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2023 Estate and Gift Tax Conference

Beyond Term Insurance

Friday, March 10, 2023
2:30 pm - 3:30 pm

Speakers:

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Conference Reference Materials

Private Split Dollar Arrangements

Presented By

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Split Dollar Definition

- Defined by Treasury Regulation Section 1.61-22(b) as an arrangement between an owner and a non-owner of a life insurance contract in which a third-party is a “donor” of the premium and is entitled to recover those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract.

- Donor (Grantor) holds the contractual rights to be repaid greater of the cash value or the aggregate premiums paid. This “Right of Reimbursement” is typically paid on death unless contract is terminated by mutual consent of the Donor and the Owner (Trust/Trustee) or the just the owner (Trust/Trustee)

- Death benefit and the cash values are collaterally assigned to Donor (Grantor) to secure this contractual right but may have restrictions placed which prevent Donor from unilaterally collapsing the policy and obtaining the cash values.

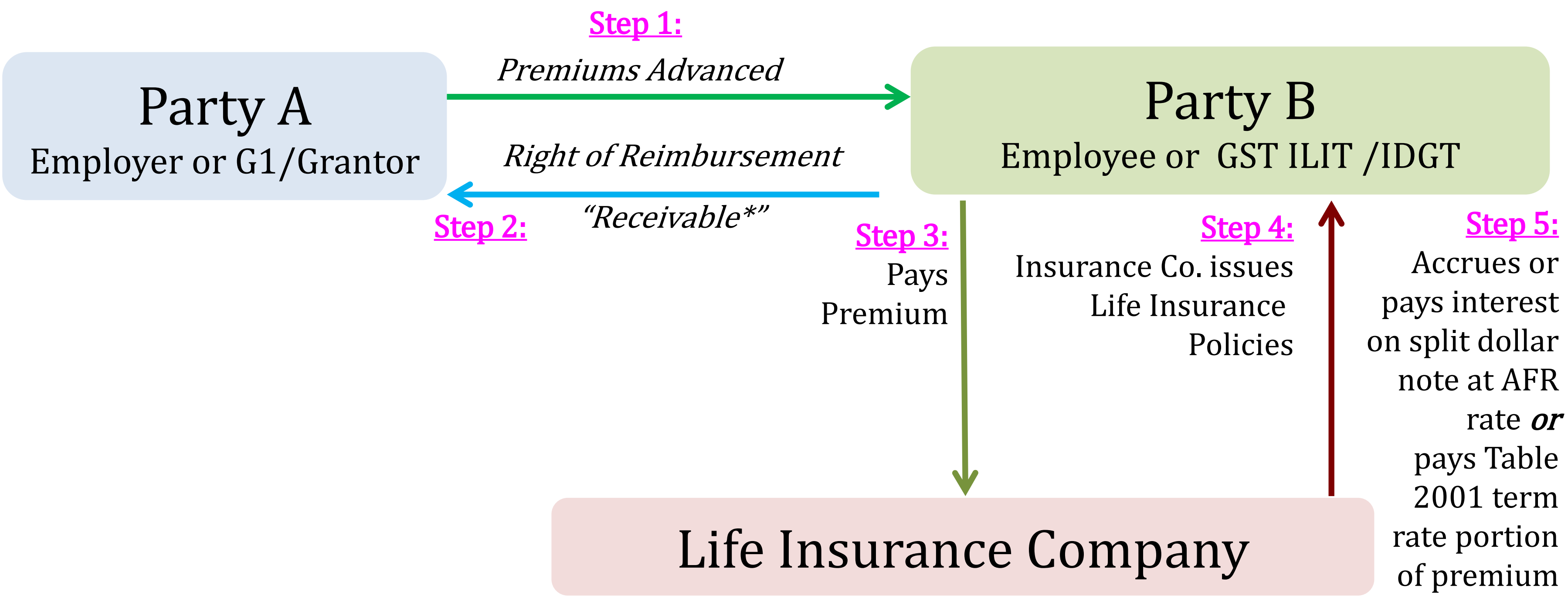
- The arrangement was largely used in the business/corporate setting as means of supplemental executive compensation between 1964 & 2003 and relied on Revenue Rulings 64-328 & 66-110

- Since 2003 (publishing of Final Regulations), there has been an increase in popularity in the planning community of “private split dollar” (*often labeled multi-gen or inter-generational split dollar arrangements*). This is the same concept except but most often used between related parties in a family and in the estate planning context as a means to tax efficiently fund life insurance and transfer wealth between multiple generations.

- Private Split Dollar will be the focus of most of our discussion.

Split Dollar Overview (Simplified)

- Under these arrangements, Party A (Employer or G1) would typically fund the premium payments. Party B (Employee or G2) can access the cash value and name their own beneficiary. Party B will then receive the net proceeds after Party A receives the advanced premiums.



- Cash value in a life insurance policy has the potential to grow and accumulate over time. Any cash value or death benefit growth above the contributed premiums is a gain (or equity) to Party B. Party B's equity in the policy was non-taxable entirely prior to 2003. The IRS viewed the gain as escaping taxation.

Revenue Rulings, Treasury Regulations and Birth of Two Regimes

- The IRS and Treasury Department felt the untaxed equity in a split-dollar life insurance policy was abusive. In 2001, the IRS published Notice 2001-10 and 2002-8 to address the taxable amounts of split-dollar life insurance policies. In September 2003, the Treasury implemented regulations similar to the IRS notices.

- Rev. Rul. 2003-105 Treasury Decision 9092 provides comprehensive final Regulations (under §§1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q), and 1.7872-15 of the Income Tax Regulations) regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements (as defined in §1.61-22(b)(1) or (2)).

Revenue Rulings, Treasury Regulations and Birth of Two Regimes

- The final split-dollar regulations created two tax regimes for arrangements moving forward – economic benefit and loan regime.

  - Under **economic benefit regime**, the insured receives only the benefit of a death benefit coverage and the value is quantified by the IRS Table 2001 and taxable to the owner (or owner pays term portion of the premiums)

  - Under the **loan regime**, the premiums can be structured as a loan at AFR rates ; principal & interest will be recovered by the donor at termination of the arrangement or at death

  - Which regime is best will depend on an economic analysis of the age of the insured and related term costs in comparison to the prevailing AFR Rates and the interest cost. Prior to 2008 Economic Benefit was popular. Over the last 12 years, with AFR rates at historic lows, loan regime gained popularity & has become more commonplace in private split dollar arrangements.

Repayment Mechanism & Taxation of Each Regime

GENERAL SUMMARY OF SPLIT DOLLAR REGIMES			
TYPE	**RECOGNITION**	**REPAYMENT TO NON-OWNER**	**TAXATION**
Economic Benefit	Economic benefit is based on IRS Table 2001 or insurer's annual renewable term rates, if lower.	Greater of premiums paid or policy cash value.	Gift and income tax values are based on the economic value of the death benefit.
Loan Regime	The annual premium paid is considered an annual loan. Loan interest is paid annually on cumulative premiums or the loan can be capitalized.	Cumulative premiums paid including capitalized interest, if any.	Gift and income tax value is based on the annual loan interest.

Estate Planning Applications of Split Dollar

- Split-Dollar Arrangements were developed to mitigate the impact of gift and income taxes to the parties in the contract. **While it is a form of tax deferral and tax mitigation, the existence of a non-tax business or planning purpose is a prerequisite to a split dollar arrangement and tax courts have ruled recently in favor of the taxpayers where there was evidence of substantial non-tax motives**. There are many good planning and business motivations for use of split dollar both in corporate and private (family) settings; examples for private SD

  - **Estate Liquidity at G2**: Liquidity beyond lifetime needs or income substantially in excess of lifestyle needs exists at G1 and large amounts of illiquid assets such as real estate, a family business, art, have been passed down to G2 and beyond via GRATS, Sales to IDGTs, Gifting, etc. There is a large tax liability at G2 , and substantial insurance may be a solution for estate taxes

  - **Intra Family Buy-Sell at G2**: Substantial singular asset exists at G2 (such as family business) or which will be inherited by G2 (multiple beneficiaries) within the family. There is a desire to keep the asset in the family instead of having to sell to a third party if a beneficiary dies. This creates a need for intra family buy-sell funded with life insurance on G2 . Premiums can reduce the value of G1's estate while solving the estate planning need.

Estate Planning Applications of Split Dollar

- **Estate Equalization**: There are G2 members who are operators of a business and some who are not. Rather than leave large parts of the business to non-operators, insurance on G1 can be funded in a trust for the non-operators at G2 (if G1 is healthy and younger) or on G2 so that the cash value build up emulates distributions from the business and death benefit emulates what is otherwise the G3 inheritance in the business.

- **Recovery of Tax Erosion / Wealth Depletion**: Large family businesses owned by multiple family segments and multiple generations often make distributions of cash to the heirs of a deceased owner in order to pay estate taxes and make a 6166 arrangements. The business is the primary source of income and livelihood for dozens of family members. Insuring multiple generations by taking smaller current distributions for insurance (or financing by G1 supported by his/her business interest) can put less pressure on the business in the future, create a predictable pool of liquidity and reduce future reliance on third party debt under unpredictable rates and terms.

- **AFR Arbitrage For Greater Wealth Transfer:** There is excess liquidity at G1 and a desire for economic arbitrage between the AFR rate on a split dollar note and the compounding rate inside a growth oriented policy (such as an indexed policy or PPLI) to benefit G2 via cash value build up and eventual access to such CV tax free via policy loans or distributions to trust

Efficient Wealth Transfer Planning With Private Split Dollar Insurance

- Private split dollar is a flexible, and cost-effective tool for incorporating life insurance into a multi-purpose estate plan to address above needs. This can provide family security, generate estate liquidity, and create a multi-generational legacy that would otherwise erode

- G1 can lend premiums to a trust for the benefit of or to insure G2 and beyond. Sometimes G1 finances the premiums and turns around lends it to a trust. Low interest rates have made this popular.

- It is actuarially likely that the insured (G2/G3)—generally a child or grandchild of the donor—will live for many more years after the parties have entered into a private (intergenerational) split dollar agreement

- As a result, it is unlikely that the donor's estate will be paid back any time soon and the value of the receivable repayment is subject to appraisal at fair market value when calculating the taxable estate of the donor

- **This possibility to include the fair market value of the split dollar receivable in the estate of the donor rather than the full amount of the premiums advanced + interest makes intergenerational private split dollar even more attractive for efficient wealth transfer beyond the gift tax implications of the premiums and income tax implications of the insurance cash value build up and death benefit**

Unanswered Questions (Now Answered b/w 2016-2022)

- Is the transfer between private or related parties a disguised gift or gift taxable event ?
  - **No**
- Is there an adjustment to FMV (i.e. potentially substantial discount)?
  - **Yes.** Expert testimony by an IRS expert recently indicated the appropriate *annual discount rate* for valuation of a split dollar receivable is 8.85% for a universal life policy and 6.4% for a whole life policy. That could change by insurer , ratings, yield environment, etc. e.g. Terminal value of $10M note @ 3.74% 30 years from now is $30M. Discounting at 8.85% =PV of $3M.
- Can 2036(a) & 2038(a) be avoided?
  - **Yes.** Grantor's rights to terminate, amend, modify, revoke the arrangement and recover the cash surrender value constitute rights to designate who would possess and enjoy the property under IRC § 2036(a)(2); so eliminating the Grantor's right to terminate the arrangement avoids this issue.
  - *In addition an exception to the bona fide sale rule needs to be met via a non-tax motivation.* Otherwise donor is giving something of greater current value than he/she is receiving. The Tax Court in Morrissette specifically said that full and adequate consideration requirement can be met through non-financial considerations such as desire to retain a business within the family; equalize estates of multiple beneficiaries, economic arbitrage, etc..
- Can the § 2703(a)(1) & § 2703(a)(2) be avoided and can the § 2703(b) exception be satisfied ?
  - **Yes.** By removing termination rights and access to cash values held by the ILIT and also not restricting the Grantors rights to use or transfer the split dollar receivable. Grantor is not transferring the property held in the ILIT. Cash values were never owned by him; they were from the beginning owned by the ILIT.
- *Morrisette I; Morrisette II; Cahill, Levine*

Tax Court Guidance (Levine)

- **Estate of Marion Levine v. Commissioner, 156 T.C. No. 2 (2022)**

In Levine, a $6.5 million receivable was discounted to $2,282,195 – a discount to FMV of 65%. The $6.5 million refers to premiums paid for two separate policies with a total face value of approximately $17.25 million.

This valuation of the receivable in the estate of the donor was the result of a settlement among the parties and should not be interpreted as an endorsement of any valuation technique. Many of the valuation issues were addressed in Morrissette 2021. First and foremost, there has to be a bona fide reason for the insurance.

The split-dollar agreement provided that the Decedent had no right to terminate the agreement - only the ILIT could terminate the agreement

The Tax Court held that IRC § § 2036 and 2038 did not apply on grounds that Decedent did not retain any interest or rights in the cash surrender value of the policies because she had no right, alone or with the ILIT, to terminate the arrangement. The Court also found that the ILIT Trustee's right to terminate and realize the cash surrender values was not a right retained by Decedent (even though that Trustee was also Decedent's power-of-attorney) because the Trustee owed fiduciary duties to different beneficiaries (the grandchildren).

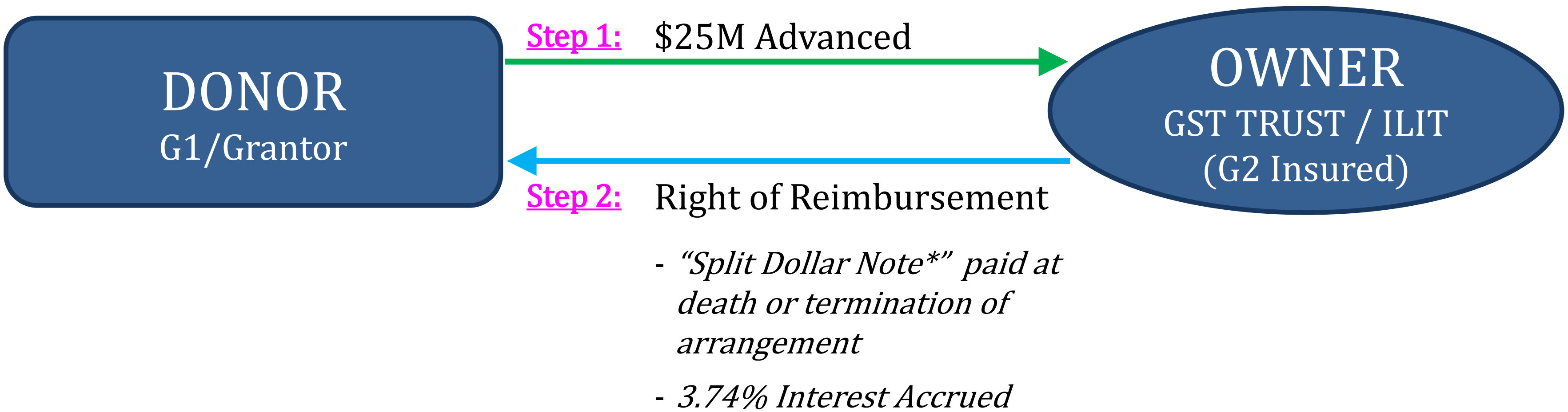
The Tax Court also held that IRC § 2703 did not apply because the Decedent retained no right to terminate the agreement (and therefore had no interest or rights in the underlying cash value of the policies) and there were no restrictions on Decedent's rights to use or transfer the split-dollar receivable.

Advanced Planning With Split Dollar Insurance

Case Study Assumptions…

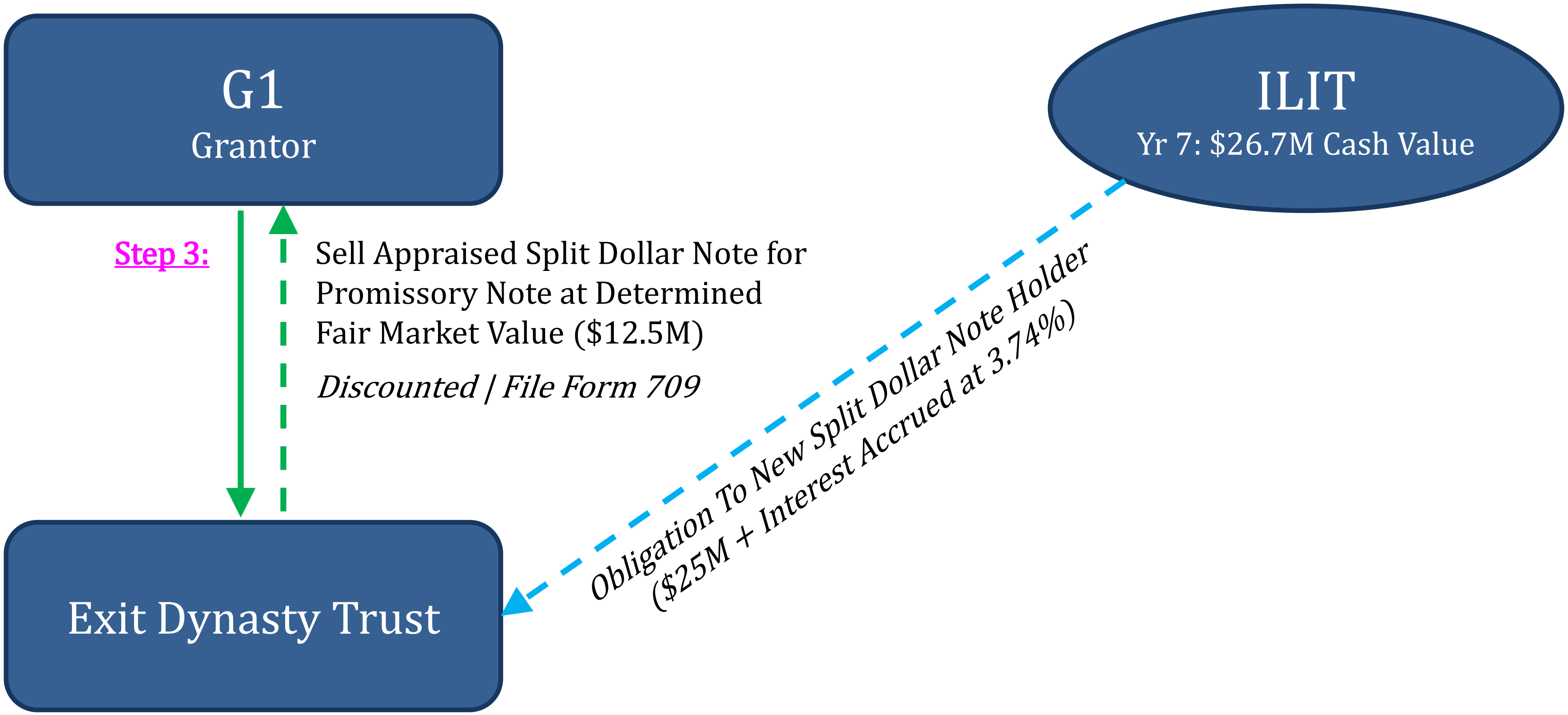
- HNW Family; Primarily Business Interest; Overall wealth 100M+
- Age of Grantor (G1) : Female 79; Spouse Deceased
- Insured Age (G2) : 56, 55, 52
- Net Worth of Grantor After Existing Planning : ~70M (Business / Real Estate/ Liquidity)
- Goals:
  - Move 25-30M + of target taxable assets (notes from sales to IDGTS or Business Interests, real estate , etc) out of estate w/o gift taxes in~ 10-11 years
  - Bona fide need to acquire insurance on G2 to satisfy buy-sell obligation among the siblings
  - Move target assets out to generation skipping “dynasty” trusts w/o generation skipping taxes to benefit G2 & G3, etc.
  - Some reduction in size of taxable estate even if grantor was to pass prior to transaction completion in next 6 years
- Assumed Design: $25M Split Dollar Premiums
- Valuable Planning Completed & Contemplated
- Lifetime Exemptions Utilized or Earmarked for Other Planning; Some May be Available for Current Planning

Basic Structure (Year 1)



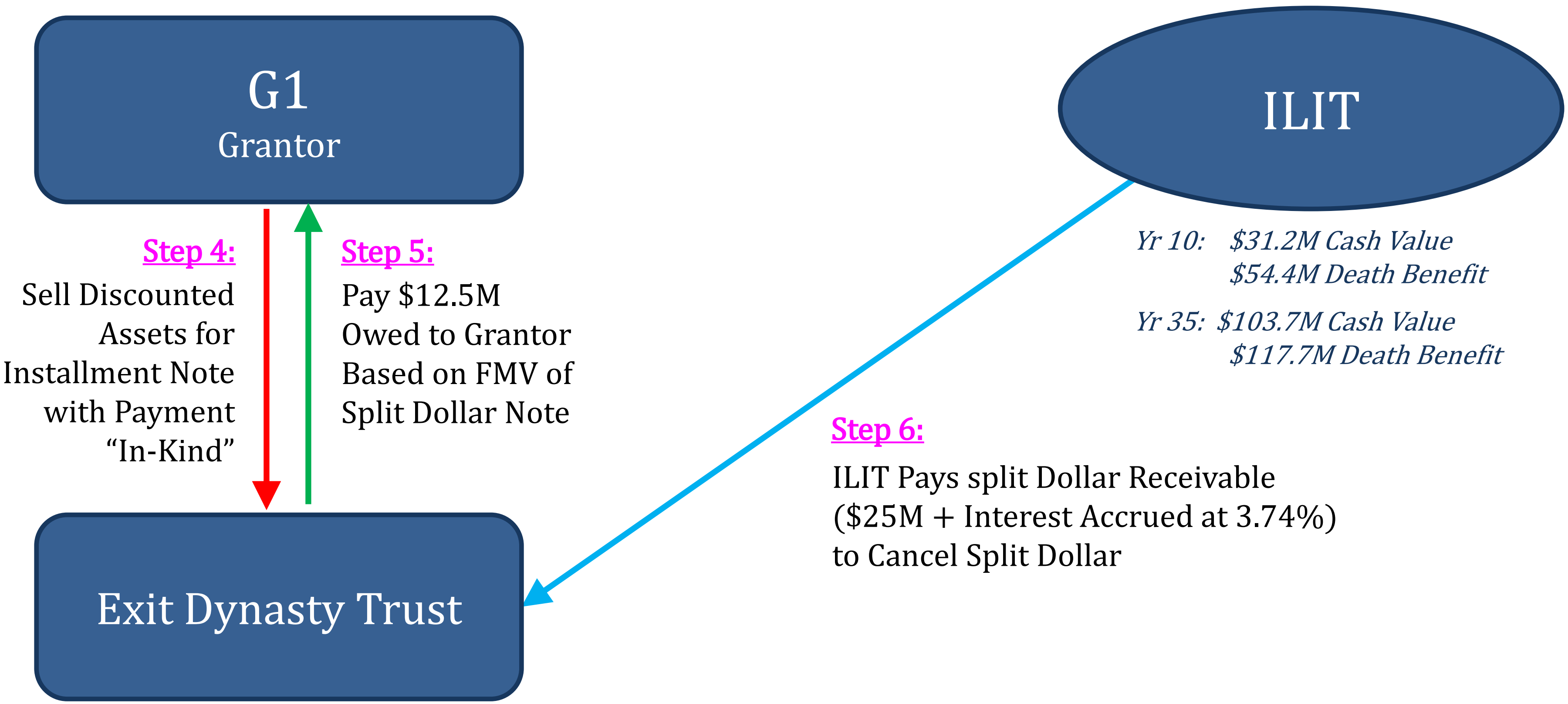
- Death benefit and the cash values are collaterally assigned to Donor (Grantor) to secure this contractual right but may have restrictions placed which prevent Donor from unilaterally collapsing the policy and obtaining the cash values.

Planning (Year 7)



WAIT 3 YEARS

Exit Strategy

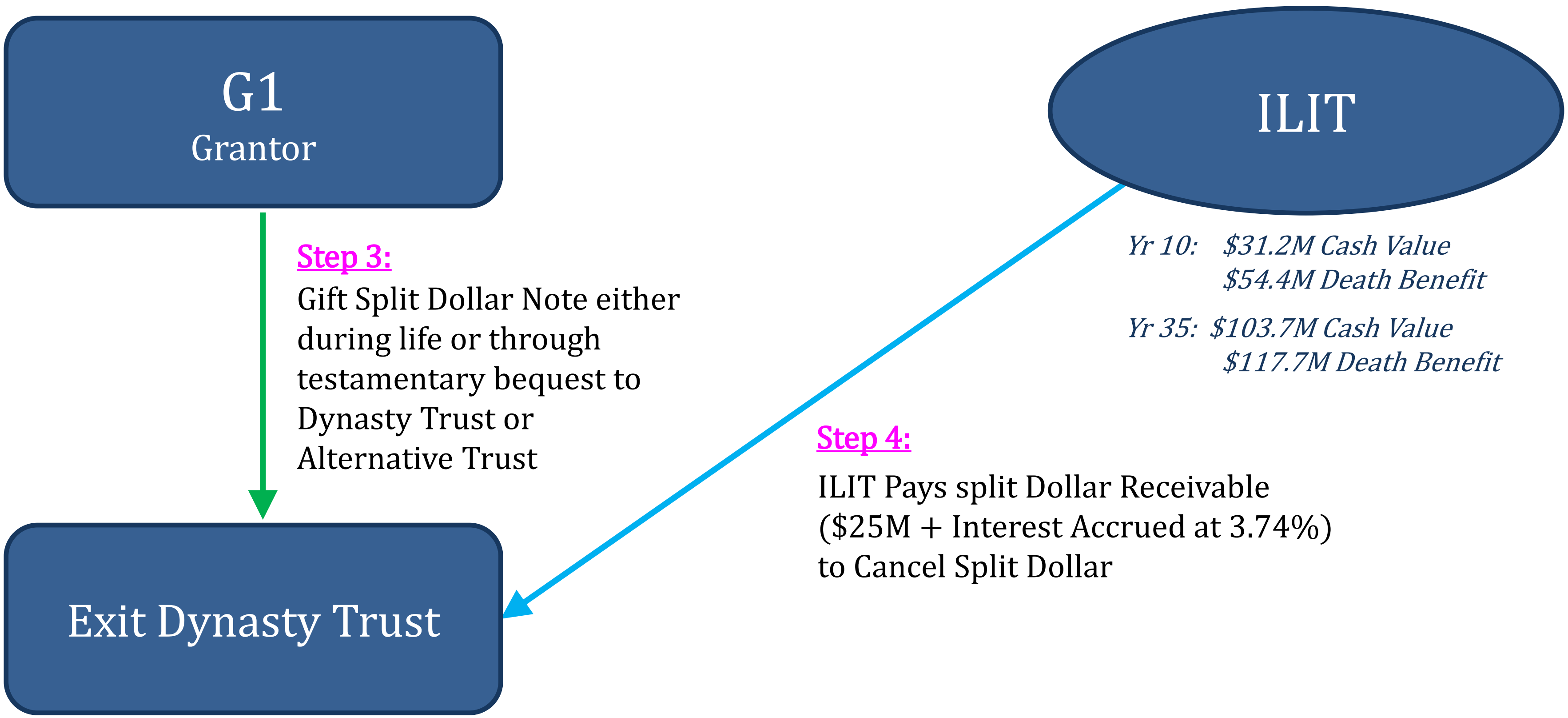


Net proceeds from sale of discounted assets are used as an "in-kind" payment to extinguish SD Appraised note

No gift taxes,
No estate taxes,
No generation skipping taxes

* **Note**: Split Dollar regime (EB or Loan) elected will influence the future SD receivable amount.

Alternative Planning and Exit Strategy



Discounted gift, estate, and generation skipping transfer taxes based on FMV of Note at transfer to Dynasty Trust

* **Note**: Split Dollar regime (EB or Loan) elected will influence the future SD receivable amount.

Financed Private Split Dollar Arrangements

Executive Summary

- **<u>SPLIT DOLLAR:</u>** By financing $25M, loaning it to an ILIT, discounting and rearranging the private SD receivable, the planning creates a liability in taxable estate to a dynasty trust outside the taxable estate for future generations

- Ultimately, satisfying that liability by payment "in kind", removes the 25M of discounted assets ($36M of real assets) and future growth from a taxable environment to a dynasty (generation skipping) trust.

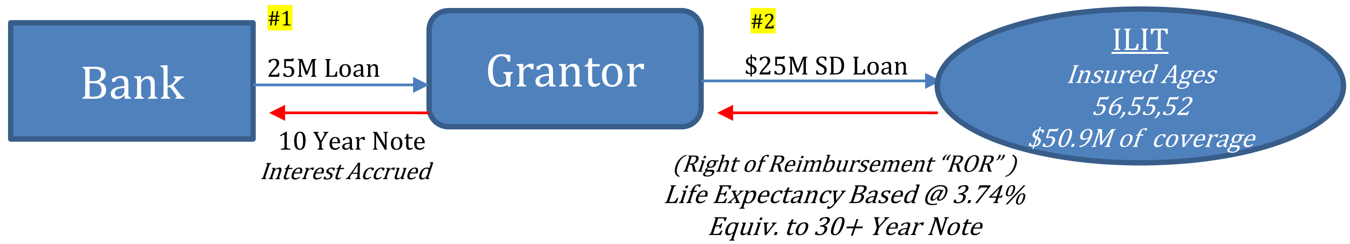
- Can be done in conjunction with other estate planning ; GRATS and Sales to IDGTs remove growth but Split Dollar & Grantor trust planning can move out principal (note from IDGT sale)

- Overall planning saves $15M in gift & estate taxes at year 10/11 and more the longer Grantor survives; it also prevents Generation Skipping Taxes.

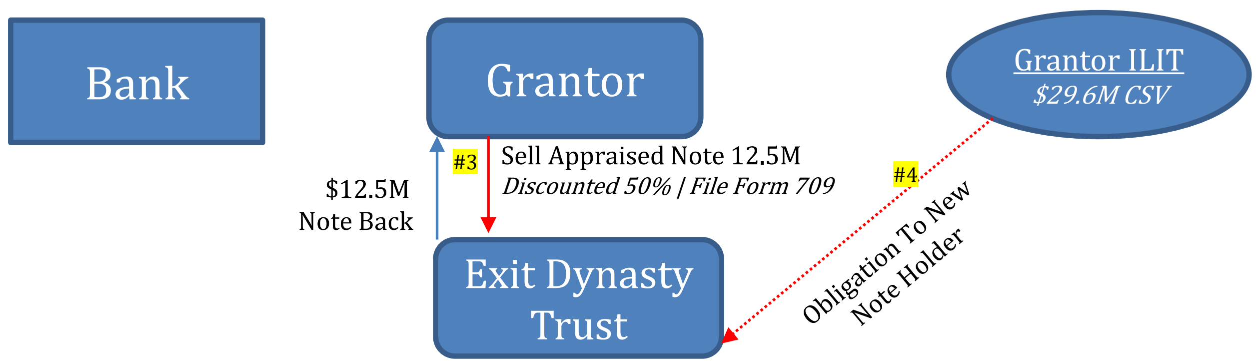
- By-product of the planning is that there is permanent insurance on G2 (20M+) and strong income stream to trust ($30M+) ; Strong overall economics aside from the tax benefits

- $2.3M cash equivalent or $3.1M securities is needed for the transaction for 10 years.

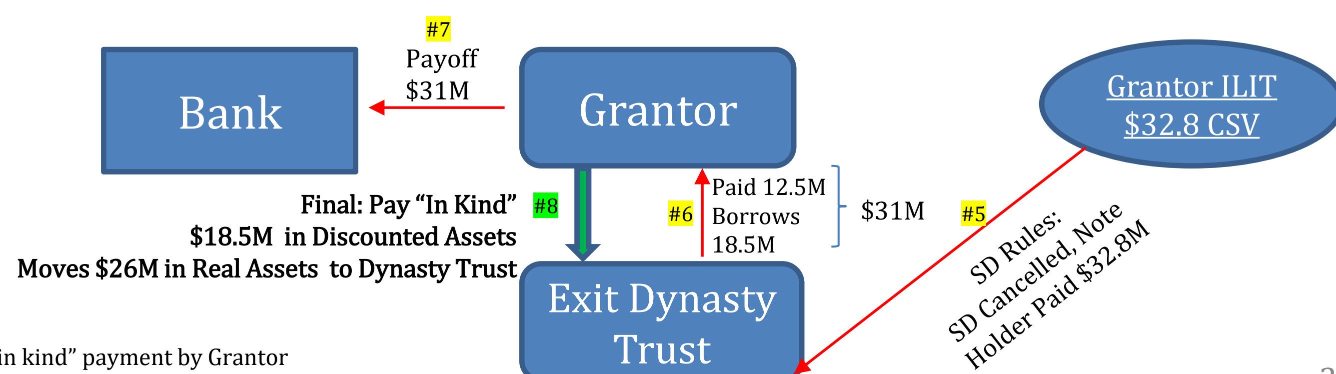
Phase 1: Funding
(Years 0-9)



Phase 2: Selling Note
(Year 9)



Phase 3: Removing Asset
(Year 11)



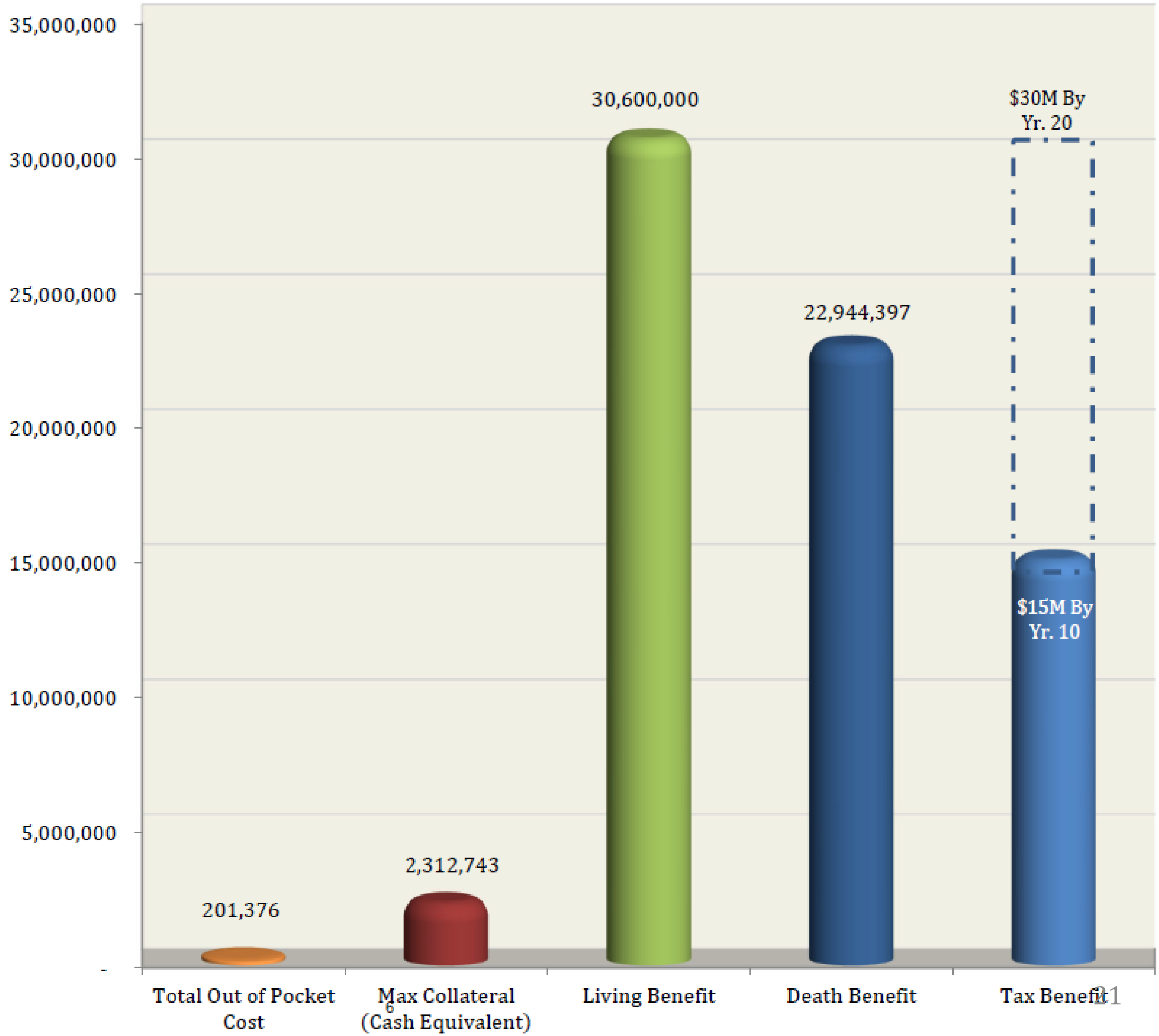
*Assume that the assets used to make "in kind" payment by Grantor
To Dyansty Trust are FLP,FLLC or other fractional interests @ 30% discount

Program Economics| Cost and Benefits

Program Economics

Cost, collateral exposure, and benefit summary based on custom developed proposal discussed herein

*Underlying assumptions, basic insurance illustrations, loan and legal documents should be reviewed in order to better understand these economics and program suitability.



Caution: Improper & Abusive Use of Split Dollar Arrangements

- Massive discounts (Cahill – 98% discount and no non-tax motivation; unlikely that the exception to bona fide sale rule was met under 2038)
- Use of FLPs, BDITs, etc. to further discount receivable
- Bailout gifts
- Creation of intrafamily debts that are used to completely shelter assets from transfer tax – meaning split dollar transaction equal to or greater than taxable estate
- Premium payments are large portion of net worth/taxable estate
- Certain premium finance arrangements that lack no economic substance other than deduction to taxable estate

Third Party Valuation Critical

- Treasury Reg. 20.2031-4 : The value of a note receivable, whether secured or unsecured is presumed to be the amount of unpaid principal plus accrued interest unless it can be established that the value is lower, or the notes are worth less as of the valuation date.

- TAM 8229001 & Rev Ruling 67-276 define proper valuation method of notes to include all available financial data and relevant factors affecting FMV

- Key factors influencing value of debt obligations are amount & type of security, rate of return, and time to maturity, certainty as to timing, potential additional cash flow to support receipt (i.e. Additional funding of policy), marketability

- Conservative discount rates we are seeing: 8%-10% (Risk Free Returns + Risk Premium + Liquidity Premium); certain appraisals compare the returns that would be required on such “receivable instruments” to be comparable to investments in start up companies and therefore approach or exceed 15%

- Typically, the probability of death for each year is multiplied x the right of reimbursement payment assumed in any given year discounted back to present value using the stated discount rate (or rates). The sum of these values typically till age 100 creates the value.

Important Valuation Elements

- A review of guarantees, cash values and mortality charges within the policy as well as likelihood of underperformance and negative cash flow (additional payment) by grantor
- A review of mortality statistics of the US using Life Tables provided by the SSA or National Vital Statistics
- A review of the rates of return of various fixed income instruments with long duration to maturity
- A review of the bond quality and bond yields of the underlying insurer and its peer companies
- Due diligence with note brokers, and life settlement companies regarding rates of return required in private transactions involving secured notes and life settlements
- A review of the split dollar agreement and more critically, specifics of restrictions, marketability, etc.
- A copy of the trust or other entity which is party to the split dollar arrangements.

Tax Court Guidance (Morrissette I)

- **Estate of Clara M. Morrissette v. Commissioner, 146 T.C. 171 (2016)**

Case involving the gift tax consequences of split-dollar arrangements under the economic benefit regime.

On the Estate's motion for partial summary judgment, the Tax Court held that the split-dollar life insurance arrangement is governed by the economic benefit regime under Treas. Reg. § 1.61-22 because the only economic benefit conferred upon the ILITs was current life insurance protection. Under the regulations, the ILITs did not have current access to any portion of the policy cash value and no additional economic benefits (e.g., future insurance protection) were provided.

Under the economic benefit regime, the payment of $30 million in premiums by Decedent was not a taxable gift. Instead, Decedent made taxable gifts each year in an amount equal to the cost of current life insurance protection.

This case was not decided based on the merits of valuation techniques applies to the split-dollar life insurance receivables, but rather on the legal issue of whether the subject arrangements were eligible to be taxed under the economic benefit regime.

Tax Court Guidance (Cahill 2018)

- **Estate of Richard F. Cahill v. Commissioner, T.C. Memo. 2018-84**

Case involving the estate tax consequences of split-dollar arrangements under the economic benefit regime.

On the Estate's motion for partial summary judgment, the Tax Court held that IRC § § 2036, 2038, and 2703 applied to the split-dollar arrangement.

Decedent's rights to terminate the arrangement and recover the cash surrender value constitute rights to designate who would possess and enjoy the property under IRC § 2036(a)(2) and rights to alter, amend, revoke, or terminate the transfer under IRC § 2038(a)(1). The full and adequate consideration prong of the bona fide sale exception was not satisfied because Decedent transferred $10 million and in exchange received something that the Estate valued at less than $200,000 on the estate tax return. The Tax Court did not decide whether the nontax purpose prong was met, but the opinion suggests it was unlikely based upon the facts.

The provisions of the split-dollar agreement that gave the ILIT the ability to prevent termination and prevented the Decedent from immediately withdrawing his investment constitute agreements to acquire or use property at a price less than fair market value under IRC § 2703(a)(1) and constitute restrictions on Decedent's rights to sell or use property under IRC § 2703(a)(2). The Tax Court did not decide whether the IRC § 2703(b) exception applied because the parties did not address it.

Tax Court Guidance (Morrissette II)

- Estate of Clara M. Morrissette v. Commissioner, T.C. Memo 2021-60

Case involving the estate tax consequences of economic benefit regime split-dollar arrangements

Under IRC §§ 2036 and 2038, the Tax Court held that the bona fide sale exception was satisfied so the cash surrender value of the policies was not included in the gross estate. The Court found legitimate and significant nontax purposes based upon the facts (Decedent's desire to keep the business in her family and to provide for a smooth transition in management of the business) and found that Decedent received adequate and full consideration.

The Tax Court held that I.R.C. § 2703 did not apply to disregard any restrictions for valuation purposes because the IRC § 2703(b) exception was satisfied. The Court found that the split-dollar agreement (including the mutual termination restriction, which allowed the ILIT to veto termination of the agreement) was a bona fide business arrangement, was not a testamentary device to transfer funds at less than adequate and full consideration, and contained terms comparable to similar arrangements entered into by parties in an arms' length transaction.

In determining the fair market value of the split-dollar receivable included in the gross estate, the Tax Court found it reasonable to apply discount rates of 8.85% (American General policy) and 6.4% (MassMutual policy) to the future/expected payments. Because the facts showed that the split-dollar agreements would likely be terminated before the death of the insureds, the Tax Court incorporated an assumption that the agreements would be terminated and the policies would be surrendered three years after the filing of the estate tax return (at which point in time the children had complete control over the split-dollar agreements). This resulted in a fair market value of nearly $28 million.

The Tax Court held that the Estate was liable for a 40% penalty for a gross valuation misstatement.