. 81-198, 1981-2 C.B. 188.

### *Estate taxes*

Private Letter Ruling 9636033 ruled on the estate tax consequences of a private split dollar plan patterned after the standard plan. The IRS concluded that the insurance proceeds payable to an ILIT and the insured's spouse are not includible in the insured's estate for estate tax purposes because the insured held no "incidents of ownership" in the policy. However, the cash value received by the insured's spouse, to the extent that those values have not been consumed by his or her death, will be includable in the insured spouse's estate for estate tax purposes.

Therefore, as with life insurance in general, as long as no portion of the proceeds is payable to, or for the benefit of, the insured's estate, and the insured avoids any "incidents of ownership" in the policy, the net death benefits can completely escape estate taxation.

## Life insurance issues

### *Type of policy*

Choosing the right type of life insurance policy that forms the basis for a private split dollar plan to optimize both death benefit and retirement income is a vital step in this process. Virtually any type of cash value policy can be used.

Spouses, however, should select a single-life policy, not a survivorship policy. If a survivorship policy is used, both spouses retain access to the policy's cash values, which is an "incident of ownership," and the proceeds will not avoid estate taxation.

Your particular needs and desires will ultimately determine which type of policy is best for you and your family. Keep in mind that your needs and desires may change over time, so flexibility may be an important factor.

Talk to your insurance agent about the types of policies available and how they might suit your needs.

### *Whom to insure*

Generally, it makes economic sense to insure the party with the shortest life expectancy. This reduces the possibility of adverse income tax consequences resulting at a later date when loans and withdrawals tend to exceed return of capital.

However, if the older party is in poor health, or uninsurable, the insured should be the party with the longer life expectancy. If this is the case, be careful to keep an adequate amount of cash in the policy to keep it in force until the insured's death.

If both parties in a private split dollar plan are uninsurable, the insured may be a third party in whom there is an insurable interest. However, several potential problems may arise, and this alternative may not be economically or practically viable. If this is the case, be sure to seek expert advice.

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